Wednesday, October 3, 2012
9:00 AM - 10:30 AM

308 – Establishing Cross-Border Product Distribution Arrangements: The Practical Do's and Don'ts

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Rosetta Stone Inc.

Scott Thayer
Senior Counsel
ConAgra Foods, Inc.

Faculty Biographies

Alicia Ashfield

Alicia T. Ashfield is the associate general counsel and international counsel for Church & Dwight Co., Inc., in Princeton, NJ. Church & Dwight is a leader in the household consumer products and personal care industry, with popular brands such as ARM & HAMMER, Trojan, First Response, Spinbrush, Oxi Clean and more. Her responsibilities include providing general legal counsel on a variety of issues to the international division with subsidiaries in China, France, UK, Mexico, Brazil, Canada and Australia and the company's export division with consumer products in over 100 countries. She also supports the company's licensing division for cross-brand promotion of trademarks and technology and she serves on the company's compliance council as its subject matter expert for import, export and FCPA/anti-bribery programs.

Prior to joining Church & Dwight, Ms. Ashfield was a director of North American legal affairs for Teva Pharmaceuticals in Horsham, PA, which is one of the world's leading generic pharmaceutical companies. During her tenure at Teva, she managed several complex patent litigations before transferring to the transactional and commercial side of the business.

Ms. Ashfield received a BS from Drexel University in Philadelphia majoring in finance and marketing and is a graduate of Seton Hall School of Law.

Yves Botteman

Yves Botteman is a partner in the Brussels office of Steptoe & Johnson LLP. Mr. Botteman focuses his practice on competition law and represents global and European companies in proceedings before the European Commission and national competition authorities. Mr. Botteman also advises clients on competition issues arising from distribution, IP settlement agreements, patent and know-how licensing, R&D and assists clients in implementing antitrust compliance programs.

With more than 12 years of experience in Brussels and Washington, Mr. Botteman has gained substantial exposure to industries as diverse as construction materials, chemicals, automotive, industrial gases, medical devices and hygiene products, carton packaging, and enterprise software. Prior to joining Steptoe, Mr. Botteman was a senior associate with Linklaters in Brussels.

Mr. Botteman's educational background includes Georgetown University Law Center, LLM with honors; Université libre de Bruxelles, Law Degree, magna cum laude, and Université Catholique de Louvain, BA in political sciences, and international relations, cum laude. Mr. Botteman is a Fulbright scholar.

Bruce Ghrist

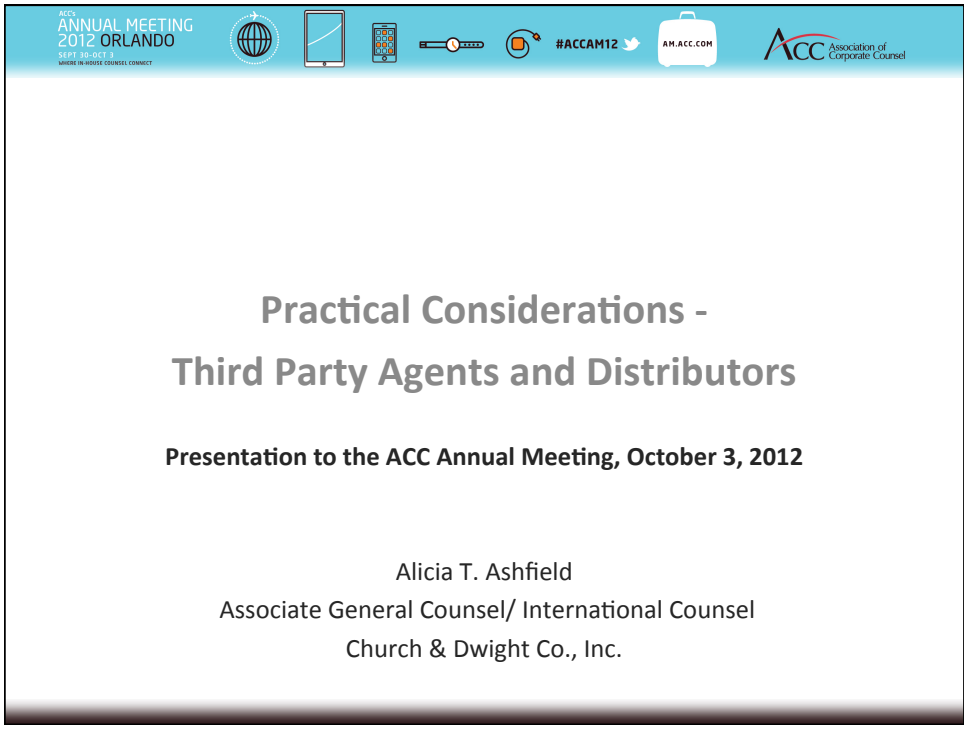
Bruce Ghrist is vice president and associate general counsel of Rosetta Stone Inc., based in Arlington, VA. Since joining Rosetta Stone, he has been engaged in providing legal support to all aspects of Rosetta Stone's commercial transactions and international growth, including retail distribution channel relationships, software licensing transactions and international business development.

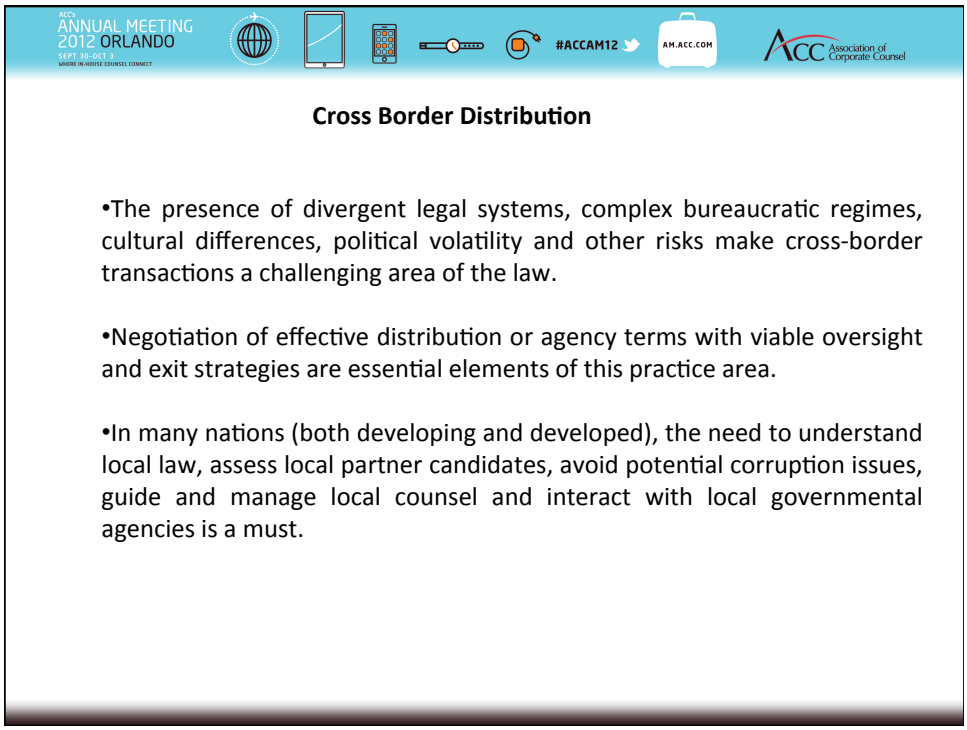
Prior to joining Rosetta Stone, Mr. Ghrist had held legal positions in several international telecommunications companies beginning with the international division of Sprint Corp in Reston, VA. He was transferred to Brussels, Belgium, to join the legal staff of Global One, an international joint venture formed by Sprint, France Telecom and Deutsche Telekom, and later transferred to London, England, to become chief counsel for Global One's operating company in the UK and Ireland. He then joined the legal staff of Teleglobe in Reston, VA, and continued with the company following its acquisition by Tata Communications of India.

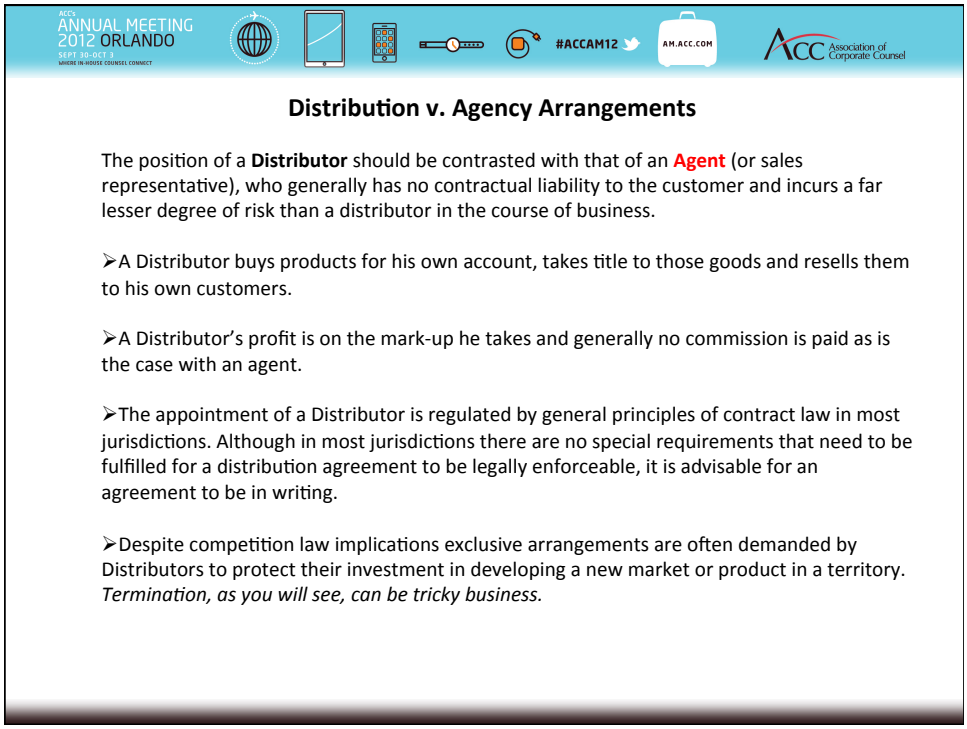
Mr. Ghrist began his legal career as an associate at Foley & Lardner in its Milwaukee, WI, and Washington, D.C. offices and subsequently joined the Overseas Private Investment Corp. in Washington, D.C. where he became assistant general counsel for Project Finance. Mr. Ghrist is a graduate of Lehigh University (BA) and Yale Law School (JD).

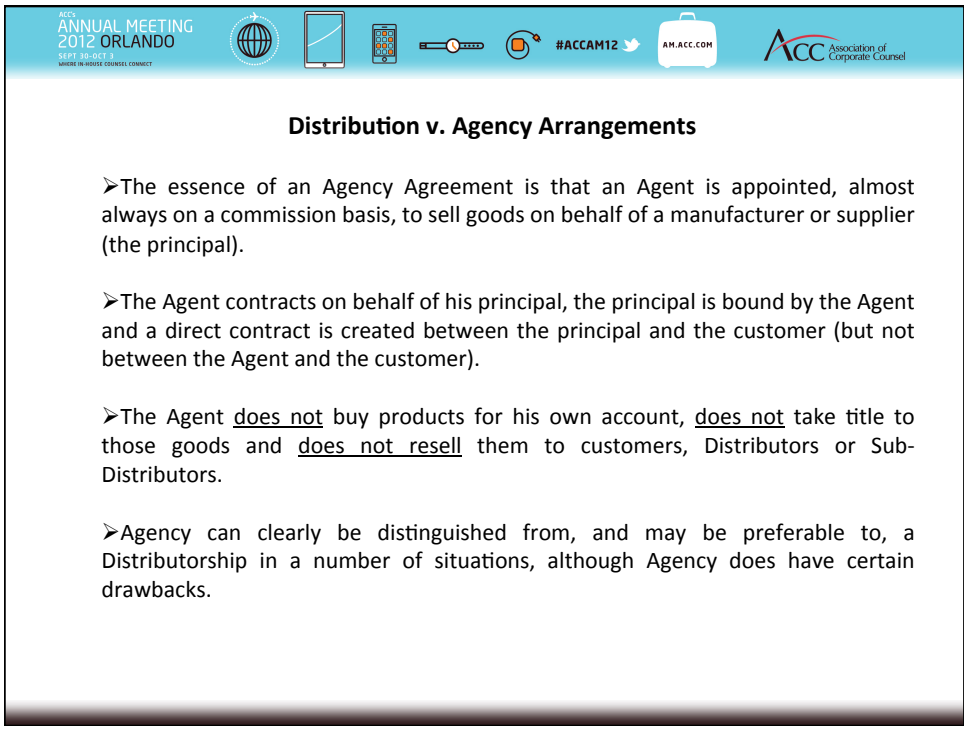
Scott Thayer

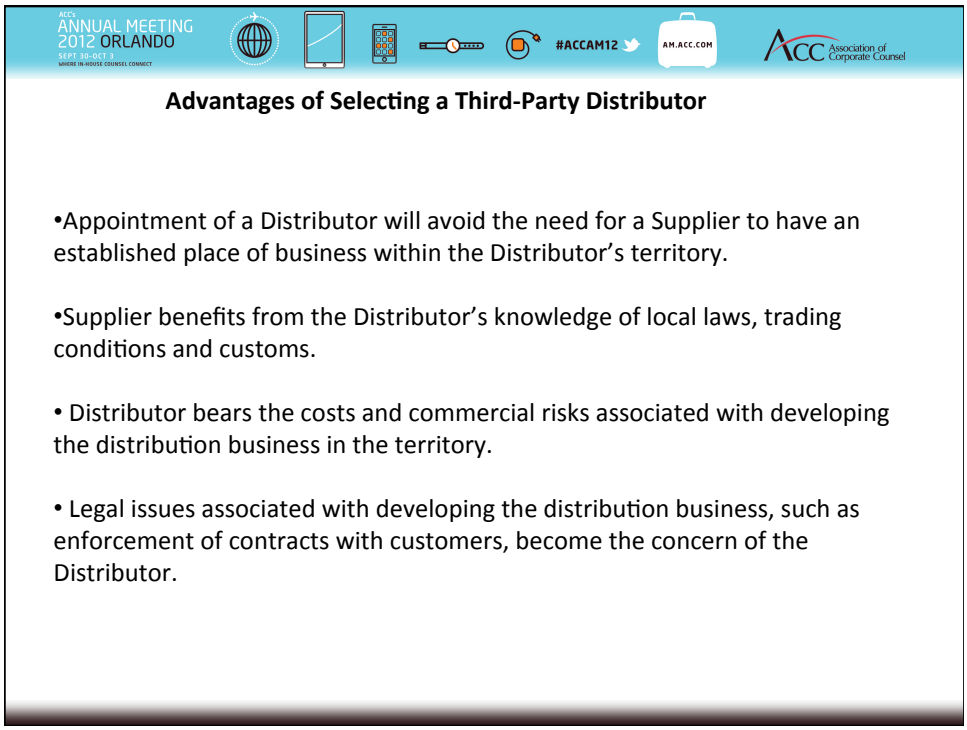
Scott Thayer is senior counsel to ConAgra Foods, Inc. in Naperville, IL. He is currently responsible for providing legal services to the snacks, store brands and international business units at ConAgra Foods. Mr. Thayer has 25 years of hands-on international and domestic commercial, supply chain, operational and manufacturing legal experience, including serving as regional counsel throughout the Americas and the Pacific, as well as general counsel-North America for the Wm. Wrigley Jr. Company. In addition to providing legal support and strategic business advice to the business units he supports at ConAgra Foods, Mr. Thayer has significant experiences in the sales, marketing, advertising and distribution of consumer products both internationally and domestically.

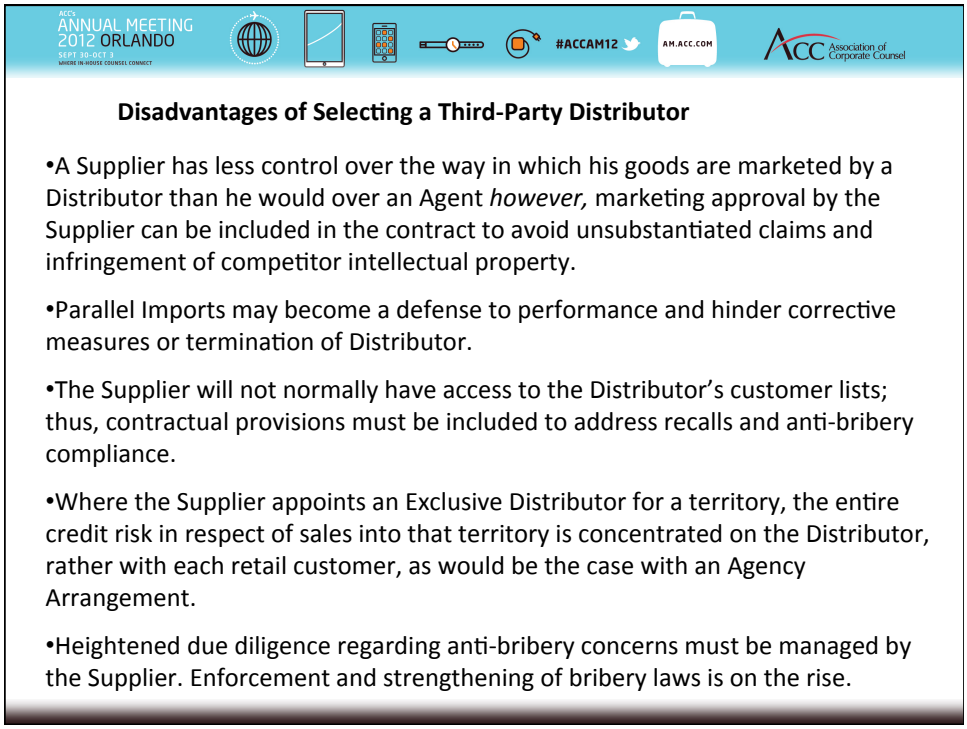


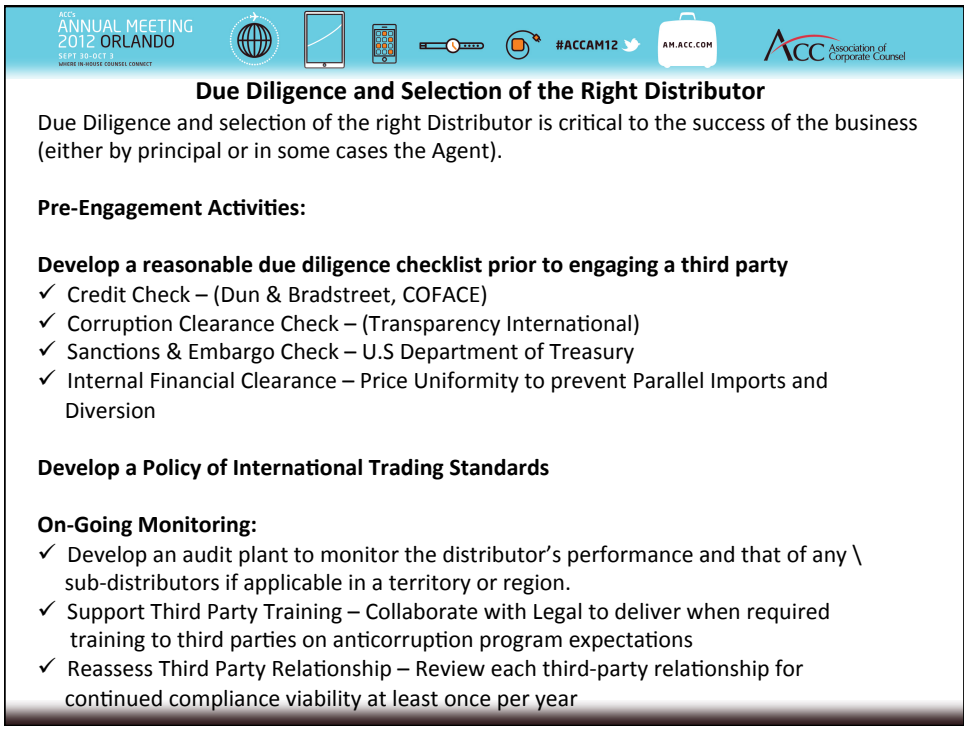


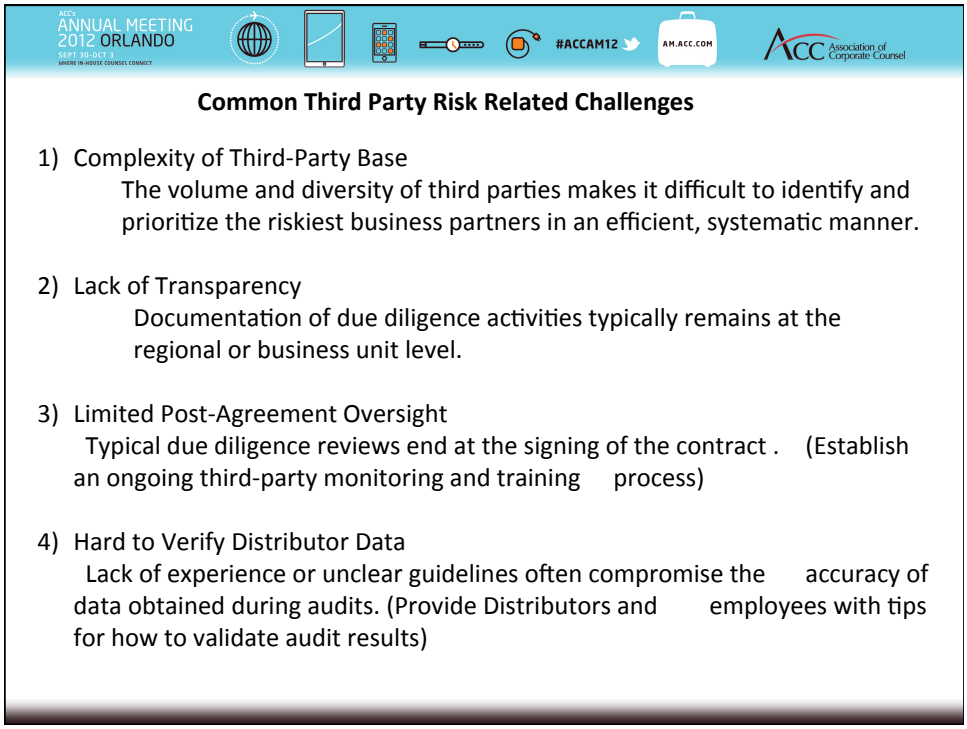


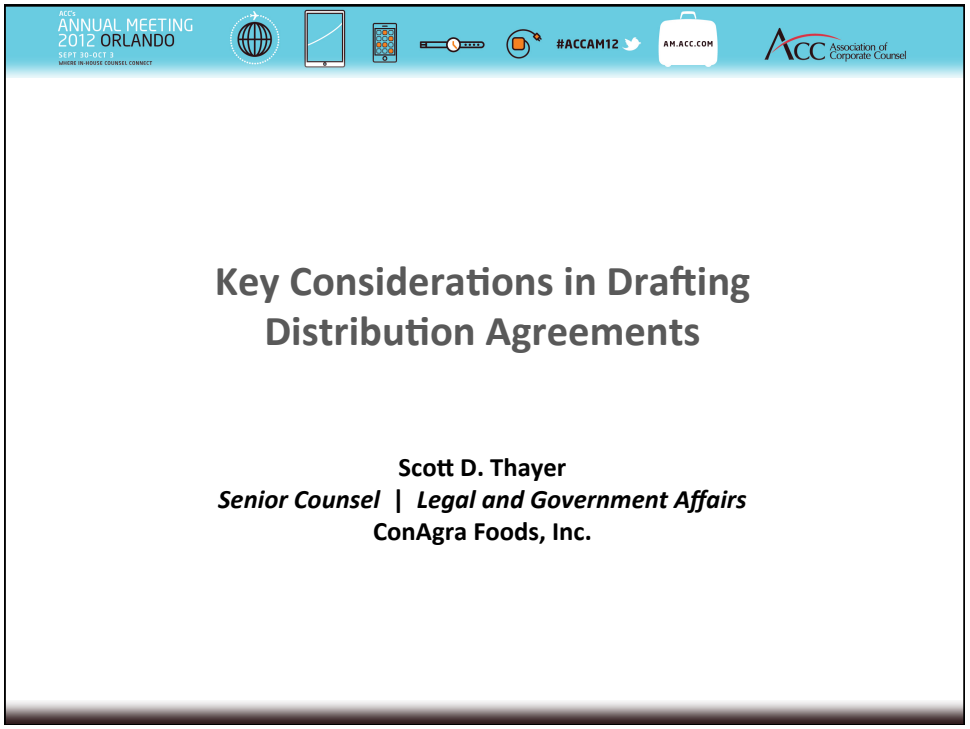












Key Considerations in Drafting Distribution Agreements

Scott D. Thayer
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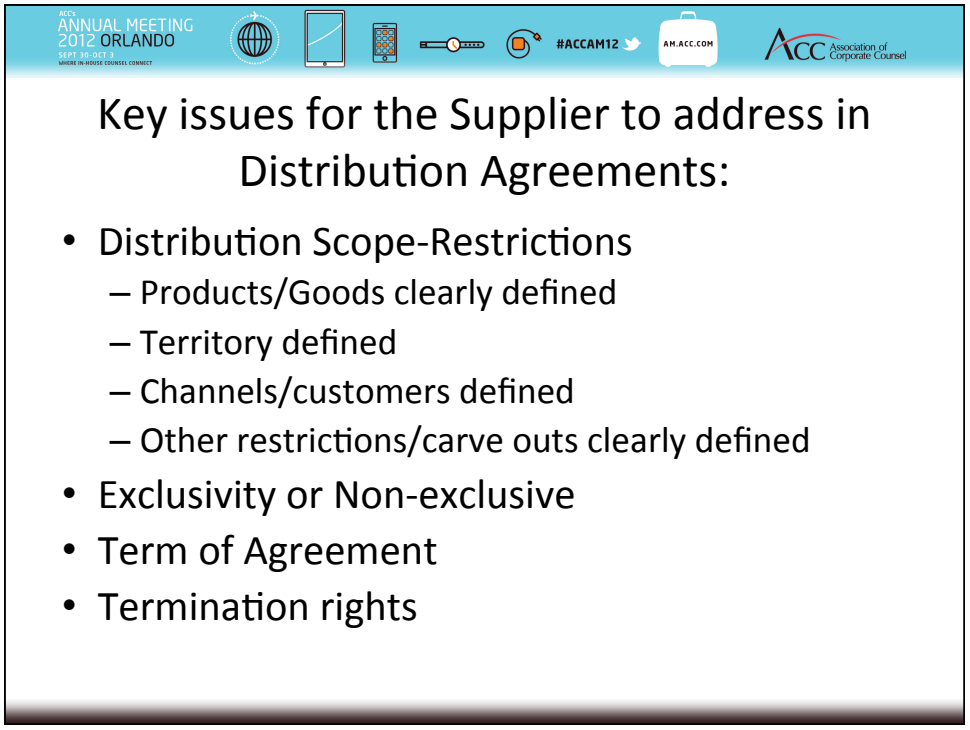
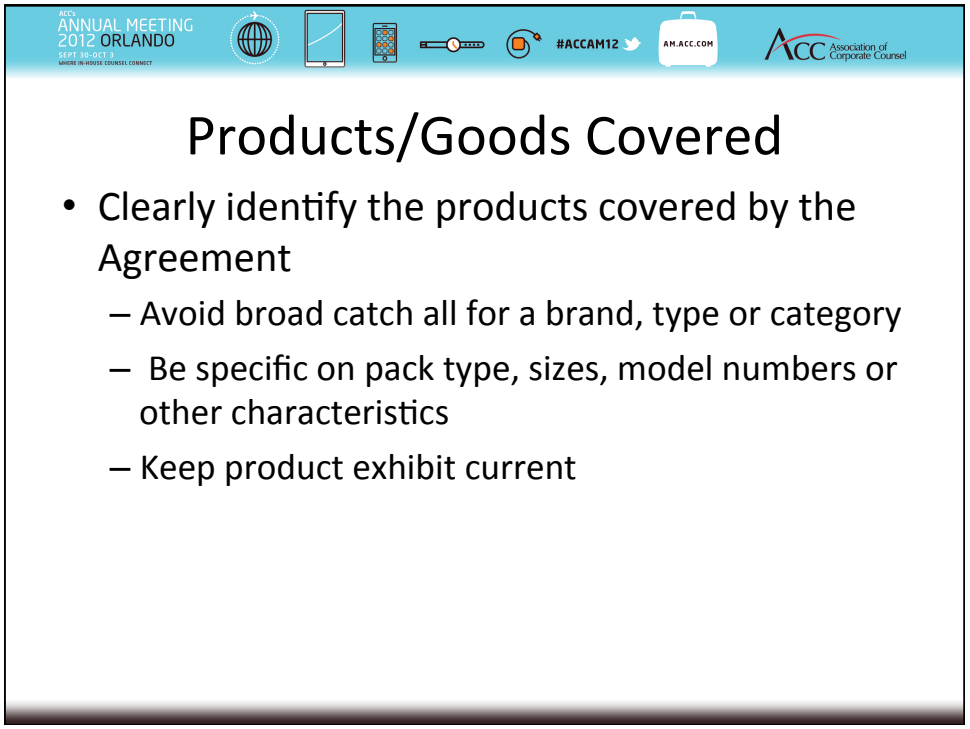
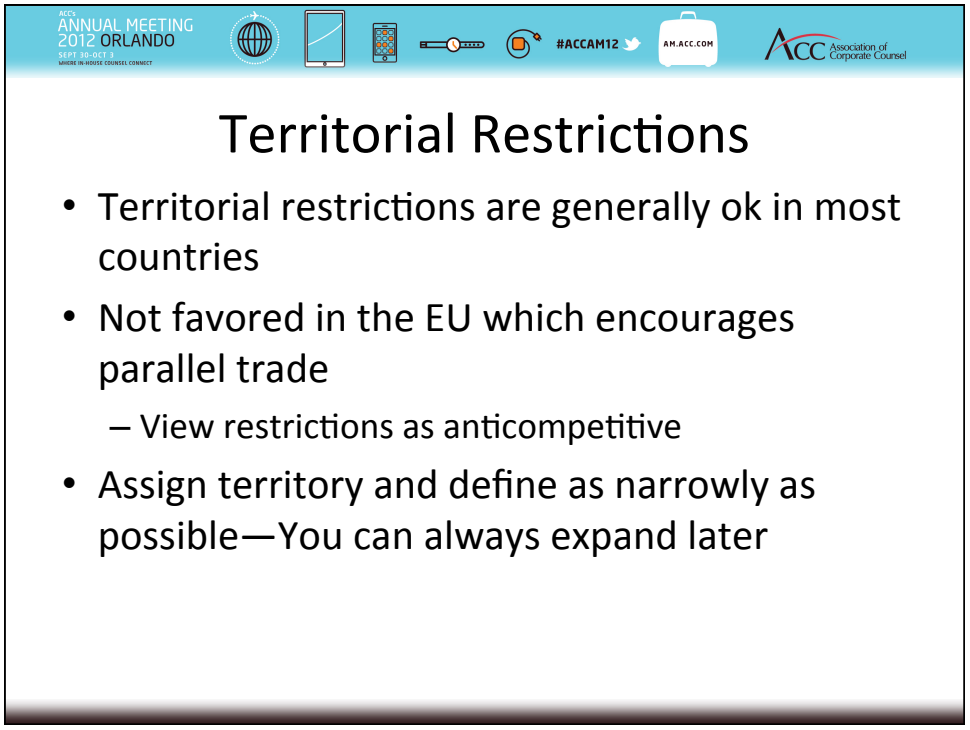
ConAgra Foods, Inc.

