An overview of competition issues impacting vertical commercial agreements

Produced in partnership with K&L Gates LLP

EU and UK competition law prohibit certain contractual restrictions where a supplier of goods or services seeks to impose restrictions on the buyer further down the production or distribution chain, such as a distributor, an agent or a franchisee. Particular ‘red flag’ areas include provisions designed to preserve exclusivity (e.g. by restricting sales by the buyer to particular customers or into particular EU territories) or provisions designed to restrict the buyer’s ability to determine its resale prices.

Where properly drafted and implemented with the guiding competition law principles in mind, the vast majority of these vertical commercial agreements should escape competition law scrutiny. However, it is always important to look out for problematic provisions, and in particular the ‘red flag’ areas highlighted below, which could expose the parties to serious risk and liability. This can include, fines and the possibility of the agreement (or offensive provisions) being found to be unenforceable.

Application of Article 101 TFEU to commercial agreements

Article 101(1) TFEU prohibits agreements (whether written or oral, and formal or informal) between undertakings that have as their object or effect the restriction, prevention or distortion of competition within the EU and which have an effect on trade between EU Member States.

References:
Art 101 TFEU

This provision is mirrored in the national competition laws of EU Member States (for example, the Chapter I prohibition in the UK).

References:
Competition Act 1998, s 2

Exceptions to the main rule

The European Commission has issued, in the form of regulations, ‘block exemptions’ which provide automatic exemption (i.e. a presumption of legality) for certain categories of agreement that fall precisely within their terms. The vast majority of commercial agreements between parties operating at different levels of the supply chain (vertical agreements), such as distribution, agency and franchise agreements, benefit from the Vertical Agreements Block Exemption.

The Block Exemption provides a broad exemption for all but a limited number of so-called ‘hardcore’ restrictions (the presence of which render an entire agreement void and unenforceable) and excluded conditions (which render the condition and any non-severable provisions void and unenforceable).

However, be aware that even if a hardcore restrictions or excluded condition is not present:

• the Block Exemption only applies if the supplier and buyer’s market shares are below 30% - if either company’s relevant market share is above 30%, it is necessary to assess any restrictions in light of Article 101(1) TFEU (it may also be necessary to consider Article 102 TFEU, which prohibits the abuse of market dominance)

• the Block Exemption does not apply to certain categories of commercial agreement, including intellectual property licences and certain aspects of motor vehicle distribution agreements, which benefit from their own block exemptions (see Applying block exemptions to IP agreements and Motor vehicles)

• the Block Exemption does not apply to reciprocal agreements between competitors - check that the parties do not compete at any level of the supply chain, and if they do that their agreement falls within a defined exception.
Assessing vertical agreements

The process for analysing the compatibility of a restriction with competition law has various stages:

- identify the type of restriction involved
- consider whether the arrangement meets the criteria in the Block Exemption
- if the agreement does not meet the criteria in the Block Exemption, carry out a case-by-case assessment as to whether the arrangement may restrict competition, and
- assess whether the agreement generates positive effects ("efficiencies") which outweigh the negative effects so that an agreement is individually exempted.

Note—the dividing line between the third and fourth stages can often be relatively blurred such that effectively one overall assessment of the impact of the arrangement on competition is conducted.

Different ways to get products to market

Vertical integration

A producer which sells or distributes its goods or services directly on the market itself is defined as being 'vertically integrated'.

Operating from a vertically-integrated business decreases the risk of a competition law infringement, on the basis that the rules on restrictive agreements apply to agreements between independent companies and do not apply to agreements between companies that form part of the same 'undertaking'.

Where a company exercises decisive influence over another company (the ability to control the affairs of the company), both companies are a 'single economic entity', meaning that the companies are part of the same undertaking, for example:

- where a parent company wholly owns a subsidiary, and
- sister companies and their parent-meaning companies which have the same parent company.

Note—companies forming the same undertaking are not considered to be competitors, even if they are both active on the same relevant product and geographic markets.

References:
EU horizontal cooperation guidelines, para 11

Intra-group agreements usually fall outside the scope of Article 101 TFEU and should only raise competition concerns if the group is abusing a dominant market position (Article 102 TFEU).
Distinguishing between distributors and agents

The main differences between the roles and responsibilities of distributors and agents are:

<table>
<thead>
<tr>
<th>Distributors</th>
<th>Agents</th>
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<tr>
<td>buy the goods from the supplier, taking ownership of the goods</td>
<td>represent their principal, contract on behalf of their principal and have fiduciary duties to act in the best interests of their principal</td>
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<tr>
<td>take on the product risk</td>
<td>have no liability to the customer for the goods or their actions (this is borne by the principal)</td>
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<tr>
<td>are liable for their own activities</td>
<td>are normally paid a commission for their services</td>
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<tr>
<td>add a margin for profit and expenses to sell on the goods</td>
<td>deal directly with both the principal and the end-customer or third party, representing the principal</td>
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<tr>
<td>have a contractual relationship with the end-customer or third party for onward sale of the goods</td>
<td>have a right to compensation on termination under the Commercial Agents (Council Directive) Regulations 1993</td>
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Buyer’s resale rights and obligations

An agreement will typically set out the nature of the rights granted by the supplier to the buyer, in particular any exclusive rights (eg the right to be an exclusive distributor in a particular territory or to a particular group of customers).

Conversely, the agreement may impose restrictions in respect of ‘no-go’ territories or customer groups. The parties must therefore ensure that the terms of appointment, and particularly any restrictions on the territories into which, or on the customers to whom, the buyer (or its customers) may sell, comply with the Vertical Agreements Block Exemption.

What resale restrictions are not allowed?

Restricting the territories into which, or the customers to whom, the buyer may sell is considered a hardcore restriction and is thus not permitted, even if the market share thresholds are not exceeded.

