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THE NEW COMMISSION BLOCK EXEMPTION: A BLURRY ROADMAP FOR FRANCHISING IN EUROPE

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On December 22, 1999, the European Commission (Commission) unveiled a new Block Exemption as part of an effort to overhaul Europe's competition laws. The new Commission Block Exemption[1] (hereafter Block Exemption or Regulations) provides a safe harbor for a broad range of vertical agreements, including types of agreements that previously were listed under three separate block exemptions, namely, the exclusive distribution block exemption,[2] the exclusive purchasing block exemption,[3] and the franchising block exemption.[4] The Block Exemption has caused some controversy in the franchise community, because franchising—recognized generally as a distinct method of distribution—has been lumped together in the Regulations with other methods of distribution and was not given much consideration in the formulation of the Regulations.

This article addresses the application of the Block Exemption to franchising practices common to U.S. franchisors and steps that franchisors might take to avoid running afoul of the Commission's competition laws.

What Is the Commission Block Exemption?

The new Regulations provide an exemption for certain categories of vertical agreements falling within Article 81(1) of the Commission Treaty. Article 81(1), much like its U.S. counterpart, section 1 of the Sherman Act, broadly prohibits anticompetitive agreements and practices. It prohibits agreements " . . . which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition."[5] However, unlike the United States, where a rich body of common law based on economic principles has emerged from the Sherman Act, the broad sweep of Article 81(1) has been interpreted in Europe primarily by regulations promulgated by the Commission. In this regard, the new Block Exemption is a significant departure from the prior regulations, which tended to take a more formalistic approach, because it is grounded on economic theory. Given its purpose to cover virtually all vertical relationships, the new Block Exemption is remarkably short and sparse in words, but then is explained in depth through supplemental guidelines published by the Commission.[6] Although clearly helpful to an understanding of the broad principles enunciated in the Regulations, the guidelines do not carry the force of law[7] and their ultimate effect on judicial interpretation of the Regulations remains uncertain.

The purpose of the Block Exemption is to create a safe harbor from antitrust scrutiny for agreements in vertical relations (e.g., manufacturer/distributor; distributor/dealer; and franchisor/franchisee relations) that are considered, on balance, to be procompetitive or at least benign to interbrand competition. Failing to meet the conditions of the Block Exemption is not necessarily fatal to an agreement; however, it is then to be judged by the principles of Article 81(1) without the same measure of certainty. Aside from seeking individual exemptions,[8] a practice that the Commission is clearly discouraging,[9] one is relegated to navigating through the relatively uncharted shoals of Article 81(1). One significant navigational aid to franchisors is the 1986 European Court of Justice decision in *Pronuptia de Paris Gmbh v. Pronuptia de Paris Irmgard Schillgallis,*[10] which dealt with some common franchise practices. Indeed, given the sparse guidance provided by the Regulations, *Pronuptia*—which fell off the radar screen when the now-expired Block Exemption on Franchising came into effect—looms large again in importance.

The basic structure of the new Block Exemption is that all vertical agreements entered into by a supplier that has a market share of less than 30 percent in the relevant market are presumed to be insufficient in anticompetitive effect to violate Article 81(1), so long as they do not contain certain "hard core" or "gray"

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provisions. Beyond this overly simplified statement, there is a great deal of complexity to the nuances of the Regulations.

As suggested by the guidelines, the Block Exemption should also be considered in light of other Commission policies, particularly the notice relating to so-called agreements of minor importance[11] and the recommendation regarding agreements between small and medium-sized undertakings (SMEs).[12] Essentially, the "agreements of minor importance" pronouncement states that provided that the agreement does not contain certain "hard core" restrictions and there is no cumulative effect, vertical agreements by undertakings whose market shares do not exceed 10 percent of the relevant market generally fall outside the scope of Article 81(1) because they are unlikely to appreciably affect trade between Member States or restrict competition.[13] In the same vein, subject to similar conditions, agreements between SMEs generally fall outside the scope of Article 81(1).[14]

Key Provisions Relevant to Franchising

The key provisions of the Block Exemption are Articles 2 through 5. Paragraph 1 of Article 2 provides for the exemption by stating that

> [p]ursuant to Article 81(3) of the Treaty and subject to the provisions of this Regulation, it is hereby declared that Article 81(1) shall not apply to agreements or concerted practices entered into between two or more undertakings, each of which operates for the purpose of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services ("Vertical Agreements").