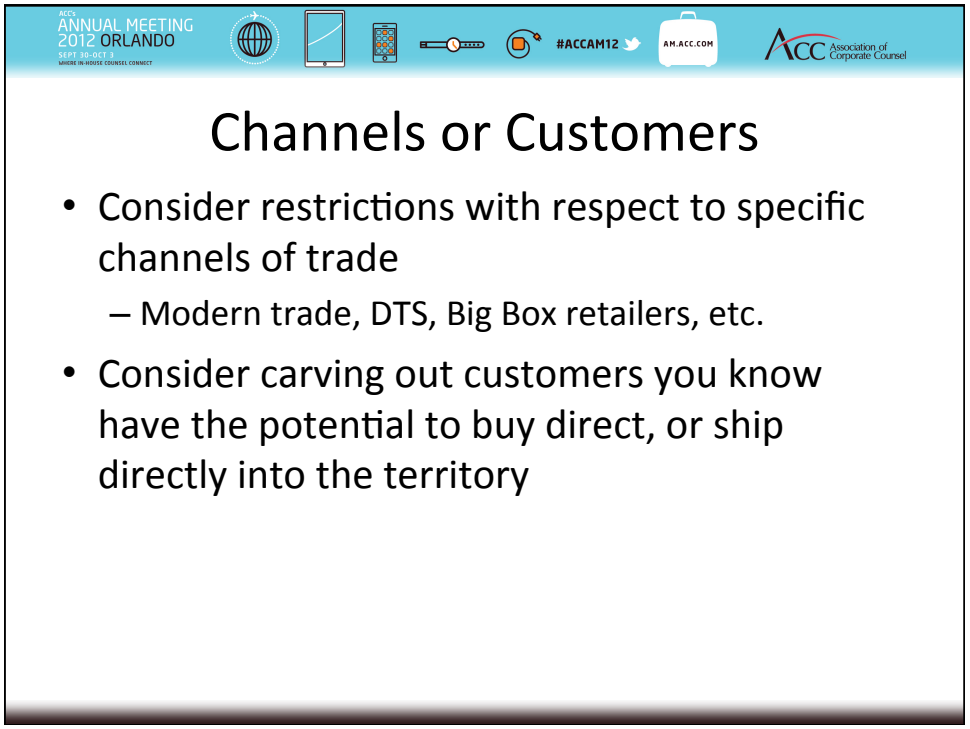


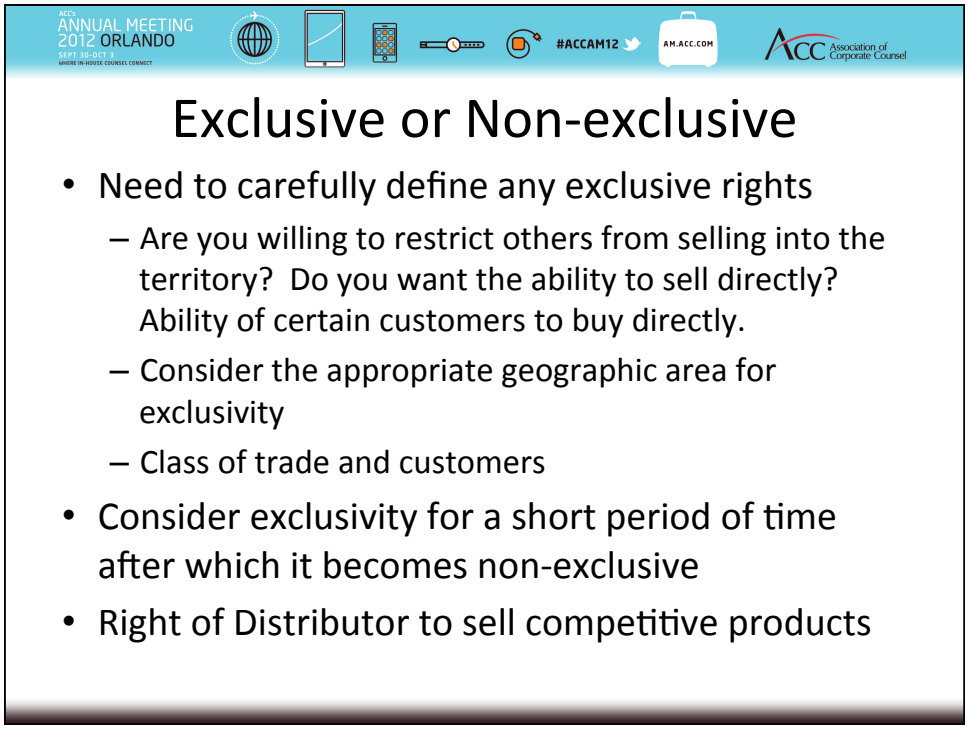
Key issues for the Supplier to address in Distribution Agreements:

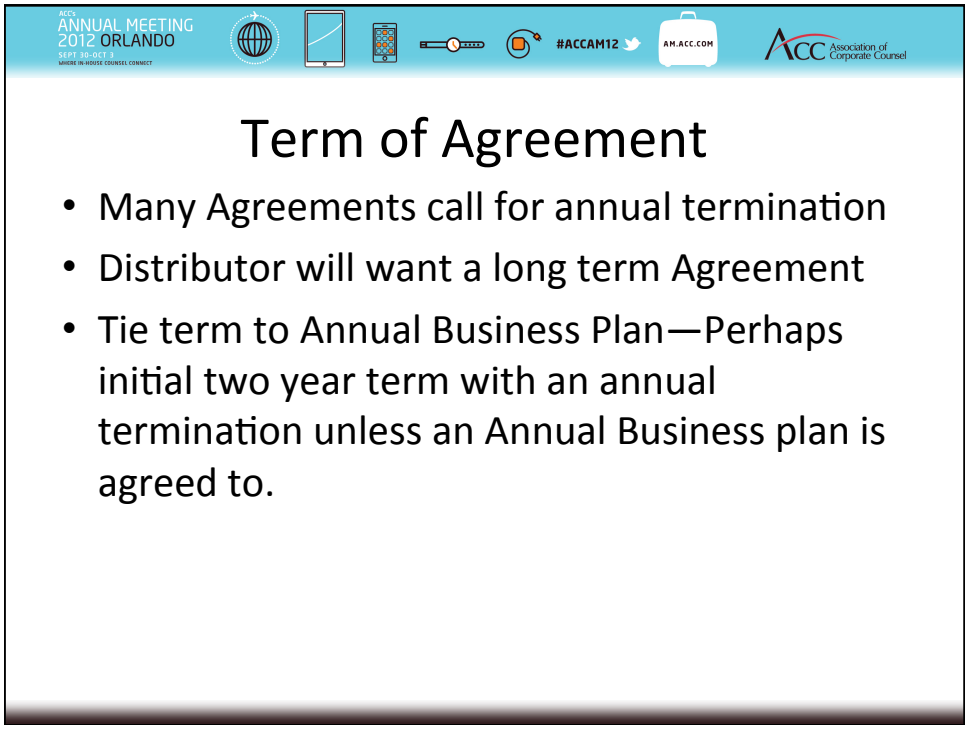
- Distribution Scope-Restrictions
  - Products/Goods clearly defined
  - Territory defined
  - Channels/customers defined
  - Other restrictions/carve outs clearly defined
- Exclusivity or Non-exclusive
- Term of Agreement
- Termination rights

