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EU ISSUES VERTICAL RESTRAINT GUIDELINES

DATLINE BRUSSELS - We were in Brussels the day the European Commission issued the new Guidelines on Vertical Restraints, and we talked there with the Administrator of the new European Union Vertical Restraints Block Exemption ("VRBE"). The VRBE was adopted by the Commission last December. The companion Guidelines, effective June 1, provide clarification on a host of issues.

The new VRBE is designed to replace the Franchise Block Exemption ("FBE"), which has been in place for 12 years. Franchise agreements that were in existence prior to June 1 to continue to benefit from the FBE until December 31, 2001. Thus, between now and December 31, 2001, franchisors who qualify for the VRBE face two challenges: (1) determine whether they need to negotiate changes to their pre-existing franchise agreements over the next 18 months in order to avoid having them fall outside the VRBE come 1/1/02; and (2) promptly modify their forms of franchise agreements so that all franchise agreements entered into after June 1 will qualify for the VRBE.

It is desirable to qualify for the VRBE in order to take advantage of the "safe harbor" it provides under EU's competition law, specifically, Article 81(a) of the Treaty of Rome. In essence, Article 81(a), as interpreted by a German court in the famed *Pronuptia* case, makes unlawful the inclusion in Franchise Agreements of certain clauses (e.g., many territorial restrictions) which distort competition or divide markets. The old FBE made clear which clauses would violate 81(1) ("Black Clauses"), which clauses were lawful ("White Clauses"), and which clauses were permitted under certain conditions ("Grey Clauses"). The VRBE eliminates this certainty and lumps franchising together with other "vertical" agreements on the theory that franchising in Europe has matured and no longer needs special guidance and treatment.

While the FBE took a legalistic approach, allowing contract clauses to be measured against certain rules, the VRBE takes an economic approach first. The market share of the franchisor will determine whether the VRBE applies — in general, if the market share is below 30%, the VRBE will be available. While significant questions remain as to the proper definition of a "market" (e.g., is it the market for the goods or services sold by franchisees, the market for franchises, or the market for master franchises?) and how it is to be measured (e.g., is it the percentage of the market for hamburgers, fast food, or restaurant services?), it is likely that most franchisors will have

less than 30% and therefore will qualify for the VRBE. This view is consistent with the Commission's goal of automatically exempting arrangements that are unlikely to generate significant anticompetitive effects.

In addition to the market share threshold, application of the VRBE is conditioned upon the absence of any "hardcore" restrictions. While franchisors do not typically include many of these "hardcore" prohibitions, there are some which — depending on how they are construed — could be found in franchise agreements. For example, indirect means to achieve resale price maintenance will fall outside the VRBE, as will certain restrictions on the territory within which, or the customers to whom, the franchisee may sell. The territory and customer restrictions always are prohibited if they restrict "passive" sales (responding to unsolicited requests, such as requests generated by web sites). In addition, to the extent a franchise agreement is considered to be a "selective distribution" system, (i.e., where the franchisor prohibits resale by franchisees to unauthorized distributors) most restrictions of "active" sales (i.e., solicited sales) to final purchasers will lose the benefit of the VRBE.

Even franchisors who avoid hardcore restrictions may find some of their clauses subject to antitrust scrutiny and beyond the protection of the VRBE. For example, requirements to purchase from a single source for more than five years or indefinitely do not enjoy the VRBE safe harbor unless "necessary to maintain the common identity and reputation of the franchised network." Post-term non-compete clauses longer in duration than one year, or applicable to locations other than the franchisee's location, also may be outside the VRBE. In addition, while most franchisors will be permitted to require their franchisees to carry their branded products exclusively, those whose networks constitute selective distribution systems may not prohibit their franchisees from carrying a particular competing brand.

In general, the new Guidelines provide much added insight for determining whether a (master) franchise agreement for Europe will be lawful or suspect and, if suspect, what needs to be changed to bring it within the scope of the VRBE. The VRBE contains both advantages and disadvantages compared to the old FBE. Franchisors now need to analyze whether their new European agreements need to be modified and existing European agreements need to be renegotiated. Especially with the VRBE's many details, and exceptions on exceptions, this is a necessary — but not easy — analysis.

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