Paragraph 1 of Article 2 importantly continues by stating that "[t]his exemption shall apply to the extent that such agreements contain restrictions of competition falling within the scope of Article 81(1) ('Vertical Restraints')."[15] In other words, to the extent that restrictions or provisions in vertical agreements do not violate Article 81(1) of the Treaty, the Block Exemption is not implicated. As noted below, this proviso is important because a number of contractual restrictions common to franchising have been recognized in the *Pronuptia* decision as falling outside of Article 81(1), yet do not meet the literal requirements of the Block Exemption.

Paragraph 3 of Article 2 establishes that the exemption applies to vertical agreements relating to the use of intellectual property rights that are incidental to the sale of goods or services (such as franchise agreements).[16] Paragraph 4 of Article 2 establishes that the exemption does not apply to vertical agreements among competitors, although it does apply to so-called dual distribution systems, e.g., a franchise system that has both corporate units and franchised units.[17]

Paragraph 1 of Article 3 provides for the 30 percent market share limitation on the Block Exemption, i.e., it only applies "on condition that the market share held by the supplier does not exceed 30 percent of the relevant market on which it sells the contract goods or services."[18]

Article 4 lays out the "hard core" restrictions that, if present in an agreement, would nullify the application of the Block Exemption to the entire agreement.[19] The first one is price fixing. The exemption does not apply to any vertical agreements that contain restrictions on "the buyer's ability to determine its sale price, without prejudice to the possibility of the supplier's imposing a maximum sale price or recommending a sale price, provided that they do not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties."[20] This is very similar to U.S. antitrust laws enacted after the *Kahn* decision[21] that make fixed or minimum prices unlawful but allow the establishment of maximum price limits so long as they do not in effect result in fixed prices. Also, minimum prices or fixed prices may be recommended, so long as they're not accompanied by coercion or incentives.

Certain types of territorial and customer restrictions are also deemed to be "hard core" restrictions. In relevant part, Article 4(b) states that the exemption does not apply to agreements that contain a

> . . . restriction of the territory into which, or of the customers to whom, the buyer may sell the contract goods or services, except—the restriction of active sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to another buyer, where such a restriction does not limit sales by the customers of the buyer.[22]

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The concept of "active" selling is discussed below.

Another of the "hard core" restrictions that has no parallel in U.S. antitrust law relates to what is called "selective distribution systems." It is important for U.S. franchisors to understand what is meant by "selective distribution," because the guidelines suggest that franchising may contain elements of selective distribution. On the other hand, dicta from the *Pronuptia* decision distinguishes franchising from selective distribution. This is discussed further below, but, in any event, "selective distribution systems" are severely limited in imposing resale restrictions. Article 4(c) states that the Block Exemption does not apply to agreements that contain a "restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level or trade . . ." or that contain a "restriction of cross supplies between distributors within a selective distribution system, including between distributors operating at a different level of trade."[23]

Article 5 contains a number of so-called gray provisions. These are provisions that will not be protected by the Block Exemption but, unlike the "hard core" provisions of Article 4, do not result in the entire agreement losing the protection of the Block Exemption. Only the particular provision that violates Article 5 is rendered unenforceable.

The primary focus of Article 5 is on exclusive purchasing arrangements and noncompetes. Although Article 5 only talks in terms of "noncompetes," the definition of a noncompete obligation includes not only the normal notion of selling competing goods and services, but also exclusive purchasing arrangements: " . . . any obligation on the buyer to purchase from the supplier or from another undertaking designated by the supplier more than 80 percent of the buyer's total purchases of the contract goods or services."[24] Article 5(a) renders unenforceable any noncompete obligation (i.e., noncompete or exclusive purchasing requirement) during the term of the agreement that is of an indefinite duration or that exceeds five years. This is subject to an exception where the franchisor owns the premises from which the franchisee operates, in which case the restriction may apply during the term of the lease.