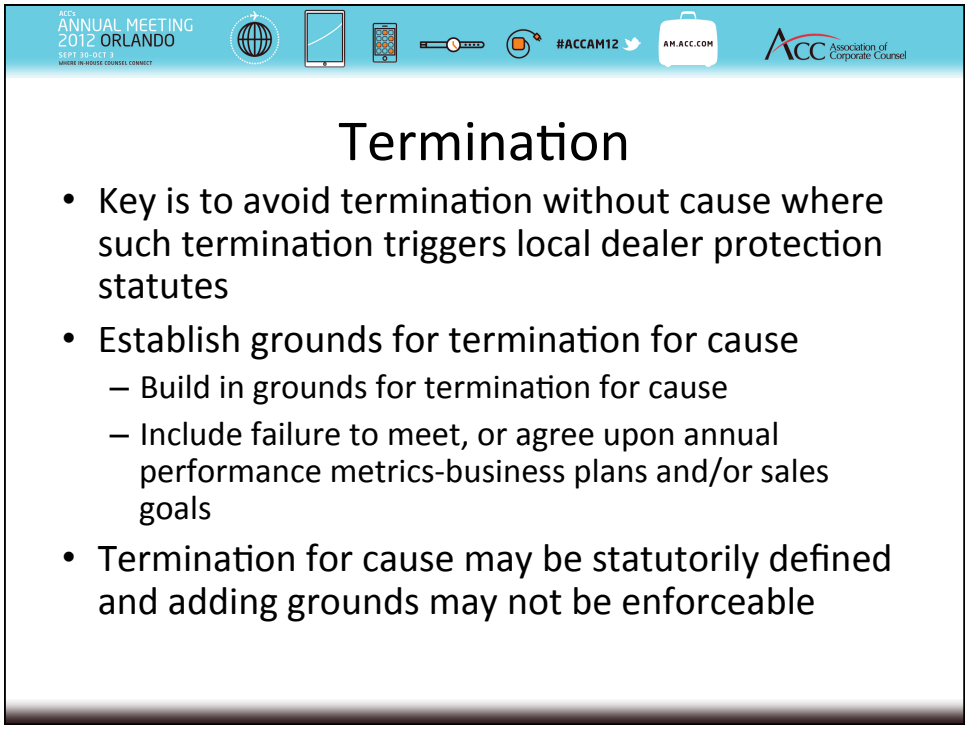


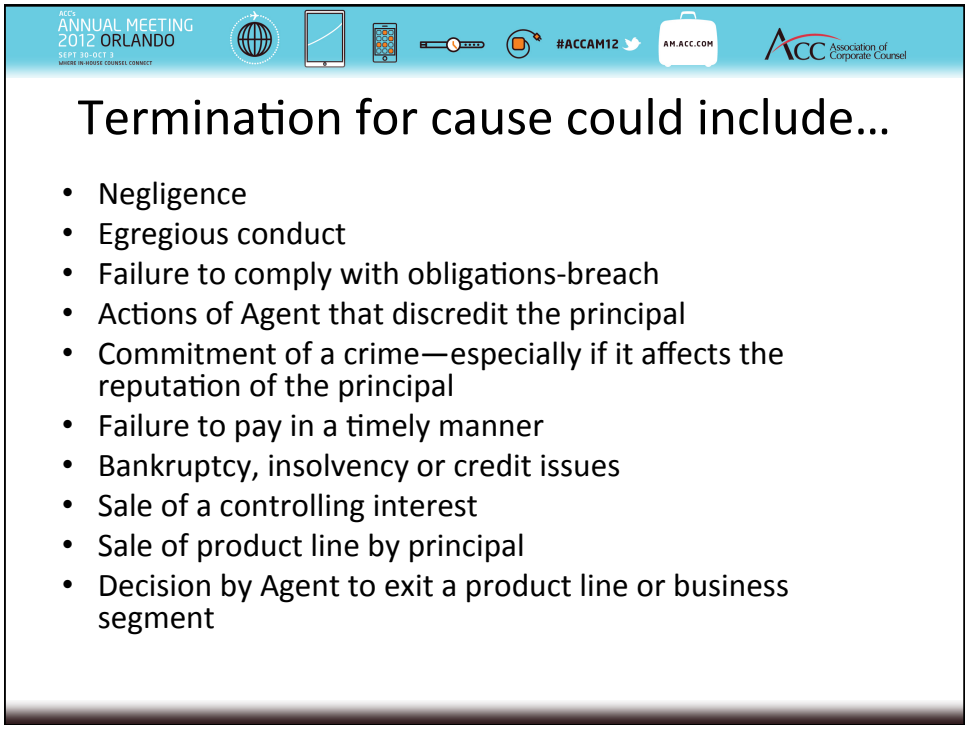


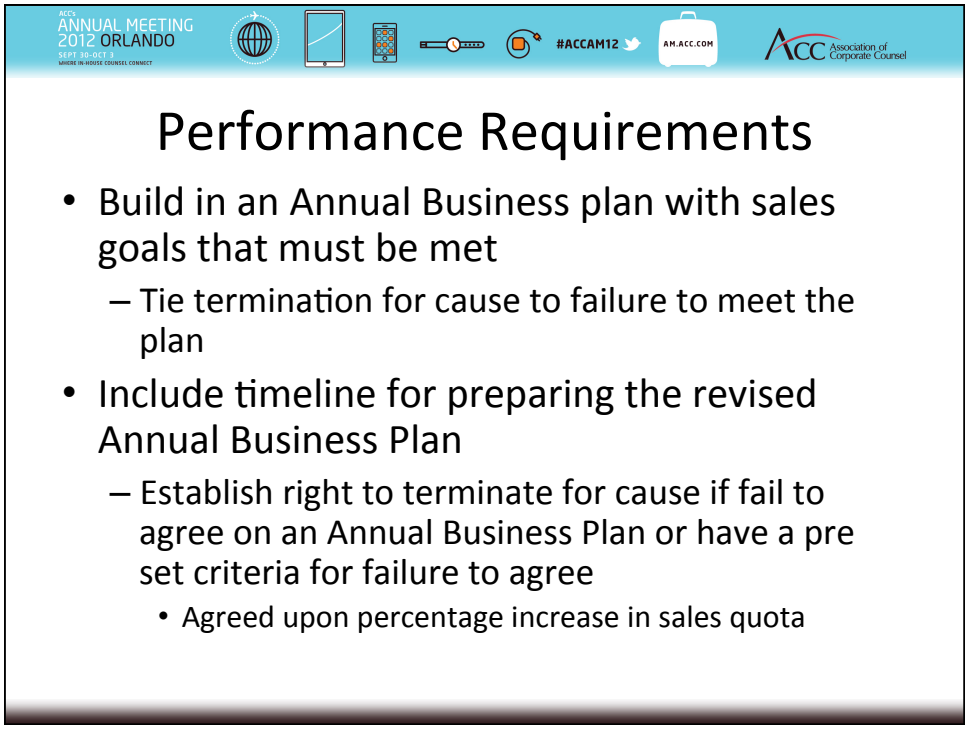


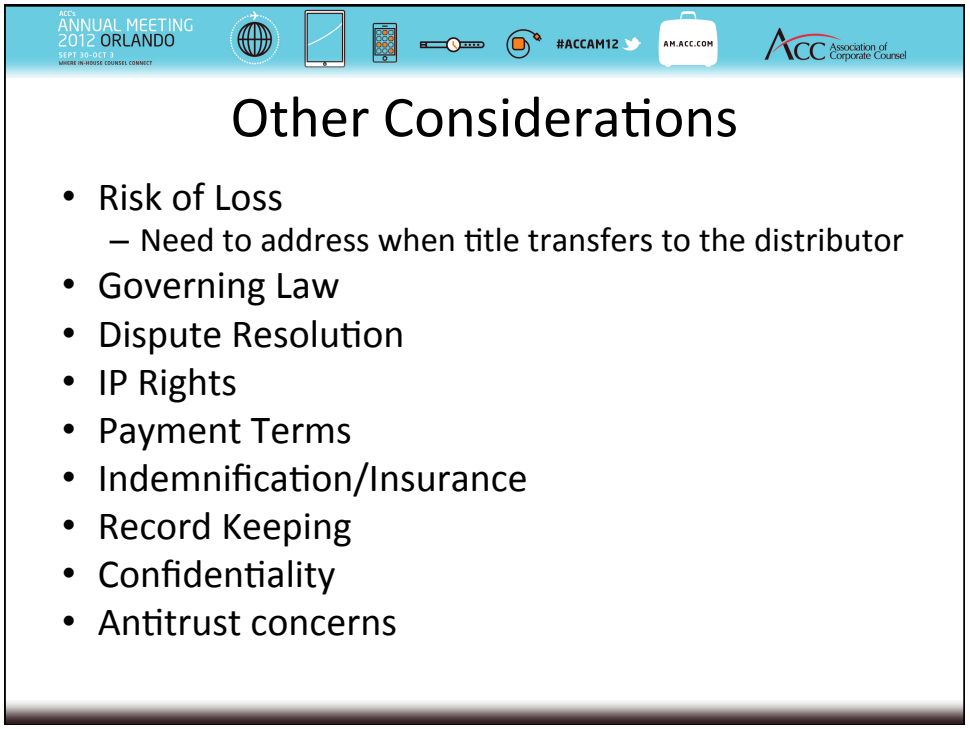


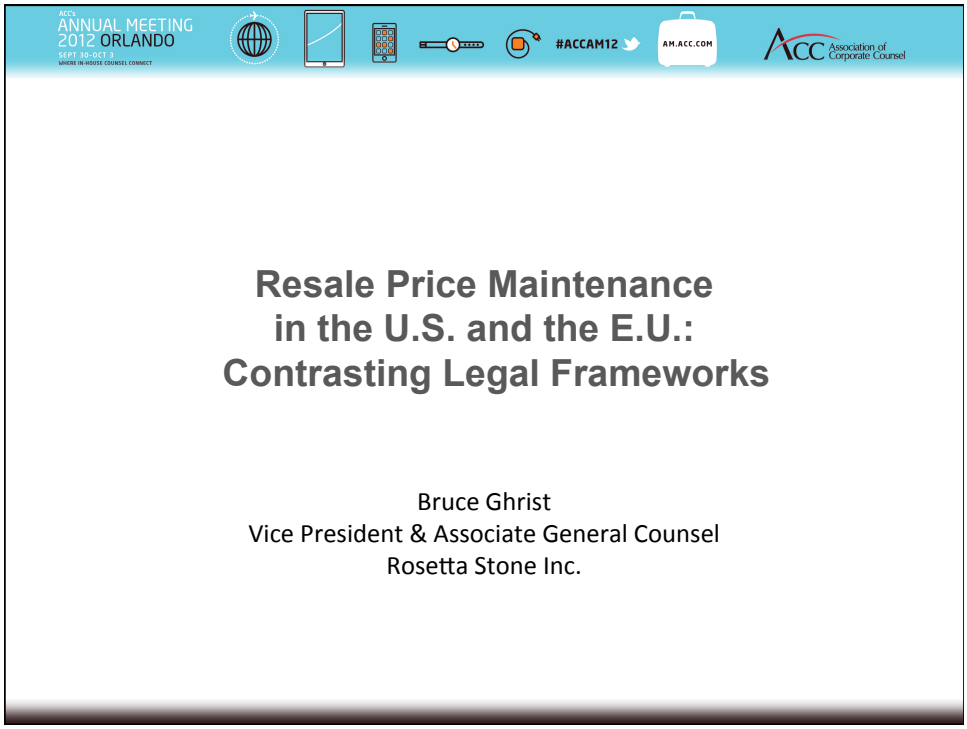


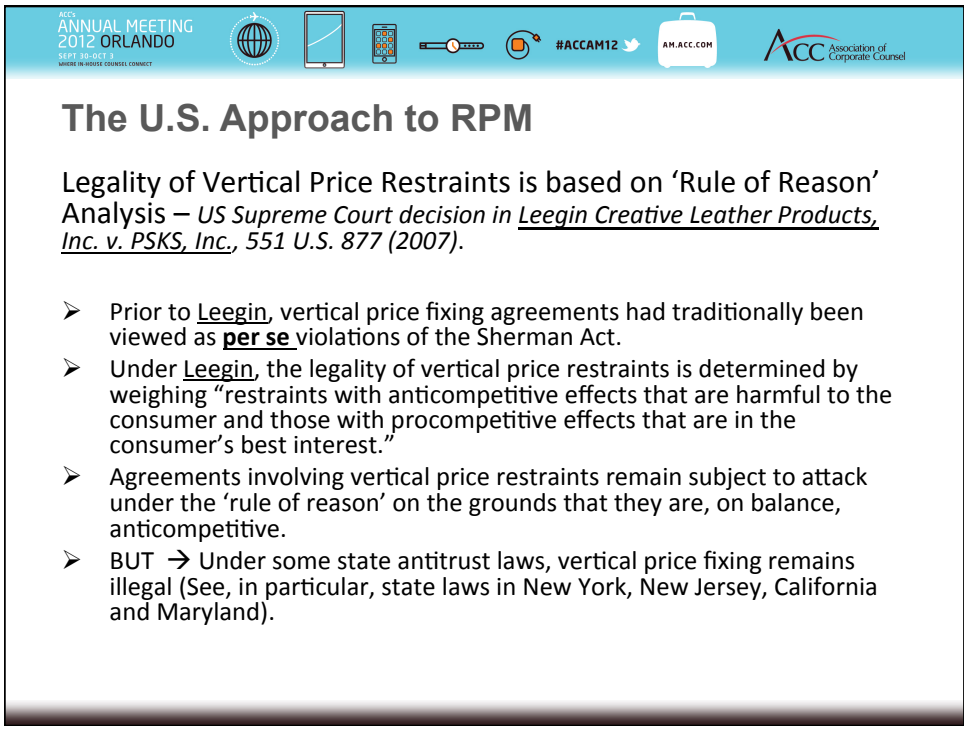


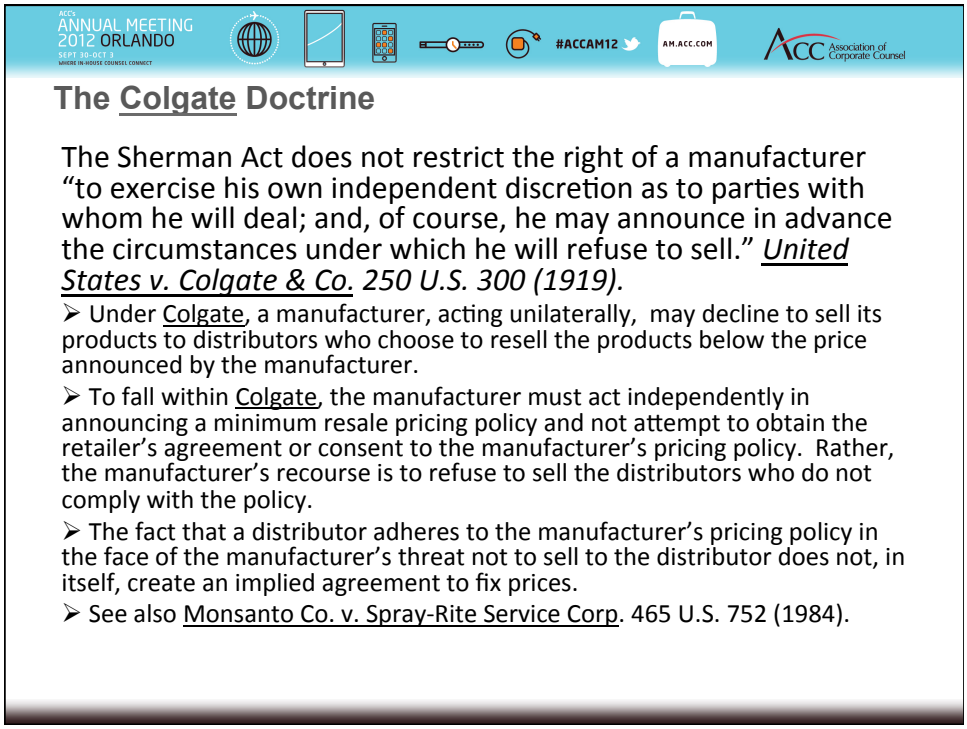


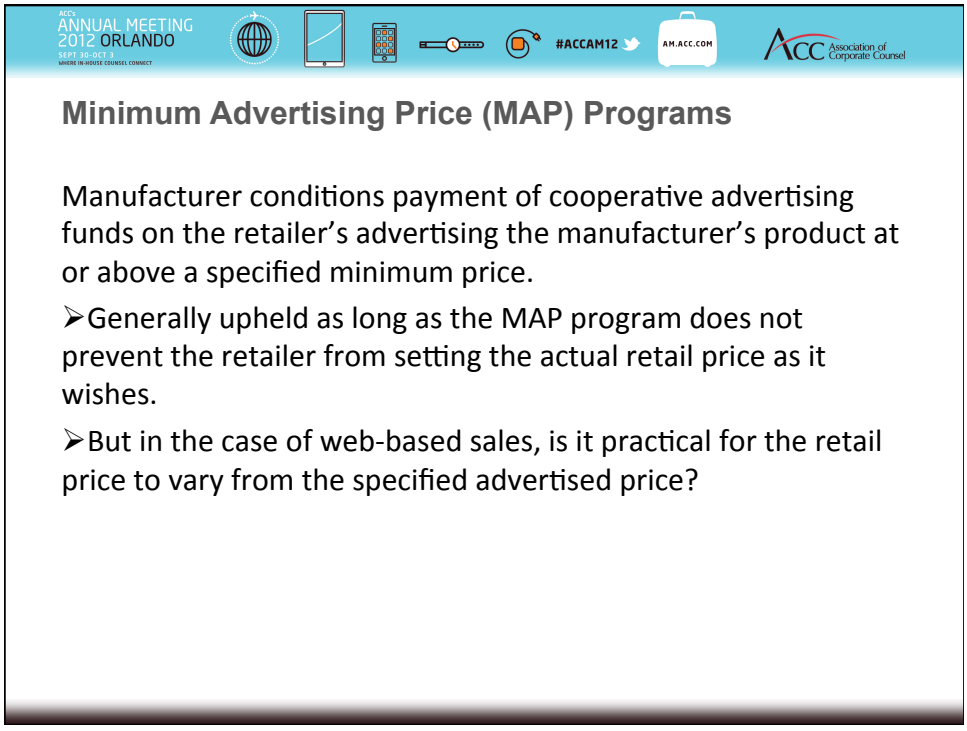


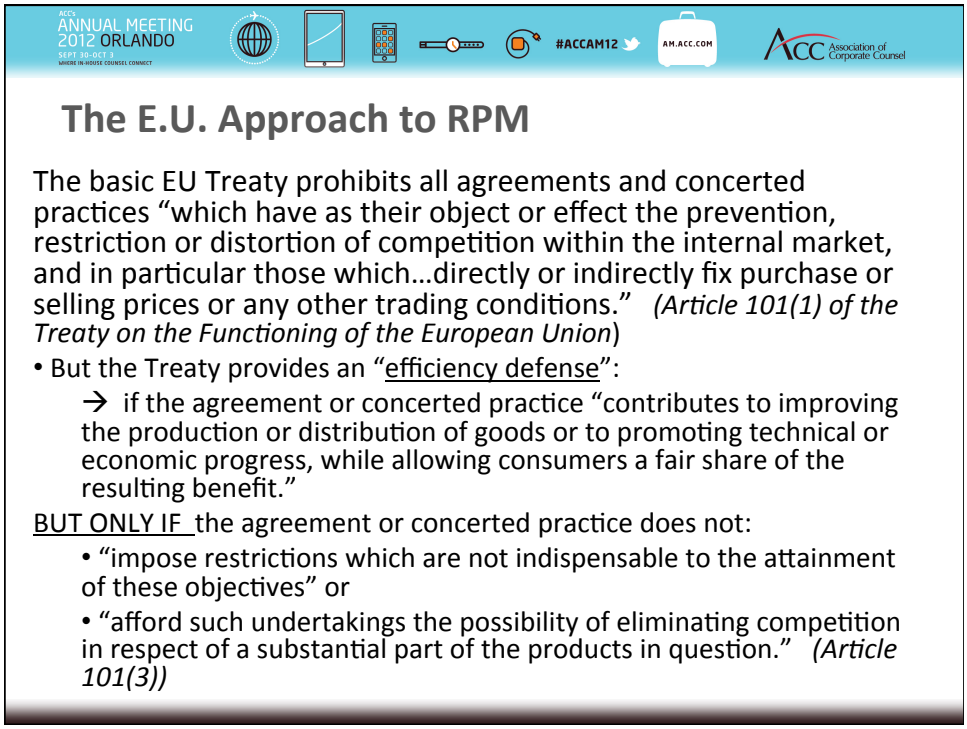


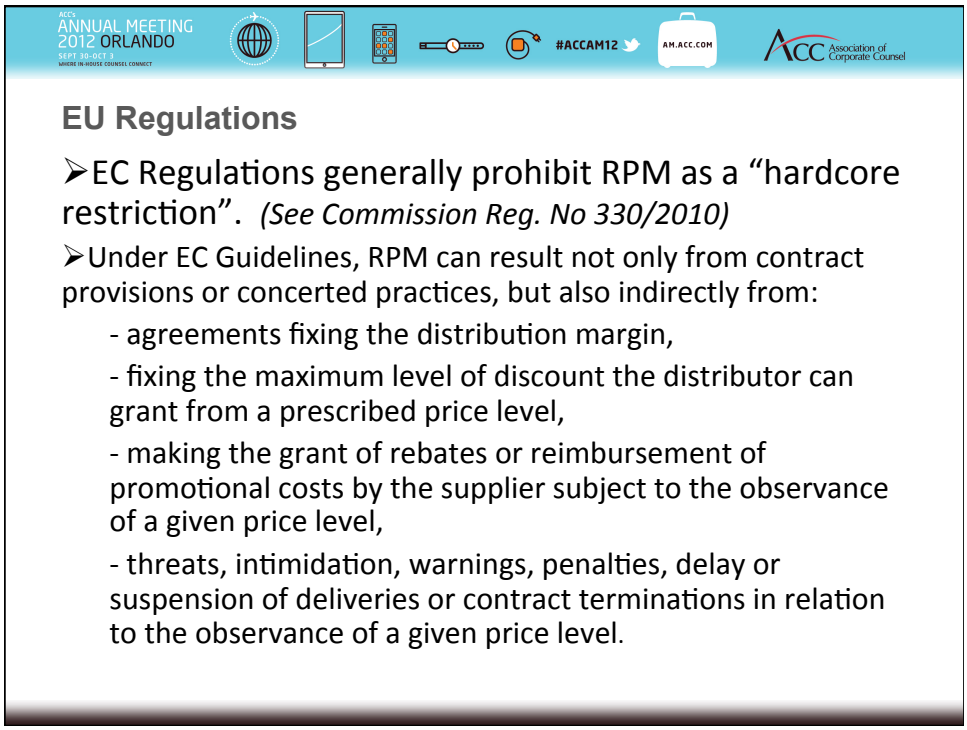


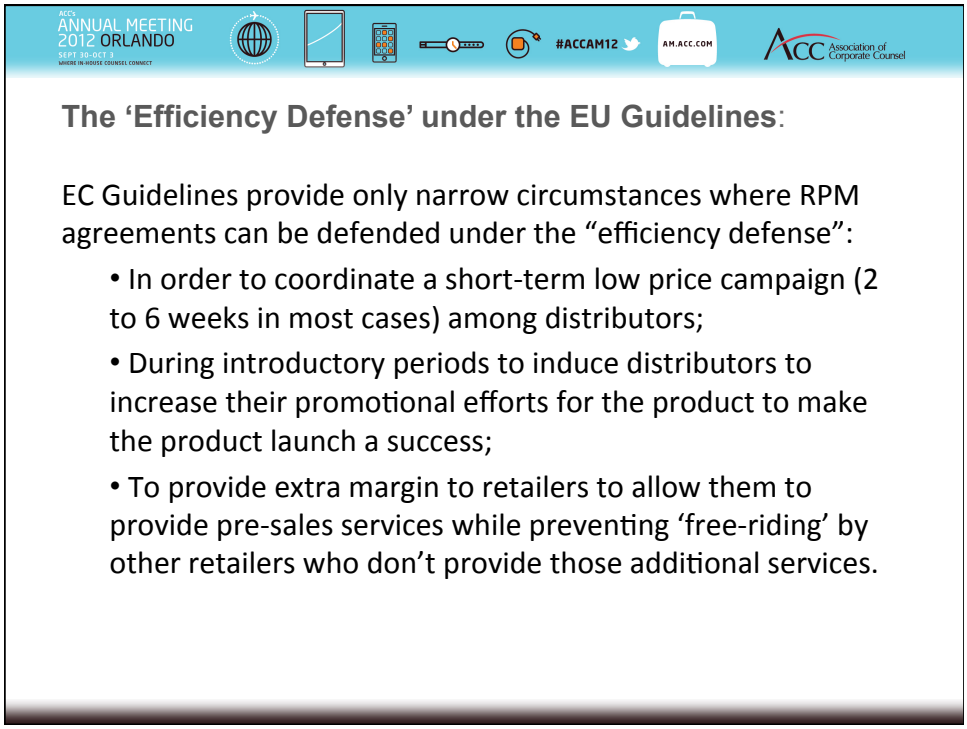


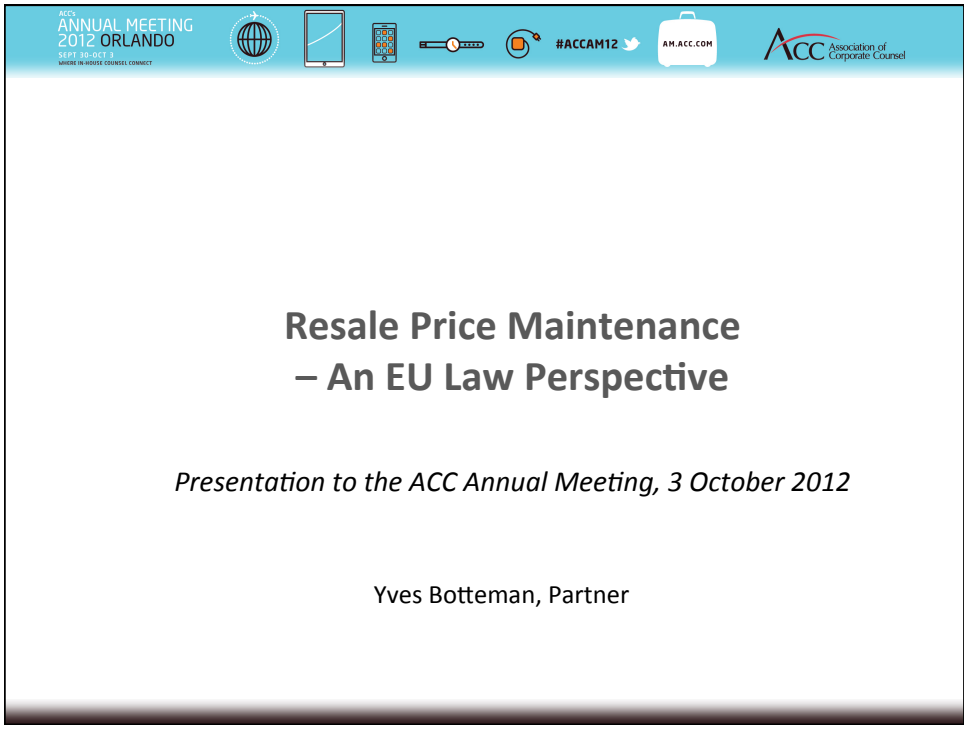


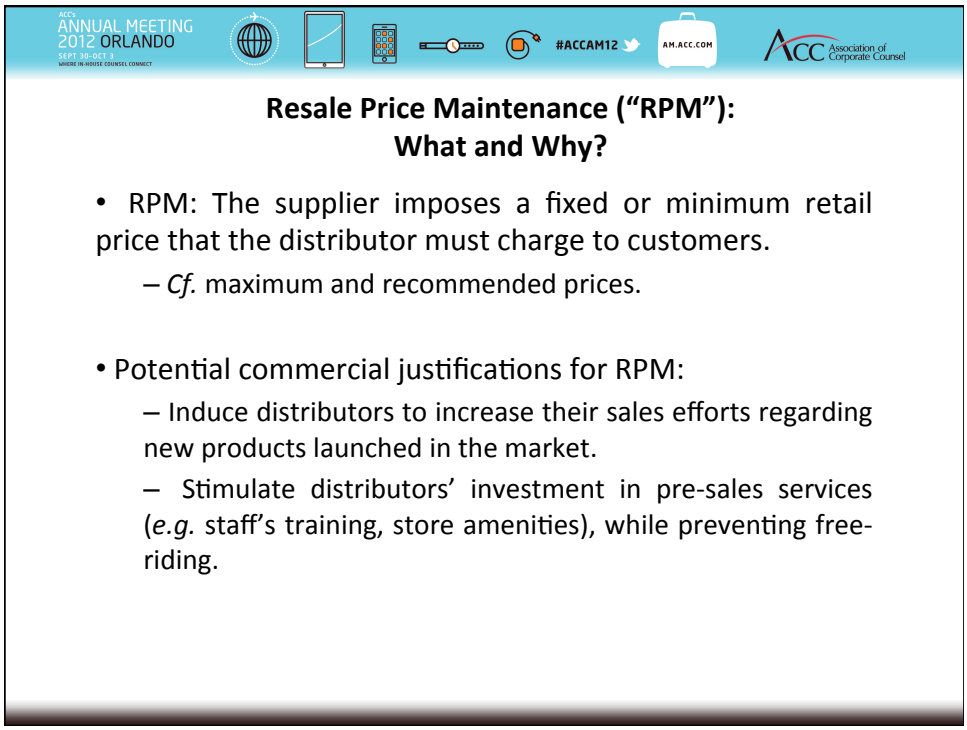


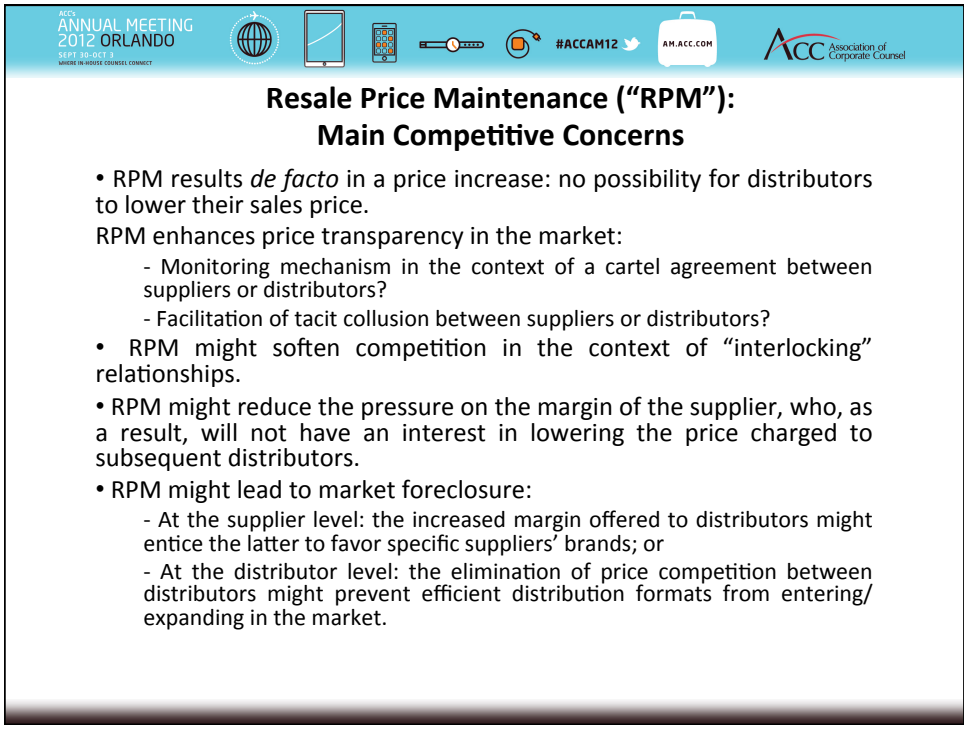


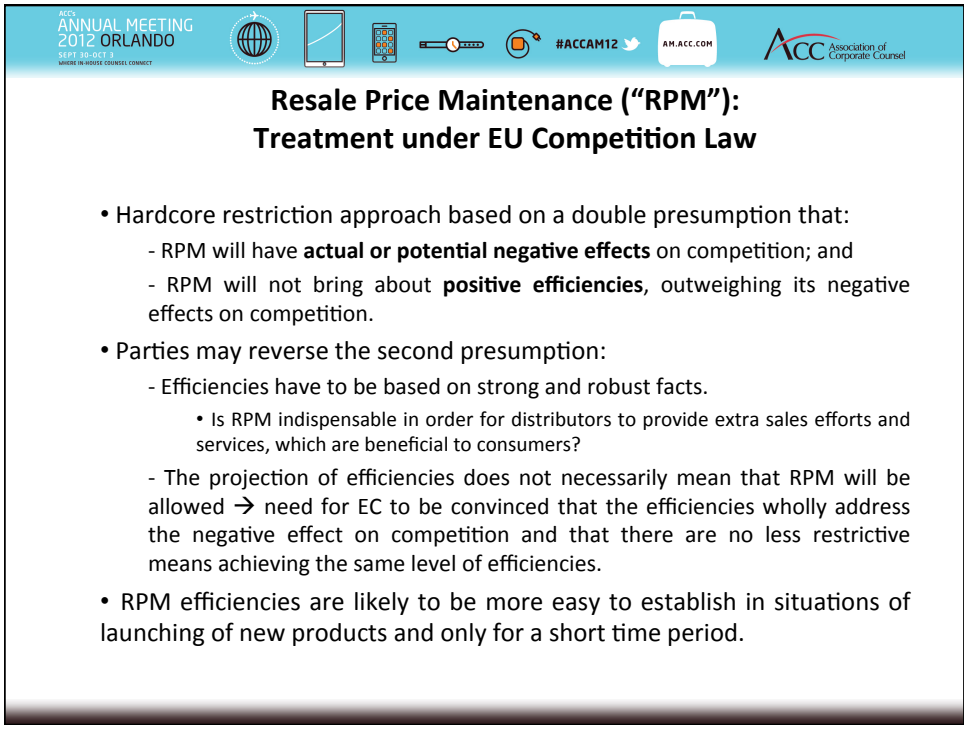


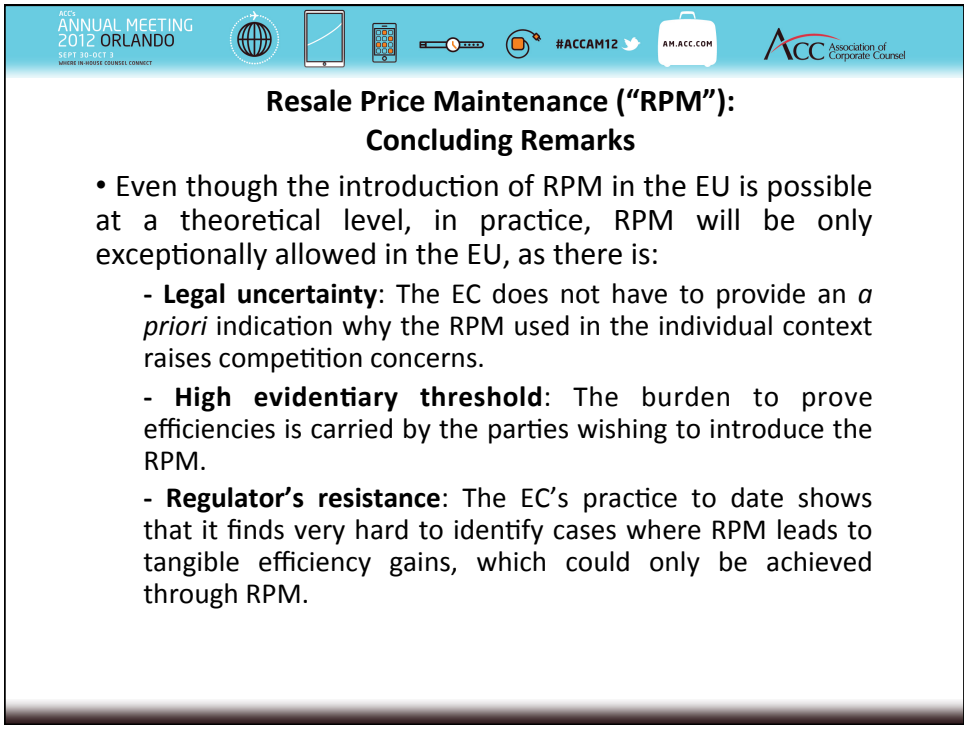


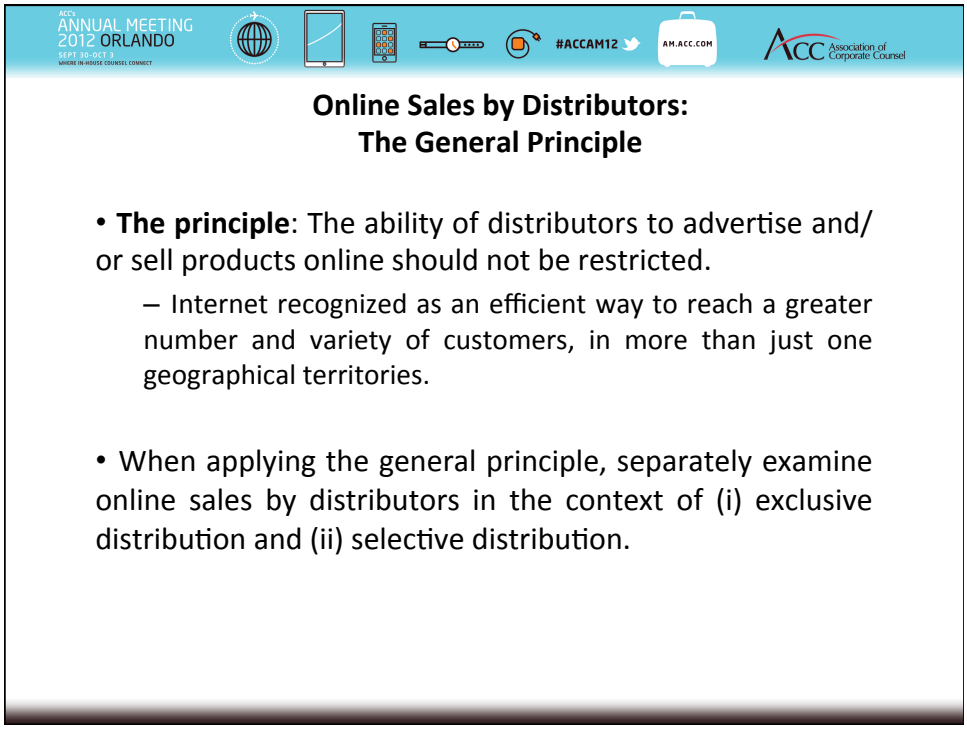


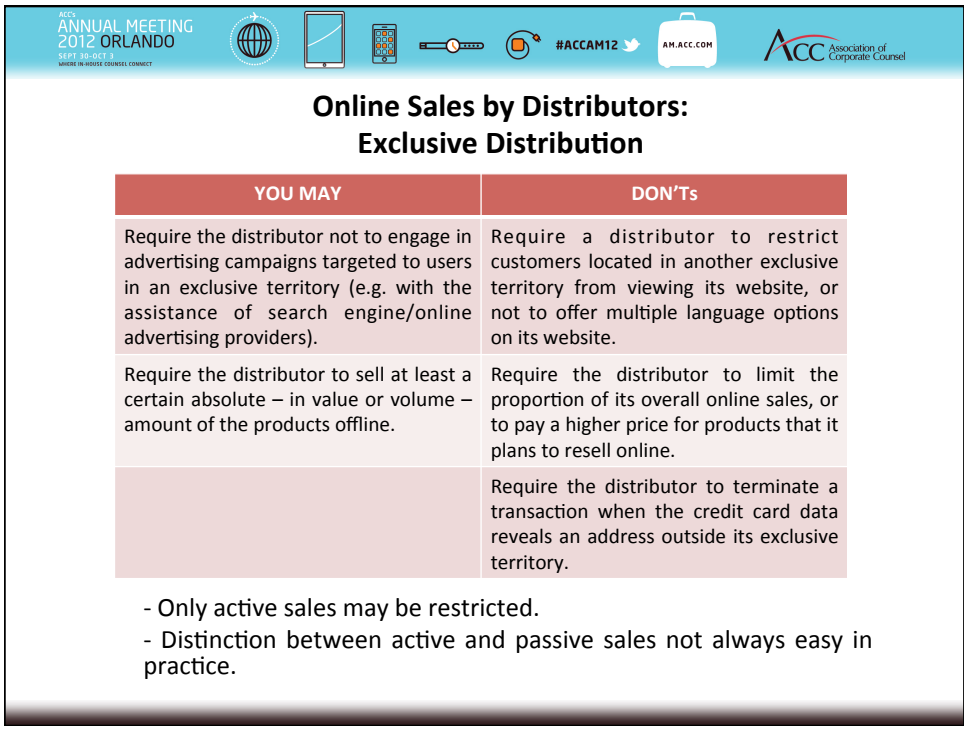


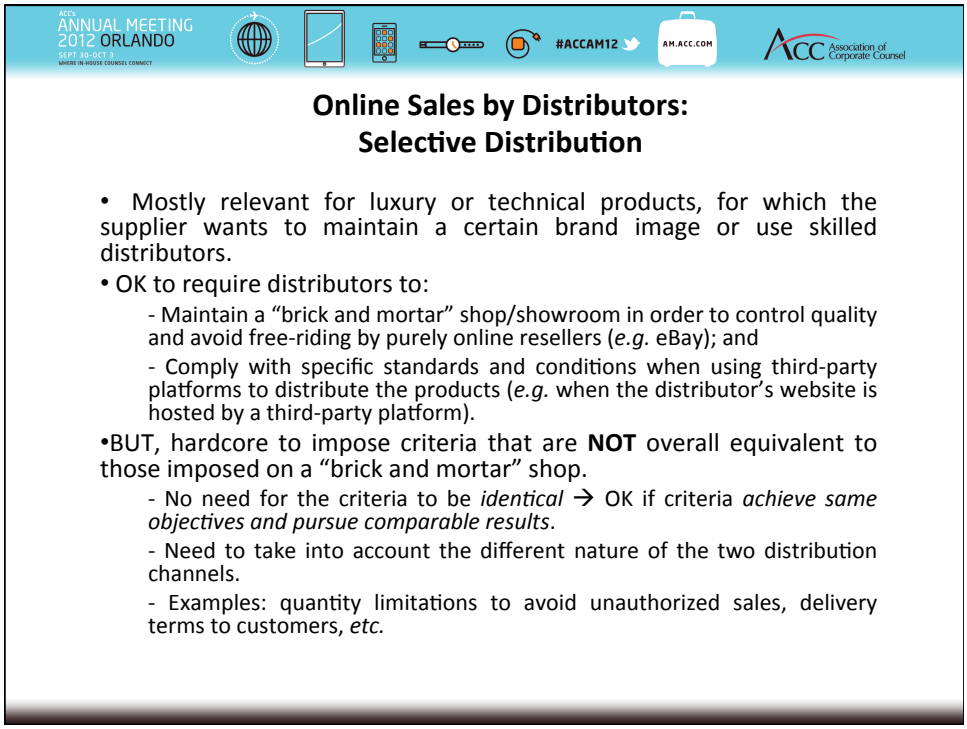


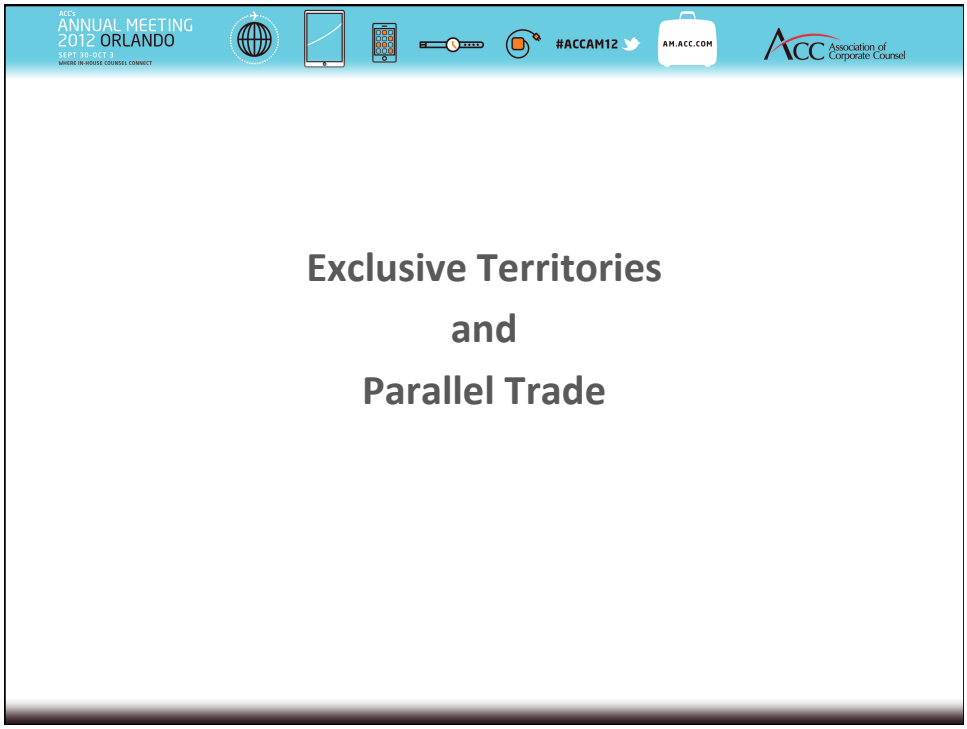


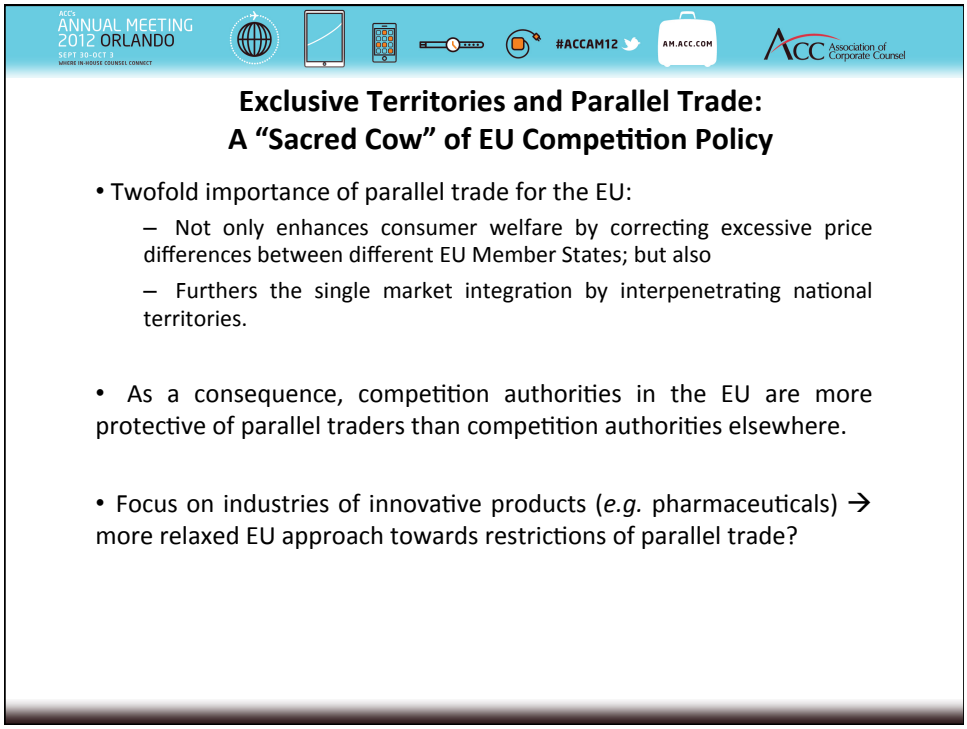


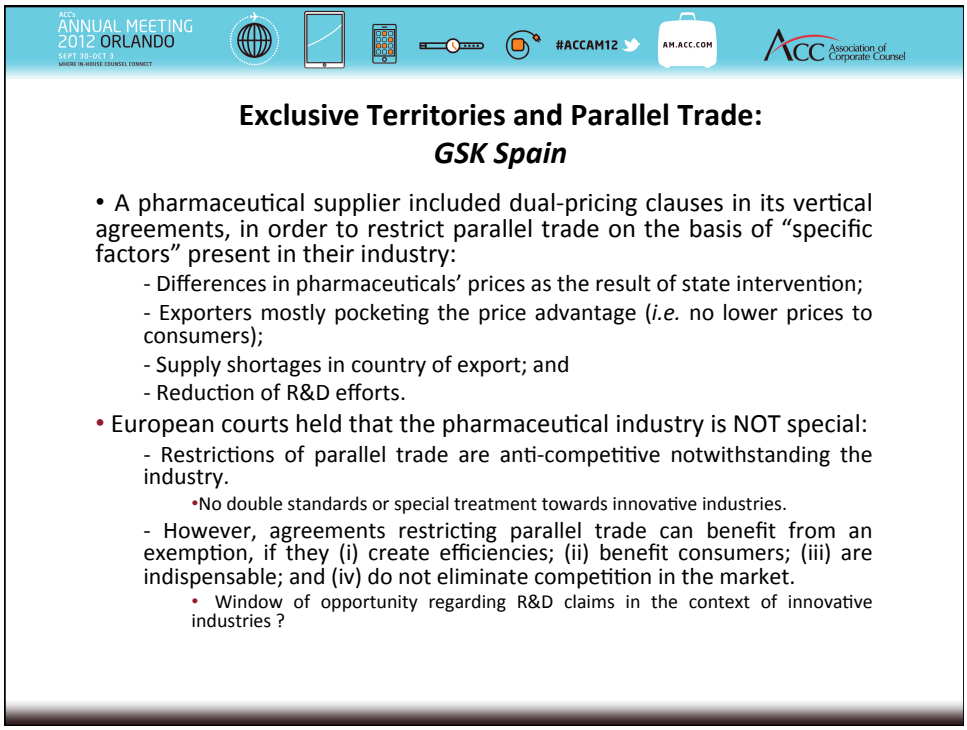


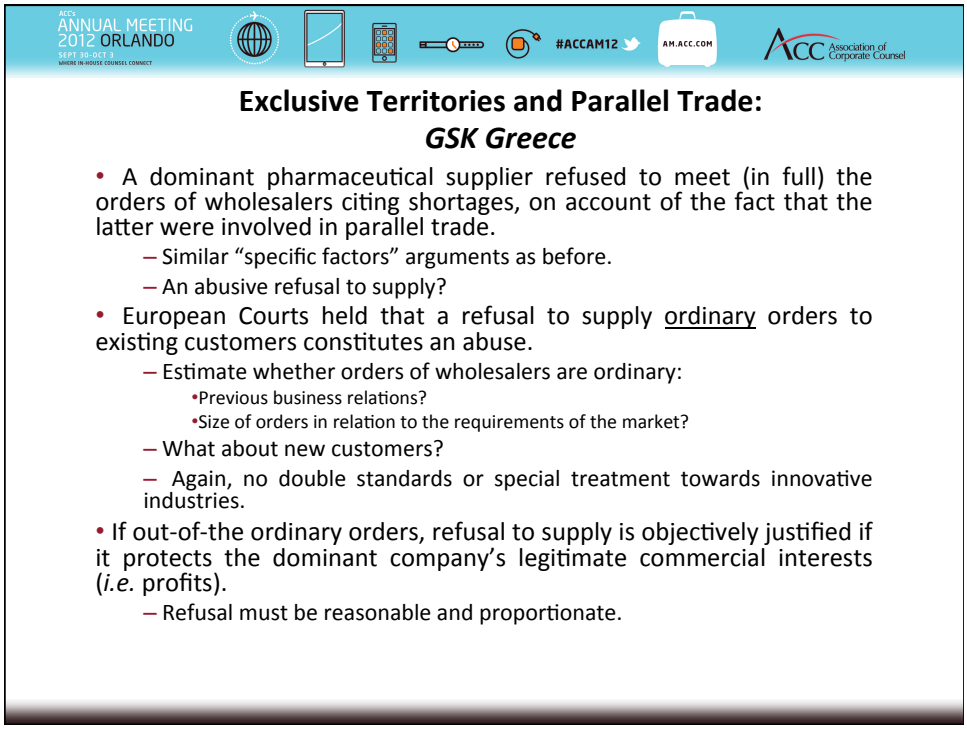


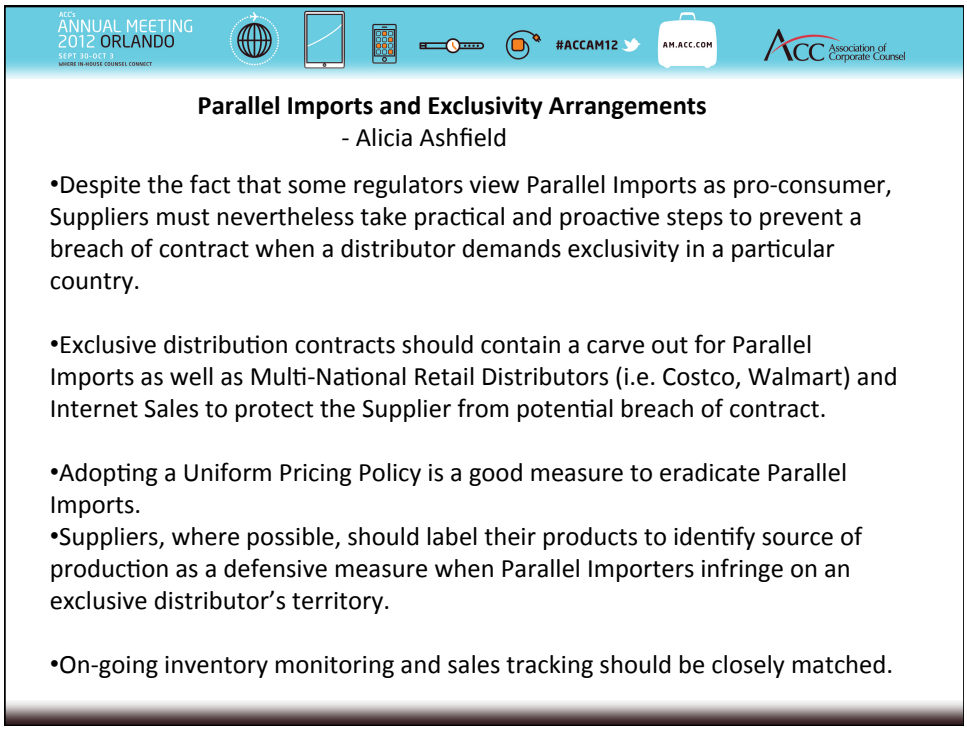


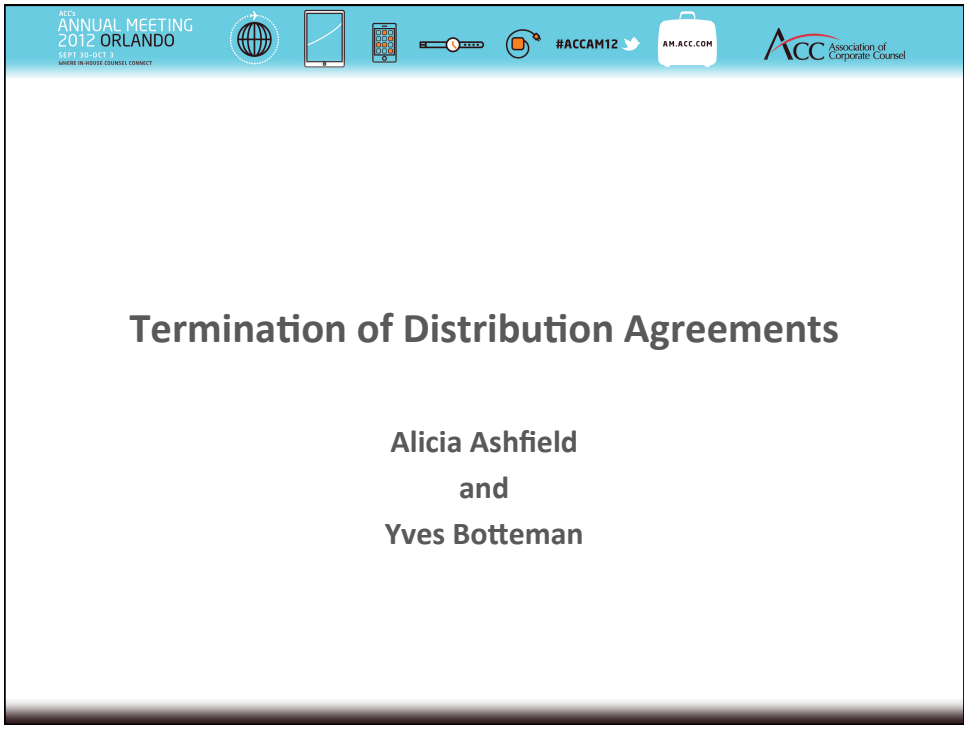


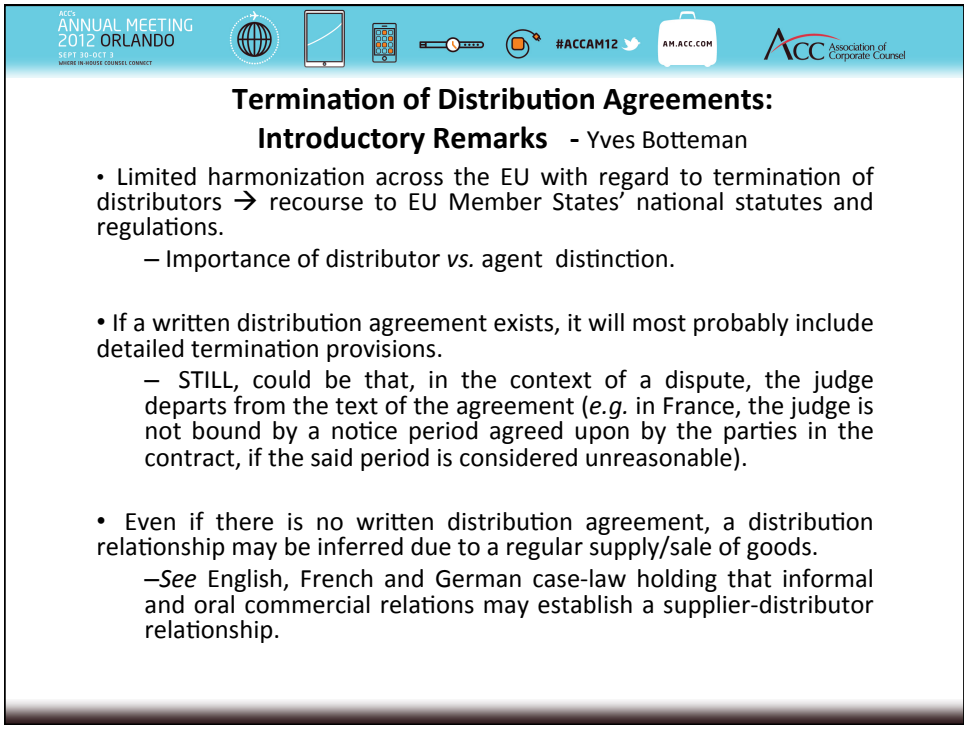


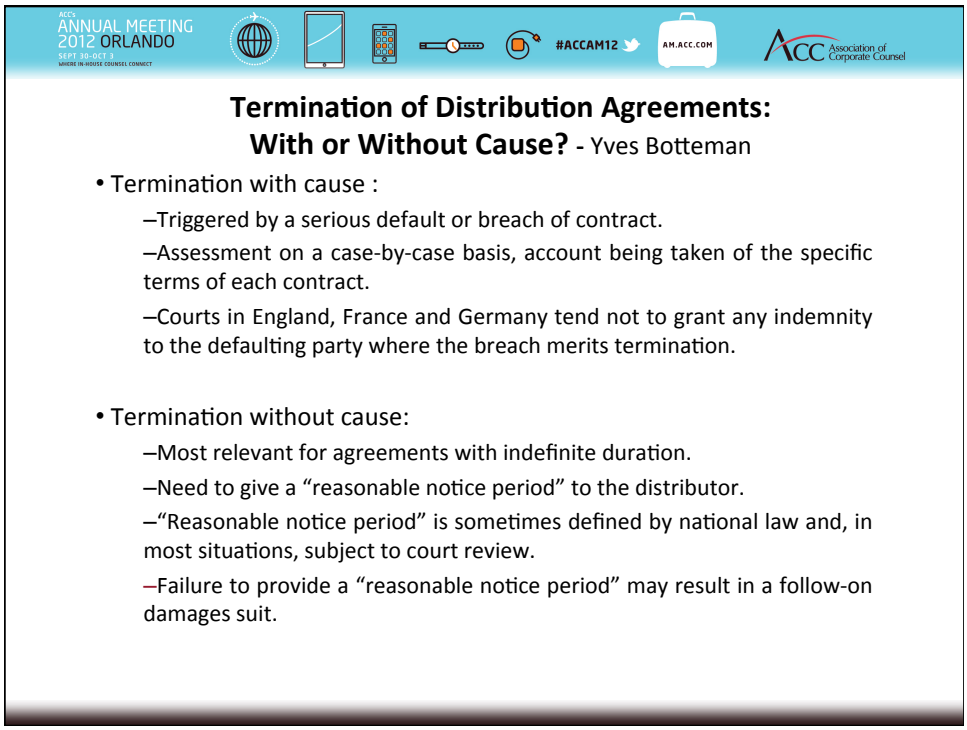


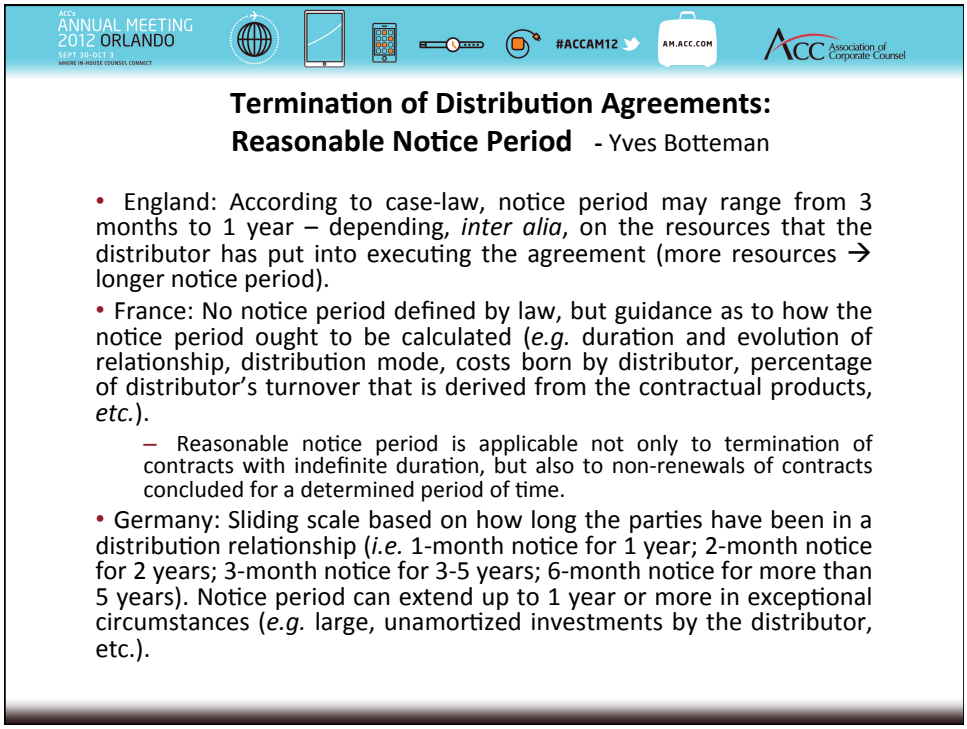


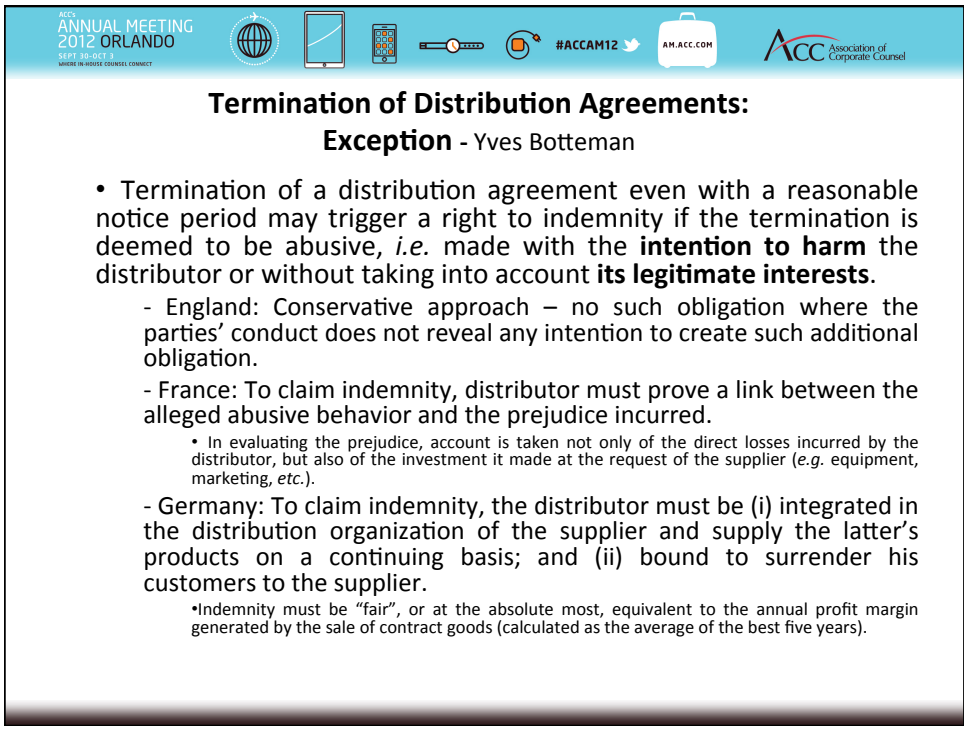












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(Minimum) Resale Price Maintenance Under the New Guidelines: A Critique and A Suggestion

Yves Botteman & Kees J. Kuilwijk
Steptoe & Johnson LLP

(Minimum) Resale Price Maintenance Under the New Guidelines: A Critique and A Suggestion

Yves Botteman & Kees J. Kuilwijk[1]

I. INTRODUCTION

During its recent revision of rules regarding vertical agreements, which culminated in a revised block exemption for certain such agreements and new Guidelines on Vertical Restraints,[2] the European Commission initiated a debate on the treatment of (minimum) resale price maintenance ("RPM") under EU competition rules. From the perspective of the supplier of a product, RPM consists of fixing or imposing a minimum retail price that the distributor must charge to consumers. To some degree, the debate in Europe was spurred by the *Leegin* decision of the U.S. Supreme Court in 2007 which overturned a long standing precedent, *Dr. Miles*, that treated minimum RPM as a *per se* violation of U.S. antitrust rules, in favor of a rule of reason analysis.[3] Some commentators have suggested that, given the fact that defendants often succeed in lower courts when restraints are examined under the rule of reason, *Leegin* would cause minimum RPM to be treated as, in effect, *per se* legal in many situations.[4]

In Europe, RPM has long been treated as a "hardcore" restriction of competition falling within the prohibition of Article 101(1) of the Treaty on the Functioning of the European Union ("TFEU") with virtually no scope for meeting the strict conditions for exemption under Article 101(3). The latter provision enables the defendant to put forward an efficiency defense that will be balanced against the detrimental effects of the restraint. Given the fact that this defense was de facto unavailable for RPM, this practice has often been considered as a *per se* violation of EU competition rules.[5] In practice, this meant that suppliers could not impose RPM on their dealers in the EU.

