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EDITORIAL COMMENTS

The modernization of the Community competition rules on vertical agreements

Following the consultation exercise launched by the Green Paper on Vertical Restraints in EC Competition Policy,[1] the Commission has now published a policy proposal which is intended to introduce an improved legislative framework and a simplified system of administrative supervision for dealing with vertical agreements concerning exclusive distribution, exclusive purchasing, franchising and selective distribution.[2] The current system of block exemptions is based on a white list approach, that is to say that it lists all clauses that are acceptable and therefore exempted from the prohibition of Article 85(1). Since, as a consequence, all other clauses restricting the parties' freedom of action are *not* automatically exempted, a contract easily loses the benefit of the exemption. These other clauses can only be saved if they are notified to the Commission and qualify for an individual exemption. This system is generally perceived to be over-rigid, and to be out of line with economic thinking on the effects of distribution restraints.

The proposals now put forward by the Commission include a new broad block exemption regulation for vertical agreements (including selective distribution agreements, which up to now have not been subject to a block exemption system), as well as certain amendments to Regulation No. 17. The changes contemplated by the Commission aim to ensure more effective protection of competition while at the same time providing adequate legal certainty for firms. In particular, the new rules must remedy the shortcomings that have elicited increasing criticism of current policy with regard to the application of Article 85(3) to certain types of vertical agreements.[3] Taken as a whole, the Commission's views appear to be based on sound economic

1. COM(96) 721 final of 22 Jan. 1997.
2. Commission Communication on the application of the EC competition rules to vertical restraints; Follow-up to the Green Paper on Vertical Restraints COM(98)546 of 21 Sept. 1998. See also Riley, "Editorial – Vertical restraints: A revolution?", (1998) ECLR, 483–492.
3. See e.g. Hawk, "System failure: Vertical restraints and EC competition law", 32 CML Rev., 973–989.

and legal reasoning and capable of curing a substantial number of the current system's defects.

In the Communication containing its proposals, the Commission explains that the Block Exemption Regulations (BEs) now in force for exclusive distribution[4] and for franchising[5] comprise rather strict form-based requirements and frequently work as a straitjacket. It is recognized that under the current BEs, small companies suffer unnecessarily strict regulation; often they are unable to comply with the conditions for exemption of vertical restraints that are not at all likely to harm competition. On the other hand, there is a real risk that harmful agreements profit from the possibilities of exemption, especially since for the purposes of exemption, the market size of the participating parties is totally irrelevant. Indeed, as the BEs are form-based and thus do not involve an economic analysis of an agreement's actual or probable effect on competition, it is relatively simple for companies with significant market power to benefit from them. Such companies can easily protect themselves by drafting the contract clauses in such a way that they fit correctly within the existing block exemption regulations. This may result, for instance, in exemption of non-compete obligations of up to 100% market share, even though such practices may cause serious foreclosure effects and enable the parties to the agreement to charge higher prices than are normal in a competitive environment. It is true that in such situations the BEs allow the Commission to withdraw the benefit of the exemption but such withdrawal only has effects for the future and not *ex tunc*.

Another drawback of the current system is that the BEs only cover vertical agreements concerning the resale of *final* goods; agreements concerning intermediate goods or services do not benefit from the exemptions. Therefore, an important percentage of all vertical agreements are not covered by the current BEs, even though the parties involved may have no market power (so the agreements are very unlikely to have anti-competitive effects). These agreements must then be notified in order to obtain individual exemptions. Given the Commission's limited resources for dealing with these notifications, it cannot react swiftly to applications, so many companies are uncertain about the fate of their applications and the validity of the agreements notified.

4. Commission Regulations No. 1983/83 of 22 June 1983 on the application of Article 85(3) of the Treaty to categories of exclusive distribution agreements, O.J. 1983, L 173/1; Commission Regulation No. 1984/83 of 22 June 1983 on the application of Article 85(3) to categories of exclusive purchasing agreements, O.J. 1983, L 173/5.

5. Commission Regulation No. 4087/88 of 30 Nov. 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements, O.J. 1988, L 359/46. See also Commission Regulation No. 1475/95 of 28 June 1995 on the application of Article 85(3) to certain categories of motor vehicle distribution and servicing agreements, O.J. 1995, L 145/25.

In its recent Communication, the Commission describes the economic theory concerning the relative harmfulness of the various types of vertical restraints. It argues that there is room for a simplified system of exemption. At the same time the Commission demonstrates the need for a more economic approach in the sense that it is necessary to analyse vertical agreements in their market context.