Article 5(b) is equally harsh on post-term noncompetes. A post-term noncompete is permitted only if it: (1) relates to competing goods and services; (2) is limited to "the premises and land" from which the franchisee operated his or her business; (3) is indispensable to protect the franchisor's know-how licensed to the franchisee; and (4) is limited to one year after termination. That the post-term noncompete must be indispensable to the protection of the know-how suggests that the Commission contemplates a high standard of justification for the noncompete. This is further buttressed by the restrictive definition of what is considered to be "know-how."[25] Finally, Article 5(c) prohibits selective distribution systems from causing their members not to sell the brands of particular competing suppliers.

The Block Exemption also contains a number of more procedural articles, such as those dealing with withdrawal of the Block Exemption in individual cases, the power of national authorities to withdraw its benefits, and its inapplicability to parallel networks with similar vertical restraints. Finally, Article 12 provides that the new Block Exemption will apply retroactively to all agreements in existence on June 1, 2000, except that it will not apply until January 1, 2002, for agreements that complied with one of the old block exemptions.

Market Share Threshold

The applicability of the Block Exemption is driven by market share analysis. If the market share does not exceed 30 percent of the relevant market during the term of the relationship, the Block Exemption applies. If the market share exceeds 30 percent (subject to certain exceptions relating to temporary increases in market share)[26] at any time during the relationship, the Block Exemption will not apply. However, exceeding the 30 percent threshold does not result in any presumption of invalidity of the agreement; instead, one simply does not have the safe harbor that the Block Exemption affords.

Market share is to be determined on the basis of market sales value for the preceding calendar year of the contract goods or services sold by the supplier that are regarded as "interchangeable or substitutable" by the buyer.[27] If market sales value data are not available, estimates based on other reliable market information, including market sales volume, may be used.[28]

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For franchisors, the market share requirement is complicated by the need to perform a two-pronged market share analysis. According to the guidelines, in conducting a market share analysis

> a franchisor must take into account not only . . . its market share as a supplier of the goods or services sold to the licensees, but also of its market share as a provider of a distribution concept. Which distribution concepts are substitutes in the relevant distribution concept market depends in the first place on the preferences of the licensee. In any case, a competition problem can normally only arise in such a distribution concept market when a significant part of the goods or services concerned are distributed by companies operating with such distribution concepts.[29]

What this means exactly is subject to differing interpretations, but presumably the last sentence clarifies that the most important measurement is the market in which the franchise system's goods or services are sold. If so, it is difficult to imagine that many franchise systems, particularly those offering consumer products or services, would approach the 30 percent threshold.

For franchisors using master franchising arrangements, the guidelines seem to suggest that a market share analysis must be conducted on the master franchise level as well. According to the guidelines, in a vertical agreement involving more than two parties on different levels of trade, the market share at both levels must remain below 30 percent for the Block Exemption to apply.

A major source of unpredictability with the Block Exemption is the requirement of meeting the market share threshold throughout the term of the relationship. Although a franchisor may initially meet the 30 percent threshold, continuous growth could result in the franchisor or a master franchisee exceeding the market share maximum and losing the benefit of the Block Exemption.

Is Franchising "Selective Distribution"?

As mentioned above, there are specific "hard core" prohibitions relating to "selective distribution," including a prohibition against resale restrictions. "Selective distribution system" is obliquely defined in Article 1(d) of the Regulations as "a distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on the basis of specified criteria and where these distributors undertake not to sell such goods or services to unauthorised distributors."[30] The guidelines further explain selective distribution arrangements by distinguishing them from exclusive distribution arrangements in that the restriction on the number of dealers is not based on territories but on selection criteria "linked in the first place to the nature of the products"[31] and that restrictions on resales are not based on active selling outside a territory but on resales to unauthorized dealers.

