Franchising in the Common Market: A Survey of the Application of Competition Law of the European Community to Retail Franchising

Paul C. Ridgeway

Follow this and additional works at: http://scholarship.law.unc.edu/ncilj

Part of the Commercial Law Commons, and the International Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/ncilj/vol13/iss1/6

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Journal of International Law and Commercial Regulation by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
Franchising in the Common Market: A Survey of the Application of Competition Law of the European Community to Retail Franchising

Paul C. Ridgeway*

I. Introduction

Franchising, since its introduction into the Common Market in the early 1970s, has become one of the most rapidly growing sectors of commercial activity. Member States have witnessed the number of franchise networks double and redouble every few years; France, for example, experienced an increase from 300 networks to 500 networks from 1981 to 1985, with a total of 25,000 franchisees by 1985. With figures like these to rely on, it seems safe to say that franchising is becoming an important method of retailing in the Common Market.

The European Community and the Member States have been slow to respond legislatively or judicially to franchising. However, 1986 can be viewed as the “year of the franchise” in the EEC; both the Court of Justice and the Commission have issued decisions directly examining franchising from a competition perspective. The decisions are broadly based with far-reaching implications for franchising, and the Commission has promised more consideration of the issue in the future.

This article is a survey of the law relevant to franchising in the Common Market. It is divided into four primary sections: first, a factual examination of the various proclamations, statements, decisions, and opinions issued by the institutions of the European Community; second, a brief examination of law applicable to the related issues of exclusive distributorships, selective distributor arrangements, licensing agreements, jurisdictional matters, and the policies regarding small and medium-sized enterprises; third, an examination

* Associate, Barringer, Allen & Pinnix, Raleigh, N.C.; B.S., M.P.A., North Carolina State University; J.D., cum laude, Campbell University; D. Int’l L., University of Amsterdam. The author recently completed a fellowship sponsored by the Netherlands University Foundation for International Cooperation in the field of European market integration.

of the Community law directly applied to franchising in general and to selected clauses from typical franchise agreements; and finally, concluding observations regarding the application of the rule of reason to franchising and the future of franchising in the EEC.

II. The Definition of Franchising and its Legal Characteristics

The definition of franchising in the Common Market, as originally set forth by Mr. E.M. Kneppers-Heynert, and adopted by the Community institutions, is as follows:

Franchising is a contractually governed form of commercial cooperation between independent undertakings, whereby one party, the franchisor, gives one or more parties, the franchisees, the right to use his trade name or mark and other distinguishing features, in the sale of products or of services. The sale takes place on the basis of an exclusive marketing concept (system or formula) developed by the franchisor; in return, the franchisee is supervised by the franchisor in order to ensure uniform quality of goods or services.\(^2\)

This definition covers both the provisions of goods and services, but excludes manufacturing franchises. Essential in this definition are the main elements of franchising: legal independence, royalties, supervision, a common marketing strategy, image, and trade name or trademark.

III. European Community Institutions' Considerations of Franchising: 1976 to Present

The official institutions of the European Community have directly examined franchising on five occasions to date.\(^3\) The first occasion was a preliminary study sponsored by the Commission in October 1976 through its working committee on commerce and distribution. The committee set about to analyze franchising on the basis of information obtained from the various Member States and to outline the advantages and disadvantages that might be connected with the system. Further, the committee was instructed to "state whether or not legislation on this relatively new form of cooperation in the Community was desirable and whether other measures should be taken in the Community to help this system develop as effectively as possible."\(^4\)

The results of this study, published in March 1978, were somewhat mundane. The study concluded that franchising was wide-


spread and transnational, but that data was fragmentary,\(^5\) and that franchising had advantages for the consumer and the contracting parties, but that the franchisee could be subjected to abuse from the stronger franchisor.\(^6\) No Member State had adopted legislation concerning franchising.\(^7\) Finally, the report concluded that "in certain cases, individual franchising contracts may run counter to the principles embodied in Article 85 of the E.C. Treaty."\(^8\) The report suggested that another study be conducted to examine the issue further.

The second occasion where the issue of franchising was examined arose in the form of a parliamentary question submitted in 1980 to the European Commission. The member of the European Parliament asked the Commission: "Does not the Commission feel that the time has come to put an end to the legal uncertainty prevailing in this area by publishing a communication clearly setting out its

\(^5\) Id. at 7.
\(^6\) Id. at 18.
\(^7\) Id.
\(^8\) Id. at 17. Article 85 of the European Economic Community Treaty prohibits as incompatible with the Common Market, *inter alia*, all agreements between undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction, or distortion of competition within the Common Market. European Economic Community Treaty, Mar. 25, 1957, 298 U.N.T.S. 3, 11 [hereinafter cited by appropriate Article number]. Agreements or decisions prohibited pursuant to Article 85(1) are void *ab initio*. Furthermore, parties to such agreements may be subjected to sanctions from the Commission including cease and desist orders and fines of a magnitude of one million ECU (roughly one million U.S. dollars) or up to ten percent of the annual turnover of the parties concerned, whichever is greater. Council Regulation (EEC) 17, First Regulation Implementing Articles 85 and 86 of the Treaty, 5 O.J. EUR. COMM. (No. 204) 62, 2 Common Mkt. Rep. (CCH) ¶ 2401 (1962) [hereinafter Council Regulation 17].

The Commission may, however, declare the prohibition and consequences of Articles 85(1) and (2) inapplicable to a specific agreement or concerted action, or to a general class of agreements. The Commission's decision in these matters depends upon whether the anticompetitive effects of the practice or agreement are sufficiently counterbalanced by a number of beneficial conditions listed in Article 85(3), which includes considerations such as whether the agreement contributes to the improvement of distribution or production or economic progress, whether the consumer benefits by the agreement, whether the restrictions are indispensable, and the competitive nature of the market in general. See EEC Competition Rules: Guide for Small and Medium-Sized Enterprises 18 (1983).

To obtain such an exemption, the parties to an agreement or practice must notify the Commission of the agreement or practice. Although notification is not mandated, once an agreement or practice is notified, the Commission will impose no fines for further activities of the parties based upon the notified course of action until a final decision is reached. Once notified, the Commission may grant a negative clearance, which is a formal decision of the Commission that the agreement or practice does not in fact violate Article 85(1), or the Commission may grant an exemption, which is a formal decision that allows the parties to continue with the agreement or practice in spite of its violation of Article 85(1). An exemption is always limited in time, and may require the parties to modify the agreement or practice in some way as a prerequisite to the exemption. Id. at 42. The Commission may dispense with the need for notification altogether by issuing a block exemption, whereby all agreements or practices complying with the block exemption regulation may be assumed exempted without the need for notification. Id. at 32-34. See infra notes 44-48 and accompanying text (regarding the block exemptions for agreements and practices connected with exclusive distributorships and exclusive purchasing).
policy?" The Commission responded that "under the present circumstances there does not appear to be any need to publish a notice clarifying the application of the competition rules to franchise agreements," and referred to its "considerable number" of decisions and judgments clarifying the applicability of Articles 85(1) and (3).11

The final three occasions require more extensive analysis. Initially, it may be observed that the Commission now feels that the time has come to establish a degree of legal certainty in the area of franchising. In 1986 the Commission came forth with two decisions, the Pronuptia decision12 and the Yves Rocher decision.13 The Court of Justice, however, led the way with its opinion in January 1986 regarding the Pronuptia franchise network.14

A. The Facts of the Pronuptia Judgment

The Pronuptia dispute15 came before the Court of Justice by means of an Article 177 reference from the Bundesgerichtshof (the German Supreme Court for civil matters) seeking interpretation of Article 85 and Regulation 67/67 of the Commission as applied to franchise agreements. The litigants, the plaintiff-franchisor Pronuptia de Paris GmbH and the defendant-franchisee Pronuptia de Paris Irmgard Schillgalis of Hamburg, had come to the German court following a refusal of the franchisee to pay arrears of several years' license fees, an amount totalling DM 158,502.