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[1] Yves Botteman is a senior associate and Dr. Kees Jan Kuilwijk is a partner in the Brussels office of Steptoe & Johnson LLP. Their practice focuses on competition law. Special thanks to Kenneth P. Ewing for his valuable comments and contributions to this article. All errors or omissions are the authors.

[2] The new block exemption regulation, Commission Regulation 330/2010, 2010 O.J. (L 102) 1 (hereinafter BER), and the Guidelines, Commission Notice: Guidelines on Vertical Restraints, 2010 O.J. (C 130) 1, are conveniently *available at* http://ec.europa.eu/competition/consultations/2009_vertical_agreements/index.html.

[3] Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007); Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 US 373 (1911).

[4] *See*, *e.g.*, Marina Lao, *Free Riding: An Overstated, and Unconvincing, Explanation For Resale Price Maintenance*, in HOW THE CHICAGO SCHOOL OVERSHOT THE MARK: THE EFFECT OF CONSERVATIVE ECONOMIC ANALYSIS ON U.S. ANTITRUST, OXFORD UNIVERSITY PRESS (Robert Pitofsky, ed.) (2008); John B. Kirkwood, *Rethinking Antitrust Policy Toward RPM*. ANTITRUST BULL., 2010; Seattle University School of Law Legal Research Paper 10:05, *available at* SSRN: http://ssrn.com/abstract=1559377.

[5] *See,* Frederik Van Doorn, *Resale Price Maintenance in EC Competition Law: The Need for a Standardised Approach* (November 6, 2009), *available at* SSRN: http://ssrn.com/abstract=1501070. But see Eric Gippini-Fournier, *Resale Price Maintenance in the EU: In Statu Quo Ante Bellum ?* (September 21, 2009). Fordham Corp. L. Inst - 36th Annual Conference on International Antitrust Law and Policy, 2009 (B. Hawk ed., 2010), *available at* SSRN: http://ssrn.com/abstract=1476443.

The draft Guidelines, which were published for consultation in the summer of last year, marked a relative softening of the Commission's policy towards RPM. Under the draft, RPM would still be categorized as a hardcore restriction of competition. However, the use of RPM would not necessarily mean that it would be *per se* illegal. RPM would continue to be presumed (i) to fall within Article 101(1) and (ii) to be unlikely to fulfill the conditions for exemption under Article 101(3). But the Commission would make the presumption rebuttable, leaving open the possibility for firms to plead an efficiency defense. In cases where the efficiency defense was sufficiently supported, the Commission, national competition authority, or court would then have to assess the likely negative effects on competition prior to ruling on whether RPM fulfills the conditions of Article 101(3). The new Guidelines, adopted by the Commission on 20 April 2010, maintain this rebuttable presumption. They also provide insights into the motives for treating RPM as a hardcore restriction and suggest circumstances in which RPM is likely to generate overriding efficiencies.[6]

In this commentary, we discuss the Commission's new approach toward RPM. We also discuss an alternative approach to the assessment of RPM. Before doing so, it is important to note that, although much has been written since *Leegin* about RPM by economists and legal practitioners alike, there is relatively little empirical evidence on the actual effect of RPM on consumer welfare. At the same time, there seems to be broad recognition that RPM is generally harmful to consumers where there is either a certain degree of market power or a widespread use of RPM in a given market.[7] Conversely, it is equally recognized that RPM can generate efficiencies overriding the negative price effect when it is used by a single or only a handful of suppliers without market power.

II. WHY TREAT RPM AS A "HARDCORE" RESTRICTION OF COMPETITION?

The Commission does not clearly lay out why it believes RPM is so inherently suspect or bad for competition and consumers that it should be treated as a hardcore restriction. The new Guidelines do discuss several ways in which the Commission believes RPM "may restrict competition."[8] Recognizing, however, that this discussion comes after the Commission has already presumed not only that all RPM arrangements[9] violate Article 101(1) but also that none of them qualifies for exemption under Article 101(3), the Commission must be presuming that in every RPM situation at least one of those possible restrictions in fact arises. We discuss each in turn.[10]

A. Facilitating Cartel Behavior

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[6] Guidelines on Vertical Restraints, O.J. C 130, 19.05.2010, p. 1, ¶¶223-225.

[7] *See*, Brief of *Amici Curiae* Economists in Support of Petitioner (22 January 2007), in Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S. Ct. 2705 (2007); Opinion of the EAGCP, Hardcore restrictions under the Block Exemption Regulation on vertical agreements: An economic view, by the Vertical Restraints subgroup, September 2009, *available at* http://ec.europa.eu/dgs/competition/economist/eagcp.html (visited on 21 May 2010)*; see also* Kenneth Elzinga & David E. Mills, *Leegin and Procompetitive Resale Price Maintenance*, in ABA SECTION OF ANTITRUST LAW, ISSUES IN COMPETITION LAW AND POLICY (Kenneth G. Elzinga & David E. Mills, eds., 2008) (hereinafter Elzinga & Mills, *Leegin and Procompetitive RPM*).

[8] *See* Guidelines at ¶ 224.

[9] We note that the Guidelines make clear that treatment as hardcore RPM also applies to "indirect" mechanisms such as agreements on distribution margins, maximum resale discounts, or linking promotional support to observing minimum resale prices.

[10] The Commission enumerates seven, but we treat two at once, namely the possible facilitation of collusion among (1) suppliers and (2) dealers.

First, the Guidelines contend that RPM can facilitate cartel behavior among suppliers or dealers. The Commission believes that, at the supplier level, RPM used in a coordinated fashion can increase transparency and make it easier for cartelists to detect deviation, thus facilitating cartels, even if it is not the main mechanism by which a cartel can take shape.[11] The Commission sees the same risk when RPM is imposed by suppliers at the request of dealers. In that scenario, dealers might use RPM to enforce a cartel among them, but it is equally not a necessary element for a cartel to take shape at the dealer level. The Guidelines also envisage the adoption of RPM to facilitate tacit coordination. However, under well-established principles identified in the context of the EU Merger Regulation, tacit coordination requires additional ingredients for RPM to be effective in reaching an anticompetitive outcome.[12] In particular, as a facilitating tool for tacit collusion, RPM must operate in an oligopolistic market with relatively high barriers to entry, limited innovation, and lack of countervailing buyer power.

The main objection to the perceived risk of facilitating cartels is that despite decades of successful enforcement against cartels of many kinds, there have been very few (if any) cases where RPM was actually identified as a focal point for the functioning of a cartel. The Guidelines refer to none, and we are not aware of any. A second objection is that non-price vertical restraints may, when used in parallel by many or all suppliers, achieve the same collusive outcome. For instance, parallel networks of exclusive distributors with minimum purchase requirements may yield a similar market price outcome to RPM. Yet rather than treat non-price vertical restraints as hard-core restrictions, the Commission left them free of presumed negative effect. Instead, the Commission introduced the possibility for national authorities to withdraw block exemptions to parallel networks of vertical restraints that have significant restrictive effects on the affected market.[13] The Commission offers no justification for these very different treatments of apparently similar vertical arrangements.

B. Softening Competition

Second, the Commission considers that RPM softens competition in the specific context of "interlocking" relationships, whereby suppliers use the same retailers to distribute their products and where RPM is used pervasively. Again, there is *prima facie* nothing wrong with the idea that this constitutes a risk. But, as was the case for the Commission's first reason, it is the use by many or all suppliers in a given market that creates the risk, not the use by a given supplier individually.

C. Price Increase

The third reason put forward by the Commission is somewhat circular. In substance, the Guidelines state that RPM causes prices to go up. The Commission is right: The immediate effect of the restraint is a price increase. However, it seems to us that the key issue is not whether prices of the RPM supplier's product will go up. Rather, the real question is whether RPM has *appreciable* effects on prices in the relevant product market.[14] This "appreciable" standard is inherent to the application of Article 101(1) to any vertical restraint. The Commission must

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[11] *See, e.g.*, Ittai Paldor, *The Vertical Restraints' Paradox: Justifying the Different Legal Treatment of Price and non-Price Vertical Restraints* (January 24, 2007), *available at* http://ssrn.com/abstract=951609.

[12] Case T-342/99, Airtours v. Commission, Judgment of the Court of First Instance, [2002] ECR II-2585, ¶¶ 61-62.

[13] Recital 14 and Article 6 of the BER and the Guidelines on Vertical Restraints, O.J. C 130, 19 May 2010, p. 1, ¶ 78.

[14] Case C-27/87, Erauw-Jacquery, [1988] ECR 1919, ¶¶ 12 and seq.

prove that the particular RPM has an appreciable effect on competition for that specific restraint to fall within Article 101(1). We, therefore, question the initial presumption in the Guidelines that all RPM falls within Article 101(1).[15] The Commission should not through the Guidelines simply transfer the burden of proof to the defendant, arguing that the immediate effect of RPM is almost always a price increase.

D. Commitment Problem

The Commission's fourth reason concerns the "commitment problem" of a monopolist. By adopting RPM, a supplier with significant market power can "commit" itself not to follow its otherwise natural propensity to lower the wholesale price charged to new dealers in order to raise his market share. While this situation is no doubt plausible, it requires a certain degree of market power for RPM to result in detrimental effects on competition and consumers.

E. Foreclosure of Competing Suppliers.

The fifth concern that the Commission has with RPM is that a firm with some degree of market power might impose such a measure to induce retailers to deny access to rival brands. But whether this form of inter-brand competition injures consumers or competition must depend on more than just success in inducing retailers to favor one brand over another. Again, for RPM to affect competition appreciably, it would be necessary to establish that the supplier and/or the retailer has sufficient market power so that RPM is likely to foreclose competitors from being able to compete. This requires an initial assessment of the likely foreclosure effects and the risk that foreclosure poses to consumer welfare, rather than a presumption that all RPM that induces brand-shifting is detrimental.

F. Foreclosure of Innovative Retailers

Finally, the Commission cites the possibility that RPM could reduce retailer innovation and entry by low-cost retailers. On this view, RPM can operate as a barrier to entry against innovative dealers. This view sounds intuitively appealing but seems to lack empirical support. The Guidelines seem to equate innovation with low retail prices or low pre-sale service and support. But for low-price or low-cost retailers to be hindered in any significant way, RPM should presumably be pervasive in the relevant market, including all relevant, competing brands. This concern would thus not materialize if RPM is engaged in by only a limited number of suppliers operating in a relatively unconcentrated market.

The Commission's apparent reasons for black-listing RPM thus rest upon three perceived risks: (i) collusion (tacit or explicit) among suppliers or retailers, (ii) foreclosure by a dominant supplier or a supplier with some degree of market power, and (iii) the widespread use of RPM in a given market.

III. SHIFTING THE BURDEN OF PROOF

Under the Commission's framework, every RPM is presumed to fall under Article 101(1) and it is for the defendant to adduce convincing evidence that RPM generates pro-competitive

[15] *Cf.* Eric Gippini-Fournier, *Resale Price Maintenance in the EU: In Statu Quo Ante Bellum?* [citation] (Sept. 21, 2009) ("The reference to a double "presumption" is novel and does not appear to find an obvious basis in existing case law.").

effects that justify exemption under Article 101(3).[16] The Commission's approach raises at least two concerns.

First, and most significant, there may be many situations where RPM could be used outside of the anticompetitive scenarios outlined by the Commission in the Guidelines. Without providing much explanation, the Commission considers that all such situations will be presumed to fall within Article 101(1) and firms will have to come up with a forceful efficiency defense.[17] This approach skips the requirement for the Commission, national authority, court, or complainant to establish the existence of *appreciable* effects on competition prior to finding that the restraint falls within the scope of Article 101(1).[18]

Even assuming that—despite the Guidelines—the parties would not be prevented from arguing that their particular use of RPM did not even violate Article 101(1), the Commission's approach effectively shifts the entire burden of proof onto the parties. Following the Commission's logic, pro-competitive efficiencies have to be provided by the supplier in a precise and articulate way while there is no *a priori* indication why RPM used in the individual context raises competition concerns. The onus is thus on the parties to justify a practice for which there is no initial evidence that it should be a concern in the first place.

Before going straight to the efficiency defense under Article 101(3), one should at least consider the potential harmful effects that RPM may have in individual cases. In other words, the standard screening under Article 101(1) should be carried out. As RPM entails a loss of intrabrand competition and hinders the ability of dealers to lower their price to meet interbrand competition, one should in particular assess the existence of constraints resulting from interbrand competition. The stronger the competitive pressure exerted by other suppliers and retailers, the less likely RPM will result in market-wide price increases. Likewise, low barriers to entry should be an indicator that RPM is unlikely to result in a significant price increase if a supra-competitive price is likely to attract new entrants. Finally, the position of buyers may make RPM difficult to sustain over time. A large buyer may have the ability and incentives to ignore the RPM clause because its volume of sales significantly contributes to the penetration of the supplier's brand in a given market.

Once these market conditions are taken into account, can the defendant assess the extent of pro-competitive efficiencies necessary to override the likely harmful effects of RPM? Similar to a merger control analysis, efficiencies need not be significantly greater than the perceived harm to competition.[19] In other words, the lower the risk posed by RPM to effective competition in a retail market, the lower the efficiencies need to be to meet the conditions of Article 101(3).

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[16] Guidelines, at ¶¶ 47 and 223.

[17] The Guidelines do not indicate a specific level of persuasion applicable to all "efficiency defenses" but regarding elimination of free riding, "[t]he parties will have to convincingly demonstrate" relevant facts. Guidelines at ¶ 225.

[18] Indeed, the Guidelines only contemplate that the parties using RPM would offer an efficiency defense under Article 101(3); there is no mention of an opportunity to demonstrate—at any level of persuasion—that the facts show no violation of Article 101(1) in the first place. *See*, Guidelines on the application of Article 101(3) TFEU, O.J. C 101, 27 April 2004, p. 97, ¶ 16.

[19] *See*, Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, O.J. C 31, 5 February 2004, p. 5, ¶ 84. See also Guidelines on the application of Article 101(3) TFEU, O.J. C 101, 27 April 2004, p. 97, ¶ 43.

However, the Guidelines do not suggest that authorities and complainants embark on such an analysis. Rather, they suggest that, irrespective of the market share held by the supplier or its dealers, and ignoring the competitive constraints exerted by rivals and buyers, efficiencies will have to be substantiated in detail for a supplier to engage in RPM with its dealers. For example, before using RPM to resolve a free-riding problem, the supplier will need to "convincingly demonstrate that the RPM agreement can be expected to not only provide the means but also the incentive" for dealers to provide pre-sale services and that "the pre-sales services overall benefit consumers."[20]

Second, the Commission's Guidelines discuss potential efficiencies in only three sets of circumstances: (i) the launch of a new product, (ii) a short-term, low-price campaign in a franchise or similar distribution system, and (iii) the elimination of free riding by some retailers on the provision of additional pre-sale services by other retailers of "experience" or "complex" goods.[21] Beyond those circumstances, the Guidelines do not provide a method or guidance on the type of efficiencies that ought to be put forward by those considering making use of RPM for the distribution of their product. As noted in the previous section, RPM may serve other legitimate purposes that enhance interbrand competition, particularly in markets with low concentration of suppliers and distributors, easy entry, or limited use of the RPM mechanism. Parties using RPM when market conditions do not suggest that appreciable anticompetitive effects are likely thus face significant uncertainty about whether the Commission would challenge their RPM and, if so, how to defend against it.

In light of the foregoing, it is difficult to reconcile this allocation of the burden of proof with the view, shared by the Commission, that RPM only entails significant harmful effects when there is either some degree of market power or pervasive usage of RPM in a relevant market.

IV. PRACTICAL IMPLICATIONS FOR SUPPLIERS AND RETAILERS

RPM is often portrayed as a straightforward and easily administered mechanism to align the interests of dealers with those of the supplier. RPM may not fully address all the concerns that the supplier may have all at once. For instance, while better retail services generally raise consumer demand, fixing the retail price may not cause all dealers to provide the pre-sale services that the supplier expects them to provide, or to stock or shelve more of the RPM'ed products. But it is at least a relatively simple and convenient way to achieve some degree of commitment on the part of a sufficiently large number of dealers to support and invest efforts in the RPM'ed product at low marketing and monitoring costs for the supplier.[22] Alternative and possibly less restrictive ways to achieve a similar outcome may not always be available and suitable in a particular context, as they may prove very costly for the supplier to implement and monitor. For instance, providing subsidies to retailers in exchange for service may use up a significant portion of the marketing budget or generate monitoring costs that a supplier cannot afford for a particular line of product. Likewise, the supplier may not have a sophisticated view of the types of selective distribution criteria that ought to be implemented in a network.

For all these reasons, RPM may indeed improve distribution of products. Yet the Commission's Guidelines make it questionable whether suppliers would turn to RPM to align their interests with those of dealers. The Commission's aggressive shifting of the burden of proof

[20] *See*, Guidelines, ¶ 225.
[21] *See* Guidelines at ¶ 225.
[22] *See*, John B. Kirkwood, *supra* note 3, at p. 25.

causes a great deal of legal uncertainty as it requires the supplier to articulate an efficiency defense before any assessment of harmful effects and, importantly, stops short of providing clear guiding principles.

As a result, many suppliers and distributors across the EU might be deterred from entering into RPM arrangements. This appears not only inconsistent with the perceived competitive risks that RPM entails, but also deprives the business community and competition authorities alike of badly needed experience in this field. Experience with a restraint would inform about the frequency and conditions under which negative effects do in fact arise and, in turn, would allow the Commission and national competition authorities to make more thorough appraisals when confronted with RPM in individual cases.

V. ALTERNATIVE METHOD TO ASSESS RPM?

There is scope to devise a more flexible and practical approach consistent with the concerns identified by the Commission. The Commission recognizes that RPM need be feared primarily when it facilitates cartelization of suppliers or dealers or when it forecloses distribution to competing suppliers or by competing retailers. The Commission also seems to recognize that RPM is pro-competitive when it stimulates retailers to provide better services to consumers and encourages interbrand competition. Since RPM is likely to raise significant concerns only when there is some degree of market power or where it is used pervasively, RPM should not be treated as hardcore below certain thresholds. The Commission can build on a regulatory mechanism already in place to give effect to these insights.

During the consultation on the draft Guidelines, the *Economic Advisory Group on Competition Policy* suggested that the market share test in the *De Minimis* Notice[23] could prove useful to screen clearly inoffensive RPM from those requiring further inquiry. We propose taking this suggestion one step further by amending the Notice to apply directly to RPM.

The *De Minimis* Notice provides thresholds under which vertical agreements do not fall within the scope of the prohibition of Article 101(1). In particular, under the Notice, the Commission holds that an agreement does not appreciably restrict competition where the market share of the supplier and the distributor does not exceed 15 percent on the relevant markets affected by the agreement. Suppliers with low market shares should therefore find comfort under the Notice and no further antitrust analysis should be required. This threshold recognizes that in most circumstances restraints affecting 15 percent or less of the market are unlikely to cause any anticompetitive effects.

However, since it is nearly ten years old, the Notice still reflects the Commission's historical view that RPM is always an anticompetitive restriction. This means that even below the market share threshold of 15 percent, RPM is blacklisted.

The Notice's absolute blacklisting is no longer fully consistent with the Commission's partial, if arguably inadequate, opening of the door to potentially pro-competitive RPM programs. Amendment of the Notice to conform to the new Guidelines would thus be appropriate and also presents the opportunity to begin addressing the problems raised by the new Guidelines.

[23] Commission Notice on agreements of minor importance which do not appreciably restrict competition under Article 81(1) of the Treaty establishing the European Community (de minimis), O.J. C 368, 22.12.2001, p. 13.

In particular, we suggest that the Notice be amended to remove RPM entirely from the black list of clauses that prevent application of the Notice. That would permit RPM to be used when the market shares of the supplier and the dealer fall to or below 15 percent.[24]Above the threshold of 15 percent, RPM would be examined under the approach set out by the Guidelines.

Although this approach does not fully resolve concerns about the new Guidelines, it would help to accumulate experience with RPM in the future. The Commission, courts, and parties required to "self-assess" the legality of their agreements would hopefully learn more about when RPM is, in fact, problematic. Such experience would also help the Commission to apply the Guidelines flexibly, with due regard for when actual facts should overcome the double presumption of illegality.

[24] The Notice provides that when a restrictive practice is used pervasively in a relevant market, the market share threshold falls to 5 Percent. It states also that a "cumulative foreclosure effect is unlikely to exist if less than 30 percent of the relevant market is covered by parallel (networks of) agreements having similar effects."

Antitrust & Competition Advisory - European Commission releases proposal on distribution agreements

July 29, 2009

On 28 July 2009, the European Commission issued a draft antitrust regulation and guidelines on distribution agreements between suppliers and retailers.[1] The proposal would replace existing rules, which exempt certain forms of distribution agreements from EU competition law, by no later than May 2010.[2] The Commission proposes largely to renew these rules, but addresses additional requirements on three fronts: (i) Internet retailers, (ii) resale price maintenance and (iii) purchasing power of large retail chains.

The release of the proposed legislative package opens a two-month consultation to allow the industry and stakeholders to provide views and input on the proposal, in particular on the three topics, discussed below. Companies and organizations may submit public comments until 28 September.

Internet Retailers

Sales over the Internet have expanded dramatically over the last few years. Under the existing rules, suppliers of luxury or complex goods can impose an obligation on their appointed retailers to maintain a "brick and mortar shop" or showroom before engaging in online distribution. Purely online retailers, such as eBay, have militated against this restriction by arguing that the Internet complements rather than competes against traditional sales channels. Luxury goods manufacturers have battled to prevent online selling to avoid alleged "free riding" and to control quality over the distribution of their products.

The proposed rules maintain the possibility for suppliers, in a selective distribution system (suitable for luxury or experience goods),[3] to require appointed retailers to maintain a brick and mortar shop. However, the European Commission insists that retailers should not be prevented or dissuaded from using the Internet as a retail channel, for instance by imposing criteria for online sales that are not equivalent to those imposed for the sales from "brick and mortar shops" or by requiring retailers to charge the recommended sales price.

Regarding exclusive distribution networks,[4] the draft rules clarify that advertising and selling over the Internet, even where it reaches out to consumers located in territories exclusively allocated to other retailers, should not be restricted. It will be considered a hardcore restriction for suppliers to require the distributor to re-route consumers located in another exclusive territory to the allocated supplier's or exclusive retailer's website. Likewise, card-holder information should not be used to limit sales to certain categories of consumers.

While the Commission regards restrictions on online retailing with suspicion, it appears that lobbying efforts of luxury goods manufacturers have so far prevailed over attempts by purely online retailers to eliminate the "brick and mortar shop" requirement.

Resale Price Maintenance

In view of the U.S. Supreme Court's ruling in *Leegin*,[5] which provides that requiring the retailer to resale the products or services at a fixed or minimum price (a.k.a. "resale price maintenance" or RPM) should be reviewed under the rule of reason, the European Commission has considered whether a

similar approach should be adopted in the EU.

Under the proposed rules and guidelines, RPM is considered a hardcore restriction, meaning that any agreement containing such a requirement would fall outside the safe harbors. The European Commission adds that there will be a rebuttable presumption that RPM violates Article 81(1) of the EC Treaty and is unlikely to meet the efficiency defense under Article 81(3) of the EC Treaty. On the other hand, the Commission lists three specific cases where RPM may generate pro-competitive benefits and, hence, overcome the presumption. In particular:

- RPM may be necessary to introduce a new product or enter into a new market. This rests on the theory that temporary RPM could induce retailers to invest in promotional efforts in order to generate and develop demand for the product;
- RPM may also be authorized in franchise systems to coordinate a short-term low price campaign; and
- Finally, RPM may be necessary to avoid loss leading practices of retailers with market power.

It is, however, anticipated that RPM will be allowed only exceptionally in the EU.

Buying power of large retail chains

The European Commission considers that the existing rules, by limiting the application of the 30% market share threshold to the supplier, do not adequately address the potential anticompetitive effects resulting from restrictions requested and obtained by large retail chains with market power. An obvious example, already captured in the existing regulation, is a large retailer with national coverage that secures exclusive supply commitments on the part of multiple brand owners. The Commission has in mind additional restrictive practices that may have similar foreclosure effects on smaller retailers, e.g., appointed resellers imposing selective distribution criteria on their supplier which limit entry of new retailers or exclusive territories being granted to retailers with market power.

To address this concern, the Commission suggests extending the application of the market share test to retailers. Beyond an individual market share of 30% at the retail level, distribution agreements would not benefit from the exemption provided for by the regulation and the parties would need to self-assess the compatibility of their agreement applying the strict EU competition rules (in particular, Article 81(3) EC).

One of the main concerns of the Commission seems to be the collective exercise of market power by large retailer organizations. However, it is unclear how the market share test, which will now apply to individual retailers, will play out in practice and how it will effectively and adequately deal with those concerns.

Conclusion

The Commission's proposal, if adopted as is, would largely continue the EU's unique competition rules governing distribution agreements between suppliers and retailers. However, those with Internet sales businesses may be disappointed with the Commission's proposal, as may be others hoping for a shift toward the U.S.'s more *laissez-faire* rules on resale price maintenance. Uncertainty about the proposed tightening of rules for large retail organizations may also cause concerns for those selling to such groups and perhaps even for customers of large retail chains if they lose some benefits of high-volume purchasing by those retailers. Companies or organizations with concerns or suggestions are urged to make them known through comments to the Commission, which are due by 28 September 2009.

Antitrust & Competition Advisory - European Commission releases proposal on distribution agreements

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[1] Available at: http://ec.europa.eu/competition/consultations/2009_vertical_agreements/index.html.
[2] See, Commission regulation n° 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices, O.J. L 336/21 of 29 December 1999.
[3] In a selective distribution agreement, the supplier undertakes to sell the contract goods only to distributors selected on the basis of specified criteria and where those distributors undertake not to sell the contract goods to unauthorized distributors.
[4] In an exclusive distribution agreement, the supplier undertakes to sell his products to one distributor for resale in a particular territory.
[5] Leegin Creative Leather Products, Inc. v. PSKS, Inc., 127 S.Ct. 2705 (2007).

ECJ Rules on GlaxoSmithKline's Parallel Trade Restriction

Professionals

- Yves Botteman

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ECJ Rules on GlaxoSmithKline's Parallel Trade Restriction

September 16, 2008

Today, the European Court of Justice ("ECJ") handed down its long-awaited judgment in the dispute between GlaxoSmithKline ("GSK") and a number of independent Greek wholesalers of prescription medicines.

In October 2000, GSK had refused to meet the orders of these wholesalers citing shortages. It later resumed the supply of the medicines but restricted the quantities, effectively limiting the wholesalers' ability to export to high-price Member States since they were also under an obligation to supply the domestic market.

In *Syfait*, the ECJ was asked to decide whether GSK's refusal to meet fully the orders of the wholesalers constitutes an abuse of dominance under Article 82 EC. At the time, the ECJ dismissed the case on procedural grounds. However, the opinion of Advocate General ("AG") Jacobs was widely read and commented upon. AG Jacobs had concluded that in a highly regulated market, such as that for pharmaceuticals, parallel import restrictions by a dominant company are not abusive.

In the case decided today, AG Ruiz-Jarabo Colomer completely diverged from AG Jacobs' opinion, arguing instead that the prevention of parallel imports does constitute an abuse and, moreover, cannot be justified by reference to specific market conditions that characterise the pharmaceutical sector, or otherwise. In particular, AG Ruiz-Jarabo Colomer concluded that no "efficiency defense" is available in this case.

Today, the ECJ relied on the *United Brands* and *Commercial Solvents* line of cases, striking a balance between the two conflicting AG opinions. It held that a refusal to supply medicines to wholesalers in order to prevent parallel exports constitutes an abuse *unless* the practice is considered reasonable and proportionate to protect that company's legitimate commercial interests.

Specifically, the ECJ held that "*it is permissible for that company to counter in a reasonable and proportionate way the threat to its own commercial interests potentially posed by the activities of an undertaking which wishes to be supplied […] with significant quantities of products that are essentially destined for parallel imports.*" In practice, added the ECJ, it must be ascertained whether the undertaking's refusal to supply relates to orders of wholesalers that "*are out of the ordinary*". This requires an appraisal of both the "*previous business relations*" between the pharmaceutical company and the wholesalers and the "*size of the orders in relation to the requirements of the market*" concerned.

GSK argued that State intervention in the pharmaceutical sector is such that pharmaceutical companies do not control the prices of their products. Therefore, the general logic behind protecting competition within a brand does not function in this sector. GSK also pointed out that parallel trade reduces profits that are needed for R&D. The ECJ dismissed these arguments. Irrespective of price control and State supervision, the laws of supply and demand continue to apply to pharmaceutical products. This is because pharmaceutical companies are actively involved in price setting at the national level. The ECJ also pointed out that intra-brand competition is the only form of competition for drugs under patent protection. Parallel trade is liable to exert pressure on prices in the importing country. GSK cannot justify its practice by saying that the benefit of lower prices to consumers is negligible.

The ECJ confirmed previous case-law that a dominant company cannot refuse to meet its wholesalers' "ordinary" orders. The ruling does not however provide clear guidance as to how "ordinary" ought to be interpreted. Pharmaceutical companies are now faced with a reversal of AG Jacobs' opinion and deciding on how to deal with parallel trade will prove very difficult in practice.

Furthermore, while the Commission is promoting a more "effects-based" analysis in the application of Article 82 EC, it appears that the ECJ has refused to embark on such an exercise. Likewise, the ECJ has not shed light on the extent to which dominant undertakings may put forward overriding efficiency arguments in support of a refusal to supply. Clarifications on this aspect would have been welcome.

The full text of the ECJ's decision is available here.

If you have any questions regarding this matter, please contact: Yves Botteman.

STEPTOE&JOHNSON LLP

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Consultation on review of the competition rules for vertical agreements

INTRODUCTION

1. Steptoe & Johnson LLP is grateful to the Commission for the opportunity to comment on its proposals with respect to a revised block exemption and guidelines on vertical agreements. The proposals show that the Commission is of the opinion that the present rules are working reasonably well and do not need to be fundamentally changed. Steptoe & Johnson shares this view. The proposals appear to be mainly intended to respond to two important market developments since the adoption of the current block exemption regulation, namely the enhanced purchasing power of large retailers and the growth in sales over the Internet. Steptoe & Johnson's comments will be largely limited to the Commission's proposals in these two areas. It will also touch on its suggested approach of "resale price maintenance" ("RPM").

2. The Commission's current approach with respect to vertical restraints is certainly not free from criticism. In the literature, attention has in particular been drawn to two systemic problems. In the first place, it has been pointed out that the main reason for the establishment of the block exemption was to facilitate the assessment by the Commission of notified distribution agreements. As notification since the entry into force of Regulation 1/2003 is no longer required, the block exemption has become obsolete and is now an obvious anomaly in European competition law. Secondly, Regulation 2790/1999 should have become the first concrete example of the shift from the legalistic to a more economic-based approach. The Commission had not long before its adoption promised that it would found its competition policy on a more solid economic basis. Many felt however that the new regulation and guidelines did not live up to the expectations.

3. Although market power was taken as the main reference point many commentators, including prominent economists, were of the view that the market share threshold of 30% was too low, and probably unnecessary in the first place, and that it was uncalled for in any event to bluntly blacklist certain fairly innocent vertical restraints. In a true economic approach, one would expect that first of all the circumstances in which restrictive clauses might produce negative effects on competition would be defined and that they would only be prohibited where such

circumstances actually occur. The block exemption was described as a less than brilliant compromise between a more, but not sufficiently, economics-based approach and the apparently felt need to pursue a competition policy based on strict rules.