Firstly, this rule covers direct restrictions on resale outside a particular territory or customer group, (subject to the limited exceptions described below). In particular, a ban on ‘passive sales’ outside the territory or customer group is not allowed. In other words, the supplier cannot prevent or discourage the buyer from selling the product or service in response to an unsolicited order from outside the reserved sales territory. As a general rule, internet sales (ie from a website) are treated as passive sales and can therefore not be restricted (see The vertical agreements block exemption - Active and passive sales).

In addition, the general rule covers indirect restrictions or measures, such as:

- measures designed to induce a distributor not to resell to customers outside its reserved territory or customer group, for example, reduced discounts, bonuses, reimbursements or supplies from the supplier, or less favourable treatment as compared with the supplier’s other distributors, or

• an obligation on the buyer to refer any orders received from customers outside its reserved territory or excluded customers to other distributors.

What resale restrictions are allowed?

The Vertical Agreements Block Exemption provides that the following resale restrictions are not hardcore restrictions and are therefore permitted:

References:
Regulation 330/2010
- A restriction on ‘active sales’ by the buyer into the exclusive territory or exclusive customer group reserved to the supplier or allocated by the supplier to another buyer, provided that the restriction does not limit sales by the buyer’s customers (eg by requiring the buyer to insert a restriction on active sales into its agreements with its customers). ‘Active sales’ means actively approaching a specific customer group or customers in a specific territory via media advertisements, the internet or other promotions specifically targeted at that customer group or customers in that territory (see The vertical agreements block exemption - Active and passive sales).
- A restriction prohibiting the buyer from establishing or maintaining a branch, sales outlet or distribution depot in territories reserved to the supplier or another buyer. In addition, in order to avoid potential ‘free rider’ issues, a supplier may impose an obligation on the buyer to operate a minimum of physical sales outlets within the territory in which it is granted exclusivity, and to make a minimum number of ‘off-line’ physical sales through those outlets (subject to specific rules as to how the minimum is calculated).
- A restriction on a buyer who is a wholesaler from reselling to end users. This exception allows restrictions of both active and passive sales.
- A prohibition imposed on all distributors to sell to certain end users provided it is based on objective grounds related to the product (such as a ban on selling to certain customers for reasons of health or safety).
In the context of a supply contract covering components for the purpose of incorporation into finished products, a restriction on a buyer from reselling components to customers who will use them to manufacture the same type of goods as those produced by the supplier (ie the seller’s competitors). This exception allows restrictions of both active and passive sales. However, note that a provision in an agreement between a supplier of spare parts and a buyer who incorporates the spare parts into its own product (an original equipment manufacturer) which restricts the supplier from selling the spare parts to end users, independent repairers or service providers not entrusted by the buyer with the repair or servicing of its goods is not permitted.

Note-the Block Exemption sets out specific hardcore restrictions and exceptions relating to selective distribution systems (ie concerning the appointment of distributors who meet specific requirements) (see Selective distribution).

Non-compete provisions

In addition to the resale restrictions outlined above, it is common for an agreement to contain an obligation on the buyer to buy all or the vast majority of a particular product or service from the supplier only, and not to manufacture or deal in (eg purchase and/or sell) competing products or services without the supplier’s consent.

However, such a non-compete obligation (whether direct or indirect) is only allowed under the Vertical Agreements Block Exemption if it has a duration of less than five years (a minimum purchase obligation which requires the buyer to buy more than 80% of its total purchases of the contract products and their substitutes from the supplier or someone designated by the supplier is considered a non-compete obligation subject to this rule). A non-compete obligation of indefinite duration (including one which is tacitly renewable beyond five years) or of over five years’ duration is an excluded condition under the Vertical Agreements Block Exemption, thus it and any part of the agreement from which it cannot be severed are void.

One exception to this is where the product is resold by the buyer from premises owned or leased by the supplier. In such cases, the non-compete obligation is exempted provided that its duration does not exceed the period of the buyer’s occupancy of the premises.

Post-term non-compete obligations

The supplier may also wish to restrict the buyer from manufacturing, purchasing or distributing competing products or services after the termination of the agreement. However, under the Block Exemption, such a non-compete obligation (whether direct or indirect) is not allowed unless it:

- relates to the goods or services which compete with the contract goods or services
- is limited to the premises and land from which the buyer has operated during the contract period
- is indispensable for protecting substantial and necessary know-how transferred by the supplier to the buyer, and
- is limited in duration to a period of one year after termination of the agreement.

An agreement can, however, contain a non-compete restriction of unlimited duration on the use and disclosure of know-how that has not fallen into the public domain, provided that the know-how is substantial (ie includes information that is significant and useful to the buyer for the use, sale or resale of the contract products or services).

Note that non-compete obligations may also be subject to the UK common law doctrine on restraints of trade. The UK doctrine stipulates that to be enforceable, a restraint of trade must be reasonable in extent and duration. This national rule cannot be used to invalidate a non-compete obligation that does not infringe Article 101(1) TFEU, however it may apply where, for example, an agreement is unlikely to have an appreciable impact on trade between EU Member States.

References: Days Medical Aids Ltd v Pihsiang Machinery Manufacturing Co. Ltd [2004] EWHC 44

Supplier’s obligations

In addition to obliging the supplier to supply products or services to the buyer, the agreement may depending on the terms under which the buyer is appointed (eg as an exclusive distributor) prohibit the supplier from supplying the products or services to customers in the buyer’s exclusive territory or exclusive customer group. Such a restriction is permissible and may cover both active and passive sales.

Always ensure that if this restriction does not apply (and the supplier therefore retains a right to supply products or services to customers in the buyer’s territory or customer group), that the parties are not competitors at one or more level of the supply chain (and thus potentially precluded from exemption under the Block Exemption).

