PRODUCT DISTRIBUTION IN EUROPE

Considerations Under EC Competition Law

By Todd A. Smith

With the scheduled accession of 10 additional countries to the European Union (EU) in 2004, the EU's importance in the global distribution strategies of Michigan's companies will likely grow.[1] Operating efficient European distribution systems will be increasingly critical to their continued commercial success. Challenges for Michigan's companies in this regard will include complying with the legal requirements of the EU's common market, such as European Community (EC) competition law.[2] Failure to comply may lead to disastrous consequences to their distribution systems. To avoid these consequences, Michigan companies should understand the scope of EC competition law as it relates to their European product distribution.

Vertical Agreements under Article 81

The basic provisions of EC competition law are contained in Articles 81 to 89 of the Treaty of Rome of 1957, as amended and renumbered. For product distribution agreements (or "vertical agreements,"[3] in the parlance of EC competition law), Article 81 is of primary importance.[4]

Article 81 is divided into three subsections. Article 81(1) prohibits agreements that restrict or distort competition. Article 81(2) provides that any agreement prohibited under Article 81(1) shall be automatically void. Article 81(3) permits the European Commission (the commission) to exempt from Article 81(1) agreements that have certain pro-competitive effects, which exemption is obtained either through applying for an "individual exemption" from the commission of a particular agreement or by drafting the agreement to satisfy a "block exemption" promulgated by the commission (i.e., a safe harbor exempting a category of agreements).

Companies with vertical agreements infringing Article 81(1), which are not otherwise saved by Article 81(3), may find these agreements unenforceable, be subject to fines from the commission totaling as much as 10 percent of the companies' worldwide revenue, and acquire a raft of negative publicity in the market. Because vertical agreements are critical for business operations, the risk created by their infringement of Article 81(1), or the uncertainty associated with their potential for such infringement, is unacceptable.

Companies can manage this risk and uncertainty, and avoid the time and expense of applying for individual exemptions of their vertical agreements under Article 81(3), by

determining whether their vertical agreements fall outside the scope of Article 81(1) or benefit from the safe harbor established by the Vertical Restraints Block Exemption Regulation.

FAST FACTS:

Product distribution agreements in Europe must comply with EC competition law to ensure their enforceability and avoid possible fines.

By understanding the scope of EC competition law and the safe harbor provided by the Vertical Restraints Block Exemption Regulation, Michigan businesses and their advisors may reduce the complexity of these compliance requirements.

Agreements within Single Economic Entity

Relevant to many multinationals is recognition that vertical agreements between entities considered a single economic entity—agreements between a parent and subsidiary company, "genuine agency" agreements, and certain subcontractor agreements—generally fall outside the scope of Article 81(1).

An agreement between a parent and its subsidiary does not fall within the scope of Article 81(1) if the parent has sufficient control over the subsidiary so that the subsidiary does not enjoy real independence in its decision-making and in determining its course of action in the market. Where the parent is a majority shareholder of the subsidiary, the presumption is that the parent controls the subsidiary affairs.

An agency agreement does not fall within the scope of Article 81(1) if it is genuine. There are two types of commercial risk in an agency relationship that are material to determining whether it is "genuine." First, there are risks directly related to the contracts concluded or negotiated by the agent on behalf of the principal (e.g., financing inventory of the principal's products). Second, there are risks related to market-specific investments (e.g., investments specifically required for the activity for which the principal has appointed the agent). The agreement is genuine if the agent does not bear either of these risks. If the agent does bear either risk, it is as an independent dealer who must remain free in determining its own marketing strategy to cover its risk and investments.

Additionally, certain clauses of subcontractor agreements involving a contractor's know-how do not fall within the scope of Article 81(1). Where a contractor transfers know-how to the subcontractor, clauses restricting the use of any technology or equipment transferred fall outside the scope of Article 81(1). The technology or equipment must, however, be necessary to enable the subcontractor to manufacture the goods or supply the services.

De Minimis Notice: Agreements of Minor Importance and Small and Medium-sized Undertakings

A notable exception to the scope of Article 81 is also set forth by the De Minimis Notice.[5] Pursuant to the De Minimis Notice, a vertical agreement entered into by a company with a market share on the relevant market not exceeding 15 percent will generally be considered of minor importance, providing it does not contain any hardcore restrictions (see infra, discussion of *No Hardcore Restraints*).

The De Minimis Notice also states agreements between small and medium-sized undertakings (SMEs) generally fall outside the scope of Article 81. SMEs are companies with fewer than 250 employees worldwide and either a worldwide annual turnover not exceeding EUR 40 million or an annual balance sheet total not exceeding EUR 27 million. To benefit from this safe harbor, each party to the agreement must qualify as an SME.