The franchisor is a subsidiary of a French public limited company specializing in the sale of bridal wear and accessories. The parent company carries on business throughout Europe, the United States, Canada, Japan and Lebanon, and has approximately 235 franchised outlets in Europe, as well as a system of wholly-owned outlets.16 It requires approximately $20,000 to $70,000 minimum

---

9 Written Question No. 1694/74 by Mr. Becmen to the Commission of European Communities, 23 O.J. EUR. COMM. (No. C 131) 33 (1980).
10 Commission Answer to Question No. 1694/74, 23 O.J. EUR. COMM. (No. C 131) 34 (1980).
11 Id.
15 A number of commentaries have been written dealing with the Pronuptia case. See Goebel, Case Annotation, 23 COMMON MKT. L. REV. 685 (1986); Korah, Pronuptia Franchising: The Marriage of Reason and the EEC Competition Rules, 4 EUR. INDUS. PROP. REV. 99 (1986); Van Empel, Franchising in the EEC: Pronuptia ex Post, 20 J. WORLD TRADE L. 401 (1986); Venit, Case Comment, 11 EUR. L. REV. 213 (1986).
start-up capital of its franchisees,\textsuperscript{17} and an initial fee depending upon
the population of the allotted sales territory.\textsuperscript{18} A royalty of about ten
percent of total turnover is due monthly.\textsuperscript{19}

The franchisor and the franchisee entered three identical agree-
ments on February 24, 1980, granting the franchisee a retail distribu-
tion franchise in three areas. The franchisor promised (i) the
exclusive right to use the "Pronuptia de Paris" trade name within the
defined geographic territory, (ii) not to open another Pronuptia shop
within the territory, (iii) not to provide goods or services to third
parties within the territory, and (iv) to provide commercial assistance
in advertising, training, stocking, and generally increasing turnover
and profits.\textsuperscript{20}

The franchisee, in turn, remained a sole proprietor, bearing the
risk of the business itself, and promised (i) to sell Pronuptia-marked
products only from the shops referred to in the contract, which were
to be equipped in accordance with the image of the franchisor, (ii) to
purchase eighty percent of its wedding-related inventory from the
franchisor and the remainder of its inventory from approved suppli-
ers, (iii) to pay an entrance fee and monthly royalties, (iv) to refrain,
for the duration of the contract plus one year thereafter, from com-
peting with the Pronuptia brand within the Federal Republic of Ger-
many or any area where the brand was already represented, (v) to
use best efforts in its sales of Pronuptia products, (vi) to maintain the
integrity of the trade name and trademark of the franchisor, (vii) to
use the business methods of the franchisor, and (viii) to harmonize
its advertising with that of the franchisor, using advertising materials
supplied by the franchisor with the recommended resale price
therein.\textsuperscript{21}

When the franchisor sued the franchisee for arrears in royalty
payments, the franchisee responded that the franchise agreements
were illegal and void under German and EEC competition law. The
Oberlandesgericht, the German court of appeals, accepted this defense,
whereupon the franchisor appealed to the Bundesgerichtshof. The
Bundesgerichtshof referred the following questions to the Court of
Justice:

(1) Is Article 85(1) applicable to franchise agreements?
(2) If the first question is answered affirmatively, is Regulation
67/67 applicable so as to exempt franchise agreements, and,
(3) If the second question is answered affirmatively, is Regula-

\textsuperscript{17} 30 O.J. EUR. COMM. (No. L 13) at 39 n.5, 4 Common Mkt. Rep. (CCH) at 12,040
n.5.
\textsuperscript{18} Id. at 41 n.1, 4 Common Mkt. Rep. (CCH) at 12,040 n.1.
\textsuperscript{19} G. GOLZEN, C. BARROW & A. SEVERN, supra note 16, at 212.
\textsuperscript{20} Pronuptia de Paris v. Schillgalis, 4 Common Mkt. Rep. (CCH) at 16,436.
\textsuperscript{21} Id. at 16,436-37.
tion 67/67 applicable to franchise agreements which contain, among other things,
(a) recommendations regarding resale prices and advertising requirements,
(b) location clauses, or
(c) exclusive purchasing obligations?22

The Court of Justice, for reasons elaborated upon below, responded to the Bundesgerichtshof by describing franchising as a system which “is not itself restrictive of competition.”23 As such, the Court continued, those clauses of franchise agreements which are “indispensable to prevent the know-how and assistance provided by the franchisor from benefiting competitors” and those clauses which are “essential for the preservation of the identity and the reputation of the organization”24 are permitted under the Community’s competition law. To the extent that the Pronuptia franchise agreement contained only such clauses, the Court of Justice responded to the Bundesgerichtshof by holding that Article 85(1) did not apply.25 Other clauses of the agreement may violate Article 85(1), especially if a clause has the effect of partitioning markets or constitutes resale price maintenance. The determination of whether the Pronuptia agreement contained any impermissible clauses, was left to the Bundesgerichtshof.

To the extent that the Bundesgerichtshof’s first question was answered affirmatively, the Court of Justice addressed the second question. The Court noted that franchising has fundamental characteristics not found in distribution agreements—e.g. common marking, uniform marketing methods, royalty payments, and the critical need for protection of network identity, reputation, and secret marketing methods. For this reason, the Court concluded that Regulation 67/67 could not apply, primarily because the drafters did not envision franchises when the Regulation was drafted.26

B. The Facts of the Pronuptia Commission Decision

The publication of the Court’s Pronuptia decision prompted the Commission to deliver its finding regarding the standard form retail franchise agreement used by Pronuptia. Pronuptia, perhaps disconcerted over the prospect of having its entire scheme of franchising throughout the Common Market declared illegal and void, applied for negative clearance on April 22, 1983, under article 2 of Commis-

22 Id. at 16,442-43 (opinion of Advocate General P. VerLoren van Themaat).
23 Id. at 16,438.
24 Id. at 16,440-41.
25 Id. at 16,441.
26 Id. at 16,440-41. The third question of the Bundesgerichtshof was thus rendered moot.
Retail franchising in the EEC

The standard form franchise contract considered by the Commission was essentially the same, although somewhat more complete than the agreement considered by the Court of Justice. The obligations placed on the franchisor were identical to those listed above, except arguably for the possibility of company-owned outlets opening within the territory of the franchisee. The obligations placed upon the franchisee included all of the items listed above, with the additional requirements that the franchisee (i) order at least fifty percent of its estimated sales in advance according to a fixed timetable, and (ii) carry a full line of items listed in the catalogue of the franchisor. Further, the contract considered by the Commission specifically allowed the franchisee to (i) obtain Pronuptia products from any other franchise in the network, (ii) establish its own retail price in spite of recommendations or advertised prices of the franchisor, and (iii) purchase goods not connected with the essential object of the franchise business from suppliers of its choice, subject to *ex post* vetting by the franchisor. Finally, the post-termination covenant not to compete was mitigated to allow post-termination competition if the franchisee had (i) been in business more than ten years, (ii) had discharged its contractual obligations, and (iii) did not use accumulated know-how on behalf of a competing network.