Pricing restrictions

A supplier negotiating a vertical agreement with a buyer may wish to impose restrictions on the price at which the buyer resells the goods or services.

In certain circumstances this can constitute a ‘hardcore’ restriction which is considered to have a negative impact on competition. For example, a supplier that dictates resale prices by its distributors (so called resale price maintenance (RPM)), would be imposing a hardcore restriction on that distributor.

The Vertical Agreements Block Exemption will not exempt an agreement which contains a restriction which limits the ability of a reseller to determine its resale price.

Certain clauses that affect resale pricing may not qualify as a pricing restriction, meaning that they could be permitted as they fall within the Block Exemption, such as maximum or recommended resale prices (see below). If the agreement falls outside of the Block Exemption, a case-by-case assessment is required taking into account the market conditions.

If it seems that the agreement may restrict competition, the agreement may still benefit from an individual exemption if its positive effects outweigh its negative effects (though this is highly unlikely if the agreement contains an RPM clause).

There are two broad categories of pricing restrictions:
- resale price maintenance (RPM) - where a supplier instructs its buying customers not to resell below a certain price, and
- maximum and recommended resale prices - where the supplier recommends or caps resale prices.

Resale price maintenance

Any obligation that stipulates that a buyer resells its goods or services at a fixed or minimum price (so-called RPM) is considered to be a ‘hardcore’ restriction of competition and cannot benefit from the Block Exemption.

RPM can result from direct obligations in vertical agreements relating to resale prices, but can also result from less direct measures. It is therefore very important to look out for provisions which might not seem to be RPM obligations at first sight, for example:

References:
EU vertical restraints guidelines, para 48
- fixing the level of the resale distribution margin
- fixing the maximum level of discount the distributor can apply to a certain price
- granting rebates to a distributor only if a certain resale price is set, and
- linking the resale price to the resale prices of similar products sold by competitors.

As well as analysing contractual provisions which may lead to RPM, it is important to assess the behaviour of a supplier in practice. Though no contractual provisions might be in place that would result in RPM, a supplier may be acting in a fashion that, in effect, forces a distributor to resell their goods at a certain price.

For example, a supplier could delay or suspend deliveries to a distributor that sets a higher level of discount than recommended by the supplier.

Suppliers might also use threats or warnings to induce a distributor into pricing at a certain level.

Only in very limited circumstances may RPM be acceptable and can benefit from an individual exemption where the efficiencies outweigh the negative effects.

RPM can restrict competition in a number of ways:
- it can limit price competition and make collusion between suppliers easier, as they are able to monitor changes to fixed price levels more easily
- it can limit price competition between distributors for that brand but it could also impact competition in the downstream market generally by affecting the prices charged for competing products, and
- it can result in higher prices, as there is a lack of downward pressure on prices as distributors cannot lower their prices below the level agreed with suppliers.

For more detail on RPM, see Resale price maintenance.

Maximum or recommended resale prices

Whilst RPM is a hardcore restriction, a supplier may be able to impose maximum or recommended resale prices (RRP) on a buyer.

References:
Commission Regulation (EU) 330/2010, art 4

However, the effect of the maximum price or RRP and what’s actually happening in practice needs to be carefully considered. What is described in a distribution agreement as RRP or a maximum prices in practice may be operating as a fixed price.

Also, it may be that in practice even genuine RRP or maximum prices are having a restrictive effect.

The supplier must ensure that an RRP/maximum price is genuine - this means that:

References:
EU vertical restraints guidelines, paras 227-228
- it does not pressure a buyer to stick to a maximum or recommended price, as this would essentially result in RPM (eg a supplier could penalise a distributor by restricting volume of the product if they did not adhere to an RRP), and
- it does not offer incentives to a buyer to stick to a maximum or recommended price, as this could result in RPM (eg a discount or rebate which only comes into play if RRP is followed).

The potential competitive harm regarding maximum or recommended resale prices is:
- the risk of a supplier imposing maximum or recommended resale prices is that most or all resellers might follow these prices, as they would compare their prices with those of other resellers in the market. This may act to reduce competition in the market between products of the same brand or to facilitate collusion between suppliers, and
- the stronger the market position of the supplier, the higher the risk that a maximum or recommended resale price will lead to a uniform price level in the market. Resellers may find it difficult to deviate from what they think is the preferred resale price proposed by an important supplier on the market

Assessing pricing restrictions

RPM obligations are ‘hardcore’ restrictions and cannot benefit from the Block Exemption, whether or not the restriction can be severed from the rest of the agreement and without regard to the market share of the supplier. An agreement containing RPM will therefore need to be assessed individually.
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Fixed resale prices might be necessary for co-ordinating short-term limiting the proportion of sales that can be exported by a buyer and a pricing system under which buyers are charged a higher price for goods sold outside a certain territory than for those resold within a certain territory.

An agreement with RPM (or recommended or maximum prices that operate as fixed prices) are hardcore restrictions and unlikely to be acceptable on a case by case assessment.

However, when the agreement (which imposes pricing restrictions) does not fall within the Block Exemption, and a case by case assessment indicates that the restrictions are anti-competitive, the agreement may still be capable of an individual exemption.

An agreement with RPM will need to be assessed to determine whether the agreement generates positive effects or ‘efficiencies’ which outweigh the negative effects, so that an individual exemption might apply to the agreement.