Most troublesome to franchisors are the statements in the guidelines that "[s]elective distribution is almost always used to distribute branded final goods or services"[32] and that "[f]ranchise agreements are usually a combination of different vertical restraints, i.e., selective distribution and/or noncompete and/or exclusive distribution and/or weaker forms thereof."[33]

In contrast, *Pronuptia* distinguishes franchising from selective distribution in that selective distribution is said not to involve the use of a single business name, application of uniform business methods, or the payment of royalties.[34] This description is more in line with the historical notion of selective distribution as being more like what is known in the United States as a "fractional franchise" or "leased department" type of arrangement. Classical selective distribution systems involve areas of department stores dedicated to particular brands of luxury goods, such as perfumes.

The definition in the Regulations of "selective distribution" is not very helpful; in fact, one of the two elements of the definition simply restates what is and is not permissible for selective distribution systems.[35] However, it would appear that most franchise systems could be structured in such a manner as to minimize the chances of being deemed a "selective distribution system" by setting up a traditional franchise system—as outlined and distinguished from selective distribution by *Pronuptia*—and avoiding selection criteria that are linked principally to the nature of the products, i.e., by offering franchises on a more general basis. Yet, product distribution franchises, particularly specialty products sold through what is commonly referred to as "nontraditional locations" or existing retail channels, may need to very carefully consider the applicability of the selective distribution prohibitions.

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Passive Selling and the Internet

Another issue raised by the Block Exemption is the prohibition on restricting a franchisee's selling activities. Article 4(b) provides that a party may not restrict " . . . the territory into which, or of the customers to whom, the buyer may sell the contract goods or services, except the restriction of active sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to another buyer. . . ."[36] The effect of this prohibition is that a franchisor is permitted to limit a franchisee's ability to "actively" sell outside a defined geographical area, but may not interfere with a franchisee's "passive" sales. The Regulations do not define "active" selling; instead, the guidelines describe "active" selling as direct mail, personal visits, or targeted advertising. "Passive sales" are described as responding to unsolicited customer requests or general advertising that is reasonably intended for the dealer's own customers but that may spill over into other territories or customer categories.

One of the difficulties with this provision is its application to the use of the Internet. According to the guidelines, the Internet is generally considered to be a form of passive selling unless a franchisee is sending unsolicited e-mails or specifically targeting consumer groups within another franchisee's exclusive territory. The guidelines state:

> The use of Internet to advertise or to sell products must be free for every distributor. A restriction on the use of Internet by distributors could only be compatible with the [Block Exemption] to the extent that promotion on the Internet or sales over the Internet would lead to active selling into other distributors' exclusive territories or customer groups. . . . Notwithstanding what has been said before, the supplier may require quality standards for the use of the Internet site to resell its goods, as the supplier may require quality standards for the shop or for advertisement and promotion in general. The latter may be relevant in particular for selective distribution. An outright ban on Internet or catalogue selling is only possible if there is an objective justification on grounds such as safety or health.[37]

Given this view of the Internet, it would seem difficult to justify reserving the Internet as an exclusive channel of distribution in the context of any distribution system using third parties. At best, one appears only to be able to require quality standards to maintain the image and standards of each franchisee's Website. Depending on the importance of the Internet to a particular type of business, this restrictive view may create incentives to establish vertically integrated distribution systems.

Purchase Restrictions and Noncompete Covenants

The Block Exemption is most enigmatic with respect to purchase restrictions and noncompetition covenants commonly found in franchise relationships. As noted above, in order for a franchise system to benefit from the Block Exemption, designated supplier provisions and in-term noncompetes can last no more than five years and post-term noncompetition covenants are severely restricted. If this is what the Commission really means, it would put franchise systems at substantial risk in maintaining standards and protecting intellectual property rights.