4. Even though Steptoe & Johnson considers this criticism not entirely unfounded, we believe that the block exemption regulation has served its purpose and remains necessary for two main reasons. First of all, the block exemption and its guidelines are a useful tool for companies when self-assessing the compatibility of their vertical agreements with competition law. Secondly, the block exemption is a binding instrument, not only for the European Commission but also for the NCAs and the national and Community courts. The block exemption regulation includes a common frame of reference for these NCAs and courts which obviously contributes to harmonisation and an EU-wide level playing field.

MARKET SHARE THRESHOLD

5. Back in 1999, one of the main points of criticism was the Commission's introduction of market share ceilings. Many people pointed to the existing consensus among economists that market shares are often not a reliable indicator of a company's market power. Others argued that with such low market share thresholds, the Commission should have allowed wider exemptions for most forms of vertical restraints.

6. To this criticism can be added that in practice it is extremely difficult to determine the actual level of a particular market share with, as a logical consequence, legal uncertainty for businesses. It also should be noted that the market share of a company will obviously fluctuate with the passage of time. Distribution agreements are almost always concluded for a number of years and, therefore, it is almost certain that the original estimate of the market share will be different from the market share at the end of the contract. In cases where a company's market share rises after the conclusion of the agreement, the block exemption remains applicable for a period of only one, and maximum two years. This places parties in a difficult situation; they continuously need to verify whether the market share limit has not been exceeded. In fact, parties continually run the risk of losing the protection of the block exemption. In our view, it would be better if the next regulation did not contain a market share threshold.

7. Perhaps the most important proposed amendment to the existing regulation concerns the application of the current market share threshold not only to the vendor but also to the buyer. The Commission wishes to take into account the further strengthening of the market power of major distributors during the last ten

years, and therefore proposes that a vertical agreement should only qualify for the block exemption if not only the market share of the vendor, but also the market share of the buyer does not exceed 30%. Steptoe & Johnson does not believe that such a change would be a good idea.

8. First of all, we foresee major practical problems. As mentioned, it is already extremely difficult for a supplier to determine with any degree of certainty the actual level of his own market share. It will be even more difficult for a supplier to determine how high the market shares of his (in many cases numerous) buyers are, particularly since the buyer will often be very reluctant to share such information. And where the purchaser is active in different local markets, this exercise becomes almost impossible. In addition to the difficulty of the assessment of market shares, anticompetitive effects may equally arise in cases where the market share is less than 30%. The existence of buyer power depends on a number of factors and a significant market share is only one of those factors. Should the combination of supplier and buyer power prove to be problematic in an individual case, the Commission can always withdraw the benefit of the block exemption. The presumption of legality conferred by the regulation may be withdrawn if a vertical agreement, considered either in isolation or in conjunction with similar agreements enforced by competing suppliers or buyers, comes within the scope of Article 81(1) and does not fulfil the conditions of Article 81(3). For these reasons, Steptoe & Johnson suggests that the Commission rethink its proposal to apply the market share threshold to both vendor and buyer.

INTERNET SALES

9. In the past decade, the sale of goods over the Internet has become a popular form of distribution. The Commission proposes to distinguish clearly between sales as a result of active marketing and sales on the initiative of the consumer (that is, between active and passive sales). The inclusion of a clear definition in the revised guidelines is useful, because in practice many companies have great difficulties distinguishing between the two. Furthermore, the Commission's proposals explain how the revised regulation would deal with conditions imposed in relation to Internet sales, such as the requirement imposed by a supplier that the distributor should have a "brick and mortar" shop before engaging in online sales.

10. When the block exemption regulations and guidelines were adopted in 1999 the phenomenon of sales over the Internet was still relatively new. Since it lacked practical experience in this area, the Commission decided to follow the basic approach that any additional form of distribution means more competition and would therefore be good for consumers. In addition, it saw the Internet as an additional tool in its continuous struggle to achieve a truly single European

internal market. Restrictions on sales over the Internet should therefore *prima facie* be viewed as anticompetitive. The Commission did also realize however that the Internet harbours dangers for consumers, and that its great potential was no justification for ignoring the existing case law on exclusive and selective distribution. The last ten years have made abundantly clear that the Internet indeed has both positive and negative aspects. It is both an ideal place for consumers to compare prices and quickly order products, particularly products such as books and CDs, and an ideal place for those inclined to engage in piracy and fraud or free-ride on the efforts and investments of others.

11. Steptoe & Johnson is of the opinion that the current proposals with regard to online sales strike the right balance between, on the one hand, the legitimate demands of suppliers and distributors and, on the other hand, the Commission's own legitimate policy objective of stimulating the sale of goods through the Internet. Of course, for the obvious reasons the ability of European consumers to make intra-European cross-border purchases should be encouraged as much as possible and it is undeniable that this is greatly enhanced by the Internet. It is also indisputable, however, that at least limited sales restrictions are necessary in order to prevent certain traders from taking advantage of the investments of their competitors in marketing and brand promotion. That too is in the interest of the consumer.

12. European competition law has long recognized that certain vendors, in particular those of luxury and high-tech products, are permitted to organise protected distribution networks within which distributors may be selected on the basis of specific qualitative criteria in order to protect the image of the products sold. These criteria vary from requirements as regards the store's interior, the presence of trained personnel and the availability of after-sale services. This policy has been reflected in Regulation 2790/1999 and its accompanying guidelines which are currently the subject of review but had already been recognised in the case-law of the European and national courts long before that.

13. Producers of luxury products are rightly concerned that a bad presentation of their products on websites of inferior quality (for example, by means of low-resolution photos) is detrimental to the brand. For these reasons, they generally restrict the online sale of their products, require their authorized distributors to maintain a physical outlet and put high demands on their websites. These requirements equally aim to prevent the free-riding of traders on the investments of authorised distributors in their physical outlets. An online store that does not need to invest in a physical outlet, or in the training of staff, obviously has lower costs which may lead to lower consumer prices. Consumers can make use of the services offered in real shops to make their choices, and can then elsewhere order

the product online. This obviously takes away the incentive for physical distributors to invest in their shop and services.

14. Selective distribution is not incompatible with the development of Internet sales. Most luxury products can be purchased online by consumers on websites owned by the manufacturer or the distributor of the product. Many distributors have no difficulty complying with the rules for selective distribution. It is certainly possible to find an acceptable balance between the protection of the consumer and his interest in low prices on the one hand and the preservation of legitimate distribution networks on the other hand by recognising that suppliers may require from distributors who want to sell luxury products online that they already have a serious outlet that meets objective quality criteria and, like the other distributors network, make the necessary investments in their websites to protect the brand image.

15. Steptoe & Johnson agrees with the Commission, however, that some of the more serious restrictions on passive sales over the Internet should be considered hardcore restrictions. There are vertical restrictions that simply entail unnecessary distortions of competition. The revised guidelines give a few examples. Requiring a distributor to terminate consumers' transactions over the Internet once their credit card data reveal an address that is not within the distributor's territory, is a good example of an unnecessary restriction.

16. The Commission further proposes to offer a certain protection to start up activities of distributors. A distributor which will be the first to sell a new brand or the first to sell an existing brand on a new market, may have to commit substantial investments to start up and/or develop the new market where there was previously no demand for that type of product. Such expenses are often sunk costs and in such circumstances the distributor probably would not enter into the distribution agreement without protection for a certain period of time against passive sales into its territory or to its customer group by other distributors. Steptoe & Johnson supports the Commission's proposal to provide a protection of two years in such cases. However, we believe that since this exception is of considerable practical importance, in particular to suppliers with a large cross-border network of distributors, it belongs in the text of the block exemption and should not just be mentioned in the guidelines as is currently the case.

RPM

17. In the Commission's current proposal, resale price maintenance continues to be a hardcore restriction. Including a hardcore restriction in an agreement gives rise to the presumption that the agreement falls within Article 81(1) and is

unlikely to fulfil the conditions of Article 81(3), for which reason the block exemption does not apply. The Commission states that situations do exist in which RPM could lead to efficiency gains that should be taken into account in the assessment under Article 81(3). It is, however, extremely doubtful whether the Commission will take these potential efficiencies seriously given its strong aversion to RPM. The Commission has made it very clear that it finds it hard to identify cases where RPM leads to efficiency gains. It is perhaps for this reason that since the entry into force of the current block exemption regulation the Commission in all RPM cases which it has dealt with has concluded that the arrangements did not fulfil the conditions of Article 81(3).

18. Economic literature makes clear that RPM can have procompetitive as well as anticompetitive effects. In the most cynical view, RPM is primarily used to facilitate cartels at the retail or production level and never produces any efficiencies. However, most of the explanations for RPM are based on the assumption that RPM is a legitimate practice designed for the benefit of a single producer (acting alone) and his distributors. These explanations describe the benefits that they can obtain from the establishment of minimum retail prices.

19. At first sight, RPM may seem a rather strange phenomenon. For any given wholesale price it must be assumed that the lower the markup for the retailer, the lower the retail price, the higher the sales, and therefore the higher the profit for the manufacturer. The establishment of a minimum retail price is tantamount to an increase of these prices and this reduces the total sales of the product and thus the income of the manufacturer. It is in the economic interest of the manufacturer that the retailer sells against the lowest possible price. What can be then a plausible explanation for the imposition of a minimum retail price?

20. There are in fact several plausible explanations. To give just one example, a higher margin between the wholesale price and the retail price can stimulate investments in various point of sale-specific types of services which consumers value above their actual costs. This may include investments in qualified sales people or store interior. Retailers will be less inclined to invest in staff and store amenities without a restriction on price competition, simply out of fear that their competitors will free-ride on their efforts and will be able to sell at lower prices. Consumers appreciate good service and an enjoyable shopping experience and are prepared to pay for it. That is why these shops exist and look the way they look. An increase in demand caused by a better service and luxurious stores can increase consumer welfare even if accompanied by higher prices.

21. The danger of free-riding is often underestimated, which is a serious mistake. Consumers can only benefit in the short term from the free-riding of distributors

outside the network. A well known example of free-riding relates to high-quality audio equipment where pre-sale assistance by an expert seller is required to inform the consumer and to convince him of the merits of the product. After having obtained the required information from the expert salesperson, the satisfied customer leaves the shop without however having completed the sale. He goes straight to the discount store around the corner, goes directly to the cash register and purchases the product for a lower price. The discount store, which can offer the lower price because it only employs part-time students without any relevant experience, takes a free ride on the investments of the full service retailer who faces much higher costs in order to bring his products to the market. To give another example: many manufacturers of high-end TVs or audio equipment usually develop different models and require their distributors to put all of these models on display in their shops. These distributors must invest, e.g., to obtain knowledge about the technical specifications of these different models. After some time it becomes clear which model is the most popular among consumers and the other models disappear from the market. Discount stores simply wait until it has become clear which model comes out on top. They don't invest in knowledge or fancy displays. They free-ride on the investment of the authorized distributors.

22. Evidently, the situations which we have just described are untenable in the long term for the full service retailer. He cannot both employ expert sellers and at the same time continue to compete with the discount stores in his area. The retailer will have to limit its service in order to be able to survive. Many will not survive. Consumers must decide which brand to buy with less than complete information. Products for which pre-sale assistance is required become less available. The consequences are bad for consumers. Ultimately, free riders prevent consumer access to retail services for which they are perfectly willing to pay. The end result is sub-optimal.

23. As stated above, it is sometimes argued that RPM can be a deliberate stabilizing measure for a cartel among retailers. These retailers are well aware that each of them separately has good reason to defect and charge lower prices in order to stimulate his sales at the expense of the other members of the cartel. They realise that it is therefore better to jointly approach the common producer and ask him to impose RMP, and take rigorous action against members who ignore it. Another explanation points out that RPM can be used as an information tool for producers cartels. The theory states that RPM is of great value in sectors where retail prices are more visible than wholesale prices. The establishment of minimum retail prices facilitates the detection of foul play in relation to wholesale prices. None of these explanations seem particularly convincing. Fixed minimum prices do stabilize prices, but if this leads to better service it would seem to be a

legitimate restriction on competition. Facilitation of producer cartels through RPM seems somewhat unlikely, in particular since a disparate retail price does not necessarily indicate a disparate wholesale price.

24. The Commission has quite rightly been criticised for its *de facto per se* approach of RPM. This is particularly worrying because the European courts have never confirmed this strict approach. Quite to the contrary, it is clear from the ECJ's judgment in Binon that RPM is not *per se* unlawful under Article 81 EC. The criticism increased after the Leegin judgment of the U.S. Supreme Court. In Leegin, the Supreme Court overturned nearly a hundred years of antitrust precedent in a landmark 5-4 decision. The decision overturned Dr. Miles Medical Co. v. John D. Park & Sons (1911), which made it per se illegal for a manufacturer and its distributor to agree on a minimum price. The majority emphasized that the rule of reason, which distinguishes between restraints with anticompetitive effects that are harmful to the consumer and those with procompetitive effects that are in the consumer's interest, is the accepted standard for determining whether agreements violate Section 1 of the Sherman Act, and that per se rules should be reserved only for those agreements that almost always would be found unreasonable after a rule of reason analysis. "Economics literature is replete with procompetitive justifications for a manufacturer's use of resale price maintenance, and the few recent studies on the subject also cast doubt on the conclusion that the practice meets the criteria for a per se rule," the Supreme Court held.

25. The Commission has claimed that EC competition law applies a similar standard because a party can always argue that the conditions of Article 81(3) are met. Since it is clear however that the Commission is not prepared to change its strict approach to RPM, any recourse to Article 81(3) will almost certainly prove to be in vain. Steptoe & Johnson is in favour of a more open approach to RPM, not in the least because this would be more in line with a genuine economics-based approach to European competition law in general and vertical restraints in particular.

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Brussels, 28 September 2009

Yves Botteman
Kees J. Kuilwijk

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JUDGMENT OF THE COURT (Grand Chamber)
16 September 2008 (*)
(Article 82 EC – Abuse of dominant position – Pharmaceutical products – Refusal to supply wholesalers engaging in parallel exports – Ordinary orders)

In Joined Cases C-468/06 to C-478/06,

REFERENCES for a preliminary ruling under Article 234 EC from the Efetio Athinon (Greece), made by decisions of 3 March 2006 (C-468/06 to C-474/06), 17 March 2006 (C-475/06 and C-476/06) and 7 April 2006 (C-477/06 and C-478/06), received at the Court on 21 November 2006, in the proceedings

Sot. Lelos kai Sia EE (C-468/06),
Farmakemporiki AE Emporias kai Dianomis Farmakeftikon Proionton (C-469/06),
Konstantinos Xidias kai Sia OE (C-470/06),
Farmakemporiki AE Emporias kai Dianomis Farmakeftikon Proionton (C-471/06),
Ionas Stroumsas EPE (C-472/06),
Ionas Stroumsas EPE (C-473/06),
Farmakapothiki Farma-Group Messinias AE (C-474/06),
K.P. Marinopoulos AE Emporias kai Dianomis Farmakeftikon Proionton (C-475/06),
K.P. Marinopoulos AE Emporias kai Dianomis Farmakeftikon Proionton (C-476/06),
Kokkoris D. Tsanas K. EPE and Others (C-477/06),
Kokkoris D. Tsanas K. EPE and Others (C-478/06),

v

GlaxoSmithKline AEVE Farmakeftikon Proionton, formerly Glaxowellcome AEVE,

THE COURT (Grand Chamber),

composed of V. Skouris, President, P. Jann, C.W.A. Timmermans, A. Rosas, K. Lenaerts (Rapporteur) and A. Tizzano, Presidents of Chambers, R. Silva de Lapuerta, K. Schiemann, J. Makarczyk, P. Lindh, J.-C. Bonichot, T. von Danwitz and A. Arabadjiev, Judges,

Advocate General: D. Ruiz-Jarabo Colomer,

Registrar: L. Hewlett, Principal Administrator,

having regard to the written procedure and further to the hearing on 29 January 2008,

after considering the observations submitted on behalf of:

Sot. Lelos kai Sia EE (C-468/06), by S.E. Kiliakovou, dikigoros,

Farmakemporiki AE Emporias kai Dianomis Farmakeftikon Proionton (C-469/06 and C-471/06), Konstantinos Xidias kai Sia OE (C-470/06), Ionas Stroumsas EPE (C-472/06 and C-473/06), Farmakapothiki Farma-Group Messinias AE (C-474/06) and K.P. Marinopoulos AE Emporias kai Dianomis Farmakeftikon Proionton (C-475/06 and C-476/06), by L. Roumanias and G. Papaïoannou, dikigoroi,

Kokkoris D. Tsanas K. EPE and Others (C-477/06 and C-478/06), by G. Mastorakos, dikigoros,

GlaxoSmithKline AEVE Farmakeftikon Proionton, by A. Komninos, D. Kyriakis, T. Kloukinas and S. Zervoudaki, dikigoroi, and by I. Forrester QC and A. Schulz, Rechtsanwalt,

the Italian Government, by I.M. Braguglia, acting as Agent, assisted by F. Arena, avvocato dello Stato,

the Polish Government, by E. Ośniecka-Tamecka, P. Kucharski and T. Krawczyk, acting as Agents,

the Commission of the European Communities, by T. Christoforou, F. Castillo de la Torre and E. Gippini Fournier, acting as Agents,

after hearing the Opinion of the Advocate General at the sitting on 1 April 2008,

gives the following

Judgment

These references for a preliminary ruling concern the interpretation of Article 82 EC.

The references were made in proceedings brought by Sot. Lelos kai Sia EE, Farmakemporiki AE Emporias kai Dianomis Farmakeftikon Proionton, Konstantinos Xidias kai Sia OE, Ionas Stroumsas EPE, Farmakapothiki Farma-Group Messinias AE, K.P. Marinopoulos AE Emporias kai Dianomis Farmakeftikon

Proionton, and Kokkoris D. Tsanas K. EPE and Others, pharmaceuticals wholesalers, ('the appellants in the main proceedings') against GlaxoSmithKline AEVE Farmakeftikon Proionton, formerly Glaxowellcome AEVE, ('GSK AEVE') in respect of the latter's refusal to meet those wholesalers' orders for certain medicinal products.

The legal framework

Community legislation

Council Directive 89/105/EEC of 21 December 1988 relating to the transparency of measures regulating the prices of medicinal products for human use and their inclusion in the scope of national health insurance systems (OJ 1989 L 40, p. 8) lays down certain requirements for Member States when applying national measures to control the prices of medicinal products for human use or to restrict the range of medicinal products covered by their national health insurance systems.

The second to fourth recitals to that directive read as follows:

'Whereas Member States have adopted measures of an economic nature on the marketing of medicinal products in order to control public health expenditure on such products; whereas such measures include direct and indirect controls on the prices of medicinal products as a consequence of the inadequacy or absence of competition in the medicinal products market and limitations on the range of products covered by national health insurance systems;

Whereas the primary objective of such measures is the promotion of public health by ensuring the availability of adequate supplies of medicinal products at a reasonable cost; whereas, however, such measures should also be intended to promote efficiency in the production of medicinal products and to encourage research and development into new medicinal products, on which the maintenance of a high level of public health within the Community ultimately depends;

Whereas disparities in such measures may hinder or distort intra-Community trade in medicinal products and thereby directly affect the functioning of the common market in medicinal products[.]'

Article 81 of Directive 2001/83/EC of the European Parliament and of the Council of 6 November 2001 on the Community code relating to medicinal products for human use (OJ 2001 L 311, p. 67), as amended by Directive 2004/27/EC of the European Parliament and of the Council of 31 March 2004 (OJ 2004 L 136, p. 34), ('Directive 2001/83') provides:

'With regard to the supply of medicinal products to pharmacists and persons authorised or entitled to supply medicinal products to the public, Member States shall not impose upon the holder of a distribution authorisation which has been granted by another Member State any obligation, in particular public service obligations, more stringent than those they impose on persons whom they have themselves authorised to engage in equivalent activities.

The holder of a marketing authorisation for a medicinal product and the distributors of the said medicinal product actually placed on the market in a Member State shall, within the limits of their responsibilities, ensure appropriate and continued supplies of that medicinal product to pharmacies and persons authorised to supply medicinal products so that the needs of patients in the Member State in question are covered.

The arrangements for implementing this Article should, moreover, be justified on grounds of public health protection and be proportionate in relation to the objective of such protection, in compliance with the Treaty rules, particularly those concerning the free movement of goods and competition.'

National legislation

Article 2 of Greek Law 703/1977 on the control of monopolies and oligopolies and the protection of free competition (FEK A' 278) essentially corresponds to the provisions of Article 82 EC.

Under Article 29 of Greek Law 1316/1983, holders of an authorisation to market pharmaceutical products are required to supply the market regularly with the goods which they manufacture or import.

Furthermore, Greek legislation requires persons carrying out the business of pharmaceuticals wholesaler to obtain a specific licence and to supply the needs of a defined geographical area with a range of pharmaceutical products.

The main proceedings and the reference for a preliminary ruling

GSK AEVE is the Greek subsidiary of GlaxoSmithKline plc, a pharmaceuticals research and manufacturing company established in the United Kingdom ('GSK plc'). GSK AEVE imports, warehouses and distributes pharmaceutical products of the GSK group ('GSK') in Greece. As such, it holds the marketing authorisation in Greece inter alia for the medicinal products Imigran, Lamictal and Serevent for the treatment, respectively, of migraines, epilepsy and asthma ('the medicinal products in dispute'), which are available in Greece only on prescription.

Each of the appellants in the main proceedings had for a number of years bought those medicinal products in all their forms from GSK AEVE, in order to distribute them both on the Greek market and in other Member States.

Towards the end of October 2000, GSK AEVE altered its system of distribution on the Greek market, citing a shortage, for which it denied responsibility, of those medicines. From 6 November 2000 it stopped

meeting the orders of the appellants in the main proceedings for the medicinal products in dispute and began itself to distribute those products to Greek hospitals and pharmacies through the company Farmacenter AE ('Farmacenter').

In December 2000 GSK AEVE applied to the Epitropi Antagonismou (Competition Commission) for negative clearance in the form of a declaration that its new policy of selling the medicines directly to Greek hospitals and pharmacies did not infringe Article 2 of Law 703/1977.

In February 2001, taking the view that the supply of medicines on the Greek market had to some extent normalised and that stocks at hospitals and pharmacies had been reconstituted, GSK AEVE started once more to supply the appellants in the main proceedings and other wholesalers with limited quantities of the medicinal products in dispute and shortly afterwards brought its cooperation with Farmacenter to an end.

GSK AEVE then withdrew its application for negative clearance but in the course of February 2001 filed a new application for negative clearance in respect of its sales policy, which in turn was replaced in December 2001 by another such application. Following discussions with the Epitropi Antagonismou, GSK AEVE agreed to deliver quantities of medicines equivalent to national consumption plus 18%.

Meanwhile, the appellants in the main proceedings and other pharmaceuticals wholesalers, as well as some Greek associations of pharmacists and wholesalers, applied to the Epitropi Antagonismou for a declaration that the sales policy of GSK AEVE and GSK plc in respect of the medicinal products in dispute constituted an abuse of a dominant position under Article 2 of Law 703/1977 and Article 82 EC.

On 3 August 2001, a decision of the Epitropi Antagonismou ordering interim measures required GSK AEVE to meet the orders of the appellants in the main proceedings for the medicinal products in dispute pending adoption of a final decision in the case. GSK AEVE lodged applications with the Diikitiko Efetio Athinon (Administrative Appeal Court, Athens) for a stay of execution and an annulment of that decision, which that court rejected.

Having been informed by GSK AEVE of the difficulties it faced in supplying the wholesalers with the quantities requested, the Ethnikos Organismos Farmakon (National Organisation for Medicines) published a circular on 27 November 2001 which obliged pharmaceuticals companies and all distributors of medicines to deliver quantities equivalent to those required for prescription medicines plus 25%.

Between 30 April 2001 and 11 November 2002, each of the appellants in the main proceedings brought an action before the Polimeles Protodikio Athinon (Court of First Instance, Athens), claiming that the conduct of GSK AEVE in interrupting supplies of medicinal products which had been ordered and distributing them through Farmacenter constituted unfair and anticompetitive acts and an abuse of the dominant position occupied by GSK AEVE on the markets for the medicinal products in dispute. In their applications, those appellants asked for GSK AEVE to be ordered, first, to supply them with quantities of medicines corresponding to the monthly average of those it had delivered to them in the period from 1 January to 31 October 2000 and, second, to pay them damages and compensate them for loss of profits. Some of the applications contained a more specific request for GSK AEVE to be ordered to continue supplies by providing quantities corresponding to the monthly average of medicines that it had delivered to them during the same period plus a certain percentage.

In view of both the complaints mentioned in paragraph 15 of this judgment and the request for negative clearance that were pending before it, the Epitropi Antagonismou by decision of 22 January 2003 asked the Court a series of questions relating to the interpretation of Article 82 EC in a reference for a preliminary ruling, which was registered at the Court Registry under the number C-53/03.

Between January and October 2003, the Polimeles Protodikio Athinon gave judgment on the actions commenced by the appellants in the main proceedings against GSK AEVE. Although it ruled that the actions were admissible, with the exception of the claims for compensation for loss of profits, that court dismissed them as unfounded, on the ground that the refusal on the part of GSK AEVE to supply was not unjustified and could thus not constitute abuse of that company's dominant position.

The appellants in the main proceedings appealed against those judgments before the Efetio Athinon (Court of Appeal, Athens). GSK AEVE cross-appealed in some of the cases. That court however suspended its examination of some of the cases before it pending the Court's decision in respect of the reference for a preliminary ruling made by the Epitropi Antagonismou.

By its judgment of 31 May 2005 in Case C-53/03 *Syfait and Others* [2005] ECR I-4609, the Court ruled that it had no jurisdiction to answer the questions referred by the Epitropi Antagonismou, since the latter was not a court or tribunal within the meaning of Article 234 EC.

Considering that, in order to deliver its judgments, it is necessary to have answers to the same questions which the Epitropi Antagonismou had referred to the Court, the Efetio Athinon has decided to stay the appeal proceedings and to refer the following questions to the Court for a preliminary ruling:

Where the refusal of an undertaking holding a dominant position to meet fully the orders sent to it by pharmaceuticals wholesalers is due to its intention to limit their export activity and, thereby, the harm

caused to it by parallel trade, does the refusal constitute per se an abuse within the meaning of Article 82 EC? Is the answer to that question affected by the fact that the parallel trade is particularly profitable for the wholesalers because of the different prices, resulting from State intervention, in the Member States of the European Union, that is to say by the fact that pure conditions of competition do not prevail in the pharmaceuticals market, but a regime which is governed to a large extent by State intervention? Is it ultimately the duty of a national competition authority to apply Community competition rules in the same way to markets which function competitively and those in which competition is distorted by State intervention?

If the Court holds that limitation of parallel trade, for the reasons set out above, does not constitute an abusive practice in every case where it is engaged in by an undertaking holding a dominant position, how is possible abuse to be assessed?

ticular:

Do the percentage by which normal domestic consumption is exceeded and/or the loss suffered by an undertaking holding a dominant position compared with its total turnover and total profits constitute appropriate criteria? If so, how are the level of that percentage and the level of that loss determined (the latter as a percentage of turnover and total profits), above which the conduct in question may be abusive?

Is an approach entailing the balancing of interests appropriate, and, if so, what are the interests to be compared?

ticular:

is the answer affected by the fact that the ultimate consumer/patient derives limited financial advantage from the parallel trade and

account to be taken, and to what extent, of the interests of social insurance bodies in cheaper medicinal products?

What other criteria and approaches are considered appropriate in the present case?'

By Decision 318/V/2006 of 1 September 2006, the Epitropi Antagonismou ruled on the complaints lodged with it against GSK. In the decision it found that GSK did not occupy a dominant position on the markets for Imigran and Serevent in view of their interchangeability with other medicinal products, but that a dominant position existed with respect to Lamictal, on account of the fact that epilepsy sufferers may find it difficult to adjust to other medicines which treat that condition.

In the same decision, the Epitropi Antagonismou found that GSK had infringed Article 2 of Law 703/1977 during the period from November 2000 to February 2001, but that there had been no infringement of that article in the period after February 2001 and no infringement of Article 82 EC during either of those periods.

The appellants in the main proceedings have applied to the Diikitiko Efetio Athinon for an annulment of that decision.

By order of the President of the Court of 29 January 2007, Cases C-468/06 to C-478/06 were joined for the purposes of the written and oral procedures and the judgment.

The questions referred for a preliminary ruling

By its questions, which it is appropriate to examine together, the referring court essentially asks whether there is an abuse of a dominant position contrary to Article 82 EC if a pharmaceuticals company occupying such a position on the national market for certain medicinal products refuses to meet orders sent to it by wholesalers on account of the fact that those wholesalers are involved in parallel exports of those products to other Member States.

In that context, the referring court asks the Court about the relevance of a series of factors, such as the degree of regulation to which the pharmaceuticals sector is subject in Member States, the impact of parallel trade on the pharmaceuticals companies' revenues, and the question whether that parallel trade is capable of generating financial benefits for the ultimate consumers of the medicinal products.

In its observations lodged before the Court, GSK AEVE contends that its refusal to supply the requested quantities of medicinal products to the appellants in the main proceedings does not constitute an abuse. First, it was not a case of an actual refusal inasmuch as, apart from a period of a few weeks between November 2000 and February 2001, GSK AEVE was always prepared to supply the wholesalers with sufficient quantities. Second, it did not put the wholesalers at risk of being eliminated from the market, since its supplies enabled them to cover all the requirements of the Greek market, and even requirements that went beyond those of that market.

According to GSK AEVE, the decisive factors for the question whether the conduct of a company that refuses to supply certain goods is abusive depend on the economic and regulatory context of the situation in question. Thus, in the case of a supply restriction in medicinal products in order to limit parallel trade, it is necessary to take into account the omnipresent regulation of prices and distribution in the pharmaceuticals sector, the negative consequences of an unlimited parallel trade upon the investments of pharmaceuticals companies in the field of research and development, and the minimal benefit of that trade for the final consumers of those products.

By contrast, the appellants in the main proceedings, as well as the Italian and Polish Governments and the Commission of the European Communities, maintain in their observations that the refusal by an undertaking in a dominant position to supply medicinal products to wholesalers with the aim of restricting parallel trade constitutes in principle an abuse of a dominant position within the meaning of Article 82 EC. According to them, none of the factors raised by the referring court and which were taken up by GSK AEVE to justify its refusal to supply is capable of altering the abusive nature of that practice.

The existence of a refusal to supply liable to eliminate competition

Article 82 EC prohibits any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it as incompatible with the common market in so far as it may affect trade between Member States. According to point (b) of the second paragraph of that article, such abuse may, in particular, consist in limiting production, markets or technical development to the prejudice of consumers.

The established case-law of the Court shows that the refusal by an undertaking occupying a dominant position on the market of a given product to meet the orders of an existing customer constitutes abuse of that dominant position under Article 82 EC where, without any objective justification, that conduct is liable to eliminate a trading party as a competitor (see, to that effect, Joined Cases 6/73 and 7/73 *Istituto Chemioterapico Italiano and Commercial Solvents* v *Commission* [1974] ECR 223, paragraph 25, and Case 27/76 *United Brands and United Brands Continentaal* v *Commission* [1978] ECR 207, paragraph 183).

With regard to a refusal by an undertaking to deliver its products in one Member State to wholesalers which export those products to other Member States, such an effect on competition may exist not only if the refusal impedes the activities of those wholesalers in that first Member State, but equally if it leads to the elimination of effective competition from them in the distribution of the products on the markets of the other Member States.

In this case it is common ground between the parties in the main proceedings that, by refusing to meet the Greek wholesalers' orders, GSK AEVE aims to limit parallel exports by those wholesalers to the markets of other Member States in which the selling prices of the medicinal products in dispute are higher.

In respect of sectors other than that of pharmaceutical products, the Court has held that a practice by which an undertaking in a dominant position aims to restrict parallel trade in the products that it puts on the market constitutes abuse of that dominant position, particularly when such a practice has the effect of curbing parallel imports by neutralising the more favourable level of prices which may apply in other sales areas in the Community (see, to that effect, Case 26/75 *General Motors Continental* v *Commission* [1975] ECR 1367, paragraph 12) or when it aims to create barriers to re-importations which come into competition with the distribution network of that undertaking (Case 226/84 *British Leyland* v *Commission* [1986] ECR 3263, paragraph 24). Indeed, parallel imports enjoy a certain amount of protection in Community law because they encourage trade and help reinforce competition (Case C-373/90 *X* [1992] ECR I-131, paragraph 12).

In its written observations, GSK AEVE contends that the factors mentioned by the referring court in its questions constitute objective considerations, on the basis of which it cannot be regarded as an abuse for a pharmaceuticals company to limit supplies of medicines to the needs of a given national market when confronted with orders from wholesalers involved in parallel exports to other Member States where the selling prices of those medicines are set at a higher level.

In order to determine whether the refusal by a pharmaceuticals company to supply medicinal products to such wholesalers indeed falls within the prohibition laid down in Article 82 EC, in particular at point (b) of the second paragraph of that article, it must be examined whether, as GSK AEVE maintains, there are objective considerations based on which such a practice cannot be regarded as an abuse of the dominant position occupied by that undertaking (see, to that effect, *United Brands and United Brands Continentaal* v *Commission*, paragraph 184, and Case C-95/04 P *British Airways* v *Commission* [2007] ECR I-2331, paragraph 69).

The abusive nature of the refusal to supply

As a preliminary point, GSK AEVE observes, citing *United Brands Continentaal* v *Commission*, that a dominant undertaking is not under an obligation to honour orders that are out of the ordinary and that it may take reasonable steps in order to protect its legitimate commercial interests.

With regard more specifically to the pharmaceuticals sector, GSK AEVE argues, first, that the general logic behind protecting competition within a brand does not function in that sector, where the intervention of the public authorities of Member States prevents the manufacturers of medicines from developing their activities in normal competitive conditions.

On the one hand, the pharmaceuticals companies do not control the prices of their products, those prices being fixed at various levels by the public authorities, which are, at the same time, the buyers of the medicines wherever there are national health systems. Even where those prices are the result of negotiations between the authorities and the pharmaceuticals companies, the fact that those companies accept them does not in itself imply that the prices cover all the fixed costs connected with the

development of the pharmaceutical products. Moreover, even if such a system of agreed prices exists, Member States are still in a position to impose cuts in those prices.

On the other hand, the producers of medicines are subject to precise obligations with regard to their distribution. While pharmaceuticals companies are required by law to deliver their products in all Member States where they are authorised to do so, parallel exporters are free to shift their activities from one product or market to the next if the latter product or market offers a higher profit margin, which can lead to shortages in some exporting Member States. Thus parallel trade has negative consequences for the planning of production and distribution of medicines.