References:
EU vertical restraints guidelines, para 225

RPM can in certain limited circumstances lead to efficiencies, for example:
• where a manufacturer introduces a new product to the market, RPM may be helpful during the initial period following the introduction. RPM may, for example, provide distributors with the funds (through higher margins) to increase sales and marketing efforts for the products
• fixed resale prices might be necessary for co-ordinating short-term, low-price campaigns (usually two to six weeks in duration) which are implemented by distributors in a distribution network. These price promotions can benefit consumers, and
• RPM may avoid the ‘free-rider’ problem (ie where one distributor takes advantage of the promotion efforts which have been made by another distributor). The higher margins provided by RPM may allow retailers to provide additional pre-sales services, in particular in relation to complex products. These services enhance demand for the supplier’s product and this may benefit consumers.

Export bans

Suppliers may wish to restrict buyers from exporting products. A supplier might, for example, wish to supply different variants of a product to particular countries within the EU, or to supply its products at different prices to particular countries. It may therefore seek to prevent imports or exports of products between Member States so that these differences between Member States can be maintained.

An export ban can be directly included in an agreement or may result from indirect measures that are intended to restrict exports or imports between EU Member States, for example:
• limiting the proportion of sales that can be exported by a buyer
• punishing buyers which export goods by supplying smaller volumes to those buyers or boycotting those buyers, and
• a pricing system under which buyers are charged a higher price for goods sold outside a certain territory than for those resold within a certain territory.

Such agreements protect distributors from competition from imports of products obtained by third parties outside the territory allocated to them (so-called ‘parallel imports’). With these export bans, these distributors will therefore benefit from absolute territorial protection from competition outside that territory. This distorts competition between Member States in the EU, for example by maintaining price differences between countries for similar products.

Export bans are presumed to restrict competition by object (ie there is no need to show that these agreements have a negative effect on competition).

The Vertical Agreements Block Exemption will not exempt an agreement which contains an absolute export ban. Certain restrictions on the territories into which distributors may sell may be exempted under the Block Exemption.

If the agreement falls outside of the Block Exemption, a case-by-case assessment is required taking into account the market conditions. If it seems that the agreement may restrict competition, it may still benefit from an individual exemption if its positive effects outweigh its negative effects.

Assessing export bans

The restriction of the territory into which a buyer (or its customers) may resell goods or services is considered a ‘hardcore’ restriction under the Block Exemption.

References:

Any agreement which contains such a restriction will therefore be unable to benefit from the Block Exemption. This is the case unless the restriction relates to a restriction on ‘active’ sales into an exclusive territory that has been exclusively allocated to a distributor, or which the supplier has reserved for itself.

Essentially, this means that only export bans that restrict ‘active’ sales into an exclusive territory can be exempted under the Block Exemption. However, a prohibition on making passive sales into another’s territory is not permissible. ‘Passive’ selling is where a distributor responds to unsolicited requests from individual customers about the product, whilst ‘active’ selling is where a distributor carries out targeted marketing of customers outside its territory (for more detail on active and passive sales, see The vertical agreements block exemption - Active and passive sales).

This means that a supplier can prevent its distributors from directly approaching customers within other distributor’s exclusive territory, thereby protecting its exclusive distributors to some extent.
When the agreement (which imposes an export ban) does not fall within the Block Exemption, and a case-by-case assessment indicates that the restrictions are anti-competitive, the agreement may be capable of an individual exemption.

There may be some cases where an export ban is objectively justified, for example on the grounds of health and safety. A ban on passive sales might also be permissible where a distributor has made substantial investments to enter a new market (but only for a limited period). In these cases, the positive effects of the agreement may not need to be considered, as the agreement will be permissible under competition law.

There may be certain circumstances in which an agreement containing an export ban may have positive effects that outweigh its negative effects, and hence be suitable for individual exemption.

For example, in the case of a selective distribution system, cross supplies between appointed distributors must normally remain free. However, if wholesalers located in different territories are obliged to invest in promotional activities in ‘their’ territories to support sales by appointed retailers, restrictions on active sales by the wholesalers to appointed retailers in other wholesalers’ territories may qualify for individual exemption (as it overcomes ‘free-riding’).

Tying

In some vertical agreements, a buyer may be required to purchase a second distinct (tied) product from a supplier as a condition of purchasing a first (tying) product. This practice is known as tying. An example would be the sale printer cartridges being tied to the sale of printers.

References:
EU vertical restraints guidelines, paras 214, 215

Tying can result in a single branding type of obligation for the tied product, as it may result in a buyer dealing only or almost only with one supplier, rather than buying the tying and tied products from two separate suppliers.

Tying may also constitute an abuse of a dominant position where a supplier has market power (see Tying and bundling).

The type of products involved and how they are tied will be crucial in assessing the impact of the tying on the market.

The first issue to consider is whether the tied products are distinct. If customers would purchase the products together then tying these products together is not acting to alter purchasing behaviour and is unlikely to be problematic.

If customers would buy the products separately (if they were able) then the potential impact on suppliers of the stand-alone products will have to be considered.

Tying can be achieved through physical integration, for example when there is only one type of software package that will work with a given operating system (known as technical tying).

Alternatively, tying can be made a requirement of the initial sale, for example, maintenance for a product must be carried out by the manufacturer (known as contractual tying).

Tying may have several effects on competition that are similar to those discussed in relation to single branding (see Single branding below). For example, tying may lead to less competition for customers buying the second (tied) product (eg printer cartridges). If there are not enough customers interested in buying the second (tied) product alone, this can lead to competing suppliers of the tied product exiting the market, resulting in higher prices and/or poorer service for customers.

References:
EU vertical restraints guidelines, paras 216-217

Assessing tying agreements

Tying is exempted under the Block Exemption when the market share of the supplier, on both the market of the tied product and the market of the tying product, and the market share of the buyer do not exceed 30%.