The objections to vertical restraints are well known. Agreements that have as their main ingredient that a manufacturer may sell only to one buyer or a limited group of buyers (exclusive distribution) or agreements where one party undertakes to purchase supplies of certain goods for resale only from one manufacturer (exclusive purchasing) can have negative effects on the market. Such effects include foreclosure of other buyers or manufacturers, reduction of price competition if distributors are kept out of the territory assigned to each of them (absence of intra-brand competition), and collusion amongst manufacturers and distributors facilitated by vertical restraints. In addition, restraints in the course of distribution are apt to create or entrench obstacles to market integration, because such systems tend effectively to preclude the free flow of parallel imports and limit the freedom of consumers to purchase a good or service in any Member State they choose. Resale price maintenance and territorial sales restrictions are considered to be particularly deleterious practices since they help suppliers and distributors to partition markets. In a Community context, clauses to that effect are anathema.

However, vertical restraints often are not without redeeming features. Such restraints may be a proper method in the hands of manufacturers seeking to increase sales and to minimize distribution costs. If a manufacturer wishes a distributor to perform the distribution function as efficiently as possible and to work the area where he enjoys exclusivity thoroughly, some restraints may be indispensable in order to address the problem of "free riding". This phenomenon is likely to manifest itself, for instance, whenever a distributor makes an effort to promote a new or technically complex product in a certain area and is then faced with competition from persons who capitalize on the demand which the distributor has induced. Such competitors (discounters) are in a position to charge lower prices for the goods in question because they have not contributed towards the cost of pre-sales services, such as advertising or the provision of technical consumer information. The argument is then that without vertical restraints the level of investments will be sub-optimal. Without some sort of exclusivity a retailer may not be able to appropriate all the benefits generated by his activities. This may lead to reluctance to invest in the promotion of a new brand and naturally to loss of economic welfare.

Free riding can also take place between manufacturers of competing brands (inter-brand competition). If a manufacturer invests in promotion in the shops for its brands it is likely that he might wish to avoid attracting customers for competing brands and that he wishes to secure the distributor's undivided loyalties. The answer to this type of free riding could be a requirement imposed on the distributor to sell only the manufacturer's product and not the product of a competitor (non-compete clauses).

There appears to be a general consensus that, weighing the pros against the cons, the vast majority of vertical restraints are on balance efficiency enhancing, or at least do not have significant net negative effects. Consequently, the Commission correctly concludes that there is no need to continue the practice of subjecting all distribution contracts to scrutiny by reference to the criteria of Article 85. Such agreements will either fall outside Article 85(1), or when falling within Article 85(1) may be block exempted. The Commission accordingly intends to introduce a considerably wider block exemption than that which is available under the existing system. However, this conclusion is subject to two important provisos. The first is that hardcore restrictions such as resale price maintenance and territorial protection clauses that run counter to the market integration objective will have to be blacklisted.[6] The second is that no *a priori* assessments as to the innocuous nature of vertical restraints can be made in situations where markets are not competitive. In cases where manufacturers are locked into sound competition with their rivals, inter-brand competition can ensure that the distributor performs competitively and does not exploit the consumer. But markets are seldom (if ever) perfectly competitive. When the market is concentrated and manufacturers or distributors have market power, it is a fair assumption that vertical restraints will not only reduce intra-brand competition but also inter-brand rivalry. Therefore, the Commission argues, when market power exists no general presumption of legality can be made. Under these circumstances it makes sense to use market share thresholds to limit the application of the block exemption regulation. So, the future BE regulation will be characterized by two parameters: the nature of the vertical restraint and the level of market power involved.

The Commission's suggestions are to introduce either a one threshold market cap where the threshold would lie in the range of 25%–35% or, alternatively, a system where the first and main threshold market share would be around 20% and the second cap in the neighbourhood of 40%. Up to the (first) threshold there would be a "safe harbour" for all vertical agreements which do not include hardcore restraints. However, that does not mean that vertical agreements falling outside this safe harbour are presumed to be illegal;

6. Cf. the revised Commission Notice of 15 Oct. 1997 on agreements of minor importance, O.J. 1997, C 372, where the Commission explicitly states that the benefit of non-application of Article 85 is to be withheld from vertical agreements designed to fix resale prices or containing territorial protection clauses. Absent such clauses, vertical agreements not exceeding a market-share threshold of 10% will be deemed not to have an effect on competition or on intra-Community trade sufficiently significant to bring them within the scope of Art. 85.

merely, they need to be appraised individually. The Commission will continue to bear the burden of proof that the agreement in question violates Article 85(1) and it must verify whether the conditions of Article 85(3) are satisfied. Evidently, the higher the market share of the participating companies and the more restrictive the vertical restraints brought about by the distribution agreement between the parties, the more likely it is that the Commission will condemn the agreement. Thus above the (first) threshold three situations can arise: negative clearance, individual exemption or a prohibition .The same applies in case of market shares above the second threshold (in a two threshold system). In such a case the Commission must consider the effects of even the least serious restrictions of competition, e.g. non-exclusive types of agreements.