The Commission examined each of the clauses of the Pronuptia agreement in light of the Court of Justice's decision, concluding that most of the Pronuptia agreement conformed with Article 85(1). The Commission found only two clauses of the agreement that had the potential to adversely affect competition within the Common Market: the clauses granting exclusivity to the franchisee for a given sales territory, and the "location clause" obligating the franchisee to operate only from approved premises. The Commission recognized that these clauses, when juxtaposed, might hinder intrabrand competition among franchisees. However, under the powers granted to

---

27 It is not altogether clear whether this possibility exists or not because of the loose usage by the Commission and the Court of the distinction between "exclusive" licenses and "sole" licenses. The former excludes all other tradename users from the territory, including the franchisor, while the latter allows the possibility of the franchisor to sell directly into the territory. Compare Pronuptia de Paris v. Schillgalis, 4 Common Mkt. Rep. (CCH) at 16,436 with Commission Decision of 17 December 1986, in proceedings under Article 85 of the EEC Treaty, (IV/30,937 - Pronuptia), 30 O.J. EUR. COMM. (No. L 13) 39, 4 Common Mkt. Rep. (CCH) at 10,854, at 12,040 (1986).

28 Pronuptia, 30 O.J. EUR. COMM. (No. L 13) at 40-41, pt. 11, 4 Common Mkt. Rep. (CCH) at 12,040, pt. 11.

29 Id. at the request of the Commission, these allowances were added to the agreement originally submitted to the Commission and presumably were a prerequisite to exemption or negative clearance.

30 Id.

31 Id. at 45, pt. 28, 4 Common Mkt. Rep. (CCH) at 12,044, pt. 28.
the Commission by Article 85(3), the Commission ruled that even these clauses, in the context of franchising, merited an exemption from the prohibition of Article 85(1).  

C. The Facts of the Yves Rocher Commission Decision

On the same day that the Commission released its decision on the Pronuptia network’s application for negative clearance or exemption, the Commission rendered a decision regarding the Yves Rocher franchise system. Yves Rocher had applied to the Commission for negative clearance under Article 2 of Commission Regulation 17 on January 15, 1985, concerning its system of standard form franchise contracts for the retailing of cosmetics in various countries of the Common Market.

Yves Rocher is one of Europe’s leading cosmetic producers, marketing in fifty countries as well as having fifteen wholly-owned subsidiaries abroad. It maintains a mail order network of some ten million customers. In 1970 Yves Rocher developed a system of franchised retail outlets known as “Yves Rocher Beauty Centres,” now comprised of 1000 outlets. While the franchised outlets claim to provide beauty treatments, all but a small proportion of their turnover is from retail sales of cosmetics.

The Yves Rocher franchise agreement submitted to the Commission provided that the franchisor would (i) offer assistance to the franchisee in the form of training, procedures, purchasing, publicity, and (ii) grant the franchisee an exclusive geographic territory enforced by refusing to allow another outlet—either franchised or company-owned—to be established within the territory. The franchisor reserved the right, however, to sell within the territory by means other than a sales outlet (e.g. through mail orders).

The franchisee, on the other hand, would retain its legal independence and would be obligated to (i) carry on its business only at the site chosen by the franchisor, (ii) maintain a uniform shop layout and trading method, (iii) submit all promotional materials to the franchisor for prior approval, (iv) sell exclusively Yves Rocher branded products except for certain accessories approved by the franchisor, (v) refrain from assigning or transferring its rights without the franchisor’s consent, (vi) pay an initial licensing fee plus a yearly share of publicity costs, (vii) maintain business confidences, (viii) refrain from competing with Yves Rocher within the franchisee’s territory for the duration of the contract plus one year there-

\[\text{\footnotesize 32 Id. at 47, pt. 38, 4 Common Mkt. Rep. (CCH) at 12,046, pt. 38.} \]
\[\text{\footnotesize 33 30 O.J EUR. COMM. (No. L 8) at 49, 4 Common Mkt. Rep. (CCH) at 12,047.} \]
\[\text{\footnotesize 34 Id. at 49, pt. 2, 4 Common Mkt. Rep. (CCH) at 12,048, pt. 2.} \]
\[\text{\footnotesize 35 Id. at 51, pt. 15, 4 Common Mkt. Rep. (CCH) at 12,049, pt. 15.} \]
\[\text{\footnotesize 36 Id. at 52, pt. 23, 4 Common Mkt. Rep. (CCH) at 12,050, pt. 23.} \]
\[\text{\footnotesize 37 Id. at 51, pt. 19, 4 Common Mkt. Rep. (CCH) at 12,050, pt. 19.} \]
after, and (ix) refrain from selling branded products to nonfranchised resellers. The contract specifically allowed the franchisee to purchase or sell Yves Rocher branded products among other franchised outlets. Furthermore, the contract specifically allowed complete freedom in establishing retail prices.

Predictably, the Commission examined the Yves Rocher franchise agreement in much the same fashion that it examined the Pronuptia agreement, and, indeed, reached the same conclusion. Again, the Commission found that the juxtapositioning of the location clause and territorial exclusivity might lead to results affecting competition in violation of Article 85(1). However, the remoteness of the possibility of an adverse impact, as well as the positive benefits which the Yves Rocher agreement had to offer the consumer led the Commission to grant an exemption under Article 85(3) to these clauses of the agreement.

IV. The Application of European Community Competition Law to Areas Related to Franchising

Although the consideration of franchising per se is a novelty for the Court of Justice and Commission, many of the legal issues arising in franchising have been examined in great detail in analogous situations. The obvious parallels between franchising and exclusive distribution agreements, selective distribution arrangements, and licensing agreements make examination of the Community law in these areas useful in understanding the current developments in franchising. Other general issues, such as the subject matter jurisdiction of the Community institutions over franchising and the policy towards small and medium-sized enterprises, have been more or less conclusively resolved over the years and their relevance to franchising is a matter of application rather than analogy.