If an agreement does not fall within the Block Exemption, an individual assessment will be required, including assessing the impact on both the tied and tying markets. The following factors will be relevant:

- the market position of the supplier on the market of the tying product (eg printers)-the importance of the supplier on the market is the main reason why a buyer may find it difficult to refuse a tying obligation

Where anti-competitive effects are likely to arise from a tying obligation, the parties to the agreement may be able to show that efficiencies are relevant and outweigh these effects so that an individual exemption applies.

References:
EU vertical restraints guidelines, para 219

- competitors’ market positions-if competitors are numerous and strong, anti-competitive effects are less likely. Buyers have alternative suppliers from whom to purchase the tying product without the tied product (eg printer cartridges), and
- the power of buyers-powerful buyers will not easily be forced to accept tying without gaining some benefit.

Single branding

Single branding is a particular type of exclusive deal, where the buyer agrees to deal only or almost only with the supplier in relation to a particular type of product so that the supplier’s...
An overview of competition issues impacting vertical commercial agreements in relation to final products, the agreement relates to the single branding obligations of one to five years entered into by absence of barriers to entry for buyers/potential buyers. Single branding obligations exceeding five years are generally strong buyer power to counteract the market power of non-compete: whereby the buyer is obliged to purchase more locking competing suppliers out of the market if the obligation relates to intermediate rather than final where the buyer is consumer-facing, there is a reduction quantity-forcing: incentives or obligations are agreed which softening of competition between suppliers as they are not single branding obligations shorter than one year entered into commercial agreements.

The potential harm to competition includes:
- locking competing suppliers out of the market.

References:
EU vertical restraints guidelines, para 129
A single branding obligation can take two principal forms:
- non-compete: whereby the buyer is obliged to purchase more than 80% of its requirements from the supplier-this is the clearest form of single branding, and
- quantity-forcing: incentives or obligations are agreed which encourage the buyer to concentrate its purchases with the supplier such as minimum purchasing requirements (eg an agreement to purchase 10,000 items per annum), stocking requirements (eg agreeing to keep a number of items displayed which in effect precludes the display of other items), and two-part pricing structures (eg a fixed fee plus price per unit so that the overall cost per unit becomes cheaper if more items are purchased).

Note-an ‘English clause’ can also have the same effect as single branding. This requires the buyer to report any better offers from competing suppliers and means that the buyer can only accept the improved offer if the supplier refuses to match it.

The potential harm to competition includes:
- locking competing suppliers out of the market.

References:
EU vertical restraints guidelines, para 130
- softening of competition between suppliers as they are not competing on an ongoing basis for the buyer’s business, ie once the exclusive arrangement is in place there is no competition in relation to that buyer for the period of the arrangement-this becomes more problematic the greater percentage of the market that is affected by exclusive arrangements, and
- where the buyer is consumer-facing, there is a reduction of in-store inter-brand competition (competition between different brands would be reduced as the buyer/retailer would only be dealing in and stocking the supplier’s products). This is particularly problematic where the buyer has a significant market presence so that it is a key trading partner for suppliers.

Assessing single branding agreements
If a a single branding agreement falls outside the Block Exemption, a case-by-case assessment is required, which will turn primarily on the market position of the supplier. For example, if the supplier has a strong position in the market and is selling a ‘must-have’ item, competitors will find it very difficult to maintain a foothold in the market where the supplier is imposing single branding obligations. On the other hand, concerns are much less likely to arise where competitors also have strong market positions and can offer similarly attractive products.

References:
EU vertical restraints guidelines, paras 60-64 and 132-141
Note-an arrangement that does not fall within the Block Exemption because it contains a hardcore restriction, rather than, for example, because a market share threshold is exceeded, is unlikely to be deemed acceptable on a case-by-case assessment or to benefit from an individual exemption (although it’s possible for exceptions to be made). As a general rule, it is recommended that such hardcore restrictions be removed.

Duration of the agreement
The duration of the agreement is also important outside of the context of the Block Exemption. By way of guidance:
- single branding obligations shorter than one year entered into by non-dominant companies are in general not considered to give rise to an overall anti-competitive effect
- single branding obligations of one to five years entered into by non-dominant companies usually require a further balancing of positive and negative effects, ie the duration is regarded as a neutral factor, and
- single branding obligations exceeding five years are generally considered unlikely to comply with Article 101 TFEU.

Other market factors
Other exclusive agreements which are in place in the market are also important. If a number of the supplier’s competitors have also entered into single branding obligations, the cumulative effect of such arrangements may create competition concerns. However, if the buyer has a market share of less than 5%, this is not generally considered to contribute to such a cumulative effect and the agreement will not be problematic.

Factors indicating that a single branding obligation may be less of a concern include:
- an absence of barriers to entry for buyers/potential buyers which means that new buyers could enter the market
- strong buyer power to counteract the market power of suppliers
- if the obligation relates to intermediate rather than final products (the buyers of intermediate products are usually well-informed customers, able to assess quality and therefore less reliant on brand and image, whereas final goods are, directly or indirectly, sold to final consumers who often rely more on brand and image), and
- in relation to final products, the agreement relates to the wholesale level rather than the retail level (ie one level removed from the consumer).

Positive effects
Other circumstances where there may be a positive effect outweighing any negative effect include:
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Exclusive supply arrangements

Exclusive supply is where the supplier is obliged or induced to sell only or mainly to one buyer, either in general, or for a particular use (known as ‘industrial supply’).

References:
EU vertical restraints guidelines, para 192

This can mean that competing buyers are denied access to the supplier, limiting the degree of competition between buyers. However, there may also be positive effects such as where there are client-specific investments to be made by the buyer, for example in special equipment or training.

Exclusive supply arrangements may involve:

- an outright obligation to supply exclusively, or
- ‘quantity forcing’-incentives which induce the supplier to concentrate its sales on one buyer, eg higher pricing if the supplier supplies most of its products to the buyer or a minimum supply requirement.