The De Minimis Notice, as it applies to both agreements of minor importance and SMEs, is not legally binding. Companies must, therefore, exercise caution and not rely on it. The commission reserves the right to intervene in an agreement if there are significant restrictions, such as price fixing, or cumulative effects with other similar agreements of a company in a particular market that distort competition.

Distribution of New Products or Existing Products in New Geographic Markets

A further exception to the scope of Article 81 is a vertical agreement related to distribution of new products or existing products sold for the first time in a different geographic market. The agreement falls outside the scope of Article 81 during the first two years after first placing the product on the market, provided it contains no hardcore vertical restraints (see infra, discussion of *No Hardcore Restraints*).[6]

Vertical Restraints Block Exemption Regulation

The most significant limitation of Article 81, as it relates to vertical agreements, is the new block exemption, the Vertical Restraints Block Exemption Regulation[7] (the BER), effective June 1, 2000. The BER is broad in scope and replaces a number of narrower block exemptions, including exemptions on franchising, exclusive distribution, and exclusive purchasing. The BER provides a safe harbor for "vertical agreements," as defined below. Accompanying the BER, the commission has published Guidelines on Vertical Restraints (the Guidelines), a detailed explanation of the commission's interpretation of the BER and guidance for drafting vertical agreements in Europe.

The commercial success of Michigan companies in the EU necessitates an understanding of the scope of Article 81 vis-à-vis vertical agreements.

Definition of Vertical Agreement

The BER's definition of vertical agreement requires, among other things, that the parties to the agreement operate, for purposes of the agreement, at different levels of trade and that the agreement relates to the purchase, sale, or resale of goods or services. This definition excludes agreements between actual or potential competitors, for leasing goods, and for the supply of intellectual property. The BER excludes agreements falling within the scope of other block exemptions (e.g., motor vehicle distribution block exemption). The BER also does not cover any restrictions or obligations in an agreement that do not relate to the conditions of purchase, sale, and resale.

Notwithstanding the BER's definition of vertical agreement, a number of agreements that fall outside the basic definition, or otherwise appear to fall within one of the general exclusions to the definition, have been specifically included by the BER within its scope. These agreements are further described in the Guidelines and include agreements for associations of retailers, non-reciprocal agreements between competing companies where the buyer has a total turnover not exceeding EUR 100 million, and non-reciprocal agreements between competing companies where the buyer is only a distributor and does not manufacture products that compete with those supplied under the agreement.

Less than 30 Percent Market Share in Relevant Market

The BER applies only to vertical agreements where neither party exceeds a 30 percent market share threshold in the relevant market. Thus, the application of the BER may turn on a particular market definition.[8] The BER provides that the market share of the supplier is generally taken into account for determining whether an agreement benefits from the BER, except in the context of an exclusive supply agreement where the buyer's market share is relevant. Market share is calculated, if possible, based on sales value (as opposed to volume) of the relevant goods or services, with reference to the relevant sales figures from the preceding calendar year, including goods or services produced by the supplier that are substitutable with the contract goods or services. Special rules apply for market fluctuations of suppliers. If, having previously fallen within the threshold, the supplier's market share exceeds the threshold but remains less than 35 percent, then the BER will continue to apply for two calendar years. If the supplier's market share increases to 35 percent or more, the BER will continue for a single calendar year.

No Hardcore Restraints

The BER applies only to vertical agreements that have no hardcore restraints. The inclusion of any hardcore restraints—or any restriction that, directly or indirectly, has an equivalent object or effect—deprives the entire vertical agreement of the benefit of the BER. The BER lists the following five hardcore restraints:

- *Restrictions on resale prices*—This prohibits resale price maintenance or the imposition of fixed or minimum resale prices.
- *Restrictions on the territories or customers to which goods or services may be resold*—This prohibits attempts to divide territories within the EU and divide customer groups in order to increase prices to certain customer groups.[9]
- *Restrictions on active or passive sales to end users by retailers in a selective distribution system*—This requires that authorized distributors in a selective distribution system be free to sell, actively and passively, to all territories and all classes of end user.
- *Restrictions on cross-supplies between authorized distributors within a selective distribution system*—This requires that authorized distributors within a selective distribution system be allowed to cross-supply other authorized distributors.
- *Restrictions on a supplier of components on resale to end-users, repairers, or other service providers for use as spare parts*—This requires that the supplier of components be permitted to sell components as spare parts directly to end users, repairers, or other service providers, and not only the service providers or repairers appointed by the distributor. The objective is to maintain that spare parts can be obtained from the original manufacturer.