A. Exclusive Distribution Agreements

Inasmuch as a franchise agreement often contains exclusive purchasing rights, exclusive supply rights, and territoriality, retail franchising can be compared with retail distribution systems. Indeed, prior to the Court's Pronuptia opinion, speculation had arisen

---

39 Id. at 53, pt. 28, 4 Common Mkt. Rep. (CCH) at 12,051, pt. 28. This provision was included at the request of the Commission, effective December 1, 1986.
40 Id. at 53, pt. 30, 4 Common Mkt. Rep. (CCH) at 12,051, pt. 30. At the request of the Commission, Yves Rocher issued a circular to its franchisees stressing this freedom and that published price lists were to be considered purely recommendations.
41 Id. at 56-57, 4 Common Mkt. Rep. (CCH) at 12,055-56.
as to whether the Community’s regulations concerning distribution agreements might conclusively control franchising as well. While the Court and Commission have since decided to regulate franchises separately from distribution agreements, it is clear that a great deal of their theoretical analysis of franchising was derived from their experience with distribution agreements.

Exclusive distribution agreements have been often commended by the EEC Commission as beneficial contractual relations. In such agreements, a supplier appoints a dealer as the sole distributor of its goods within a defined territory, and, in many cases, the dealer agrees to sell only the supplier’s goods to the exclusion of competing brands. The Commission has stated that such arrangements lead to improved distribution through concentration of sales activities, intensification of marketing, rationalization of distribution, and circumvention of linguistic and legal barriers in transnational distribution. In general, the consumer is perceived as receiving a “fair share of the resulting benefits” of improved distribution and increased interbrand competition. Specific legislation, Commission Regulations 83/83 and 84/83, has been provided to exempt distribution agreements from the procedural requirements and sanctions of EEC competition rules, and even those agreements not qualifying for exemption under such regulations are often granted individual clearance.

Regulation 83/83 is applicable to exclusive dealing agreements. Under its provisions, even though exclusive distribution agreements for geographic territories are per se restrictions of competition as defined by Article 85(1), they are acceptable and permitted so long as the complete arrangements meet the criteria set forth in Regulation 83/83. Parties to these agreements need not notify the Commission of their activities, and may assume their exemption under Article 85(3).

Regulation 83/83 allows exclusive dealing arrangements to include certain ancillary restrictions on competition without forfeiting the exemption. These include, among other things, restrictions on


the supplier’s distribution of goods to users within the dealer’s territory, and restrictions or obligations on the dealer not to manufacture or distribute competing products, to refrain from active marketing outside of the dealer’s territory, to carry a full line of the supplier’s goods, to protect trademark rights, to provide promotion, and to purchase exclusively from the supplier.47

Regulation 84/83, in a similar fashion, allows parties to a distribution agreement to restrict competition by requiring the dealer to purchase its requirements solely from the supplier to the exclusion of the supplier’s competitors. The Regulation allows ancillary restrictions on the supplier with regard to competing with the dealer, and upon the dealer with regard to manufacturing or distributing competing goods, carrying a full line of goods, maintaining a minimum quantity of goods, protecting trademarks, and promotion.48 Both Regulation 83/83 and 84/83 allow ancillary noncompetition covenants, so long as their duration is limited to the lifetime of the agreement and not beyond.49

The Commission’s posture towards the restrictions on competition inherent in distribution agreements is, to a great extent, permissive. There are certain restrictive practices, however, which the regulations clearly forbid. The prime example of such a restrictive practice is a distribution agreement which gives a dealer absolute territorial protection. An agreement may protect a dealer’s territory by forbidding others from actively marketing within that territory, or by forbidding the supplier from supplying another dealer or even a user within that territory. Nevertheless, an agreement that hinders the import of the supplier’s goods into the dealer’s territory by a third party, or hinders the dealer’s export of the goods from the territory, and thus erects a barrier to the free movement of goods within the Community, will certainly invoke the ire of the Commission.50 Such absolute territorial protection may be attempted overtly by means of an export ban, or, as the Commission has recognized, may be disguised in schemes requiring dealers who export outside of their territory to pay compensatory payments,51 prohibitions on cross-


50 See, e.g., Commission Decision of 14 December 1985, relating to a proceeding under Article 85 of the EEC Treaty (IV/30.809 - John Deere), 28 O.J. EUR. COMM. (No. L 35) 58 (1985), where a $2 million ECU fine was imposed on the supplier for enforcing an export restriction on the dealers. See also, Gijlstra & Murphy, supra note 46, at 93-94.

51 See generally N. GREEN, COMMERCIAL AGREEMENTS & COMPETITION LAW: PRACTICE &
deliveries (sales amongst dealers),\textsuperscript{52} threats of invoking national unfair competition laws to prevent territorial infringement,\textsuperscript{53} limitations of warranties or repair policies on articles imported from another territory,\textsuperscript{54} and, in conjunction with other restrictions, restriction on advertising or seeking customers outside of a dealer's territory.\textsuperscript{55}

Likewise, the Commission's regulation of exclusive distribution agreements disfavors resale price maintenance, customer restrictions, and conditions of sale restrictions.\textsuperscript{56} These restraints on competition, if included in a distribution agreement, remove the agreement from the "safe harbor" of the Regulations and require the parties to seek individual exemption or clearance.

\textbf{B. Selective Distribution Systems}

Selective distribution, namely the practice of supplying only dealers who fulfil qualitative, or sometimes quantitative criteria, will always be associated with the business format franchise.\textsuperscript{57} Selective distribution systems may have no anti-competitive effects since generally a dealer has no absolute right to deal with any particular supplier. However, if the selection criteria are arbitrary, or the limitation on the number of dealers is deemed to be detrimenal to the consumer, the arrangement is subject to the competition rules of the Community.\textsuperscript{58}

Commission rules distinguish between "qualitative" and "quantitative" selection, allowing the first but not the second. If "resellers are chosen on the basis of objective criteria of a qualitative nature . . . and such conditions are laid down uniformly for all potential resellers and are not applied in a discriminatory fashion,"\textsuperscript{59} then no violation of Article 85 exists. Several general conditions must be met for "safe" qualitative restrictions: (i) the product must be of a type appropriate to selective distribution such as products of a complex or

\textsuperscript{55} N. GREEN, supra note 51, at 463.
\textsuperscript{57} Adams, supra note 43, at 822.
\textsuperscript{58} Chard, The Economics of Exclusive Distributorship Arrangements with Special Reference to EEC Competition Policy, 25 ANTITRUST BULL. 405, 426 (1980).
technical nature, those relying upon a brand name or image, or those requiring pre- or post-sale servicing; (ii) the qualitative obligation must not exceed that which is essential for the system as a whole; and (iii) the criteria must not be discriminatory or arbitrary. Such criteria require the undertaking of a market analysis, but generally requirements related to personnel training, stocking of inventory, maintenance, shop appearance, and after-sales service have been found acceptable qualitative criteria.

Quantitative restrictions, those which impose numerical limits on the number of dealers with access to a market, are considered by the Court of Justice and Commission to be in violation of Article 85(1) because they tend to restrict consumer choice and discriminate among equally qualified dealers. The Commission's recognition that a quantitative restriction may nevertheless be necessary for the sake of quality has led that body to grant a number of exemptions in this area, and the Commission has been criticized for its somewhat inconsistent reasoning. For example, when BMW defended its quantitative selection criteria as necessary for its marketing strategy, the Commission agreed, holding that the restrictions were indispensible and contributed to the rationalization of the sale and servicing of the product, and thus better served the public. Another defense, raised in the Guerlain case, that quantitative restrictions were required to discourage free-riders—those who sell a distributed product more cheaply than other dealers by relying upon the other dealer's promotional efforts—proved unsuccessful, perhaps because the Commission approved of the increased price competition which free-riders make possible. Needless to say, it remains difficult to draw general conclusions from the Commission's decisions to date.