The potential harm to competition includes:

- shutting other buyers out of the market-other buyers would be unable to buy from the supplier and may therefore have a reduced presence on the downstream market, and

References:
EU vertical restraints guidelines, para 194

- reduction of intra-brand competition (competition in relation to sales of the supplier’s products) as fewer buyers will offer the product.

Assessing exclusive supply agreements

If an exclusive supply agreement falls outside the Block Exemption, a case-by-case assessment is required.

References:
EU vertical restraints guidelines, paras 60-64 and 194-199

Note-an arrangement that does not fall within the Block Exemption because it contains a hardcore restriction, rather than, for example, because a market share threshold is exceeded, is unlikely to be deemed acceptable on a case-by-case assessment or to benefit from an individual exemption (although it’s possible for exceptions to be made). As a general rule, it is recommended that such hardcore restrictions be removed.

Examples of situations where competition concerns are likely to arise include where:

- the buyer’s market share on the upstream market (on which it purchases the contract goods/services) and on the downstream market (on which the buyer is active) exceeds 30%
- the buyer’s market share on the downstream market exceeds 30% and exclusive supply relates to a particular use of the products. or
- the buyer is dominant on the downstream market.

The duration of the agreement is also important outside of the context of the Block Exemption. By way of guidance:

- exclusive supply agreements shorter than five years entered into by non-dominant companies usually require a balancing of positive and negative effects, ie in this instance, the duration is regarded as a neutral factor
- agreements lasting longer than five years are generally considered unlikely to comply with Article 101 TFEU.

Factors indicating that an exclusive supply agreement may be less of a concern include:

- the existence of strong competing buyers on the upstream market which means that the buyer faces significant competition on that market
- the absence of barriers (conditions which make it difficult for firms to enter the market) for new suppliers entering the market
- strong bargaining power of suppliers so that the buyer’s conduct is constrained

References:
EU vertical restraints guidelines, paras 107, 144-147

- where a non-compete obligation enables the avoidance of free-riding by competing suppliers - eg where the supplier invests in promotional material at the buyer’s premises
- hold-up problems, ie where an investment is needed which is specific to the relationship - eg the installation or adaptation of equipment by the supplier when this equipment can be used afterwards only to produce components for the particular buyer. The supplier would not incur such costs without having an agreement with the buyer which allows the supplier to recover its investment - eg an agreement with a single branding commitment imposed on the buyer (for further information on hold-up problems, see Exclusive supply agreements below), and

the buyer is having trouble obtaining a loan from regular providers of capital (eg banks) due to imperfect information. The supplier may have better information due to its presence in and understanding of the markets and be able, through an exclusive relationship, to obtain extra security for its investment in addition to the security to which a traditional lender would have access. As a result, the supplier provides the loan to the buyer.

When considering the positive and negative aspects of the agreement, consideration must be given to whether any less anti-competitive alternative exists which would achieve the same positive effects. For a restrictive agreement to be exempted, there must be no less restrictive way of achieving the same efficiency gains.

In relation to single branding, quantity forcing/minimum purchasing obligations could be a less restrictive alternative to a non-compete but may still have the same positive effects.

For a worked example of an assessment of a single branding agreement, see Assessing vertical agreements outside the block exemption - case study - Single branding obligations - a worked example
the obligation being imposed is in relation to an intermediate rather than a final product (a manufacturer that uses a certain input usually has more flexibility to respond to the demand of its customers than the wholesaler or retailer has in responding to the demand of the final consumer for whom brands are more likely to play an important role), and

• the obligation being imposed is in relation to an undifferentiated product (the loss of a possible source of supply matters less for competing buyers in the case of a uniform product than in the case of a product with different grades and qualities).

Positive factors

An individual exemption will also available when the positive aspects of the agreement, which must benefit consumers, outweigh the anti-competitive aspects of the agreement (see Individual Exemptions under Article 101(3) TFEU).

Circumstances where there may be a counterbalancing positive effect include a situation where there is a 'hold-up problem'. This is where there are client-specific investments to be made by the buyer, such as in special equipment or training. The buyer would not incur such costs without having an agreement with the supplier which allows the buyer to recover its investment, eg an agreement with an exclusive supply commitment imposed on the supplier.

Encouraging investment in this way can be a positive effect. However, there are a number of conditions that have to be met to justify the restriction:

• the investment must be relationship-specific. An investment made by the buyer is considered to be relationship-specific when, after termination of the contract, it cannot be used by the buyer to purchase and/or use products supplied by other suppliers and can only be sold at a significant loss
• it must be a long-term investment that is not recouped in the short run, and
• the investment must be asymmetric, i.e. one party to the contract invests more than the other party.

When these conditions are met, there is usually a good reason to have an exclusive supply obligation for the duration it takes to depreciate the investment under accounting rules.

When considering the positive and negative aspects of the agreement, consideration must be given as to whether any less anti-competitive alternative exists which would achieve the same positive effects.

For a restrictive agreement to be exempted, there must be no less restrictive means of achieving the same efficiency gains.

In relation to exclusive supply, quantity forcing or a minimum supply obligation could be a less restrictive alternative to an outright exclusivity obligation but which may still have the same positive effects.

Exclusive distribution agreements

Exclusive distribution is a particular type of exclusive deal where a distributor is allocated a territory within which only that distributor can actively market itself as the distributor of the supplier’s goods.

References:
EU vertical restraints guidelines, para 151

This can lead to a reduction in competition in relation to the sale of the supplier’s goods in the relevant territory. However, the arrangement may also have pro-competitive benefits, for example, it may enable the distributor to justify the investment required to launch the supplier’s product in a new territory.

For more detail on exclusive distribution agreements and their assessment under Article 101 TFEU and the Block Exemption, see Exclusive distribution agreements.