Second, GSK AEVE points out that parallel trade in medicines reduces the profits that pharmaceuticals companies can invest in research and development activities on which they depend in order to remain competitive and attractive to investors. By contrast, distributors which profit from parallel trade make no contribution to pharmaceutical innovation. Furthermore, in the Member States where the prices of medicines are fixed at relatively low levels, the marketing of new medicines might be affected if it became impossible for pharmaceuticals companies to hold back supplies with the aim of limiting parallel trade. In such circumstances, those companies would have an interest in delaying the launch of new products in Member States where the prices are low.

Third, GSK AEVE contends that parallel trade provides no genuine benefit to the ultimate consumers. Since the greater part of the price difference which makes the business profitable is taken up by intermediaries, parallel trade does not result in genuine pressure on the prices of medicines in the Member States where those prices are higher. Equally, in the case of Member States where certain medicinal requirements are covered by public tender, parallel importers are not in a position to reduce price levels in view of their sporadic presence on the market.

While recognising that the prohibition in Article 82 EC does not apply when the conduct of an undertaking in a dominant position is objectively justified, the Polish Government and the Commission point out that it is for that undertaking to establish that there are circumstances that are capable of justifying its practice.

The appellants in the main proceedings, as well as the Polish Government and the Commission, consider that Article 82 EC cannot be applied differently in the pharmaceuticals sector simply because the prices in that sector are directly or indirectly fixed by the public authorities. Even in the Member States where prices are low, the price of a medicinal product is the result of negotiations with the pharmaceuticals companies, which will not put their products on the market if the prices proposed are not acceptable to them. Furthermore, there is no causal link between the repercussions of parallel trade on the revenues of pharmaceuticals companies and those companies' investments in research and development. Finally, parallel trade in medicinal products brings clear advantages to patients and is likely to enable national social security systems to make savings.

The appellants in the main proceedings add that taking into account the justifications advanced by GSK AEVE would run counter to the Court's case-law relating to the free movement of goods, which accepts only the justifications listed in Article 30 EC.

It should be recalled that in paragraph 182 of its judgment in *United Brands and United Brands Continentaal* v *Commission* the Court held that an undertaking in a dominant position for the purpose of marketing a product – which cashes in on the reputation of a brand name known to and valued by consumers – cannot stop supplying a long-standing customer who abides by regular commercial practice, if the orders placed by that customer are in no way out of the ordinary. In paragraph 183 of the same judgment, the Court held that such conduct is inconsistent with the objectives laid down in Article 3(f) of the EEC Treaty (Article 3(g) of the EC Treaty, and now Article 3(1)(g) EC), which are set out in detail in Article 86 of the EEC Treaty (Article 86 of the EC Treaty, and now Article 82 EC), particularly in points (b) and (c) of the second paragraph of that article, since the refusal to sell would limit the markets to the prejudice of consumers and would amount to discrimination which might in the end eliminate a trading party from the relevant market.

In paragraph 189 of the judgment in *United Brands and United Brands Continentaal* v *Commission*, the Court stated that, although the fact that an undertaking is in a dominant position cannot deprive it of its right to protect its own commercial interests if they are attacked, and that such an undertaking must be conceded the right to take such reasonable steps as it deems appropriate to protect those interests, such behaviour cannot be accepted if its purpose is specifically to strengthen that dominant position and abuse it.

It must be examined in this context whether, as GSK AEVE claims, particular circumstances are present in the pharmaceuticals sector, by reason of which the refusal by an undertaking in a dominant position to supply clients in a given Member State who engage in parallel exports to other Member States where prices for medicines are higher does not, generally speaking, constitute an abuse.

The consequences of parallel trade for the ultimate consumers

The first thing to consider is GSK AEVE's argument that parallel trade in any event brings only few financial

benefits to the ultimate consumers.

In that connection, it should be noted that parallel exports of medicinal products from a Member State where the prices are low to other Member States in which the prices are higher open up in principle an alternative source of supply to buyers of the medicinal products in those latter States, which necessarily brings some benefits to the final consumer of those products.

It is true, as GSK AEVE has pointed out, that, for medicines subject to parallel exports, the existence of price differences between the exporting and the importing Member States does not necessarily imply that the final consumer in the importing Member State will benefit from a price corresponding to the one prevailing in the exporting Member State, inasmuch as the wholesalers carrying out the exports will themselves make a profit from that parallel trade.

Nevertheless, the attraction of the other source of supply which arises from parallel trade in the importing Member State lies precisely in the fact that that trade is capable of offering the same products on the market of that Member State at lower prices than those applied on the same market by the pharmaceuticals companies.

As a result, even in the Member States where the prices of medicines are subject to State regulation, parallel trade is liable to exert pressure on prices and, consequently, to create financial benefits not only for the social health insurance funds, but equally for the patients concerned, for whom the proportion of the price of medicines for which they are responsible will be lower. At the same time, as the Commission notes, parallel trade in medicines from one Member State to another is likely to increase the choice available to entities in the latter Member State which obtain supplies of medicines by means of a public procurement procedure, in which the parallel importers can offer medicines at lower prices.

Accordingly, without it being necessary for the Court to rule on the question whether it is for an undertaking in a dominant position to assess whether its conduct vis-à-vis a trading party constitutes abuse in the light of the degree to which that party's activities offer advantages to the final consumers, it is clear that, in the circumstances of the main proceedings, such an undertaking cannot base its arguments on the premiss that the parallel exports which it seeks to limit are of only minimal benefit to the final consumers.

The impact of State price and supply regulation in the pharmaceuticals sector

Turning, next, to the argument based on the degree of regulation of the pharmaceuticals markets in the Community, it must first be examined whether State regulation of the prices of medicinal products has an impact on the assessment of whether a refusal to supply those products constitutes abuse.

It is clear that, in the majority of Member States, medicines, in particular those available only on prescription, are subject to regulation aimed at setting, at the request of the manufacturers concerned and on the basis of information provided by them, selling prices for those medicines and/or the scales of reimbursement of the cost of prescription medicines by the relevant social health insurance systems. The price differences between Member States for certain medicines are thus the result of the different levels at which the prices and/or the scales to be applied to those medicines are fixed.

The main proceedings relate to a non-harmonised area in which the Community legislature has limited itself, in adopting Directive 89/105, to placing Member States under a duty to guarantee that decisions in respect of the regulation of prices and reimbursement are taken with complete transparency, without discrimination and within certain specific time-limits.

In that respect, it should be noted, on one hand, that the control exercised by Member States over the selling prices or the reimbursement of medicinal products does not entirely remove the prices of those products from the law of supply and demand.

Thus, in some Member States, the public authorities do not intervene in the process of setting prices or limit themselves to setting the scale of reimbursement of the cost of prescription medicines by the national health insurance systems, thereby leaving to the pharmaceuticals companies the task of deciding their selling prices. Furthermore, even though the public authorities in other Member States set the selling prices of medicines as well, that does not in itself mean that the manufacturers of the medicines concerned have no influence upon the level at which the selling prices are set or the proportion of those prices which is reimbursed.

As the Commission has pointed out, even in the Member States where the selling prices or the amounts of reimbursement of medicines are set by the public authorities, the producers of the medicines concerned take part in the negotiations which are initiated by those producers and take their price proposals as a starting point and end with the setting of the prices and the amounts of reimbursement to be applied. As the second and third recitals to Directive 89/105 state, the task of the authorities when setting prices of medicines is not only to control expenditure connected with public health systems and to ensure the availability of adequate supplies of medicinal products at a reasonable cost, but also to promote efficiency in the production of medicinal products and to encourage research and development into new medicinal products. As the Advocate General indicated in points 90 to 93 of his Opinion, the level at which the selling price or the amount of reimbursement of a given medicinal product is fixed reflects the relative strength of

both the public authorities of the relevant Member State and the pharmaceuticals companies at the time of the price negotiations for that product.

On the other hand, it should be recalled that, where a medicine is protected by a patent which confers a temporary monopoly on its holder, the price competition which may exist between a producer and its distributors, or between parallel traders and national distributors, is, until the expiry of that patent, the only form of competition which can be envisaged.

In relation to the application of Article 85 of the EEC Treaty (Article 85 of the EC Treaty, now Article 81 EC), the Court has held that an agreement between producer and distributor which might tend to restore the national divisions in trade between Member States might be such as to frustrate the objective of the Treaty to achieve the integration of national markets through the establishment of a single market. Thus on a number of occasions the Court has held agreements aimed at partitioning national markets according to national borders or making the interpenetration of national markets more difficult, in particular those aimed at preventing or restricting parallel exports, to be agreements whose object is to restrict competition within the meaning of that Treaty article (see, for example, Joined Cases 96/82 to 102/82, 104/82, 105/82, 108/82 and 110/82 *IAZ International Belgium and Others* v *Commission* [1983] ECR 3369, paragraphs 23 to 27; Case C-306/96 *Javico* [1998] ECR I-1983, paragraphs 13 and 14; and Case C-551/03 P *General Motors* v *Commission* [2006] ECR I-3173, paragraphs 67 to 69).

In the light of the abovementioned Treaty objective as well as that of ensuring that competition in the internal market is not distorted, there can be no escape from the prohibition laid down in Article 82 EC for the practices of an undertaking in a dominant position which are aimed at avoiding all parallel exports from a Member State to other Member States, practices which, by partitioning the national markets, neutralise the benefits of effective competition in terms of the supply and the prices that those exports would obtain for final consumers in the other Member States.

Although the degree of price regulation in the pharmaceuticals sector cannot therefore preclude the Community rules on competition from applying, the fact none the less remains that, when assessing, in the case of Member States with a system of price regulation, whether the refusal of a pharmaceuticals company to supply medicines to wholesalers involved in parallel exports constitutes abuse, it cannot be ignored that such State intervention is one of the factors liable to create opportunities for parallel trade.

Furthermore, in the light of the Treaty objectives to protect consumers by means of undistorted competition and the integration of national markets, the Community rules on competition are also incapable of being interpreted in such a way that, in order to defend its own commercial interests, the only choice left for a pharmaceuticals company in a dominant position is not to place its medicines on the market at all in a Member State where the prices of those products are set at a relatively low level.

It follows that, even if the degree of regulation regarding the price of medicines cannot prevent any refusal by a pharmaceuticals company in a dominant position to meet orders sent to it by wholesalers involved in parallel exports from constituting an abuse, such a company must nevertheless be in a position to take steps that are reasonable and in proportion to the need to protect its own commercial interests.

In that respect, and without it being necessary to examine the argument raised by GSK AEVE that it is necessary for pharmaceuticals companies to limit parallel exports in order to avoid the risk of a reduction in their investments in the research and development of medicines, it is sufficient to state that, in order to appraise whether the refusal by a pharmaceuticals company to supply wholesalers involved in parallel exports constitutes a reasonable and proportionate measure in relation to the threat that those exports represent to its legitimate commercial interests, it must be ascertained whether the orders of the wholesalers are out of the ordinary (see, to that effect, *United Brands and United Brands Continentaal* v *Commission*, paragraph 182).

Thus, although a pharmaceuticals company in a dominant position, in a Member State where prices are relatively low, cannot be allowed to cease to honour the ordinary orders of an existing customer for the sole reason that that customer, in addition to supplying the market in that Member State, exports part of the quantities ordered to other Member States with higher prices, it is none the less permissible for that company to counter in a reasonable and proportionate way the threat to its own commercial interests potentially posed by the activities of an undertaking which wishes to be supplied in the first Member State with significant quantities of products that are essentially destined for parallel export.

In the present cases, the orders for reference show that, in the disputes which gave rise to those orders, the appellants in the main proceedings have demanded not that GSK AEVE should fulfil the orders sent to it in their entirety, but that it should deliver them quantities of medicines corresponding to the monthly average sold during the first 10 months of 2000. In 6 of the 11 actions in the main proceedings, the appellants asked for those quantities to be increased by a certain percentage, which was fixed by some of them at 20%.

In those circumstances, it is for the referring court to ascertain whether the abovementioned orders are ordinary in the light of both the previous business relations between the pharmaceuticals company holding

a dominant position and the wholesalers concerned and the size of the orders in relation to the requirements of the market in the Member State concerned (see, to that effect, *United Brands and United Brands Continentaal* v *Commission*, paragraph 182, and Case 77/77 *Benzine en Petroleum Handelsmaatschappij and Others* v *Commission* [1978] ECR 1513, paragraphs 30 to 32).

Those considerations equally deal with the argument raised by GSK AEVE, namely the impact of State regulation on the supply of medicinal products, and more particularly the argument that undertakings that engage in parallel exports are not subject to the same obligations regarding distribution and warehousing as the pharmaceuticals companies and are therefore liable to disrupt the planning of production and distribution of medicines.

It is true that in Greece, as is apparent from paragraph 8 of this judgment, national legislation places pharmaceuticals wholesalers under an obligation to supply the needs of a defined geographical area with a range of pharmaceutical products. It is equally true that, in cases where parallel trade would effectively lead to a shortage of medicines on a given national market, it would not be for the undertakings holding a dominant position but for the national authorities to resolve the situation, by taking appropriate and proportionate steps that were consistent with national legislation as well as with the obligations flowing from Article 81 of Directive 2001/83.

However, a producer of pharmaceutical products must be in a position to protect its own commercial interests if it is confronted with orders that are out of the ordinary in terms of quantity. Such could be the case, in a given Member State, if certain wholesalers order from that producer medicines in quantities which are out of all proportion to those previously sold by the same wholesalers to meet the needs of the market in that Member State.

In view of the foregoing, the answer to the questions referred should be that Article 82 EC must be interpreted as meaning that an undertaking occupying a dominant position on the relevant market for medicinal products which, in order to put a stop to parallel exports carried out by certain wholesalers from one Member State to other Member States, refuses to meet ordinary orders from those wholesalers is abusing its dominant position. It is for the national court to ascertain whether the orders are ordinary in the light of both the size of those orders in relation to the requirements of the market in the first Member State and the previous business relations between that undertaking and the wholesalers concerned.

Costs

Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Grand Chamber) hereby rules:

Article 82 EC must be interpreted as meaning that an undertaking occupying a dominant position on the relevant market for medicinal products which, in order to put a stop to parallel exports carried out by certain wholesalers from one Member State to other Member States, refuses to meet ordinary orders from those wholesalers, is abusing its dominant position. It is for the national court to ascertain whether the orders are ordinary in the light of both the size of those orders in relation to the requirements of the market in the first Member State and the previous business relations between that undertaking and the wholesalers concerned.

[Signatures]

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* Language of the case: Greek.

Distribution: international overview

Jane Tyler, Macfarlanes

Overview of the key legal and commercial considerations when appointing a distributor. The overview also considers the provisions commonly found in distribution agreements. Country specific information (updated periodically) for France, Germany, Italy, UK and US.

A distributor buys products from a manufacturer or supplier for his own account, takes the title to those goods and resells them to his own customers. He takes his remuneration from the margin he adds to cover his costs and profit; he does not generally receive a commission from the supplier. In buying and reselling the products, the distributor contracts separately with the supplier and with his customer; no contractual relationship is created between the distributor's supplier and the end consumer, and the distributor does not bind the supplier by his acts. Advantages and disadvantages of appointing a distributor as opposed to an agent are set out in the *box: Appointing a distributor*.

A distributor is not simply a reseller acting as a wholesaler; the relationship between distributor and supplier will be governed by the contract drawn up between them defining their respective obligations. Setting up a distribution arrangement will give rise to a number of issues, which are considered below:

- Regulation and legal formalities.
- Competition law.
- Intellectual property rights.
- Employment law.
- Tax.
- Product liability.
- Terms of the distribution agreement.

REGULATION AND LEGAL FORMALITIES

The appointment of a distributor is regulated by the general principles of contract law, and in most jurisdictions there are no special formalities with which the supplier must comply. However, in France and the US, there may be certain pre-contract disclosure requirements that must be complied with.

(*See Country Question 1.*)

While some countries (UK and France) have no legislation specifically directed at distributorships, others (Germany and the US) have a more highly regulated system. At EU level, there is strict regulation of the competition aspects of distribution arrangements (*see EC competition law*).

The position of a distributor should be contrasted with that of an agent, who generally has no contractual liability to the customer and incurs a far lesser degree of risk than a distributor in the course of his business (*see generally Practice note, Agency (http://us.practicallaw.com/A21033)*). Nevertheless, in some jurisdictions, the position of a distributor may be assimilated to that of an agent.

Germany, in particular, may apply national law on commercial agency, for example, in relation to termination rights, to the distributorship relationship.

Also, in Italy, distributorship can be considered an agency agreement where the distributor undertakes to promote the sale of the supplier's goods in the territory, as such a duty is normally found in an agency relationship.

(*See Country Question 2.*)

COMPETITION LAW

Distribution agreements can include a wide range of provisions which by their nature can be seen as anti-competitive. Such provisions include tied selling (that is, making the purchase of a particular product conditional on the purchase of a different product), resale price maintenance and other price-fixing arrangements, market and customer restrictions, the grant of exclusive territory and non-competition clauses. The competition law treatment of distribution arrangements can be complex.

(*See Country Question 3.*)

EC competition law

A general understanding of EC competition law principles is necessary before examining in detail the competition law implications of particular restrictive provisions commonly found in distribution agreements. Article 81(1) of the EC Treaty prohibits arrangements which prevent, restrict or distort competition in the EU and which have an appreciable effect on trade between EU member states. Agreements that infringe Article 81(1) are void and unenforceable in respect of the provisions that restrict

competition (national rules governing severability will apply); the ***European Commission*** (*see Glossary*) has the ability to impose fines on parties to such agreements of up to 10% of their worldwide group turnover, and third parties can sue for damages.

In its Notice on agreements of minor importance (*OJ 2001 C368/13*) the Commission indicates that agreements between undertakings which do not have more than a 15% combined market share do not generally fall under Article 81(1). Agreements that have as their object the fixing of prices or that confer territorial protection on the parties to the agreement or third parties cannot take advantage of this Notice. The Notice is not binding on the Commission or national authorities, but provides a strong indication of the Commission's approach to agreements.

Most distribution agreements will benefit from a block exemption afforded to ***vertical agreements*** (*Regulation 2790/1999, OJ 1999 L336/21*) (the vertical agreements block exemption) and will therefore fall outside the scope of Article 81(1), provided that the supplier's market share is below 30% and that the agreements do not contain specified hardcore restrictions. The Commission has also issued guidelines setting out a list of general rules for the evaluation of vertical restraints (*Guidelines on vertical restraints, OJ 2000 C291/1*) (the vertical restraints guidelines).

If the agreement falls within the vertical agreements block exemption it will, as a general principle, be fully valid and enforceable by national courts.

The block exemption defines vertical agreements as:

agreements or concerted practices entered into between two or more undertakings each of which operates for the purposes of the agreement at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services (*Article 2(1)*).

It covers all vertical restraints affecting finished or intermediate products and services.

The block exemption contains a blacklist of so-called hardcore vertical restraints, which, if included in a vertical agreement, will mean that the block exemption cannot apply, even where the 30% market share threshold is not exceeded:

- Price-fixing or resale price maintenance provisions (*Article 4(a)*).
- Any restrictions on territories or customers to which a distributor can make sales or provide services; for example, bans on passive sales (that is, sales made in response to unsolicited orders) outside an exclusive territory/customer group (*Article 4(b)*). Nevertheless, the following sales restrictions are permitted:
  - a ban on active sales (including sending unsolicited e-mails or targeted internet advertising) to a territory or customer group allocated exclusively to another distributor or to the supplier himself (provided that such a ban does not limit sales by the customers of the distributor);
  - a restriction on sales to end users by a buyer who acts as a wholesaler;
  - in the context of a selective distribution system, restrictions on authorised dealers from reselling to unauthorised distributors; and
  - in the context of a supply contract covering components for the purpose of incorporation into finished products, the distributor may be prohibited from selling the contract goods to competitors of the supplier.
- Dealers operating at the retail level in a selective distribution system cannot be restricted as to the end users to whom they may sell. A ban on both active and passive sales to end users is not permitted. It is possible, however, to prohibit a member of a selective distribution system from operating out of an unauthorised place or establishment (*Article 4(c)*).
- Cross-supplies between distributors in a selective distribution system. Authorised dealers in a selective distribution system must be free to sell to or buy from other authorised dealers (*Article 4(d)*).
- In the context of a supply agreement between a supplier of components and a buyer who incorporates those components into his own product, any restrictions on the supplier selling those components as spare parts to end users or to independent repairers or other service providers not entrusted by the supplier with the repair or servicing of his goods are not permitted under the block exemption (*Article 4(e)*).

Where the vertical agreements block exemption does not apply to the agreement, it may still qualify for automatic exemption under Article 81(3) of the EC Treaty. Prior to 1 May 2004, companies could notify agreements to the Commission for an individual exemption under Article 81(3). This notification system was abolished by Regulation 1/2003, which came into force on 1 May 2004 and which introduced a directly applicable exception scheme whereby agreements are automatically exempted from the prohibition in Article 81(1) if they meet the criteria set out in Article 81(3). The burden is on companies to carry out their own assessment of restrictive agreements which do not fall under the vertical agreements block exemption (for example because the 30% market share threshold is exceeded), in order to decide to decide whether they fall under Article 81(1).

Article 81(3) can be applied directly by the European Commission, the European courts, national competition authorities and national courts in the EU.

The possible application of Article 82 of the EC Treaty (under which no exemptions are available) should be considered if a supplier or distributor has a dominant position in the relevant market. Article 82 prohibits the abuse of a dominant position within the common market, or a substantial part of it, if the abuse affects trade between EU member states. A large market share (40%) could indicate dominance (although a number of factors are relevant to this assessment, including the structure of the market, the supplier's share of that market and whether that supplier can behave without regard to other operators within the market).

Examples of abuse which may be relevant in a distribution context are:

- Discriminatory pricing.
- Refusal to supply without justification.
- Imposition of non-compete obligations.
- ***Tying***.

US anti-trust law

In the US, section 1 of the Sherman Act prohibits contracts, combinations or conspiracies that unreasonably restrain inter-state trade. When evaluating possible restraints, conduct will be subject to either the rule of reason or the per se rule.

Under the rule of reason, a court will determine the legality of a restraint by balancing its pro-competitive effects against its anti-competitive effects in the relevant product and geographic market. Under section 1 of the Sherman Act, purely vertical restrictions are considered under this rule of reason.

Under the per se rule, reserved for conduct that almost always harms competition (for example, horizontal price-fixing, bid-rigging and market allocation among competitors), there is a presumption of unreasonableness without a need for further analysis. Such practices are simply condemned outright.

In practice, most distribution agreements will be examined under the rule of reason, unless they contain restrictions that are notoriously anti-competitive, such as horizontal price-fixing or market sharing.

US federal law also makes it illegal to sell goods, fix prices, or discount or rebate from goods, on the condition that the buyer will not use or deal in the goods of a competitor, where the effect may be to substantially lessen competition or tend to create a monopoly (*section 3, Clayton Act*).

It is also illegal to monopolise, or attempt to monopolise, or to combine or conspire to monopolise trade or commerce (*section 2, Sherman Act*). Such a violation typically will arise if a company with significant market share or market power tries to acquire a monopoly or maintains a monopoly through unreasonable methods.

In the US, in addition to federal law, individual states have antitrust laws that may be interpreted and applied differently than the federal antitrust statutes.

Turning to consider some restrictions commonly found in distributorships:

Exclusivity

In an exclusive distribution agreement, the supplier agrees to sell his products only to one distributor for resale in a particular territory. The distributor is usually restricted from actively selling into territories that have been exclusively allocated to other distributors. According to the EC vertical restraints guidelines, the possible competition risks of exclusive distribution arrangements are principally reduced intra-brand competition and market partitioning, which may, in particular, lead to price discrimination (*paragraph 161*). Where most or all of the suppliers in a particular market undertake exclusive distribution this may facilitate collusion, at both the supply and distribution levels.

The grant of an exclusive territory is by its very nature restrictive of competition. To fall within the scope of the vertical agreements block exemption a supplier can impose few additional restraints on an exclusive distributor (*see box: Restrictions in an exclusive distribution agreement: treatment under EC law*).

On a national level, the anti-competitive effects of a grant of exclusivity must also be carefully analysed. In Italy, for example, although the Italian Civil Code permits the grant of exclusivity in a distribution agreement, it is important to ensure that such a restriction does not prevent other parties from entering the market that is the subject of the distribution contract. In France, the permitted duration of an exclusivity clause is limited to ten years.

In the US, factors that will be taken into account in the analysis of the impact on competition of exclusivity in a distribution agreement include the reason for the restrictions, the strength of inter-brand competition and the market share of the manufacturer or supplier. The greater the degree of inter-brand competition, the shorter the term of any exclusive distribution arrangement, and the narrower the scope of the distribution arrangement, the more likely the arrangement will be upheld as reasonable. Where a dual distribution system exists (for example, a manufacturer uses independent distributors, but also distributes products in competition with those independent distributors), the grant of exclusivity opens an agreement to the risk of challenge as a horizontal restraint, which may be deemed per se illegal.

(*See Country Question 4.*)

Selective distribution

A selective distribution agreement restricts the number of authorised distributors and therefore the possibilities of resale. The restriction on the number of authorised distributors does not depend on the number of territories, as does exclusive distribution, but on selection criteria linked to the nature of the product. Selective distribution tends to be used to distribute branded products.

In the EU, the possible risks to competition are a reduction in intra-brand competition, foreclosure of certain types of distributors and facilitation of collusion between suppliers or buyers (*EC vertical restraints guidelines, paragraph 185*). In the EU, when assessing the effects on competition of selective distribution, a distinction should be made between purely qualitative selective distribution and quantitative selective distribution.

Purely qualitative selective distribution ensures that dealers are selected on the basis of objective criteria which are necessitated by the nature of the product and which do not impose a direct limit on the number of dealers. Purely qualitative selective distribution is generally considered to fall outside the scope of

Article 81(1) of the EC Treaty, provided that:

- The products in question are of a kind that selective distribution is **necessary** to ensure their proper distribution.
- Distributors are selected on the basis of **qualitative** criteria.
- The requirements for admission to the selective distribution system are applied **objectively and without discrimination.**
- Restrictions imposed on distributors are **proportional** in relation to the requirements of the product.

(*EC vertical restraints guidelines, paragraph 185.*)

Quantitative selective distribution adds further criteria for selection that more directly limit the potential number of distributors by, for example, fixing the number of dealers or by requiring minimum or maximum sales.

Where the supplier's market share does not exceed 30%, a qualitative and quantitative selective distribution agreement will be exempted by the EC vertical agreements block exemption (even if combined with other non-hardcore vertical restraints, such as non-compete or exclusive distribution obligations) provided that active selling by the authorised distributors to each other and to end users is not restricted. Any restriction on the dealer's right to sell to end users will take an agreement outside the block exemption. Selective distribution cannot therefore be combined with vertical restrictions aimed at forcing distributors to purchase exclusively from a given source. Selective distribution can however be combined with exclusive distribution provided that active and passive sales are not restricted. Furthermore, members of a selective distribution system can be restricted from selling to unauthorised distributors.

In any jurisdiction, selective distribution schemes based purely on quantitative criteria will be considered anti-competitive.

(*See Country Question 4.*)

Pricing restrictions

EC competition law prohibits agreements or restrictive practices that have as their direct or indirect object the establishment of a fixed or minimum resale price level to be observed by the buyer. A supplier may nevertheless impose maximum resale prices or recommend resale prices (provided neither of these have the effect of a fixed or minimum sale price as a result of pressure from or incentives offered by the party imposing the restriction).

UK, French and Italian laws have adopted similar philosophies.

In the US, vertical price-fixing that sets a minimum price for resale is subject to the rule of reason under Section 1 of the Sherman Act, based on a 2007 Supreme Court decision that overruled an almost century old decision under which such conduct was deemed *per se* illegal. Horizontal price fixing remains *per se* illegal under section 1 of the Sherman Act. Vertical price-fixing that sets a minimum price likely remains subject to the *per se* rule under the laws of many states. Vertical arrangements that establish maximum resale prices are subject to the rule of reason (*section 1 of the Sherman Act*).

(*See Country Question 5.*)

Minimum purchase targets

Minimum purchase obligations or targets are often included in exclusive and sole distribution agreements for the benefit of the supplier, as a means of ensuring that the distributor justifies his appointment, and are subject to the general principles of competition law.

(*See Country Question 6.*)

In the EU, this type of obligation is permitted under the EC vertical agreements block exemption (although, if the obligation requires the distributor to buy more than 80% of its requirements from the supplier, the duration of such an obligation must not exceed five years).

Under US federal antitrust law, minimum purchase obligations or targets, unless horizontal in nature, will be evaluated under section 1 of the Sherman Act using a rule of reason analysis. Depending on the scope of the obligation, it may have the same competitive impact as of exclusive dealing (a potential violation of sections 1 and 2 of the Sherman Act and section 3 of the Clayton Act) by effectively preventing a distributor from purchasing products from a competitive supplier. Even if deemed to be exclusive dealing, a minimum purchase obligations may be permissible under the rule of reason, but consideration should be given to factors such as the extent of any competitive foreclosure, the duration and terminability of the obligations, barriers to entry and any pro-competitive justifications for the obligations. Similar factors should be used in evaluating the competitive impact from the imposition by suppliers of restrictions on the sources of supply to distributors.

Exclusive purchasing obligations

Exclusive purchasing obligations are permitted under the EC vertical agreements block exemption (although if the obligation requires the distributorship to buy more than 80% of its requirements from the supplier the duration of such an obligation must not exceed five years).

Italian law specifically permits exclusive purchasing obligations, stating that if the parties agree in the contract a right of exclusivity in favour of the supplier, the other party cannot receive from third parties supplies of the same kind of goods and, unless otherwise agreed, cannot itself manufacture such goods. Other jurisdictions subject the imposition of exclusive purchasing obligations to general competition law principles.

Under US federal antitrust law, exclusive dealing is subject to sections 1 and 2 of the Sherman Act, section 3 of the Clayton Act (assuming goods, not services or intangibles are involved) and section 5 of the Federal Trade Commission Act. Exclusive dealing

arrangements tend to be evaluated under the rule of reason (*section 1, Sherman Act*) unless there is a horizontal agreement. While exclusive dealing arrangements may promote inter-brand competition, they may also foreclose competitors of the supplier or manufacturer. Relevant factors in analysing the legality of an exclusive dealing arrangement will include the extent of any such competitive foreclosure, the duration and terminability of the exclusive arrangement and barriers to entry.

(*See Country Question 7.*)

Tying

Tying occurs when the supplier makes the sale of one product conditional upon the purchase of another distinct product. If the tying is not objectively justified by the nature of the products or commercial usage it may lead to foreclosure on the market for the tied product and anti-competitive pricing. Tying is permitted under the EC vertical agreements block exemption, and is subject to general competition law principles in EU member states.

In the US, a tying arrangement will be subject to a substantial competition law analysis.

(*See Country Question 3.*)

Non-compete clauses

Although non-competition clauses are usual in distribution agreements, particularly exclusive ones, a distributor is often appointed by the supplier because of his experience in the particular type of product concerned and he may wish to handle, or have ongoing contractual obligations with respect to competing products. Rather than exclude competing products altogether, it is preferable to limit the non-competition obligation to particular defined cases.

The EC vertical agreements block exemption lists certain non-compete obligations that will fall outside the scope of the block exemption even though the market share threshold is not exceeded (*Article 5*), including the following:

- **A non-compete obligation that lasts over five years or is of indefinite duration** (*Article 5(a)*). A non-compete obligation is defined as any direct or indirect obligation preventing the buyer from selling or reselling goods or services which compete with those that are the subject of the distribution arrangements or any obligation on the distributor to purchase more than 80% of his total requirements of products/services that are the subject of the distribution agreement from the supplier or his nominated supplier (*Article 1(b)*). Unless the goods or services are sold by the distributor from premises owned or leased by the supplier and the non-compete is only for the duration of the occupancy of the premises, such a clause will infringe Article 81(1).
- **A post-termination non-compete clause unless it complies with all of the following criteria,** namely it must:
  - relate to competing goods or services;
  - be limited to the premises from which the distributor has operated during the contract period;
  - be indispensable to protect know-how transferred by the supplier; and
  - be limited in duration to one year after termination of the agreement (*Article 5(b)*).

  Unless the post-termination non-compete fulfils each of these criteria it will not be exempted from Article 81 (1). However, it is possible to impose restrictions unlimited in time on the disclosure of know-how that has not entered the public domain (*Article 5(b)*).
- **Non-compete obligations on members of selective distribution systems.** Any direct or indirect obligation preventing the members of a selective distribution system from selling the brands of specified competing suppliers will infringe Article 81(1). It should be possible, though, to draft an agreement which does not fall foul of this prohibition but allows the supplier to exercise some control over the type of products sold alongside his own products.

Severability does apply to non-compete obligations, so that the inclusion of any such obligation will mean that the benefit of the block exemption is only lost in relation to any part of the agreement from which the offending obligation cannot be severed. Consideration should be given to carrying out an assessment of the offending obligation under Article 81(3) to determine whether it qualifies for automatic exemption.

National laws tend to evaluate non-compete clauses in terms of the reasonableness of their duration, their geographic scope, activities limited, and the industry at issue. In the US, other relevant factors are whether the non-compete clause is ancillary to the distribution agreement and supported by adequate compensation. In Germany, in circumstances where a post-termination non-compete clause is allowed, the distributor must be paid adequate compensation for his acceptance of the restriction.

(*See Country Question 8.*)

Full line forcing

In most jurisdictions, the imposition by the supplier upon the distributor of an obligation to purchase and keep a full stock of each of the products comprised in the range of products which are the subject of the distribution agreement will be examined under the general principles of competition law.

In the US, full line forcing is typically analysed as a tying restriction, and is less likely to raise competitive concerns if the distributor is not restricted from selling products of competing manufacturers or suppliers.

(*See Country Question 9.*)

Distribution online

For suppliers and buyers alike, internet-based trading has obvious attractions in terms of low cost, convenient and streamlined supply and purchasing processes. The general principles of law which are applicable to traditional supplier/distributor relationships also apply to web-based trading exchanges.

Competition authorities will be concerned to ensure that these trading sites do not provide opportunities for competitors to co-ordinate and influence pricing and other terms and conditions, either in their purchasing or their selling activities.

Limited guidance on this issue is contained in the EC vertical restraints guidelines, which state that:

- The use of the internet to advertise or to sell products must be freely available for every distributor unless there are objective reasons for restricting its use, for example, due to the nature of the products sold.
- Territorial exclusivity is permitted, provided passive sales are not prohibited. Use of the internet is not considered a form of active sales into exclusively allocated territories.
- The supplier can impose quality standards on online dealers, for example, requirements to ensure that:
  - Customers' financial data are encrypted.
  - The dealer posts and respects a privacy policy or discloses any warranty limitations.
  - The layout and image of the website and the positioning of the products are suitable to protect and promote the supplier's brand-recognition and reputation.
- Resale price maintenance is prohibited.