C. Licensing Agreements

A franchise agreement may be considered a licensing agreement to the extent that the franchisor grants the franchisee the right to use its tradename, trademark, and confidential know-how. More pre-
ciscely, franchising has been described as the licensing of a Summe von Leistungen, or a bundle of rights, wherein the rights subject to protection are the essence of the franchising agreement.\textsuperscript{68} As in a licensing agreement for a trademark, the franchisor conditions the granting of the license for protectable rights and know-how on the uniform projection of the franchise image and operation, and agreements typically contain ancillary obligations to respect and assist in the defense of the franchisor's intellectual property rights, as well as to maintain confidences.\textsuperscript{69}

In the EEC, trademark and tradename licensing remains in the formative stages; much of the policy relevant to them has been developed unilaterally by the Commission and remains judicially unconfirmed.\textsuperscript{70} The leading decision setting forth the Commission's policy is the Campari case,\textsuperscript{71} where the licensing arrangement was composed of a system of international exclusive territorial licenses supplemented by a promise of the licensor not to compete in the territory of the licensees, as well as a ban on direct exports by licensees into other EEC countries. In an analysis similar to that described above regarding exclusive distributorships, the Commission found the arrangement in violation of Article 85(1), but exempted the exclusivity restrictions.\textsuperscript{72} The Commission did not permit the export ban, although it did approve a less restrictive alternative of restraining the licensees from actively marketing in the territory of other licensees.\textsuperscript{73} The Commission considered the territorial allocation and protection to be necessary for the enjoyment of sufficient returns on investment in the licensed product, and thus a desirable improvement in production; “none of the licensees and in all probability no other undertaking would have been prepared to make the investment necessary for a significant increase in sales . . . if it was not sure of being protected from competition from other licensees or Campari-Milano itself.”\textsuperscript{74}

Although the main thrust of the Campari decision involved the exclusivity provisions, additional provisions relevant to franchising were dealt with by the Commission. The Commission held the following clauses to be outside Article 85(1) or exemptable under Arti-
article 85(3): quality control measures including quantitative selection of licensees, exclusive purchasing obligations for certain secret raw materials, a covenant of confidentiality extending in duration beyond the life of the agreement, and a prohibition on assignment or sub-licensing.\textsuperscript{75}

D. Jurisdiction of the European Community

A threshold question to the application of EEC competition rules to a franchise system is a jurisdictional question. Article 85 applies where an agreement “may affect trade between Member States.” The Court has explained that:\textsuperscript{76}

Community law covers any agreement or any practice which is capable of constituting a threat to freedom of trade between Member States, in particular by partitioning the national markets or by affecting the structure of competition within the common market. On the other hand, conduct the effects of which are confined to the territory of a single Member State is governed by the national legal order.

Thus, a franchise system operating completely within a single Member State may well be free from Article 85 competition law. On the other hand, a network of franchise agreements in two or more Member States would certainly fall under EEC jurisdiction.\textsuperscript{77}

Caution must be exercised, however, in concluding that a franchise network with only superficial domestic effects is outside of EEC jurisdiction. In a 1967 case, the Court held that jurisdiction of Article 85 with regard to distribution agreements was determined by examining the agreements “either in isolation or together with others in the economic and legal context in which they were concluded.”\textsuperscript{78} Thus, by analogy, for franchise systems one must conduct a somewhat sophisticated market analysis to determine whether the aggregate effect of all similar systems for a given product, including its substitutes, may affect trade between Member States.\textsuperscript{79}

A further complication is added if the franchise system includes a ban on exports or other measures to prevent parallel trading. While a ban on exports from one Member State to another certainly

\textsuperscript{75} N. Green, supra note 51, at 724-25.


\textsuperscript{79} The Commission need not show that an agreement has affected trade between Member States, but merely that it may. See N. Green, supra note 51, at 240, for examples of aggregate effects within a single Member State which have been found to affect trade between Member States, including uniform export prices, agreements not to supply foreign buyers, or where efficient dealers are scarce.
affects trade between Member States, even a ban on a franchise network operating within a single country from exporting to markets outside the EEC may “affect trade” within the EEC. Again, a rather sophisticated market analysis must be conducted to determine whether such goods, once exported, might have a “reasonable probability” of reentering the Common Market through reimportation.\(^8\)

Finally, a location clause prohibiting a franchisee from setting up a business other than in a single, preordained location can affect interstate competition by hindering the franchisee’s establishment in another Member State, even though the franchise network operates solely within a single Member State.\(^8\)

E. Small and Medium-Sized Enterprises

Franchises, as small and medium-sized enterprises (SMEs), receive preferential treatment in the EEC, including lenient application of the Community’s competition laws.\(^8\) For example, Article 85 does not even apply to a franchise network, unless the network is of a size sufficient to “appreciably” affect trade. This so-called de minimis exception was first established by the Court in 1966, where a firm with only 0.05% of the relevant market share was found to affect the market so insignificantly that Article 85 could not be applied. This view was formalized by the Commission in its Notice on Agreements of Minor Importance.\(^8\) The current version of this Notice indicates the Commission’s view that agreements between undertakings engaged in the production or distribution of goods or the provision of services do not appreciably affect trade if:

(i) the goods or services which are the subject of the agreement together with the participating undertakings’ other goods or services which are considered by users to be equivalent in view of their characteristics, price and intended use, do not represent more than 5% of the total market of such goods or services in the area of the Common Market affected by the agreement, and

(ii) the aggregate annual turnover of the participating under-


\(^8\) N. GREEN, supra note 51, at 502.

\(^8\) Statement by Peter Sutherland, 19 BULL. EUR. COMMUNITY No. 1, 26 (1986).

\(^8\) 13 O.J. EUR. COMM. (No. C 64) 1 (1970).
takings does not exceed 200 million ECU.\textsuperscript{84}

A similar exception to the application of Article 85 has been suggested with regard to agreements necessary for the penetration of new markets, especially for SMEs. The basis of this contention is found in the Second Transocean Marine Paint Association Decision,\textsuperscript{85} where the Commission made the renewal of its exemption of certain measures providing territorial protection conditioned upon a showing that the Association, comprised of SMEs, had yet to establish itself in the relevant market.\textsuperscript{86} As noted above, the Commission in the Campari licensing decision\textsuperscript{87} applied a similar rationale by holding that territorial allocation and a degree of protection were necessary to prompt investment of licensees into new markets. This exemption is merely temporary, lasting only as long as an enterprise is engaging in those initial stages of activity that constitute market penetration.\textsuperscript{88}

While exemption from the competition rules may be available to the franchise system, either through lack of jurisdiction, de minimis status, or the penetration of new markets, it may be more cost-effective to forego the market analysis required for each of these, and abide by the rules instead. As will be seen, the Commission’s attitude towards franchising is favorable, and only in exceptional circumstances should a violation of its permissive rules be necessary.