Selective distribution agreements

Selective distribution arrangements involve a network of selected authorised distributors which are restricted in the way in which they may resell the products. Selective distribution is almost always used to distribute branded final products, as it allows brand owners greater control over how their products are retailed.

References:
EU vertical restraints guidelines, para 174

The selection of authorised distributors does not depend on the number of contractual territories or geographic areas (like exclusive distribution). Instead, it relates to selection criteria linked to the nature of the product, for example, the availability of technical sales assistance for IT products.

In addition, the restrictions affecting resale of the products do not relate to actively selling to a specified territory or geographic area, but instead restrict sales to non-authorised distributors, meaning that only other selected authorised distributors and final customers can buy from a selected authorised distributor.

For more detail on selective distribution agreements and their assessment under Article 101 TFEU and the Block Exemption, see Selective distribution.

Agency agreements

An agency agreement is defined as an agreement between an agent and a principal, whereby the agent is vested with the power to negotiate and/or conclude contracts on behalf of the principal.

References:
EU vertical restraints guidelines, paras 12-16

The agent must not bear any, or bear only an insignificant commercial or financial risk in relation to the contracts negotiated or concluded on behalf of the principal. An agent will usually be paid a commission on the sales he makes.
In general, the rules on restrictive agreements will not apply to contracts concluded and/or negotiated by an agent in a genuine agency agreement, except in certain situations.

For more detail on the application of competition law to agency agreements, see further Agency under EU Competition Law.

**Identifying risk**

The question of risk for the agent must be assessed on a case-by-case basis.

**References:**
EU vertical restraints guidelines, paras 14 and 16-17

It must be based on the economic reality of the situation, as opposed to the legal form. Where the agent bears some risk, it is likely to have been acting independently rather than as an agent. This means that the agreement with the supplier will be subject to the rules on restrictive agreements.

In practical terms, the assessment of the agreement and identifying the risk should involve the following steps:

**Step 1**
Can any contract-specific risks be established (ie financing of stocks)?

Examples of contract-specific risks are where the agent:

• contributes to the costs relating to the supply or purchase of the contract goods or services (including transportation costs)
• maintains (at his own cost or risk) stocks of the contract goods
• undertakes responsibility towards third parties for damage caused by the product sold (unless in relation to the agent’s own fault)
• takes responsibility for customer’s non-performance of the contract (unless in relation to the agent’s own fault), or
• has an obligation to invest in sales promotions, such as contributions to the advertising budgets of the principal.

**Step 2**
Where no contract-specific risks are established, can any risks related to market-specific investments be established (ie investments by the agent for the particular activity which the agent is appointed by the principal for)?

An example of market-specific investments includes the agent investing in equipment, premises or training of personnel (unless fully reimbursed by the principal).

**Step 3**
Where no contract-specific risks and no market-specific investments can be established, can any risks related to other required activities within the same market be established (ie other activities undertaken on the same product market, at the agent’s own risk)?

Only risks taken by the agent in the same product market are relevant. This means that:

• it is not possible to be an agent for one product and an independent distributor for another product of the supplier if these products are in the same product market, and
• risks taken by the agent in a different product market are not relevant to the agency contract.

**Restrictions in agency agreements**

In addition to governing the conditions of sale or purchase of the goods by the agent on behalf of the principal, agency agreements can also contain provisions on the relationship between the agent and principal.

**References:**
EU vertical restraints guidelines, para 19

These provisions may:

• prevent the principal appointing other agents for a specific type of transaction, customer or territory (ie an exclusivity obligation), or
• prevent the agent acting as an agent or distributor for other businesses which compete with the principal (ie a single branding obligation).

Because the agent is a separate business (ie independent) from the principal, any such provisions concerning the relationship between the agent and principal will be subject to, and have the potential to infringe, the rules on restrictive agreements.

**References:**
Art 101 TFEU

Exclusive agency provisions will not normally result in anti-competitive effects.

Single branding agency provisions and post-term, non-compete agency provisions may infringe the rules on restrictive agreements where they lead to, or contribute to, restricting competition on the relevant market where the goods are sold.

However, an agreement containing these provisions may benefit from the Block Exemption where the relevant market share thresholds and the other criteria are fulfilled, or may be capable of an individual exemption.

**Franchising**

Use of the franchise distribution model has significantly increased in the last few decades and can enable the franchisor to establish, with limited investments, a uniform network for the distribution of its products.

A franchise involves an arrangement whereby the franchise owner, Company A, allows third parties, such as Company B, to use a name, trademark, and/or a particular business method (for example, know-how) which is associated with the franchisor.

**References:**
EU vertical restraints guidelines, para 189
A franchise system will commonly be used where:

- an already existing and successful business wants to expand, or
- a new business or an existing business wishes to enter into a new business area or market without relevant experience in it.

Types of franchise agreements

Different types of franchise can be identified as follows:

- a production or industrial franchise—where Company B manufactures products in line with Company A’s specifications, and then sells them under Company A’s trademark
- a distribution franchise—where Company B sells certain products from a retail outlet under Company A’s business name
- a service franchise—where Company B offers a service under Company A’s business name and business method, and
- a wholesale franchise—where Company B distributes certain products directly to retailers, as opposed to end-users, using Company A’s business name, method or products.

Step-by-step analysis to identify a franchise agreement:

- Step 1—does Company B conduct its own business, but under Company A’s name, trademark and/or business method?
- Step 2—does Company B remain as an independent trader who bears its own financial risk?
- Step 3—is Company A able to exercise control over Company B and the way in which Company B operates his/her business, for example, in relation to how the product is sold and/or the layout of the premises? This ensures uniform presentation and sales of products or services at the same level of quality. A franchise agreement will usually contain licences of intellectual property rights (e.g., trademarks or signs and know-how) for the use and distribution of goods or services.
- Step 4—does Company B provide Company B with commercial or technical assistance during the life of the agreement, for example, training, advice on real estate or financial planning?
- Step 5—does Company B pay Company A a fee or royalty for the use of the particular name, trademark or business method of the franchise?