Clauses Not Covered by BER

The BER also lists three types of clauses not covered by the BER (and thus individually subject to review under Article 81(1)), even if the rest of the vertical agreement is otherwise covered by the BER. In contrast to hardcore restraints, the inclusion of any of these clauses does not deprive the entire agreement of the benefit of the BER, only the following clauses, themselves, are not covered by the BER:

- *Non-compete obligations with a duration exceeding five years*—The BER broadly defines a "non-compete" obligation as including an exclusive purchasing obligation, an obligation to source more than 80 percent of requirements from the supplier,

or an obligation not to manufacture goods that compete with the supplier. The BER also provides that a non-compete for a shorter duration that is tacitly (i.e., automatically) renewable will be considered a non-compete for an indefinite period.

- *Post-termination "non-compete" obligations*—The BER provides that post-termination obligations must be limited to one year, limited to the premises from which the distributor operated during the agreement, and necessary to protect know-how transferred by the supplier.
- *Obligations on distributors within a selective distribution system not to sell the brands of particular competitors of the supplier*—The BER's purpose is to prevent supplier's using selective distribution systems from restricting access of a specific competitor to distribution.

Both the clauses not covered by the BER and the hardcore restraints (see supra, discussion of *No Hardcore Restraints*) are subject to a number of refinements beyond the scope of this article. Michigan companies should refer directly to the BER and its guidelines for further information.

Conclusion

The commercial success of Michigan companies in the EU necessitates an understanding of the scope of Article 81 vis-à-vis vertical agreements. Many vertical agreements, of course, do not infringe Article 81(1), and there is no necessity to satisfy the requirements of recognized exceptions to the scope of Article 81(1) or the safe harbor of the BER. Nonetheless, Michigan companies may avoid the detailed analysis required to determine whether a vertical agreement infringes Article 81(1), and potentially the expense and complication of applying for an individual exemption under Article 81(3), by satisfying the requirements of an exception or the BER's safe harbor. Michigan companies should consult their advisors for further information. ✦

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Footnotes

1. The EU currently consists of 15 Member States. 13 candidate countries have applied for accession to the EU, which will eventually add more than 100 million people to the EU's current population of 370 million. On May 1, 2004, Hungary, Poland, the Czech Republic, the Slovak Republic, Slovenia, Estonia, Latvia and Lithuania, Malta and Cyprus will join the European Union. Two other applicant countries, Bulgaria and Romania, will join in 2007, provided they meet the required standards in time. Turkey has been given no firm date for accession negotiations, but accession negotiations could begin in December 2004. For more information on EU enlargement, see http://europa.eu.int/pol/enlarg/index_en.html.
2. EC competition law is the term for antitrust law in the European Community, one of the three European treaty communities (the EC, Euratom, and ECSC) forming the European Union.
3. The term "vertical agreement" is specifically defined in the Vertical Restraints Block Exemption Regulation, infra, and comprises a wide range of agreements, including distribution agreements.
4. Article 82 of the Treaty prohibits abuse of a dominant position in the relevant market by a company and may affect a dominant company's vertical agreements, but is beyond the scope of this article.
5. Notice on Agreements of Minor Importance, 2001, OJ C 368/07.
6. Guidelines on Vertical Restraints, 2000, OJ C 291/01, p. 25.
7. Commission Regulation 2790/1999, OJ L 336, p. 21–25.
8. The calculation of market share is a fundamental part of the analysis related to application of the BER, as well as the De Minimis Notice. This calculation, predicated on first determining the relevant market, is deceptively complicated and requires consultation with specialists in EC competition law. Guidance on market definition is provided by the commission's Notice on the Definition of Relevant Market for the Purpose of Community Competition Law, OJ C 372, p. 5.
9. There are four exceptions to this general hardcore restraint, which include: (i) restrictions on active (but not passive) sales to the exclusive territory or exclusive customer groups allocated to another party or reserved to the supplier; (ii) restrictions on sales to end-users by wholesale distributors; (iii) restrictions on sales to non-authorized distributors under a selective distribution system (i.e., a system where the supplier selects the group of distributors on the basis of defined criteria); (iv) restrictions on resale of components.

Online Resources for EC Competition Law

European Commission Website on European Competition Policy
http://europa.eu.int/comm/competition/index_en.html

Text of Article 81 of the EC Treaty
http://europa.eu.int/comm/competition/legislation/treaties/ec/art81_en.html

De Minimis Notice
http://europa.eu.int/eur-lex/pri/en/oj/dat/2001/c_368/c_36820011222en00130015.pdf

Vertical Restraints Block Exemption Regulation
http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=EN&numdoc=31999R2790

Guidelines on Vertical Restraints
http://europa.eu.int/eur-lex/pri/en/oj/dat/2000/c_291/c_29120001013en00010044.pdf

Paper: Competition Policy in Europe: The competition rules for supply and distribution agreements
http://europa.eu.int/comm/competition/publications/rules_en.pdf