\section*{V. Community Competition Law Applied to Franchising}

Typical franchise agreements, such as those found in the Pronuptia and Yves Rocher decisions, contain a number of clauses which could prevent, restrict, or distort competition. Since Article 85(1) is drafted so as to prohibit, unless specifically exempted, all agreements which “prevent, restrict, or distort” competition, it is crucial to examine each clause of a franchise agreement to assess its affect on competition and to determine what exceptions, if any, are available. Fortunately, the Court and the Commission have provided practical and quite detailed guidance for the analysis of most retail distribution franchise agreements. The following section addresses the competition aspects of a variety of clauses typically found in franchise agreements and analyzes them in terms of specific Court or Commission guidance or lack thereof.

\begin{footnotesize}


\textsuperscript{86} Gijlstra & Murphy, supra note 46, at 98.

\textsuperscript{87} See supra text accompanying note 71.

\textsuperscript{88} Décision de la Commission du 27 juin 1967 relative a une procedure au titre de l'article 85 du traité CEE (IV/223 - Transocean Marine Paint Association), 9 O.J. EUR. COMM. (No. 163) 10 (1967).
\end{footnotesize}
A. Generalities

Before addressing specific clauses from franchise agreements, certain observations can be made regarding the Court and Commission's general attitude towards franchising. These generalizations apply to most franchise agreements, especially in instances where there is no specific legal guidance for the contracting parties.

Restrictions of competition aside, the institutions of the Community favor the concept of franchising and are seeking to accommodate it into the economic infrastructure of the Common Market. Franchising is viewed as a form of business with a higher-than-average success rate, an efficient means of penetrating new markets, an opportunity for employment, a price-depressing system, and a means of providing mass quantities of consistent quality goods to a wide range of consumers, irrespective of national boundaries. Indeed, the Community views it as an "inextricably-linked component of tomorrow's Europe." In spite of the favor in which franchising is viewed, the Commission has the propensity for reacting slowly to innovative marketing systems. In this regard, the criticism of U.S. antitrust policy-making offered by Assistant Attorney General McGrath is equally well applied to the Commission. Enforcement agencies often forbid even tactics neutral as to their effect on competition out of a fear of setting unfavorable precedents. This excessive caution by these agencies discourages experimentation.

The Commission is well aware of this criticism. It has observed that "clarity and efficiency in implementing competition policy is essential to increase the legal security of firms operating in the Community." Especially with franchising, it seems that the Commission has tried to become more forthcoming; one of the prime motivations behind the Pronuptia and Yves Rocher decisions was the intention to provide, as stated by Commissioner Sutherland, "parties to such agreements with the necessary legal certainty." Business enterprises demand more than certainty of antitrust laws; they demand flexibility. Arguably, the franchising decisions provided by the Commission have fulfilled the former, but has the Commission addressed the latter? Flexibility requires rules of law

89 Goebel, supra note 43, at 92; Statement by Peter Sutherland, supra note 82, at 26.
90 Revitalizing the Community, BULL. EUR. COMMUNITY, supp. 1, at 14 (1986).
91 Goebel, supra note 43, at 91 (citing McGrath, U.S. Antitrust Policy and Export Cartels Panel Discussion, in FORDHAM CORPORATE LAW INSTITUTE ch. 16 (B. Hawke ed. 1984)).
93 Statement by Peter Sutherland, supra note 82, at 27.
94 Lang, EEC Competition Policies: A Status Report, in ENTERPRISE LAW OF THE 80s: EUROPEAN & AMERICAN PERSPECTIVES ON COMPETITION & INDUSTRIAL ORGANIZATION 26 (F. Rowe, F. Jacobs & M. Joelson ed. 1980). He further points out that these two notions are essentially mutually exclusive.
which are adaptable to the particular circumstances of a given franchise system. And, indeed, the Pronuptia and Yves Rocher decisions do provide two guidelines for the flexible application of the rules of competition law to franchising. The advent of this accommodating approach to antitrust regulation of franchises is the most important accomplishment of these two recent European Commission decisions.

The first of these rules of application is that Article 85(1)’s prohibition should be tempered by the unique requirements of business confidentiality. Those clauses of the franchise agreement, albeit restricting or distorting competition, which are “essential to prevent the know-how made available and the assistance given by the franchisor from benefiting competitors,” are “inherent in the very existence in [the franchisor’s] right in its intellectual creations and fall outside the scope of . . . Article 85(1).” The second rule of application relates to the essential element of franchising: the tradename or trademark reputation. The Commission has held that “clauses that provide for the control essential to preserve the common identity and reputation of the network trading under the franchisor’s name” are also outside of the prohibition of Article 85(1).

The Commission’s approach to franchising from a policy perspective is somewhat similar to the U.S. doctrine of ancillary restraints, that an agreement involving an otherwise illicit restraint of trade may nevertheless be legal if that agreement is subordinate to a legitimate purpose of the contract. The Commission has identified the essential elements of franchising, and excludes those clauses necessary for their achievement from Article 85(1). While this approach is not entirely new to the Commission, the franchising decisions represent the boldest use of the doctrine to date.

More important than the novelty, however, is the maximized flexibility that the ancillary restraint doctrine offers. Parties under-
taking a franchise agreement, if reasonably certain that a trade-restricting clause is necessary to attain one of the legitimate ends cited by the Commission, may employ that clause with a degree of confidence that it will not violate Article 85(1). A contract can be drafted in such a way so as to protect the varying needs of the multi-dimensional franchising industry. The parties may authorize certain restraints on competition in the knowledge that, should question ever arise, the Commission will endeavor to understand any relationship which may exist between the restraint and an essential element of franchising.

B. Territoriality and Parallel Imports

Territorial restrictions exist where the franchisor restricts the franchisee’s sale of the product to particular geographic markets. Often, territorial restraints are coupled with exclusive franchises, where the franchisor agrees to supply no other franchisee within the territory, and sometimes agrees to refrain from operating there itself. There are two general types of territorial restrictions. In open territorial restrictions the franchisee is restrained from actively seeking customers outside of its territory, but may sell to any customer who comes into the territory. In closed, or absolute, territorial restrictions, the franchisee can sell only to customers who actually reside within the territory. This distinction is fundamental in the application of EEC competition law to franchising.

Territorial restraints may be accomplished directly by a contractual clause detailing the geographic market available to a franchisee or the customers it may serve. Or, where the economic profit threshold for the transport of a product is small, territoriality may be achieved indirectly through a location clause—a clause specifying the location of a franchisee’s shop and forbidding it from opening a second shop elsewhere. Similarly, for some products, a mere restriction on advertising outside of a defined territory is sufficient to create a de facto territorial restraint in the distribution of the product.

Territoriality serves a number of purposes in franchising systems. Franchisees may insist that territorial restrictions be placed on all franchisees within the system so as to protect each individual franchisee’s exclusivity. The franchisees fear that “free-riders”—parasite franchisees utilizing the promotional or servicing efforts of other franchisees offering the same brand—may skim profitable accounts and undermine returns on investments.