National laws have not so far legislated in this area, general contract and competition law principles being applicable.

(*See Country Question 10.*)

INTELLECTUAL PROPERTY RIGHTS

Products subject to a distribution agreement may be protected by intellectual property rights (IPR), including copyright, rights in designs, patents, know-how and trade marks. The nature of these rights is considered in the *PLC E-Commerce Practice Manual, Protecting website content: Intellectual property rights (http://us.practicallaw.com/A21114)*.

In some countries, a distributor will have an implied licence to use the supplier's IPR in the performance of his obligations under the distribution contract.

(*See Country Question 11.*)

It is, however, generally advisable for intellectual property rights to be expressly licensed in the distribution agreement, in which case the following issues may be relevant:

- Ownership of IPR.
- Which IPR may be used by the distributor, and any limitations on that use.
- Whether the licence is to be exclusive or non-exclusive.
- Obligation to use trade marks (to avoid possible revocation of the mark for lack of use).
- Obligation to notify infringements within the territory and to co-operate in any proceedings that are necessary to protect those rights.
- Prohibition on the distributor holding himself out as owner of an IPR.
- Whether the distributor will be allowed to assist with registration and maintenance of any trade marks or designs which relate to the contract products.
- Prohibition on the distributor using any mark or symbol similar to the licensed trade marks in any connected business both during the life of the agreement and for a reasonable period beyond its termination.

Distributors should consider the need to register intellectual property licences. Generally, registration is advisable in those countries where it is possible to do so (UK, France, Italy) as it will offer increased protection, especially in relation to third parties.

(*See Country Question 12.*)

Although the distributor may be granted a right to sell products carrying a trade mark in a given territory he should not thereby become entitled to any rights in the trade mark.

(*See Country Question 14.*)

In some countries, a local distributor cannot import goods bearing a trade mark of which he is not the registered owner or user. In such cases, it would be necessary to enter into a registered user agreement defining the capacity in which the distributor can use the mark. Failure to enter into and register such agreement may allow the distributor to build up rights in the trade mark, which, if the mark is not registered in the territory, will entitle him to register himself as its owner in the territory or, if the mark is registered but local law demands some sale of the goods under the mark by the owner in order for registration to become effective, enable the distributor to attack the owner's registration. This is not, however, a problem in the countries covered in this Practice note.

(*See Country Question 13.*)

The distributor will want the supplier to warrant that the intellectual property in the contract products is valid and properly registered and that the supplier is entitled to license it. The distributor will generally expect to receive an indemnity in respect of any loss he suffers if the licensed rights infringe IPR belonging to a third party. In return, the supplier should require the distributor to co-operate in defending the supplier's intellectual property from third party infringement.

Co-branding (the use of the distributor's brand on the products together with that of the supplier) will generally be seen as diluting the goodwill in the supplier's brand and so tends to be avoided.

The licensing of IPR will of course have competition law implications.

(*See Country Question 15.*)

At EU level, licences of IPR in distribution agreements are covered by the vertical agreements block exemption in so far as they do not constitute the primary object of the agreement and are directly

related to the use, sale or resale of the distribution of goods or services (*Article 2(3)*). A trade mark licence to a distributor is generally considered to be necessary for, and ancillary to, the distribution of goods or services in a particular territory (*Vertical restraints guidelines, paragraph 38*).

In the US, most licensing arrangements will be evaluated under the rule of reason analysis contained in section 1 of the Sherman Act. Under section 1 of the Sherman Act, some restraints, such as horizontal price-fixing, output restraints, market divisions among horizontal competitors and certain group boycotts may be condemned as *per se* unlawful. United States Department of Justice and Federal Trade Commission Antitrust Guidelines for the Licensing of Intellectual Property set out the Agencies' enforcement intentions. The guidelines are not, however, binding.

Confidentiality

During the course of the agreement the supplier is also likely to provide information and know-how which is confidential. A distribution agreement should therefore contain a confidentiality clause. To be effective, the clause should clearly define the information classified as confidential, restrict its use to that necessary only for the purposes of the agreement and restrict any public disclosure of it. The confidentiality clause should be expressed to survive the termination of the agreement.

(*See Country Question 16.*)

EMPLOYMENT LAW

Depending on the nature of the relationship between a supplier and distributor, there may be a risk that the distributor may be treated as an employee of the principal, with all the attending employer obligations and employee rights that this will bring. The most important factors in any assessment of this type are the mutuality of obligation, the level of control the supplier has over the distributor and whether the work has to be performed personally by the distributor.

(*See Country Question 17.*)

A particular concern in the UK arises where, after the termination of the distribution agreement, the supplier proposes to appoint a replacement distributor or to set up an in-house distributor. Consideration should be given to the question of whether the employment contracts of the previous distributor could be transferred to the replacement distributor or even the supplier himself.

(*See Country Question 18.*)

TAX

Unless the distributor is considered a permanent establishment of the supplier, the supplier is not generally regarded as carrying on trade or business in the territory of the distributor, thereby avoiding the possibility of local taxation.

(*See Country Question 19.*)

If the distributor does constitute a permanent establishment of the supplier in the country in which he is carrying out his duties, double tax treaties will protect the foreign supplier from double taxation. A distributor will only constitute a permanent establishment if he is not independent and habitually exercises authority to enter into binding contracts in the name of the supplier. Suppliers using an independent third party as distributor - which is usually the case - will not be subject to tax in the country of the distributor.

Where there is no double tax treaty in place the supplier will be subject to tax in the country in which the goods are being supplied. Sales taxes may also be applicable.

(*See Country Question 20.*)

In both Europe and the US, generally there are no foreign exchange restrictions, but there are reporting obligations in Germany.

(*See Country Question 21.*)

PRODUCT LIABILITY

Under local consumer protection laws in all EU member states and in the US, a manufacturer-supplier will be liable in his own right for any damage or injury caused to third parties by defects in his products. The distributor must therefore not be allowed to admit liability for the products to customers without the permission of the supplier.

EU legislation imposes strict civil liability on manufacturers for damage and personal injury caused by defective products (*Product Liability Directive 85/374, OJ 1985 L210/29*). Distributors can also be liable where:

- They are importers of a product that is manufactured outside the EU;
- They hold themselves out to be producers by affixing their name or trade mark to the product; and
- They fail to identify to the injured party the person who supplied the faulty product.

In the US, generally, both the distributor and the supplier can be liable for the supply of defective product under the theories of strict liability, negligence and breach of warranty. The usual theory of recovery against a distributor is strict liability, although some states release distributors from strict liability where the supplier is solvent and can be sued. A well-drafted distribution agreement will limit a distributor's ability to make modifications to the product and state that the distributor agrees to indemnify the supplier for any unauthorised changes to the product. The agreement may also contain a clause stating that the supplier's express warranty is void if the distributor makes changes to the product.

National laws differ on the extent to which liability for supply of a defective product can be excluded by contract.

(*See Country Question 22.*)

A distributor may always seek to protect himself by obtaining an indemnity from the supplier. The extent of any indemnity will depend upon the type and value of the products supplied and the degree of risk of third party claims arising. It can cover civil and possibly criminal liability in some jurisdictions such as the UK. The distributor can also require the supplier to take out insurance to ensure that there are funds to pay under the indemnity. He can also ask for contractual warranties regarding the safety of the product.

For a more detailed discussion of product liability issues see *Practice note, Product liability (http://us.practicallaw.com/A23721)*.

THE DISTRIBUTION AGREEMENT

(*These notes should be read in conjunction with the Distribution agreement: skeleton (http://us.practicallaw.com/A24246) andaccompanying commentary (http://us.practicallaw.com/A24240).*)

Although in most jurisdictions there are no special requirements that need to be fulfilled for a distribution agreement to be legally enforceable, it is advisable for an agreement to be in writing. Indeed, in France and Germany, this is mandatory in certain circumstances.

(*See Country Question 23.*)

The relationship between supplier and distributor can be adjusted by the distribution contract so that the parties can allocate obligations between themselves as commercially appropriate. The actions of the distributor can be so restricted and his indemnities so wide that he approaches the position of an agent. On the other hand, the supplier can assume obligations to such an extent that the relationship approaches that of a joint venture. The agreement will reflect the level of control, involvement and risk that the parties negotiate.

Conditions of sale

A supplier should consider incorporating his own conditions of sale into the agreement, which may be attached as a schedule.

(*See Country Question 24.*)

Typical standard conditions of sale deal with:

- Specification of goods.
- Place and time of delivery.
- Damage in transit/non-delivery.
- Price.
- Payment conditions.
- Passing of title to the goods.
- Warranties and indemnities.
- Insurance.
- Liability in respect of breach.

(*See generally Practice note, Supply contracts: Title and risk (http://us.practicallaw.com/A23058)*).

Structure

A distribution agreement will normally be structured in the following way:

- Date.
- Parties.
- Definitions.
- Appointment of distributor.
- Distributor's undertakings.
- Supply of products.
- Supplier's undertakings.
- Prices and payment.
- Advertising and promotion.
- Compliance with laws and regulation.
- Conditions of sale.
- Trade marks.
- Product liability and insurance.
- Duration and termination.
- Effects of termination.
- Confidentiality.
- Severability.
- Third party rights.
- Boilerplate including:
  - entire agreement;
  - assignment;
  - notices;
  - *force majeure*;
  - waiver; and
  - governing law and jurisdiction.
- Execution clauses.

Definitions

Definitions are essential to determine the exact meaning of the terms used in the agreement. The most important definitions will cover:

- Products. It is important to cover variations to the definition of products during the life of the agreement. Variations may arise from the need for a new product in the market, the withdrawal of a particular product from the market and the introduction of improved versions of the products.
- Territory.
- Confidential information.
- Trade marks.

Exclusivity and contract territory

Bearing in mind any competition law implications, the parties need to record precisely:

- The territory in which the distributor is to carry out his operations.
- The extent and nature of any exclusive rights granted under the distribution agreement.

The basic grant of the distributorship can be on several bases:

- **Exclusive distribution.** An exclusive distribution is an arrangement whereby a supplier agrees to sell the contract products only to the distributor within a certain defined territory and agrees not to appoint other distributors or himself to sell the products directly to customers within the territory.

  The grant of exclusivity is a restriction on the free movement of goods and competition and as such should be examined under competition law rules (*see Competition law*).
- **Sole distribution.** The term sole distribution is generally used to describe an agreement whereby a supplier appoints a distributor as his only or sole distributor within a territory, but the supplier reserves the right to supply the products directly to end users.
- **Non-exclusive distribution.** A non-exclusive distribution gives the supplier freedom both to sell directly and to appoint other distributors within the contract territory. The terms of the appointment will be far less onerous on the distributor than those within an exclusive or sole appointment, as he will need to compete with the supplier and other distributors in terms of both pricing and promotion of the product.
- **Selective distribution.** Under a selective distribution system a supplier agrees to supply only approved distributors who meet specified minimum criteria, and the distributors themselves agree only to supply end users or other distributors or dealers within the approved network. Selective distribution arrangements are seen as particularly suitable where the nature of the product requires an enhanced level of service, advice at the point of sale to the customer and/or after-sales support.

Within the EU, the supplier should ensure that the terms of the appointment and, in particular, any restrictions on resale and territory, comply with the vertical agreements block exemption (*see EC competition law*).

Distributor's obligations

The distributor's obligations are likely to cover the following areas:

- **Sales promotion and organisation of the distribution network:**
  - to provide an after-sales maintenance service;
  - to retain sufficient and suitable premises, staff and facilities;
  - to submit written reports showing the details of sales, stocks, outstanding orders and prospective business;
  - to maintain an inventory;
  - to keep accurate sales and customer records and allow inspection by the supplier. The right of audit is useful for tracing products in the event of a product recall exercise;
  - to keep the supplier informed of any reorganisation of his business which may affect the distributor's performance of the agreement;
  - to maintain and properly insure adequate stocks to meet anticipated customer demand;
  - to ensure conformity with local legislation, rules and regulation as to labelling requirements, permitted ingredients, licensing and safety legislation. The distributor should make sure that his supplier/manufacturer is aware of local legislation and produces goods in conformity; and
  - to promote and advertise the products.
- **Non-compete and other restrictive covenants:**
  - to purchase the products only from the supplier;
  - not to deal in any competing products without the consent of the supplier;
  - to use best endeavours to promote and expand the sale of the products within the territory;
  - not actively to seek customers from outside the territory for the products or to establish any branch or distribution depot outside the territory; and
  - not to manufacture products of the same type as the contract goods.

  (For competition law implications of non-compete obligations see *Competition law*.)
- **Intellectual property rights:**
  - to sell the products under the trade marks and not to interfere with or alter the products or their packaging in any way.
- **Not to assign** the agreement without the prior consent of the supplier.

Supplier's obligations

Certain national laws impose several obligations on the supplier. In Germany, for example, there is an obligation on the supplier to provide the distributor with all information necessary for the performance of his obligations. In the UK, obligations as to title, price, delivery and quality are implied, in the absence of express terms dealing with these matters.

(*See Country Question 25.*)

In the distribution agreement itself the supplier must, obviously, agree to supply goods under the agreement.

If the agreement is exclusive the supplier will undertake not to supply other users or dealers in the territory.

It is common for a distribution agreement to include the following obligations on the supplier:

- Only to supply goods which are safe in relation to risk to personal property.
- To comply with specific legislation relating to the goods concerned.
- To maintain adequate defective products insurance.
- To repair or replace the goods supplied (either at no cost or at a reasonable cost) if a defect or a risk emerges.
- To supply such equipment, know-how, technical and further support, training, promotional and other literature and know-how, models and samples as required by the distributor to operate effectively. Control of advertising and promotion is particularly important if the products are to carry valuable trade marks, the reputation of which it is vital to retain. The supplier may wish to retain the right to approve any promotional material produced by the distributor.
- To supply spare parts as and when requested by the distributor.
- To continue to supply spare parts for service facilities for a limited time after the agreement has terminated, so as to enable the distributor to provide a repair service.

Title, payment and insurance

In the UK, it is an implied term of a sale of goods contract that a seller has the right to sell the goods, and, in Germany, a seller is under an obligation to deliver goods free of third party claims. Otherwise it is not common to specify in an agreement that a supplier has good title to the goods he is selling.

(*See Country Question 26.*)

Nevertheless, distribution agreements commonly include a retention of title clause, stipulating that ownership of the contract products will not pass to the distributor until full payment has been made to the supplier. The effectiveness of retention of title clauses will depend on the country in which the distributor is based. Clauses which simply retain title to goods in their original state while they remain in the distributor's possession are generally the most effective. Clauses that, for example, purportedly give the supplier the right to the proceeds of sale of products that the distributor has sold on are, in practice, likely to be unenforceable. (For a detailed discussion of the validity of retention of title clauses, see *Practice note, Supply contracts: Retention of title (http://us.practicallaw.com/A23058).*)

As an alternative to a retention of title clause a supplier should protect his position by ensuring at the outset that the distributor has a sound financial standing, and secure payment by letter of credit, for example.

Payment conditions must be clear, for example, as to time, currency and method. The parties will need to decide who will take the risk of any exchange rate fluctuations. Interest for overdue payment may be charged.

Term of the agreement

The parties to a distribution agreement may choose either:

- A fixed term agreement; or
- An open-ended agreement.

A fixed term will come to an end automatically at the agreed date and may only be terminated in advance in exceptional cases. In practice, if a fixed term is chosen, the parties will provide for it to be automatically renewable at a specified date unless one of the parties objects.

An open-ended agreement may only be terminated after notice has been given. In the absence of specific legislation relating to the distribution agreement, the parties may fix the length of notice, insofar as it is a reasonable period. In Germany and Italy, agency law provisions as regards notice periods are applied by analogy (*see Practice note, Agency: Duration (http://us.practicallaw.com/A21033)*).

In the case of exclusive distributions, an initial fixed term is usually agreed upon, to encourage the distributor to develop a market for the products and allow him to recover his investment. Sometimes there may be an initial trial period, at the end of which the supplier may terminate the agreement if certain criteria (for example, a minimum purchase target) are not met. In the US, many states have laws regulating the termination of distributions regardless of the contract provisions. Whether and which of those laws apply will depend on numerous factors set forth in the laws themselves, but usually relate to the location of the distributor or its territory, the type of products at issue, whether a sufficiently close relationship exists between the distributor and supplier and various other factors which must be considered.

(*See Country Question 27.*)

Termination

In most countries, the law allows agreements to be terminated in the case of a material breach. The different legal criteria giving grounds for immediate termination vary from country to country.

(*See Country Question 28.*)

It is advisable to list the circumstances in which termination may be justified, whether or not they arise from the fault of one of the parties. Whereas in most countries, insolvency of one of the parties is considered a justifiable ground for termination, in France it is not.

In most EU countries, there is no legislation dealing with the payment of compensation to the distributor on termination. It has not been seen as necessary to protect the distributor in the same way as agents. The contract may of course provide for any such compensation, and there may also be a claim for compensation for wrongful termination or other breach of contract. In Germany, a distributor may, under certain circumstances, have a claim to payment for goodwill. In the US, some states require a repurchase of inventory and/or may require other compensation upon termination.

(*See Country Question 29.*)

The agreement should state what rights of ownership the supplier has over stock or money or other property held by the distributor, and to what extent he can assert his rights of ownership against third parties, for example, in the event of insolvency of the distributor or of the distributor dishonestly disposing of the supplier's goods to third parties. A retention of title clause drafted to ensure that title does not pass until full payment is made may be appropriate.

(*See Country Question 30.*)

Boilerplate provisions

The agreement should also include the following standard clauses:

- A *force majeure* clause.
- An obligation on the distributor to obtain any necessary governmental approvals to sell the product within the territory.
- An entire agreement clause.
- Choice of governing law.
- An arbitration / alternative dispute resolution clause.
- Third party rights clause.

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APPOINTING A DISTRIBUTOR

Advantages:	Disadvantages:
■ The supplier benefits from the distributor's knowledge of local laws, trading conditions and customs. ■ The distributor bears the costs and commercial risks associated with developing the distribution business in the territory. ■ The legal issues associated with developing the distribution business, such as product liability claims and enforcement of contracts with customers, become the concern of the distributor. ■ There is generally no requirement to pay compensation or indemnity to a distributor upon termination of the distribution agreement. ■ The appointment of a distributor will avoid the need for a supplier to have an established place of business within the distributor's territory, which will reduce the supplier's administrative costs, and may also be beneficial for tax reasons.	■ A supplier has less control over the way in which his goods are marketed by a distributor than he would over an agent. ■ Under EC competition law a supplier may not control the resale pricing policy of the distributor, whereas he may do so with an agent. ■ The supplier will not normally have access to the distributor's customer lists. ■ Where the supplier appoints an exclusive distributor for a territory, his entire credit risk in respect of sales into that territory is concentrated on the distributor, rather with each customer, as would be the case with an agency arrangement.

RESTRICTIONS IN AN EXCLUSIVE DISTRIBUTION AGREEMENT: TREATMENT UNDER EC LAW

Permitted restrictions	Prohibited restrictions*
Maximum resale prices	Fixed resale prices
Recommended resale prices	Minimum resale prices
Ban on active sales outside exclusive territory	Ban on passive sales outside exclusive territory
Ban on sales to end users where the distributor acts as a wholesaler	Ban on active and/or passive sales where the exclusive distribution is combined with selective distribution
Non-compete obligation limited to five years	Preventing the distributor selling to customers who the supplier wishes to retain for himself
Exclusive purchasing obligation	Partitioning of the market between the supplier and distributor
Minimum purchase obligation	Non-compete obligation longer than five years
	Excessive post-term non-compete clause

** Where the market share of the supplier is below 30% and the agreement with the distributor contains none of the above prohibited restrictions, the distribution agreement will fall within the scope of the vertical agreements block exemption.*

GLOSSARY TERMS

Block exemption

Block exemptions are contained in regulations issued by the European Commission, or in certain cases the Council of Ministers. If an agreement meets the conditions set out in a so-called block exemption regulation, it is automatically exempt from Article 81(1) of the EC Treaty. Block exemptions have been introduced for certain types of agreement (for example, vertical agreements, technology transfer agreements and research and development agreements).

European Commission

Main executive body of the European Union. Proposes, administers and enforces Community legislation. Consists of members appointed by common accord of the member state governments.

Horizontal agreement

An agreement between companies or undertakings trading at the same level of supply, for example, between two or more manufacturers, or two or more retailers.

Exemption under Article 81(3)

An exemption in respect of an agreement that infringes Article 81(1) which arises automatically under Article 81(3) of the EC Treaty if the criteria set out in Article 81(3) are satisfied. Under

Regulation 1/2003, which came into force on 1 May 2004, Article 81(3) can be applied by the European Commission, national competition authorities and courts of the EU member states, and European courts.

Inter-brand competition

Competition between suppliers/dealers selling different brands of the same or equivalent goods; for example, when manufacturer A (producing brand A washing powder) faces competition from manufacturer B (producing brand B washing powder), brands A and B will be competing against each other and against other brands.

Intra-brand competition

Competition between suppliers/dealers when selling the same brand of goods; for example, retailers X, Y and Z will be competing against each other for sales of brand A washing powder.

Passive sales

Sales made by a licensee or dealer in response to unsolicited orders from outside the territory of the licensee or dealer.

Selective distribution

A system in which a supplier agrees to supply only approved distributors who meet specified minimum criteria, and the distributors themselves agree only to supply end users or other distributors or dealers within the approved network.

Tying

Making the purchase of a particular product conditional on the purchase of a different product.

Vertical agreement

An agreement between companies or undertakings trading at different levels of the supply chain, for example, between a manufacturer and wholesaler, a wholesaler and retailer, or a licensor and licensee.

Agency: international overview

Macfarlanes. Edited and updated by Jane Tyler and Neil Wallis, from an original work by them both, together with Tom Bridgford.

Overview of the key legal and commercial considerations when appointing a sales or marketing agent. The overview also considers provisions commonly found in agency agreements. Country-specific information (updated periodically) for France, Germany, Italy, Russia, UK and US.

The term agent is often used indiscriminately to refer to anyone acting under the instructions of another. This Practice note considers those agreements which in the strictest sense may be termed commercial agency agreements, that is, where an agent acts as an intermediary in the making of a contract between his principal and the principal's customer.

Appointing a commercial agent will give rise to a number of issues, which are considered below:

- Definition and authority.
- Regulation and legal formalities.
- Competition law.
- Employment law.
- Tax.
- Duties of the agent.
- Duties of the principal.
- Remuneration.
- Termination.
- Terms of the agency agreement.

DEFINITION AND AUTHORITY

The essence of an agency agreement is that an agent is appointed, almost always on a commission basis, to sell goods on behalf of a manufacturer or supplier (the principal). The agent contracts on behalf of his principal, the principal is bound by the agent and a direct contract is created between the principal and the customer (but not between the agent and the customer). The agent does not buy goods for trading on his own account. Agency can clearly be distinguished from, and may be preferable to, a distributorship in a number of situations, although agency does have certain drawbacks (*see box: Appointing an agent*).

In the EU, Directive 86/653 on the co-ordination of the laws of the member states relating to self-employed commercial agents (*OJ 1986 L382/17*) defines a commercial agent as a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person (the principal), or to negotiate and conclude such transactions on behalf of and in the name of that principal.

In the United States, the definition of agency for most purposes is established by common law at state level, and reflects a similar position, that is, of one person acting in representation of another. There are, however, differences between US and European laws:

- US state legislation covers only agencies for the sale of products to wholesale customers, that is, not to end users.
- In practice, US commercial agents are given less comprehensive authority than agents in Europe, usually being authorised only to solicit orders from prospective customers. Such orders will be subject to acceptance or rejection by the supplier, and, generally, the agent will be prohibited from entering into any contractual commitment on behalf of his principal.
- US law does not recognize the concept of a *del credere* agency; an agent that assumes financial responsibility for the orders it solicits will probably be treated as a distributor under US law.

(*See Country Question 1.*)

The question of authority is essential in the appointment of an agent. An agent's power to affect the legal position of his principal rests on his authority, which can be actual or apparent. Actual authority is a legal relationship between the principal and agent created by a consensual agreement to which they alone are parties. Apparent (or ostensible) authority is the authority of an agent as it appears to others.

Generally, the principal is bound by (and entitled to the benefit of) the contract made by his agent on his behalf and within the scope of the agent's actual authority. Any action arising out of the agent's express authority to act on behalf of the principal is construed as an action by the principal himself. Further, where the principal, by words or conduct, represents to a third party that another has authority to act on his behalf, he may be bound by the acts of that other person as if he has in fact authorised them. Where the agent acts outside the scope of his authority, the principal will not be bound by those acts unless he later ratifies them.

Normally, where an agent discloses the fact that the agent is acting on behalf of a principal, and provided he acts within the scope of his authority, the agent will have no liabilities under the contract between his principal and the customer. As an exception to this, it is worth noting the existence of *del credere* agents. A *del credere* agent undertakes to indemnify his principal if the customers he finds fail to pay the principal under the contracts which he concludes on behalf of the principal.

In the UK, where an agent fails to disclose the fact that he is acting as agent for a principal, he will be liable to the customer who (if he has a legal claim) can choose to sue either the agent or the principal if he discovers the agency. In Germany, an undisclosed agent will only bind himself.

France, Italy and Germany have developed the concept of the commissionaire. The relationship between a commissionaire and his principal is similar to that between an agent and an undisclosed principal. A commissionaire acts in his own name for the account of the principal. The principal is contractually bound to the commissionaire to deliver (through the commissionaire) the products sold to the customer and the commissionaire is bound to the principal to remit the price received from the customer. No relationship is created between the principal and the customer, so the customer does not have any claim against the principal, nor can the principal sue the customer for the price.

(*See Country Question 2.*)

REGULATION AND FORMALITIES

In contrast with distributorships, agency arrangements are the subject of special regulation and formalities as to registration in most countries.

(*See Country Question 3.*)

In the UK, France, Italy and Germany, such regulation originates from the EU Directive on self-employed commercial agents (the Directive).

EU regulation

When considering the appointment of an agent whose activities are to be carried out anywhere in the European Economic Area (EEA) (*see Glossary*) it is first necessary to determine whether the agency agreement will be covered by the Directive.

The Directive deals with:

- Mandatory rights and obligations of principals and agents;
- Remuneration of the agent;
- Termination of the agency agreement;
- Payment of compensation to the agent; and
- Post-termination non-competition clauses.

The Directive is modelled upon French and German legislation, which has traditionally granted greater levels of protection to agents than found in the UK. Its application may affect the decision whether or not to use an agent, and indeed whether to use a self-employed as opposed to an employed sales force.

The Directive applies to commercial agents (defined as a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person (the principal), or to negotiate and conclude such transactions on behalf of and in the name of that principal (*Article 1(2)*)) whenever such an agent performs any part of his duties anywhere in the EU. By virtue of the EEA Agreement of 1 June 1994 the Directive has also been extended to apply to Norway, Iceland and Liechtenstein.

In the context of continuing authority to negotiate, it is unclear what negotiate means, and it is arguable that a marketing agency agreement which merely allows an agent to carry out marketing and promotion, effect introductions and pass on orders to the principal falls outside the definition because the agent is not negotiating sales or purchases of goods. However, no guidance is available on the point and it would be safer to assume that courts would construe its meaning widely.

The Directive does not apply to undisclosed principals, as in such cases the agent is clearly not negotiating and concluding transactions in the name of the principal.

Certain classes of people are excluded from the definition of commercial agent:

- Officers of companies or associations;
- Partners; and
- A receiver, a receiver and manager, a liquidator or a trustee in bankruptcy.

(*Article 1(3).*)

In addition, the Directive specifically does not apply to:

- A commercial agent who is unpaid;
- Commercial agents operating on commodity exchanges or in commodity markets; and
- In the UK, the Crown Agents for Overseas Governments and Administrations, and its subsidiaries.

(*Article 2(1).*)

The Directive allows EU member states to provide that their implementing legislation does not apply to agents whose activities, under national law, are secondary (*Article 2(2)*). While neither the UK nor Italy recognised the concept of a secondary agent, they chose to deal with it in different ways. Italian law does not exclude secondary agents, and they are now accepted as a concept in case law and by legal commentators. In the UK, commercial agents whose agency activities are secondary have been excluded, but the definition of what constitutes a secondary agent has been criticised as being unnecessarily complicated.

In Germany, the law excludes part-time agents, but does not define them; whether an agent is part-time being a question of fact to be decided in each case. In France, the term secondary

agent is not used, but where parties enter into an agreement whose main purpose is something other than agency and provide for an agency relationship as a subsidiary activity, the parties may exclude the operation of the Directive to this subsidiary activity.

The Directive does not apply to an agency agreement for the supply of services. Nevertheless, the scope of the French implementing legislation was extended to include services.

The Directive will apply in addition to national laws containing special collective bargaining agreements to agency (for example, Italy) or common law obligations (for example, the UK).

US regulation

US regulation of agency relationships is almost exclusively at the state level, and does not generally impose registration requirements. Instead, state legislation on commissioned agency is primarily designed to ensure that principals pay agents the commissions that they are owed in a timely manner. Failure to do so generally exposes the principal to liability for a multiple (two-to-four times) of the unpaid commissions and for reimbursement of the agent's attorneys' fees incurred in collecting. Some states' laws do impose a requirement that agency agreements be put in writing, that those agreements contain certain information (essentially, whatever is needed to calculate commissions earned), and that certain other formalities be observed. A very few impose substantive requirements, such as a minimum notice period for termination and payment of commissions on certain post-term shipments.

COMPETITION LAW

An agent will typically accept restrictions on the customers to whom he may sell, the territory in which he may sell, the prices and terms under which he may sell and his ability to deal in competing products.

A true agency agreement should not generally give rise to competition law concerns.

EC competition law

Article 81(1) of the EC Treaty prohibits agreements, decisions or concerted practices by undertakings which may affect trade between EU member states and which have as their object or effect the prevention, restriction or distortion of competition within the EU.

Article 81(1) only applies to an agreement between two or more independent undertakings. It will therefore not apply to an agency agreement if the principal and agent are so closely integrated that they are to be regarded as part of the same economic unit. The criteria for assessing such integration are set out in:

- Regulation 2790/1999 on the application of Article 81(3) of the EC Treaty to categories of vertical agreements and concerted practices (*OJ 1999 L336/21*) (vertical agreements block exemption); and
- Vertical restraints guidelines, which describe the European Commission's policy in relation to vertical agreements (*OJ 2000 C291/1*).

An agency agreement is considered a genuine agency agreement, falling outside Article 81(1), if the agent bears no, or only insignificant, financial or commercial risks in relation to the contracts concluded and/or negotiated on behalf of the principal.

Two types of financial or commercial risks are relevant:

- Those which are directly related to the contracts negotiated or concluded by the agent on behalf of the principal, for example, financing of stocks; and
- Those which relate to investments specifically required for the type of activity for which the agent has been appointed by the principal.

The question of risk is assessed on a case-by-case basis. Article 81(1) will generally not apply to sales or purchases made on behalf of a principal if property in the goods sold or bought does not vest in the agent or the agent does not act on his own account, and the agent does not undertake any of the following activities:

- Contribution to the costs relating to the agency or purchase of the contract goods or services, including transport costs;
- Investment in sales promotion.
- Maintenance at his own cost or risk of stocks of the contract goods.
- Creation or operation of an after-sales service, repair services or a warranty service, unless it is fully reimbursed by the principal.
- Investment in equipment, premises or training of personnel.
- Acceptance of liability to third parties for harm caused by the products sold.
- Acceptance of liability for customers' non-performance of the contract (except for the loss of the agent's commission), unless the agent is himself liable.

(*Vertical restraints guidelines, paragraphs 16 & 17.*)

If an agency agreement is considered genuine, all obligations imposed on the agent in relation to the contracts concluded and/or negotiated on behalf of the principal fall outside Article 81(1). Limitations or restrictions on:

- The territory in which the agent may sell those goods or services;
- The customers to whom the agent may sell; and
- The price and conditions at which the agent must sell or purchase goods or services on behalf of the principal,

will therefore be permitted.

Similarly, provisions which grant the agent an exclusive territory or impose minimum sales targets are not considered anti-competitive.

It should be noted, however, that even in a genuine agency relationship non-compete provisions, including post-term non-competes, may infringe Article 81(1) if they lead to foreclosure on the relevant market where the goods/services the subject of the agency agreement are sold or purchased (*see Non-compete clauses, below*). Furthermore, an agency agreement may fall foul of Article 81(1) if it facilitates collusion, for example, where a number of principals use the same agents while excluding others from using them, or when they use the agents to collaborate as regards marketing strategy or as a means of exchanging confidential market information between principals.

Where an agent bears such financial or commercial risks that he is to be regarded as an independent dealer, Article 81(1) will apply. This is so in the case of a commissionaire appointed under French, German and Italian laws.

An agreement that is caught by Article 81(1) may nonetheless be exempted if, broadly, the benefits to which it gives rise outweigh its anti-competitive effects. An agency agreement is a typical example of a vertical agreement, that is, an agreement between undertakings who operate at different levels of the supply chain. Agency agreements may be covered by the vertical agreements block exemption. A vertical agreement that is caught by Article 81(1) may meet the criteria for exemption by falling within the vertical agreements block exemption and the vertical restraints guidelines.

The principle underlying the block exemption is that vertical agreements will be presumed legal in the absence of market power (defined as 30% of a relevant market) and in the absence of certain hardcore restrictions, for example in relation to price-fixing and territorial limitation. Above the 30% threshold the vertical agreements block exemption will not apply. The terms of the vertical agreements block exemption and vertical restraints guidelines are considered in detail in the Practice note, Distributorships: Competition law (http://us.practicallaw.com/A21039).

Restrictions which are unlikely to be exempted include:

- A restriction on the agent's ability to respond to unsolicited orders from customers outside the exclusive territory;
- A prohibition on the agent splitting his commission with customers; and
- An over-lengthy restrictive covenant (*see Non-compete clauses, below*).

National competition laws in the UK, France, Germany and Italy tend to reflect the position under EC law.

(*See Country Question 4.*)

US anti-trust law

US anti-trust law similarly has little bearing on true agency relationships. When a US agent assumes financial responsibility for the payment for the supplier's goods, the relationship will not be considered a true agency. In such situations, the agreement will be subject to the anti-trust principles that apply to distributorships (*see Practice note, Distributorships: Competition law (http://us.practicallaw.com/A21039)*). However, it is important to note that if agents are used (or so conduct themselves) as conduits between competing suppliers parallel activities of the suppliers may be considered illegal collusion.