Note—both the IP licence and commercial or technical assistance are regarded as integral components of the business which is franchised.

Franchise agreements and competition law

Franchise agreements are subject to competition law and the rules on restrictive agreements.

In practical terms, competition law generally recognises the need for the franchisor to impose certain restrictions on the franchisee in order to protect the interests of the franchise.

However, at the same time it is similarly recognised that there are reasonable limits on those restrictions, in order to ensure that effective competition is not harmed.

Franchise agreements commonly contain a combination of different restrictions which concern the particular products being distributed, and especially:

- selective distribution obligations (i.e., restrictions on the number of authorised distributors and possibilities for resale)
- non-compete restraints (i.e., the distributor is obliged or induced to concentrate its orders for a particular type of product with one supplier), and/or
- exclusive distribution requirements (i.e., the supplier agrees to sell its products to one distributor in a particular territory)

or weaker forms of these types of vertical restraints.

Applying the Block Exemption

The following restrictions/obligations are permitted under the Block Exemption:

- preventing the franchisee from competing directly against the franchise in any similar business
- preventing the franchisee buying into any competitor
- disclosing any of the franchisor’s know-how which is not already public
- granting a licence covering know-how gained from exploiting the franchise, to the franchisee and other franchisees
- protecting and assisting the franchisee by legally protecting the franchise IP rights
- only to use the licensed franchise know-how for the purposes of the exploitation of the franchise, and
- preventing assignment of the franchise agreement without the franchisor’s consent.

See further, The vertical agreements block exemption.

Protecting IP rights

Certain obligations are generally considered to be necessary to protect the franchisor’s IP rights. These include, for example, an obligation on the franchisee not to engage directly or indirectly, in any similar business, or an obligation on the franchisee not to disclose to third parties the know-how provided by the franchisor, as long as this know-how is not in the public domain. Such provisions may otherwise normally be viewed as being restrictive of competition.

Obligations contained in franchise agreements will usually be covered by the Block Exemption where the following conditions are fulfilled:

References:
EU vertical restraints guidelines, para 31
- the IP rights
- are part of a vertical agreement (that is an agreement with conditions under which the parties may purchase, sell or resell certain goods or services) and not an agreement concerning pure licensing
• are directly related to the distribution of the goods or services by the franchisees, where marketing forms the object of the exploitation of the IP rights (ie a franchise agreement where Company A sells goods for resale to Company B and licenses Company B to use its trade name to market the goods)
• do not constitute the primary object of the agreement (the primary object must be the purchase, sale or resale of goods or services and the IP rights must simply serve to implement this)
• in relation to the contract goods or services, do not contain vertical restrictions of competition which are hard core restrictions and are not exempted under the Block Exemption, and
• the IP rights must be assigned to, or licensed for use by, the franchisee (and not the other way around, ie IP rights provided by the franchisee to the supplier). The IP rights must be provided for in an agreement to purchase or distribute goods/provide services, rather than an agreement directly concerning the assignment or licensing of IP rights for the manufacture of goods. This means that the Block Exemption applies to franchise agreements where the sale, resale, or use of goods or services can be performed more effectively because the IP rights are assigned to or licensed for use to the buyer.

The Block Exemption does not cover the following situations, among others:
• Company A provides Company B with a recipe and licenses Company B to produce a drink with the recipe
• Company A provides Company B with a mould or master copy, and licenses Company B to produce and distribute copies, or
• Company A provides Company B with a pure license of a trademark or sign for the purpose of merchandising.

References:
EU vertical restraints guidelines, para 44

Where the agreement only or primarily concerns licensing of IP rights, it is not covered by the Block Exemption. However, the Commission will, as a general rule, apply the principles of the Block Exemption and Vertical Guidelines to the agreement.

**Exempting restraints in franchise agreements**

For franchise agreements that do not automatically fall within the Block Exemption, an assessment has to be made as to whether the pro-competitive gains outweigh the negative effects of the restriction in order to justify an individual exemption.

Particular factors to consider are:
• the more a transfer of know-how is regarded as being important, the more it will be considered that a restraint on the franchisee will be more likely or necessary to create efficiencies, or be indispensable in order to protect the know-how (eg, a restriction on the type of input colour dye used in a new product for colouring sweets ‘on demand’ by the customer, sold in ‘fun shops’ of uniform image)
• where a non-compete obligation on the goods or services purchased by the franchisee is necessary to maintain the common identity and reputation of the franchise network (eg, non-compete clauses excluding any other brands of sweets from the ‘fun shops’ allowing the franchise outlets uniformity and prevents competitors benefiting from the trade name).

Practically speaking, such restrictions will usually be regarded as necessary where they clearly protect IP rights or maintain the common identity and reputation of the franchise network.

**Intellectual property obligations**

A supplier will typically seek to protect its intellectual property (IP) rights in the contract products, including trade marks, copyright, patent rights, design rights and know-how.

The Vertical Agreements Block Exemption exempts agreements which contain IP assignment or licence provisions, provided that these do not constitute the primary object of the agreement and are directly related to the use, sale or resale by the buyer or its customers.

Care should be taken when drafting IP provisions that these do not have an anti-competitive object or effect (ie indirectly result in a prohibited restriction on the buyer’s ability to trade, in one or more of the ways discussed above).

For more detail on the application of IP rights to vertical agreements, see The vertical agreements block exemption - Intellectual property rights in vertical agreements.