Benefits flow to the franchisor as well. Where service or installation of a product is necessary, the franchisor, knowing that a franchisee who did not sell the product will likely not service or install it

---

as carefully as the profiting seller, can protect the franchise's goodwill by allowing sales only to customers within a geographic proximity of the franchisee. Further, the franchisor may consider territorial restraints necessary to attract new franchisees and to induce them to exploit the depths of their markets without fear of risking their initial investment to already established intrabrand competitors. The franchisor may choose to utilize territorial restraints as a means of establishing orderly markets, facilitating estimation of production requirements or regional advertising campaigns. Finally, in view of the fact that the Common Market is not yet fully integrated, franchisors may utilize territorial restraints in an effort to protect areas with high profit margins. Prices vary from one Member State to another based on factors such as differences in standards of living, price elasticities, promotional costs, efficiencies of production and distribution structure, availability of substitutes, and varying legislation and tax burdens. These differences may prompt a franchisor to attempt to restrain sales across borders by means of closed territorial restrictions from lower-priced Member States to customers in higher-priced States.

Both the Pronuptia and the Yves Rocher franchising agreements contained clauses creating territorial restraints in conjunction with exclusive supply obligations. The Pronuptia agreement granted the franchisee an "exclusive right to use the mark 'Pronuptia de Paris' . . . for a particular territory outlined in a map attached to the agreement, as well as the right to advertise in that territory." It also required the franchisee to sell merchandise only from the shop specified in the agreement.101 The Yves Rocher agreement similarly granted the franchisee an exclusive area defined in the contract for the use of the franchisor's identifying mark, guaranteeing that no other shop would be allowed within that area. Additionally, the agreement defined the exact location of the franchisee's shop and forbade transfer of the shop or opening of a second shop.102

The Court, in its consideration of the Pronuptia agreement, found that the juxtaposition of the location clause103 and the exclusivity granted by the franchisor resulted in a market partitioning between the franchisor and the franchisee or among the franchisees, and thus constituted a restriction of competition contrary to Article 85(1).104 The Court made several interesting observations which

---

102 Yves Rocher, 30 O.J. EUR. COMM. (No. L 8) at 51, pts. 18-19, 4 Common Mkt. Rep. (CCH) at 12,050, pts. 18-19.
103 The location clause was considered to have two functions; inasmuch as it contributed to the preservation of the reputation of the identity of the franchise network, it did not violate Art. 85(1). However, to the extent it contributed to the territorial scheme, it did. See Pronuptia de Paris v. Schillgalis, 4 Common Mkt. Rep. (CCH) at 16,439.
104 Id. at 16,439-40.
provided guidance for the Commission in their consideration of the same agreement. First, the Court noted that the territorial restraints restricted competition solely within the network, reinforcing the fact that Article 85(1) sometimes prohibits vertical restraints with purely intrabrand effects. Second, the Court noted that the territoriality in the Pronuptia case was prohibited under Article 85(1) "since it concern[ed] a mark that is already well known." While the Court gave no further elaboration of this, it appears to be a reference to the clearance available to enterprises implementing measures necessary for the penetration of new markets. Finally, the Court noted that territoriality, even among franchisees all operating within a single Member State, is capable of affecting trade between Member States per se to the extent that territorial restraints prevent franchisees from setting themselves up in another Member State.

The fact that the Court found territoriality to be caught by Article 85(1) must be viewed in light of the generalizations made by the Court; namely contractual clauses necessary to safeguard know-how and to preserve network reputation were outside of Article 85(1). The Court, with little economic analysis, viewed territoriality to be "far from necessary" to achieve these safeguards. Although hypothetical to the case before the Court, the broad language of the Court appears to have overlooked those instances where the failure of franchises harms network reputation, and to have failed to note that territorial protection is instrumental in preventing these failures. The Court did, however, recognize that territoriality may be essential to the operation of a functional franchise system, noting that new franchisees presumably would not invest in the system without the protection from other franchisees, but left the consideration of this to the Commission under its exemption powers of Article 85(3).

The Commission agreed with the Court that the territorial allocation and the location clause constituted restraints of trade prohibited by Article 85(1). However, in both the Pronuptia and Yves Rocher agreements, it granted these territorial restraints an exemption under Article 85(3) on the basis that the distribution networks improved the production and distribution of the products concerned. Specifically, the Commission accepted the argument that territoriality contributes to inducing franchisees to exploit the depths of their markets, fosters efficient market organization, and attracts and protects new franchisees. Furthermore, following the

105 Id.
106 See supra text accompanying notes 85-88.
108 Id. at 16,439-40; see also Yves Rocher, 30 O.J. EUR. COMM. (No. 1) at 57, pts. 58-61.
109 Commission Decision of 17 December 1986, in proceedings under Article 85 of
Court’s analysis, the Commission noted that while territorial restraints hamper intrabrand competition, they contribute to “intensifying interbrand competition,” and presumably the benefits to the latter were perceived as outweighing any harm to the former.

The territoriality of the Pronuptia and Yves Rocher franchise agreements can be characterized as open territorial restraints with solely vertical, intrabrand restrictions of competition. Such restraints are generally acceptable to the Commission, although notification is required to gain the legal certainty of an exemption. Closed, or absolute, territorial restraints, although not present in the Pronuptia and Yves Rocher franchise systems, are contrary to EEC competition policy. Consequently, a franchise agreement containing such restraints would certainly not be exempted from fines and possibly other sanctions.

In both the Pronuptia and the Yves Rocher Commission decisions, the Commission stressed that the territorial restraints contained in those agreements did not prevent the franchisees from buying and selling the product amongst themselves irrespective of territory, and further, did not prevent customers residing in one territory from purchasing the product from another territory. The prevention of either of these transactions would have constituted closed territorial restraints.

The Commission’s position illustrates the sometimes paradoxical dual objectives of EEC competition law. On the one hand, the Commission accepts that territoriality, while restraining intrabrand competition, enhances the distribution process, yields benefits, and is perhaps necessary to interbrand competition. On the other hand, territoriality may be inimical to the unification of the Common Market, especially where territorial restraints coincide with national boundaries. There are times when the possibility of sales to customers from another territory constitutes a “corrective factor for excessive prices imposed by an exclusive concession holder and should be an element of price harmonization in a unified market having the


111 Pronuptia, 30 O.J. EUR. COMM. (No. L 13) at 46, pt. 34, 4 Common Mkt. Rep. (CCH) at 12,045, pt. 34; Yves Rocher, 30 O.J. EUR. COMM. (No. L 8) at 57, pt. 58, 4 Common Mkt. Rep. (CCH) at 12,056, pt. 58.

112 Pronuptia, 30 O.J. EUR. COMM. (No. L 13) at 47, pt. 37, 4 Common Mkt. Rep. (CCH) at 12,046, pt. 37; Yves Rocher, 30 O.J. EUR. COMM. (No. L 8) at 58, pt. 64, 4 Common Mkt. Rep. (CCH) at 12,056, pt. 64.