In addition to the one broad umbrella Block Exemption Regulation applying to both goods and services with (a) market share threshold(s) and a black list approach, the Commission envisages elaborating guidelines detailing its policy above the thresholds and the possible withdrawal of exemption. It also seeks to limit the extent to which notification is required prior to exemption, through an adaptation to Article 4(2) of Regulation No. 17. The changes to be made to Article 4 must ensure that when a vertical agreement is caught by Article 85(1) and satisfies the tests of Article 85(3) the Commission is at liberty to exempt it with effect from the date on which it was entered into. Under the present system, notifiable agreements that are found to fall foul of Article 85(1) can only be exempted pursuant to Article 85(3) with effect from the date of notification of the agreement.[7] This change may be viewed as a friendly gesture toward companies that make mistakes in assessing their market share. If companies are no longer concerned to proceed to notification of their agreements merely "to be on the safe side", great savings can be made in terms of money and energy wasted in unnecessary notifications. A further advantage is that the change may put an end to a lot of useless and abusive litigation. Indeed, a policy amendment that makes it less attractive for contracting parties to use Article 85 in a spurious fashion is to be welcomed. Every practitioner can cite situations where parties have sought to justify an unjustifiable breach of contract by alleging that the contract in question is void under Article 85(2) for the sole reason that it has not been notified and regardless of the question whether the conditions of Article 85(3) were fulfilled. The present system all too frequently allows these sinners to be rewarded.

Finally, it is also proposed to modify the existing legislation in such a way as to enable national competition authorities and national courts to play a

7. With the exception of agreements in the maritime sector falling under Regulation No. 4056/86.

more active role in the application of Article 85(1) with regard to vertical agreements above the market share thresholds. In this context, the Commission mentions that it regards as desirable that national authorities are granted power to withdraw the benefit of an exemption under the regulation in their territory if the conditions of Article 85(3) are no longer fulfilled. While it is certainly important news that the Commission is prepared to explore new avenues for decentralizing the enforcement of Community competition rules, it is unfortunate that its policy paper fails to discuss the several obvious problems which surround any attempt at sharing with national competition authorities the power to apply Article 85(3). Naturally, the question whether the time has come to delegate the power to apply or disapply Article 85(3) demands discussion on a more general basis and not just in relation to BEs. It needs little imagination to appreciate that the proposal involves serious problems. One of the obvious difficulties is that the uniform application of the competition rules could be put in jeopardy if Member States' cartel authorities were given power to apply Article 85(3) to cases brought before them. Disparities in the interpretation of the criteria for exemption under Article 85(3) would certainly be the result and new opportunities for forum-shopping in search of the most accommodating national authorities could ensue. Further, there is the issue of allocation and sharing of jurisdiction. If a case does not have an exclusively national focus – and if it has it will probably not be caught by Article 85 –, the question arises as to whether exemption decisions adopted by the national authorities of one Member State will be recognized and enforced in an other Member State which disputes the former's jurisdiction or disapproves of its interpretation of Article 85(3).

These Editorial Comments are not the proper place for presenting a more detailed discussion of the Commission's proposals. Rather, their function is to direct the reader's attention to developments which, as seen from the perspective of this Review's field of interest, may be termed important or, at least, promising. In seeking to solve the three major shortcomings of current policy (form-based straitjacket regulation, neglect of market power and block exemptions which are too narrow), the steps now taken by the Commission without doubt deserve the label "important". The qualification "promising" appears to fit the approach taken by the Commission where it seeks to find a reasonable balance between legal regulation and an economic assessment of the effects of vertical restraints. Adopting market share as a criterion for use in a block exemption regulation may not completely eliminate legal uncertainty.[8] However, it should be recalled that for the vast majority of companies, a market share approaching 20% is only something they

8. Of course, there may be difficulties for companies in defining market share, and national authorities may lack expertise. However, the Commission has issued several notices offering guidance on various points: cf. Notice on the definition of relevant market for purposes of

dream of. These companies' vertical arrangements are iron-clad as long as they stay away from blacklisted clauses. Those companies with market shares exceeding 20% could more easily be tempted to leave the straight and narrow, engaging in agreements which risk prohibition. Although there may be some legal uncertainty associated with an assessment of their vertical agreements effects in a market context, their feelings of unease should be mitigated. After all, the Commission will not fail to issue guidelines detailing its policy views;[9] and presumably the companies concerned, enjoying such a market position, will generally have the resources to enlist the services of specialized competition law experts, who should be able to help them avoid the pitfalls of Article 85.

Community competition law (O.J. 1997, C 372/5); Notice on Cooperation between national courts and the Commission in applying Articles 85 and 86 EEC (O.J. 1993, C 39/6); Notice on Cooperation between national competition authorities and the Commission in handling cases falling within the scope of Articles 85 and 86 of the EC Treaty (O.J. 1997, C 313/3). These points were also dealt with generally in "Editorial Comments – Subsidiarity in EC competition law enforcement", 32 CML Rev., 1–5.

9. These should also address the question of parallel distribution agreements, which can have far-reaching anti-competitive effects in terms of foreclosure of the market.