Yet, the Commission itself does not appear to be convinced of the need to be so restrictive, notwithstanding the specific language of the Block Exemption. In the guidelines, the Commission recognizes that restrictions that are necessary to protect a franchisor's intellectual property rights either do not violate Article 81(1) or are covered by the Block Exemption. For example, paragraph 40 of the guidelines goes through a list of seven restrictions common in franchising that are said to be covered by the Block Exemption (although no mention is made of this in the text of the Block Exemption) to the extent that they fall under Article 81(1). The first two are in-term noncompetes for the entire duration of franchise agreements. Then, in the franchising example set forth in paragraphs 192–94 of the guidelines, the Commission states that designated supplier provisions for the duration of franchise agreements fall outside of Article 81(1) when they are "necessary to maintain the common identity and reputation of the franchise network." Finally, the example of the franchise relationship given in paragraph 194 contains many restrictive clauses common in franchising. The Commission evaluates these restrictions by saying that "most of the obligations contained in the franchise agreements can be

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assessed as necessary to protect the intellectual property rights or maintain the common identity and reputation of the franchise network and fall outside Article 81(1)."

What is one to make of these apparent contradictions? Paragraph 115 of the guidelines, which explains the general rules that the Commission uses in evaluating vertical restraints, sheds some light. The Commission asserts that "the more the vertical restraint is linked to the transfer of know-how, the more reason there may be to expect efficiencies to arise and the more the vertical restraint may be necessary to protect know-how transferred or the investment cost incurred. The more the vertical restraint is linked to investments that are relationship-specific and sunk, the more justification there is for certain vertical restraints. The justified duration will depend on the time necessary to depreciate the investment."

Thus, if a restraint can be justified as being necessary (1) to protect the intellectual property rights, or (2) to maintain the common identity and reputation of the franchise network, then Article 81(1) is not implicated. This is essentially the same analysis as found in *Pronuptia.* Based on the same justifications, the court held that an unlimited in-term noncompete, an unlimited exclusive supply arrangement, a location restriction, and a post-term noncompete for a reasonable period of time in an area where the former franchisee would be competing with other franchisees all fall outside of Article 81(1).

From this, it can be concluded that the Commission is not seriously concerned that supply restrictions and noncompetition covenants commonly found in franchise relationships are likely to have anticompetitive effects. So long as the restrictions can be justified to maintain the integrity of the franchise system, the supply restrictions and in-term covenants can remain for the duration of the relationship. Likewise, the unrealistically narrow geographical scope of post-term covenants contained in Article 5(2) possibly may be ignored in favor of something broader, provided that it can be reasonably justified.[38]

Conclusion

It can be gleaned from the Block Exemption and its guidelines that the Commission is markedly disinterested in franchising. The Commission appears to be saying that it is not concerned with the restrictions commonly found in franchise agreements, unless they constitute the types of "hard core" restraints prohibited by Article 4 of the Block Exemption.

Franchisors that want to continue designated supplier requirements and noncompetes that last for the duration of the agreements and also more protective post-term noncompetition covenants will not have the protection of the Block Exemption for those provisions. Even though these practices benefit from the analysis in *Pronuptia* and its endorsement in the guidelines, opportunities remain for the authorities and franchisees to challenge them.

Endnotes

1. Commission Regulation (Commission) No. 2790/1999 (Block Exemption).
2. Commission Regulation (Commission) No. 1983/83.
3. Commission Regulation (Commission) No. 1984/83.
4. Commission Regulation (Commission) No. 4087/88.
5. Treaty Establishing the European Community, Mar. 25, 1957, Title VI, Art. 81(1) (Commission Treaty).
6. Guidelines on Vertical Restraints, ¶ 1 *et seq.* (Guidelines).
7. The Commission states in paragraph 4 of the guidelines that the guidelines are "without prejudice to the interpretation that may be given by the Court of First Instance and the Court of Justice of the European Communities in relation to the application of Article 81 to vertical agreements."
8. One of the improvements in the overhaul of Commission competition regulations is the amendment to Regulation No. 17/62 dealing with individual exemptions. Now, individual exemptions under Article 81(3) can be granted retroactively. Council Regulation (Commission) No. 1216/1999 of 10 June 1999 amending Regulation No. 17. Thus, if a franchise agreement is challenged in a national court as a violation of Article 81(1), the franchisor can seek from the Commission an individual exemption that, if granted, would be effective from the date that the agreement went into effect. It is contemplated that the national court would suspend proceedings pending the resolution of the individual exemption request. Guidelines ¶ 60.
9. *See, e.g.,* Guidelines ¶ 61.
10. Commission Case No. 161/84 (Jan. 28, 1986).
11. Notice on Agreements of Minor Importance of 9/12/1997 OJ C372,9/12/1997, C372, p 13.

