THE NATIONAL LAW JOURNAL

Antitrust Law
New E.U. Regulation

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As of Jan. 1, distribution networks or other contractual arrangements with downstream parties in the European Union are subject to a new antitrust regime. Designed by the European Union's antitrust watchdog, the European Commission (E.C.), the new rules on distribution restraints will bring E.U. law closer to U.S. law in this area. Companies should understand the similarities and differences between the U.S. and E.U. systems and consider their pros and cons.

U.S. law has two different legal standards to assess distribution restrictions, depending on the type of vertical restraint. Vertical price restraints–e.g. resale price maintenance–and tying arrangements are illegal *per se*, although this rule is subject to judicially created exceptions. Since *Continental T.V. Inc. v. GTE Sylvania Inc.,* 433 U.S. 36 (1977), vertical nonprice restraints–*e.g.* territorial division–are afforded rule-of-reason scrutiny, which means that all relevant facts and circumstances are balanced to evaluate the overall effect on competition.

The E.C.'s policy toward vertical restraints has traditionally been more stringent and less hospitable than the U.S. approach because of the importance of achieving a "common market" without national boundaries. Restrictions on distribution in the European Union therefore are, in principle, prohibited. The E.C. can, however, exempt seemingly restrictive agreements or practices when the anticipated economic benefits outweigh possible adverse effects on competition: E.U. law has an administrative notification mechanism allowing exemption of individual agreements alongside a block exemption system, for which there exists no equivalent in U.S. law. The individual notification system, in all probability, will be eliminated, so companies and their legal advisers will themselves have to assess whether certain distribution practices are lawful.

The E.C. adopted block exemptions for specific types of agreements or particular industries that justify special antitrust treatment. These block exemptions attempt to establish safe harbors from antitrust review, and they are specific to E.U. law.

New regulation offers one 'catch-all' block exemption

The E.C. found, however, that the block exemptions for distribution restrictions lacked transparency and legal certainty. Thus, it replaced the three-tier system of block exemptions (for exclusive distribution, exclusive purchasing, and franchise agreements) with a new system with one "catch-all' block exemption for vertical restraints–the E.U. Block Exemption Regulation 2790/1999 on Vertical Restraints–which generally applies as of Jan. 1.

The approach under the previous regime was based on the distinction between permissible contractual clauses ("white clauses") and clauses that were considered harmful to competition ("black clauses"). Distribution agreements free from black clauses were most likely to pass muster. Without consideration of the impact on competition, the previous regime forced companies into contractual straight jackets.

In contrast, the new Regulation focuses on competition effects, emphasizing market share analysis and contractual freedom. This effects-based approach is also followed in the United States where most restrictive distribution practices are presumed legal in absence of market power.

The Regulation arguably has a wider range than the previous regime. It extends the benefit of block exemptions to selective distribution arrangements, agreements for supply of intermediary products, and services agreements. The Regulation also allows agreements among several companies to benefit from the block exemption, provided that the companies operate at different levels of trade and are not actual or potential competitors. Under the previous regime, only limited categories of vertical restraints in agreements with no more than two parties qualified for exemption.

The Regulation introduces market-share thresholds as the principal criteria for exemption. Generally, the block exemption applies to agreements with vertical restraints if the market share held by the supplier does not exceed 30% of the relevant market. In exclusive supply arrangements, the buyer's market share must not exceed 30%. If three or more parties are involved, then their market shares must not exceed 30% at each of the respective levels of trade.

Market shares exceeding the 30% threshold do not necessarily render vertical restraints illegal under the regulation: The E.C. will carefully scrutinize an application for individual exemption, considering additional factors such as competitors' market shares, product substitutes and entry barriers.

The regulation generally doesn't cover the following "hard-core" restrictions:

- *Minimum Resale Prices.* Recommended or maximum resale pricing is allowed under the regulation, so long as it does not induce illegal price fixing. This resale price maintenance restriction corresponds to the per se prohibition

under U.S. law that bans minimum resale price agreements without balancing pro-competitive effects against anti-competitive implications or assessing market power. Under U.S. law, however, firms accused of resale price maintenance may escape *per se* illegality by invoking the *U.S. v. Colgate & Co.*, 250 U.S. 300 (1919) exception–i.e., by demonstrating that price fixing was unilaterally imposed. On the European side, the permissibility of unilateral conduct aimed at restricting distribution is under review by the European Court of Justice. Case T41/96, *Bayer v. Commission* (pending).

- *Territorial restrictions.* Territorial division can distort the European Union's single-market integration by erecting private barriers to trade, such as a ban on "passive" (unsolicited) sales into another distributor's territory. Nevertheless, the regulation creates an exception for a number of territorial restraints, including restrictions on "active" sales into exclusive territories allocated to other distributors. Furthermore, customer restrictions, including restrictions on sales to end users by a wholesaler to ensure that the wholesaler does not engage in unfair competition with retailers, are exempted. These exceptions bring the regulation closer to U.S. law, where vertical territorial and customer restraints are assessed under the rule of reason.

Even if a distribution agreement does not contain any hard-core restrictions, the regulation bans three types of contractual clauses containing: obligations not to compete (exceeding five years); obligations that make it impossible for distributors to manufacture, purchase, sell or resell goods or services after the termination of the distribution agreement, except in limited circumstances; and obligations on members of a selective distribution system to refrain from selling competing brands. The remaining clauses of an agreement may still qualify for block exemption.

Under U.S. law, exclusive dealing and requirements contracts are likely to receive a more lenient, rule of reason evaluation, and will be found anticompetitive only if a substantial part of the market is foreclosed by the contract.

The E.C. and the E.U. member states may withdraw the benefit of the regulation on a case-by-case basis if an agreement does not meet the conditions for individual exemption as defined by E.U. antitrust law–for instance when access to the relevant market is significantly impeded by the cumulative effect of parallel networks or similar vertical restraints implemented by competing suppliers or buyers.

Moreover, where different distribution networks with similar vertical restraints exist side-by-side and cover more than 50% of a relevant market, the E.C. may revoke the application of the regulation entirely with regard to that specific market, obviating the need for individual withdrawal decisions.

Assessment of the new regime: mixed reviews

The E.C. took a crucial step in the right direction by adopting one block-exemption system for vertical restraints. Yet this less formalistic approach –which allows companies to design their European distribution networks more efficiently–comes at a price.

The new regime introduces market power as the main parameter for evaluating distribution restrictions. Before entering into a distribution agreement, companies will have to appraise their market position and the competition issues under E.U. law by themselves. This will not always be an easy task, especially in rapidly evolving markets or those with low barriers to entry. Nevertheless, companies now must identify the relevant market and their position in that market without the E.C.'s intervention, since any individual guidance by the E.C. would defeat the purpose of a block exemption.

The question arises whether the new regime offers more legal certainty and transparency compared to the previous regime, especially in view of the E.C.'s ability to withdraw the exemption. The safe harbor established by the new regime may provide less certainty than companies might have hoped, particularly companies with high market shares. These companies may see their vertical arrangements challenged by third parties, by means of complaints before the E.C. or national courts.

Most distribution agreements, however, will probably be exempted under the Regulation without requiring special antitrust attention, provided that they do not involve companies with market power. This is good news, not only for U.S. companies with distribution activities in the European Union, but also for the E.C., whose workload is likely to be reduced. This, it is hoped, will enable the E.C. to allocate more time and resources to review truly anti-competitive agreements and concerted practices that unbalance Europe's level playing field.

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