Non-compete clauses

In the EU, where an agent is to be treated as independent of the principal, a non-compete provision which prevents the agent from acting as agent or distributor in competing products during the life of the agency agreement must be limited to five years' duration in order to fall within the scope of the vertical agreements block exemption. A post-termination restriction will take an agreement outside the scope of the block exemption, unless such restriction relates to goods or services which compete with the contract goods or services and is limited to the premises and land from which the agent has operated during the contract period and is indispensable to protect know-how transferred by the supplier to the agent. Even if a clause fulfils all of these criteria the post-termination non-compete must be limited to one year following termination.

Where the agent is considered genuine, non-compete clauses are generally considered not to restrict competition, unless they lead to foreclosure on the market where the contract goods are sold or purchased. Nevertheless, two years is the maximum period allowed for post-termination restrictions under the Directive (*Article 20*), and national law restraint of trade principles will be applicable to the extent they are stricter. In both Germany and Italy, an agent who accepts post-termination non-compete restrictions is entitled to reasonable compensation.

Further, under the terms of the Directive, a restraint of trade clause must, in order to be valid, be concluded in writing, and relate to the geographical area, the group of customers and the goods entrusted to the commercial agent.

In the US, it is conceivable that restrictions on agents' handling of competitive lines could be found to be unreasonable competitive restraints (and hence illegal) when one or more agents that are critical to a supplier's ability to penetrate a market are pre-empted by such restrictions. However, such restrictions during the term of the relationship are commonly found, and are considered to be enforceable, without regard to their length.

As in Europe, after expiration or termination of an agency relationship, restrictions on the agent's activities for competitors of its former principal are more easily subject to challenge. One state, California, will not enforce any such restriction. In other states, they must be reasonable in geographic and temporal scope to be enforceable. If they are not, some states will enforce them to the extent that doing so would fall within the bounds of geographic and temporal reasonableness, but other states will declare void any over-broad non-competition agreement.

(*See Country Question 5.*)

EMPLOYMENT ISSUES

Depending on the nature of the relationship between the principal and agent, there is a risk that the agent may be treated as an employee of the principal, with all the attending employer obligations and employee rights that this will bring.

For example, in Italy, agents are usually independent contractors who perform their activities either as autonomous workers or as personal companies. They are entitled to perform their promotional activities in total freedom, being subject only to very general obligations and sometimes to minimum sales targets. They are not usually granted fixed salaries (rather variable commissions) and have to meet personally all expenses deriving from the agency without any reimbursement from the principal. In such circumstances, an agent will not be considered an employee of the principal. In contrast, if an agent is paid a standard salary, works for a fixed number of hours at the principal's premises and/or has all his expenses reimbursed he may be considered an employee and so have the right to claim the minimum salary and social security contributions granted by Italian laws and regulations to employees.

In Germany, the risk that a natural person may be regarded as a pretended independent trader must be carefully considered.

In the US, the tests for determining whether a relationship characterised as being one between independent contractors should be viewed as one of employment varies somewhat by the jurisdiction involved (federal or one of the states) and the purpose for which the determination is to be made (for example, responsibility for tax withholding or payment of employment taxes). It is generally considered, however, that if a commissioned agent is an individual and handles only one principal's products, that agent will be treated as the principal's employee for most purposes.

(*See Country Question 6.*)

TAX

Under the internal taxation rules of most countries, a foreign company with a local permanent establishment is subject to local taxation on the profit that it derives from that permanent establishment. An agent who does not act independently and who habitually exercises authority to enter into binding contracts in the name of a principal is at risk of being considered a permanent establishment of that principal. The nature of most agency agreements is exactly that, meaning that the principal will be regarded as carrying on trade or business in the territory of the agent, thereby incurring liability for local taxation.

In contrast, where a commissionaire is appointed under French, German or Italian law there is a low permanent establishment risk. A commissionaire is an independent agent who acts in his own name for the account of his principal. Such an arrangement may enable the principal to export products to a high tax country, while maintaining the majority of its liability to tax within a country with a tax-friendly regime.

If the agent does constitute a permanent establishment of the principal in the country in which he is carrying out his duties, double tax treaties, where they exist, may protect the foreign principal from double taxation.

Double tax treaties are usually based on an OECD Model Treaty, which is generally favourable on the question of commissionaires and permanent establishments (*see box: Permanent establishment and double taxation*). Where the principal is established in a country with a good treaty network, he will be in a better position to take advantage of this.

In the US, because most agents are not authorised to conclude transactions on behalf of their principals, the use of agents should not result in the creation of a permanent establishment (unless the agents are treated as employees). When there is no applicable double tax treaty, however, a principal's use of a US agent is likely to subject the principal to taxation at the federal, but not the state, level.

(*See Country Question 7.*)

Where a principal is considered to be carrying on business in the territory of the agent, he will be subject to local taxation. How remittances made by an agent who is not considered to have created a permanent establishment on behalf of his foreign principal are subject to withholding tax or any other tax differs from jurisdiction to jurisdiction.

(*See Country Question 8.*)

In both Europe and the US, generally there are no foreign exchange restrictions, but there are reporting obligations in Germany.

(*See Country Question 9.*)

DUTIES OF THE AGENT

Where an agent operates in the EU and the Directive applies, the agent is under an obligation to look after his principal's interests and act dutifully and in good faith. In particular, he must:

- Make proper efforts to negotiate and, where appropriate, conclude the transactions he is instructed to take care of;
- Communicate to his principal all the necessary information available to him; and
- Comply with reasonable instructions given by his principal.

(*Article 3.*)

These duties are mandatory and may not be contracted out of (*Article 5*). It is of course always possible in a contract with an agent to include obligations which go further than a general duty of good faith, for example, an obligation to use best endeavours.

Where the Directive does not apply, national laws will in any case impose similar obligations.

(*See Country Question 10.*)

The duties of US commercial agents are primarily the subject of state common law, and are subject to variance by agreement of the parties. The most important of them are to:

- Provide the principal with information relevant to the marketing of the principal's products.
- Account for and remit to the principal collections for the principal's account.
- Avoid conduct which will bring disrepute to the principal or its products.
- Not act outside of its express and implied authority.
- Obey lawful instructions.
- Not act for an adverse party to a transaction with the principal, without the principal's knowledge.
- Not compete with the principal with respect to the business in which the agent acts as such.
- Not act as an agent for competitors of the principal, without the principal's consent.
- Maintain the confidentiality of, and not to misuse, the principal's confidential information.

In the performance of his responsibilities, the agent is subject to a general duty of good faith; but that duty generally will not override the specific terms of an agreement between the parties.

The obligations to act in good faith and to follow all reasonable lawful instructions of the principal, which are implied under national laws, will usually be set out expressly in the agency contract.

Other specific duties commonly imposed upon an agent in an agency agreement include obligations to:

- Use best endeavours to promote and sell the products.
- Maintain a dedicated sales team.
- Maintain appropriate, secure storage for the products.
- Obtain all necessary consents and licences for the products in the territory.
- Comply with, and notify to the principal, all applicable local laws and changes to them, and grant an indemnity in favour of the principal in respect of the consequences of the agent's breach.
- Not sell competing goods (*see Competition law*).
- Maintain an up-to-date customer list.
- Not incur any liability for or make representations or give any warranty on behalf of the principal except as authorised.
- Make clear to persons with whom he deals and in advertising material that he is acting as agent for the principal.
- Sell only at the price notified by the principal and on the principal's standard terms and conditions, unless he obtains the principal's specific approval to do otherwise.
- Obtain the principal's approval of promotional activities and advertising.
- Not make secret profits.
- Keep the principal informed of possible intellectual property infringements.
- Advise the principal promptly of any enquiries and orders for the products, complaints or after-sales enquiries.
- Allow the principal to inspect the agent's books.
- Not assign or sub contract the agency.
- Agree that goodwill in trade marks resulting from use by the agent enures for the benefit of the principal.

DUTIES OF PRINCIPAL

Where an agent's activities fall within the scope of the Directive, a principal must act dutifully and in good faith in his relations with his agent. He must, in particular:

- Provide his commercial agent with the necessary documentation relating to the goods concerned.
- Obtain for his commercial agent the information necessary for the performance of the agency contract, and, in particular, notify the commercial agent within a reasonable period once he anticipates that the volume of commercial transactions will be significantly lower than that which the commercial agent could normally have expected.
- Inform the commercial agent within a reasonable period of his acceptance, refusal, and of any non-execution of a commercial transaction which the commercial agent has procured for the principal.

(*Article 4*.)

Again, these duties cannot be contracted out of (*Article 5*).

Where the Directive does not apply, national laws will in many cases impose similar obligations, although UK law does not generally impose wide-ranging duties on principals.

(*See Country Question 11*.)

In most US states, common law is supplemented by statutory requirements imposed on principals. Those requirements vary a good deal state by state; and it is unlikely that they may be varied materially by contract. Among the obligations that may apply are the following:

- In most states, principals must promptly pay terminated agents the commissions that they are owed, at the risk of suffering severe (multiple-damage) penalties.
- Some states apply the same penalties to failures to pay commissions in a timely manner during the term of the relationship.
- A few of them may require that commissions be paid on transactions in the pipeline at the time the relationship ends.
- Several states require that the principal reduce the arrangement with its agent to writing and that the agreement include certain information (principally, the basis of commission calculation).
- Finally, several states require that agents be provided with, and in some cases sign, receipts for copies of their agency agreements.

In addition to those responsibilities, US common law requires that the principal indemnify the agent against liabilities to third parties arising out of the performance of the agent's responsibilities (presumably including products liability claims). In the absence of an applicable state statute, the only other significant obligation of the principal is to perform its express contractual commitments.

In addition to obligations imposed on principals by national law of all jurisdictions, specific duties commonly agreed an agency contract include obligations to:

- Pay commission.
- Supply the agent with promotional literature, samples, price lists and other necessary information.
- Provide training and after-sales services for users, if appropriate.
- Reimburse expenses incurred by the agent, if this has been agreed between them.
- Make appropriate checks on the products and maintain appropriate product liability insurance.
- Perform his contracts with third parties.
- Indemnify the agent against claims brought in relation to breaches by the principal or intellectual property claims relating to the agent's use of the principal's intellectual property.

REMUNERATION

The level of remuneration, or commission, to be paid to an agent is a subject for negotiation between the parties (*see Country Question 12*). Where the Directive applies, in the absence of any agreement or any compulsory provisions of national law, an agent is entitled to remuneration in accordance with customary practice or, where there is no customary level, that which is reasonable taking into account all the aspects of the transaction (*Article 6*).

Commission on orders during the agency agreement

Under the terms of the Directive, a commercial agent is entitled to commission on transactions concluded during the period covered by the agency contract:

- Where the transaction has been concluded as a result of his action; or
- On transactions concluded with customers whom he has previously acquired for transactions of the same kind (*Article 7(1)*).

This applies regardless of whether the agent's appointment is on an exclusive or non-exclusive basis.

Additionally, under the Directive, member states had the choice of specifying a right to commission on either:

- Transactions with customers belonging to a specific area or group with which the agent has been entrusted; or
- Transactions with customers belonging to a specific area or group for which the agent has exclusivity (*Article 7(2)*).

Where Article 7 applies, an agent may therefore have a right to commission even if he has never heard of a particular customer, provided the customer belongs to a territory or group of customers to which the agent has a right under his agency agreement.

France and Germany opted for the first of the two alternatives. The UK opted for the latter alternative. Italy implemented neither alternative, simply stating that, unless the parties expressly agree otherwise, the agent is entitled to commission on transactions directly entered into by the principal in the area entrusted to the agent (whether on an exclusive or non-exclusive basis). Additionally, under general Italian law, if a grant is made on an exclusive basis, the agent is (unless the parties expressly provide otherwise) entitled to commission on business transacted by the principal either directly or indirectly through third parties.

As a consequence of the Directive, where a principal appoints agents on a non-exclusive basis, he may be liable to pay commission twice on the same transaction - once to the agent who first acquired the customer for the principal, and again to the agent (if different) who actually concludes the transaction with the customer. There is no provision in the Directive for set-off in this situation.

Most principals would probably not grant an agent such extensive rights to commission as are included in the Directive and so may wish to exclude its operation. It is not, however, clear whether the application of Article 7 is mandatory (unlike other articles, there is no specific statement that it cannot be contracted out of) and so the effectiveness of excluding its operation is uncertain.

Where the Directive does not apply, the parties are free to negotiate appropriate rights to commission (subject to any relevant provisions of national law).

Commission after termination of the agency agreement

Where the Directive applies, a commercial agent is also entitled to commission on transactions concluded after the agency contract has terminated if:

- The transaction is mainly attributable to the commercial agent's efforts during the period covered by the agency contract and if the transaction was entered into within a reasonable period after that contract terminated; or
- The order of the customer reached the principal or the commercial agent before the agency contract terminated.

(*Article 8.*)

Again, it is unclear whether the application of Article 8 is mandatory, and consequently whether any express agreement to the contrary will be enforceable.

Where the Directive does not apply, the parties can negotiate freely rights to commission (subject to any relevant provisions of national law). There is no reason in principle why an agent should be entitled to commission on an order received after termination of the agreement.

In the US some state statutes specifically mandate that commissioned agents be paid commissions on orders placed before termination of the agency relationship and shipped thereafter. If no such statute applies, the extent to which an agent is entitled to commissions after termination is, in the first instance, a matter of contract. However, in the absence of clear contractual guidance to the contrary, common law generally entitles the agent to commissions on orders placed before termination, regardless of when shipped, as well as all orders for which it was the soliciting cause (a somewhat fluid criterion). (*See further The agency agreement, Remuneration and commission.*)

Forfeiture of the right to commission

Where the Directive applies, the right to commission can be extinguished only if and to the extent that the contract between the customer and the principal will not be executed and that fact is due to a reason for which the principal is not to blame (*Article 11(1)*). It is not possible to derogate from this provision to the detriment of the agent. The concept of not to blame is one that is not known in many jurisdictions. Clearly a breach of contract by the customer or insolvency of the customer are not reasons for which the principal is to blame. Breaches of contract by the principal may or may not be events for which the principal is to blame, depending on the circumstances.

Any commission already paid to the agent on the contract is to be refunded to the principal (*Article 11(2)*). The Directive is silent as to whether any repayments made can be set off against future commissions. On general principles, set-off should be available, whether or not there is an express set-off clause in the agency agreement. Otherwise, recovery of overpaid commission could be difficult or impossible to enforce in practice.

Secret commissions

The subject of secret commissions and corrupt gifts is not specifically regulated in the context of agency in France or Italy, but there are strict rules against the receipt of such payments by an agent in the UK, Germany and the US

(*See Country Question 13.*)

TERMINATION

An agency agreement will generally set out the term of the agreement, notice periods, events justifying termination and the consequences of termination.

The Directive is stated not to affect any law of a member state which provides for immediate termination because of failure of one of the parties to the contract to carry out all or part of its obligations or where exceptional circumstances arise (*Article 16*). Such exceptional circumstances would, for example, include gross negligence (Germany). It is worth noting that in France, unlike other jurisdictions, insolvency is not a valid ground for automatic termination of an agreement.

(*See Country Question 14.*)

US law generally leaves the subjects of termination and its consequences to the parties' contract, though in most states an agent must be given an opportunity to recoup any initial investment in handling the principal's products before the agency relationship may be terminated by the principal without default. In the absence of express agreement, reasonable (30 days is thought to be adequate) advance notice of termination is required.

Commercial agents to whom the Directive applies are entitled to either an indemnity or compensation upon termination of the agency agreement (*see further box: An agent's right to compensation or indemnity: EC self-employed commercial agents Directive*). The idea underlying both indemnity and compensation is that the agent has contributed to developing the goodwill of the principal's business, that in broad terms such goodwill is jointly owned by the principal and agent and, in effect, that when the agency relationship is terminated the principal should buy out the agent's interest in that goodwill.

The remedies of indemnity and compensation were based on German and French law respectively. In all EU countries other than the UK, the Directive was taken as meaning that the member state was to make a choice in its implementing legislation between compensation and indemnity. The indemnity model operates in Germany and Italy. France retained its compensation system. In the UK, both alternatives were implemented, allowing the parties to decide for themselves, but on the basis that, in the absence of agreement on the point, the agent would be entitled to compensation rather than indemnity.

There is no minimum period specified in the Directive that must have elapsed under the agency agreement before the agent's rights to compensation or indemnity arise.

In contrast, under US law, a commissioned agent has no right to any indemnity or other compensation upon lawful termination of its relationship with a principal/supplier, although statutes in most states impose varying penalties (usually, liability of two-to-four times the unpaid commissions, plus reimbursement of attorneys' fees incurred in collection) on principals who fail to pay commissions to which agents are entitled after termination.

In any jurisdiction, and also whether or not the Directive applies, an agent may always make a claim for compensation for wrongful termination.

(*See Country Question 15.*)

Indemnity

The right to indemnity arises if and to the extent that:

- The agent has brought the principal new customers or has significantly increased the volume of business with existing customers and the principal continues to derive substantial benefits from the business with such customers; and
- Payment of the indemnity is equitable having regard to all the circumstances, in particular, the commission lost by the commercial agent on the business transacted with such customers (*Article 17(2)(a)*).

It would appear that if the agent has not made a significant increase in business (whether or not through lack of effort on his part) no indemnity is payable. Similarly, if he has increased business, but takes the customers with him when he leaves, he has no right to an indemnity.

The amount of the indemnity must not exceed a figure equivalent to an indemnity for one year calculated from the commercial agent's average annual remuneration over the preceding five years or the length of the contract if less (*Article 17(2)(b)*).

The grant of an indemnity does not prevent the commercial agent from seeking damages, for example, for breach of contract (*Article 17(2)(c)*).

As the remedy of indemnity is modelled on German law, the method of calculation used in Germany should provide appropriate guidance. There are however difficulties in the way which member states have implemented this alternative. (*See Country Question 15.*)

Compensation

Under EC law, as an alternative to indemnity, the agent is entitled to be compensated for the damage he suffers as a result of the termination of his relations with his principal. Damage which will give rise to a right to compensation is deemed to occur particularly when the termination takes place in circumstances:

- Depriving the commercial agent of the commission which proper performance of the agency contract would have procured him while providing the principal with substantial benefits linked to the commercial agent's activities; and/or
- Which have not enabled the commercial agent to amortise the costs and expenses that he had incurred for the performance of the agency contract on the principal's advice (*Article 17(3)*).
- In contrast with the indemnity alternative, no maximum amount is specified for the compensation alternative.

Time bar

The agent's claim for indemnity or compensation under the Directive becomes time-barred if he has not notified the principal within a year of termination that he intends to pursue a claim (*Article 17(5)*). No formalities are prescribed by the Directive for this notification. However, the UK regulations require that unless the agency agreement provides otherwise, all notices should be served according to certain procedures and (by implication) must be in writing. (See *Country Question 15.*)

THE AGENCY AGREEMENT

(*These notes should be read in conjunction with the Agency agreement: skeleton and accompanying drafting notes.*)

In most jurisdictions there are no special requirements that need to be fulfilled for an agency agreement to be legally enforceable. Agency agreements are governed by the general principles of contract law and it is advisable for an agreement to be in writing as a means of clearly defining an agent's authority and the rights and obligations of the parties. Where the Directive applies, member states have the option to provide that an agency agreement shall not be enforceable unless evidenced in writing (*Article 13(2)*). This has not been adopted in either France, Germany or the UK. Nevertheless, a party to an agency agreement has the right to request a signed written document setting out the terms of the agreement (*Article 13(1)*), and restraint of trade clauses must be put in writing (*Article 20*).

In Italy, it is necessary for an agreement to be in writing for it to be executed, written form being necessary to prove the existence of the contract. Several US states also impose similar requirements. In addition, some US states severely penalise late payment of commissions to terminated commissioned agents, making it advisable, and in some cases mandatory, that all provisions affecting the calculation and payment of commissions be precise and detailed (*see further Remuneration and commission*).

(*See Country Question 16.*)

Del credere guarantees

Where an agent is required by the principal to enter into a guarantee of the debts to the principal of customers whom he finds for the principal with whom he concludes contracts on behalf of the principal (*del credere* agent), the guarantee must be in writing for it to be valid in Germany. No such formalities are required in the UK, France or Italy, but, it is clearly advisable to define the scope of such guarantee.

The scope of a *del credere* agent in Italy is severely limited, the agent being prohibited from entering into **general** guarantees of the debts to the principal of all the customers whom he finds for the principal or with whom he concludes contracts on behalf of the principal. Exceptionally, the agent may enter into *star del credere* guarantees in favour of the principal, on the condition that:

- The guarantee refers to single agreements, of particular type and value, individually defined.
- The amount of such guarantee cannot exceed the amount of the commission on which the agent would have the right for that agreement.
- The agent is paid a specific consideration for the *star del credere* guarantee.
- The concept of a *del credere* guarantee is not recognised in the US.

(*See Country Question 17.*)

Structure

An agency agreement will normally be structured in the following way:

- Date.
- Parties.
- Definitions.

- Appointment of agent.
- Agent's obligations.
- Principal's obligations.
- Commission and payments.
- Advertising and promotion.
- Compliance with laws and regulations.
- Product liability and insurance.
- Duration and termination.
- Effects of termination.
- Confidentiality.
- Boilerplate including:
  - entire agreement;
  - assignment;
  - notices;
  - *force majeure*;
  - waiver;
  - severability; and
  - governing law and jurisdiction.
- Execution clauses.

Appointment and authority

It is essential to define precisely the scope of an agent's appointment and authority. The following elements should be considered:

- The **products** for which the agent is appointed. It is important to cover variations to the definition of products during the life of the agreement. Variations may arise from the need for a new product in the market, the withdrawal of a particular product from the market and the introduction of improved versions of the products. The definition of products covered should specify whether spare parts and any consumables are included.
- The **territory** in which the agent is to operate. The agent's appointment is usually restricted to dealing with customers in a defined territory or possibly to a defined type of customer.
- Whether the agent is to be appointed on an **exclusive, sole or non-exclusive** basis. Agents will be granted either exclusive, non-exclusive or sole rights in their defined territory:
  - exclusive rights prevent the principal from himself actively seeking sales in the agent's territory and from appointing other agents or distributors or other types of resellers there;
  - sole rights prevent the principal from appointing another agent for the territory and other distributors and other types of resellers, but will not prevent the principal himself actively seeking sales in the territory at the level of customers at which the agent is operating; and
  - non-exclusive rights leave the principal free to appoint other agents and resellers and himself actively to make sales in the territory at the same level of customers as the agent.

There is no universally accepted meaning of exclusive and sole so it is advisable to set out in the agreement exactly what rights the agent is intended to have.

- **The precise nature of the agent's role.** Where the sale of goods is concerned, there are two types of agent:
  - a **sales agent**, who will be authorised in the agreement to promote, market, negotiate and enter into contracts on the principal's behalf, but on such terms and conditions as the principal stipulates. The agent will be required to bring those terms and conditions to the customer's notice and not to make any promises or representations which exceed them. The principal should retain the right to decide whether or not to do business with a particular customer, reserving a right to decline, for any reason, any order; and
  - a **marketing agent**, who is authorised to promote and market the principal's products and solicit orders for them, and has authority only to transmit to the principal any requests for quotations or orders. He does **not** have the authority to enter into a contract of sale on behalf of his principal and a specific prohibition should be included to this effect. The agent should be restricted to bringing the principal's terms and conditions to the customer's notice and not making any wider representations. This type of relationship is not seen as a true agency relationship by UK law.
- **Does the agent have the authority to bind the principal?** The agreement should clearly set out what authority the agent has, for example, to agree discounts or other deals with the customer. If the agent is a sales agent the extent of his authority to enter into contracts on behalf of the principal should be clearly set out. *See further Definition and authority*.

Agent's obligations

Principals are advised to set out the agent's duties in detail. These will cover the following areas:

- Sales and marketing activities.
- Reporting obligations.
- Performance targets.
- Good faith and compliance with local laws.

See further Duties of the agent.

Principal's obligations

Other than an obligation to act in good faith, obligations imposed upon the principal will depend on the negotiations between the parties. Consideration should be given to the following issues:

- Providing the agent with samples, price lists, catalogues, and so on.
- Ownership of materials provided to the agent.
- Retention of a right by the principal to market directly to customers in the agent's territory. Indemnification of the agent for breaches by the principal or for intellectual property claims.

See further Duties of the principal.

Remuneration and commission

The issues which commonly arise in the negotiation of an agent's remuneration are:

- The amount of commission payable (usually a percentage of the net sales value of the products sold through the agent or of the cash ultimately received by the principal from those sales).
- How often is commission to be paid?
- On what transactions is commission payable?
- Is VAT payable or included?
- Invoicing arrangements.
- Reimbursement of expenses.

The Directive, where it is applicable, contains detailed provisions as to how commission should be calculated and when it should be paid - some of which are mandatory, others not (*Articles 7-12*).

See further Remuneration, above.

If the agent is authorised to receive payments from customers on the principal's behalf, he may want the right to retain his commission out of the payments. In the UK, the agent should be required to hold the balance (after deduction of the agent's commission) in trust for the principal in a separate identified bank account and to account to the principal for it. In this situation, the principal would usually include provisions in relation to late payment of such sums, including the right to charge interest. In jurisdictions which do not recognise the trust concept, local advice will be needed on an effective method of protection.

In the US, the most common disputes with commissioned agents have always related to commissions, and the relatively recent introduction of statutes requiring that provisions regarding the calculation and payment of commissions be in writing has raised the stakes in such arguments. Accordingly, all relationships with US commissioned agents should be reduced to writing and should address the following issues in relation to the payment of commission:

- On what products are commissions payable?
- Does the agent receive a commission on every sale to a particular group of customers or to any customer in a particular geographic area, or does the agent have to demonstrate that it is in some way responsible for an order?
- On what transactions are commissions not payable (for example, sales to house accounts, sales where warranty adjustments or other refunds are made)?
- At what rate are commissions paid?
- If commissions are in some cases to be divided among multiple agents, what criteria are used to allocate shares of the available commissions and what share is allotted to each?
- On what amount is a commission payable (typically, invoice price less reimbursable costs of the supplier, for example, for taxes, insurance, freight)?
- What event triggers payment of the commission on an order (for example, payment by the customer or shipment)?
- Exactly when, by reference to that event, is a commission payable (for example, the tenth day of the month following the calendar month in which the customer's final, full payment is received by the supplier)?
- Is there any limit (that is, other than on all sales, whenever shipped, where the agent was the soliciting cause) on commission payments after termination? This is the most troublesome issue that arises after termination of US commissioned agents. In the absence of clear contractual limits, it is not uncommon in the US for a commissioned agent to claim entitlement to commissions on:
  - shipments made more than a year after termination under a blanket order on which it is arguable that the buyer had no commitment to buy until it issued a release; or
  - orders placed after the effective date of termination.

It is a common (albeit poor) practice in the US, to allow for the principal to exercise discretion as to several of the above issues. Such provisions may violate the statutes of the several states that require written, and sometimes signed, specification of the method used to calculate commissions.

Duration

The duration of the appointment is likely to be one of:

- A fixed term with provision for termination on notice thereafter.
- An indefinite term terminable on notice from the start.
- A fixed term requiring positive extension.

Where the Directive applies, a fixed-term agreement which continues to be performed by both parties after its expiry will be deemed to be converted into an agreement for an indefinite period (*Article 14*).

Where the Directive applies and an agency agreement is entered into for an indefinite period, either party may terminate it on notice (*Article 15(1)*). Minimum notice periods are implied under the Directive: one month for the first year, two months for the second year and three months for the third and subsequent years (*Article 15(2)*). Unless otherwise agreed, the notice must expire at the end of a calendar month (*Article 15(5)*). Member states are allowed to fix the period of notice at four months for the fourth year of the contract, five months for the fifth year, six months for the sixth and subsequent years of the contract, and can decide that the parties may not agree to shorter periods (*Article 15(3)*). This option was adopted in Germany and Italy, but not in France or the UK.

Usual US practice is to provide that a commercial agency agreement remains in effect indefinitely, until terminated by either party, at its discretion, on relatively little advance notice (30 days is quite common). Such provisions are generally enforceable, except to the extent that the agent has made capital investments in order to perform, at the insistence or at least with the knowledge of the principal, and has not been given a reasonable opportunity to recoup those investments.

(*See Country Question 18.*)

Termination

The agreement should list the circumstances in which termination may be justified, whether or not they arise from the fault of one of the parties.

In most countries the law allows agreements to be terminated in the case of a material breach. The different legal criteria giving grounds for immediate termination vary from country to country. (*See Country Question 14.*)

It is also advisable to set out the consequences of termination together with any appropriate indemnities. The agreement should, for example, specify that on termination the agent is to:

- Cease to promote, market or sell the products.
- Not hold himself out as the agent of the principal.
- Stop using the trade marks of the principal.
- Return all stocks of the products, samples and promotional material relating to the products.
- Not divulge or use any confidential information.
- Give all customer lists and full details of contracts with customers to the principal.
- Pay all monies owing.

The parties will also need to address the question of apportionment of commission for sales effected after termination of the agreement.

Rights to compensation or indemnity are considered at Termination. (*See also Country Question 15.*)

Rights of ownership

The agreement should state what rights of ownership the principal has over stock or money or other property held by the agent, and to what extent he can assert his rights of ownership against third parties, for example, in the event of insolvency of the agent or of the agent dishonestly disposing of the principal's goods to third parties?

(*See Country Question 19.*)

Intellectual property

The principal will need to consider:

- To what extent the agent is to be allowed to exploit the principal's intellectual property.
- The use of the principal's name or brand on the agent's stationery.
- An obligation to notify the principal of any infringements of any intellectual property rights belonging to the principal in the territory and concerning the products, and any claim that the products infringe the intellectual property rights of a third party within the territory. The agent will usually be required to assist the principal in any such claims and not to act in any way which might invalidate or be inconsistent with the principal's intellectual property rights.
- A prohibition on the registration of any intellectual property rights by the agent in the products.
- The imposition of confidentiality undertakings on the agent and, if necessary, the agent's employees.
- Providing that goodwill from the agent's use of the principal's intellectual property shall enure to the principal's benefit.
- Whether to provide the agent with an indemnity in relation to claims arising out of the agent's use of the principal's intellectual property.

Product liability

A principal will generally provide his agent with an indemnity to cover the eventuality of a customer bringing a product liability claim against the agent (except to the extent that the claim has been brought about by the agent's own acts or omissions). The principal will, however, require that the agent assist him in the implementation of a product recall campaign and in defending product liability claims (whether the agent is sued or not), where necessary.

Product safety and liability issues are considered in the *Practice note, Product regulation, safety and recall (http://us.practicallaw.com/A23410)* and the *Practice note, Product liability (http://us.practicallaw.com/A23721)*.

Boilerplate provisions

The agreement should also include the following standard clauses:

- Entire agreement
- Assignment.
- Notices.
- *Force majeure.*
- Waiver.
- Severability.
- Governing law and jurisdiction.
- Third party rights clause.
- Execution clauses.

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APPOINTING AN AGENT

Advantages:	Disadvantages:
■ The principal under an agency agreement can retain control over the agent's marketing operations and its resale pricing policy. ■ The principal can restrict the agent's freedom to choose the customers with whom the agent will deal. ■ Agency agreements are treated more leniently than distribution agreements under EC competition law. ■ At the end of the agency arrangement, the principal will be able to take advantage of the customer contacts developed by the agent. ■ Agency is ideal for the situation where direct contact between manufacturer and customer is important (for example, because of a specialised after-sales service which can only effectively be provided by the manufacturer or principal of the product). ■ Typically the commission paid to an agent is lower than the margin which a distributor will earn (but see comments on compensation upon termination).	■ The legal, financial and commercial risks of operating in the market remain with the principal. ■ A commercial agent to whom the EC Directive on self-employed commercial agents applies has a right to compensation or indemnity upon termination of the agreement. ■ Sometimes a principal can be regarded as trading in a territory if he has an agent there, whereas the appointment of a distributor should not give rise to this problem.

PERMANENT ESTABLISHMENT AND DOUBLE TAXATION

Double taxation treaties are often closely based on the OECD's Model Treaty, which is generally favourable on the question of the permanent establishment of commissionaires. The current version of the OECD's Model Treaty is the fourth version (which was published in April 2000 and will be periodically updated).

Under the Model Treaty a sales base company will usually have a permanent establishment in any country in which a person acting on its behalf habitually exercises authority to conclude contracts in its name (*Article 5.5*). But it will not have a permanent establishment merely because it carries on business through a broker, general commission agent or any other agent of an independent status, if they are acting in the ordinary course of their business (*Article 5.6*). Commentary to the Model Treaty (*section 38*) considers that a commission agent which habitually acts as a permanent agent having an authority to conclude contracts acts outside the ordinary course of its business and so normally constitutes a permanent establishment.

From a common law perspective, the question of whether a commissionaire is a permanent establishment of the sales base company depends entirely on whether it has authority to conclude contracts in its name:

- If it has, the exception (in *Article 5.6*) does not apply and it is a permanent establishment.
- If it does not, it cannot be a permanent establishment, even if it is not truly independent.

Some civil law countries take a more restrictive interpretation of the Treaty. Italy and France require the commissionaire to be independent as well as concluding contracts only on its own behalf. In Italy, for example, the commissionaire must not receive detailed day-to-day instructions or be subject to a general and comprehensive control by the sales base company. It must assume the entrepreneurial risks of the commissionaire's business. It cannot perform activities that are under the responsibility of the sales base company. In Germany, however, the tax authorities have specifically ruled that a commissionaire is not a permanent establishment of the principal even if it is not independent.

AN AGENT'S RIGHT TO COMPENSATION OR INDEMNITY: EC SELF-EMPLOYED COMMERCIAL AGENTS DIRECTIVE 86/653

An agent's right to compensation or indemnity will **not** arise where:

- The principal terminates because of default attributable to the agent or exceptional circumstances which in each case would justify immediate termination of the agency contract under national law.
- The agent terminates either:
  - for a reason not associated with the principal; or
  - in circumstances where the agent is not elderly or incapable through illness of continuing.
- The agent assigns the agency agreement to another agent and the principal consents.

Compensation or indemnity will be payable by the principal in all other cases of termination, including those by reason of the death of the commercial agent.

GLOSSARY TERMS

Block exemption

Block exemptions are contained in regulations issued by the European Commission, or in certain cases the Council of Ministers. If an agreement meets the conditions set out in a so-called block exemption regulation, it is automatically exempt from Article 81(1) of the EC Treaty. Block exemptions have been introduced for certain types of agreement (for example, vertical agreements, technology transfer agreements and research and development agreements).

Agency: international overview

European Economic Area
The trading area established by the European Economic Area Agreement of 1 January 1994, currently comprising the 25 EU member states and, in addition, Norway, Iceland and Liechtenstein.

Foreclosure
The closing of potential opportunities to actual or potential competitors by means of exclusivity arrangements, for example a party who agrees to purchase all his requirements for products of a particular range from one supplier denies other suppliers the opportunity of supplying him.