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12. Annex to Commission Recommendation 96/280/Commission OJ L107, 30-4-1996, p. 4.
13. The policies regarding "agreements of minor importance" are said to be under review, but as of yet there is no indication as to when this might occur.
14. According to the Annex to Commission Recommendation 96/280/Commission, small and medium-sized undertakings are defined as entities with annual revenues of seven million Euros and forty million Euros, respectively.
15. Block Exemption, Art. 2(1).
16. According to Block Exemption Article 2(3),

> The exemptions provided for in paragraph 1 shall apply to vertical agreements containing provisions that relate to the assignment to the buyer or use by the buyer of intellectual property rights, provided that those provisions do not constitute the primary object of such agreements and are directly related to the use, sale or resale of goods or services by the buyer or its customers. The exemption applies on condition that, in relation to the contract goods or services, those provisions do not object or effect as vertical restraints which are not exempted under this Regulation.

17. The exemption provided for in paragraph 1 shall not apply to vertical agreements entered into between competing undertakings; however, it shall apply where competing undertakings enter into a nonreciprocal vertical agreement and ". . . (c) the supplier is a provider of services at several levels of trade, while the buyer does not provide competing services at the level of trade where it purchases the contract services." Block Exemption, Art. 2(4).
18. Block Exemption, Art. 3(1). If the market share is not more than 30 percent at the time of entering into the agreement, but subsequently rises above that level without exceeding 35 percent, the exemption continues for a period of two consecutive years following the year in which the threshold was exceeded. Article 9.2 (c), Regulation. If the market share is initially under 30 percent and later exceeds 35 percent, the exemption will continue for one year following the year in which the market share level of 35 percent was first exceeded. Article 9.2 (d), Regulation. In no event, however, can Articles 9.2(c) and 9.2(d) be combined so that the Block Exemption exceeds a period of two calendar years. However, if the 30 percent threshold is exceeded by 10 percent, then the two-year "grace period" does not apply. Block Exemption, Art. 10(2).
19. One can analogize these "hard core" restrictions to the per se violations under the U.S. antitrust laws.
20. Block Exemption, Art. 4(a).
21. State Oil v. Kahn, 522 U.S. 3 (1997).
22. Block Exemption, Art. 4(b).
23. Block Exemption, Art. 4(c).
24. Block Exemption, Art. 1(b).
25. "Know-how" is defined as "a package of nonpatented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified; in this context, 'secret' means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; 'substantial' means that the know-how includes information which is indispensable to the buyer for the use, sale or resale of the contract foods or services; 'identified' means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfills the criteria of secrecy and substantiality." Block Exemption, Art. 1(f).
26. *See* note 16 *supra*.
27. Block Exemption, Art. 9.
28. Block Exemption, Art. 9.
29. Guidelines ¶ 91.
30. Block Exemption, Art. 1(d).
31. Guidelines ¶ 177.
32. *Id.*
33. *Id.* ¶ 192.
34. Pronuptia de Paris Gmbh v. Pronuptia de Paris Irmgard Schillgallis, Commission Case No. 161/84 (Jan. 28, 1986).
35. Block Exemption, Art. 4(c) and Art. 4(d).
36. Block Exemption, Art. 4(b).
37. Guidelines ¶ 47.
38. However, it is likely that the high standard of justification of the noncompete in Article 5(2) would have to be met.

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