113 Pronuptia, 30 O.J. EUR. COMM. (No. L 13) at 47, pt. 37, 4 Common Mkt. Rep. (CCH) at 12,046, pt. 37; Yves Rocher, 30 O.J. EUR. COMM. (No. L 8) at 58, pt. 64, 4 Common Mkt. Rep. (CCH) at 12,056, pt. 64.
same features as a single domestic market." Similarly, export bans and customer restrictions used by franchisors to protect national oligopolist structures from intercountry transactions, or to insulate profit margins in higher-priced member states, are justifiably attacked by the Commission as anticompetitive and contrary to market integration. In these instances, the parallel importer, or the free rider, is the "hero of the Commission" because he restores intrabrand price competition.

Yet the free rider, although furthering the above Community goals, poses a dilemma to those who wish to encourage franchising within the Community. While the free rider's activities harmonize with one of franchising's major benefits, providing interbrand competition in a given market, they lessen another, that of allowing consumers access to uniform, dependable products. The free rider increases competition and can bring lower prices to consumers, but at the cost of undermining the franchisor's efforts to provide a full range of products of uniform quality backed up by service capability. By luring customers from the new or struggling franchisee's territory, the free rider leaves the franchisee weakened, ultimately weakening the interbrand competitive posture of the network as a whole. If a franchise really presents economic advantages, the free rider's long-term harmful effects should nevertheless be limited.

Whether the Commission can reconcile the paradox of these policies is subject to debate. The treatment of hinderance to parallel imports as a per se violation of competition law, however, is not unreasonable in light of the fact that market integration is unquestionably fundamental to the Commission's mission. Where market integration is paramount, export bans or closed territories are anathema.

C. Resale Price Maintenance and Suggested Retail Prices

The franchisor is inevitably concerned that its product is sold with the proper pre- and post-sale service and installation, that inventory is offered in sufficient quantities, and that a full line of choices is available to the consumer. Naturally, these requirements are reflected in the franchisee's cost of business. Threatening the franchisee under these conditions is the free rider, or the discount house, who offers less service and range of inventory, but attracts customers with cheaper prices. The consequent decline of services

115 Chard, supra note 58, at 412.
116 Gyselen, supra note 100, at 649.
117 See, e.g., Chard, supra note 58, at 435 (arguing for more flexibility in the Commission's policy towards closed territoriality).
and dissatisfaction of the franchisees results in a loss of the network's goodwill and reputation.

One logical approach to the deleterious effects caused by price-cutters is to establish a system of retail price maintenance. In spite of its apparent logic, resale price maintenance is virtually a per se violation of Article 85(1) and is never exempted under Article 85(3). Resale price maintenance has a number of potentially anticompetitive effects: it tends to maintain prices at a level where the most inefficient member of the network can survive and acts as a disincentive to more efficient dealers; it negates price competition but fosters nonprice competition (thus requiring the consumer to purchase services which the consumer may not desire but are nonetheless tied to the product), and it may foster collusion and other anticompetitive practices between brand owners.¹¹⁸ The need to counteract free riders is an insufficient justification for these threats to competition.

In the Yves Rocher franchise agreement, the franchisor originally implemented a resale price maintenance scheme, although it was never practiced.¹¹⁹ This was clearly a violation of Article 85(1), and the Commission required, as a prerequisite to exemption, that the franchisor delete those provisions and circulate a memo to the franchisees to that effect. But the Commission is not concerned solely with direct price maintenance; in its experience with distribution networks it has demonstrated a skepticism of recommended price lists as well. Recommended prices are not a per se violation of competition law. They do, however, tend to flatten prices to a uniform level, thereby potentially causing impermissible anticompetitive effects, especially if the recommendations are accompanied by inducements or threats. Thus, schemes whereby the franchisee must obtain the franchisor's permission to deviate from recommended prices, or inform the franchisor of its intent to deviate, or where the franchisor withholds supplies from deviators, withholds credit, or merely disseminates memos encouraging compliance, may run afoul of competition law.¹²⁰

The Court and Commission maintained this posture in their


consideration of the Pronuptia and Yves Rocher agreements. Although both networks published recommended prices, the Court considered the mere communication of recommendations to be outside of Article 85(1) so long as there was no "concerted practice between the franchisor and the franchisee or between franchisees with a view to the actual application of such prices." The Commission concurred with the Court, but reserved the right to intervene should evidence be found of coercion or collusion in establishing uniform prices. The Commission, in Yves Rocher, was especially thorough in identifying seemingly unrelated clauses in the contract and pointing out their potential for establishing an indirect price maintenance system. These included the right of the franchisor to inspect the franchisee's stocks, accounts, and balance sheets, or the requirement that the franchisee submit its advertising to the franchisor for prior approval.

In certain circumstances, franchises operating solely within a single Member State may practice resale price maintenance because of the tolerance of some national antitrust laws. However, because such practices tend to compartmentalize the national markets and hinder the integration of the Common Market, the Commission will attack these networks if the resale price maintenance is accompanied by any restrictions on export, parallel importation, customer restrictions, or price alignment for imported products. The fact that the practice is tolerated by the law of the Member State is no defense for the offending franchisor.

D. Tying, Exclusive Purchasing Requirements, and Full Line Forcing

Article 85(1)(e) prohibits arrangements which "make the conclusion of contracts subject to acceptance by the other party of supplementary obligations which . . . have no connection with the subject of such contracts." In franchising, the conclusion of the contract allowing the franchisee to use the franchisor's identity, tradename, or trademark (the tying product) is often subject to the

---

122 Yves Rocher, 30 O.J. EUR. COMM. (No. L 8) at 56, pt. 50, 4 Common Mkt. Rep. (CCH) at 12,054, pt. 50.
123 Id. at 55, pt. 44, 4 Common Mkt. Rep. (CCH) at 12,053, pt. 44.
124 For example, the Netherlands permits a producer or wholesaler to specify the resale price for many products. See Survey of Foreign Laws & Regulations Affecting International Franchising, Netherlands 7 (1982) [hereinafter Survey of Foreign Laws & Regulations].
126 Deutsche Philips, 16 O.J. EUR. COMM. (No. L 293) at 42, pt. II 2(c).
franchisee's acceptance of the obligation to purchase all of its supplies (the tied product) exclusively from the franchisor. Both the Pronuptia and the Yves Rocher franchise agreements contained requirements of this sort. At issue, of course, is whether the tying of a tradename or trademark license to supplies runs afoul of Article 85(1)(e).

In the United States, allegations of unlawful tying has generated the most private litigation in franchising. Since the late 1960s, hundreds of antitrust actions have been brought against franchisors alleging that franchisors forced franchisees to buy equipment or supplies or lease property as a condition of acquiring or retaining their franchise. The anticompetitive effects of tying considered by the courts in these cases were embodied in the "leverage theory," which focuses on the franchisor's use of legal monopoly power over its intellectual property to artificially create a market for the tied products, and the related "coercion theory," which considers the comparative bargaining power of the franchisor and the franchisee, and the possibility for the franchisor to coerce the franchisee into buying the tied product. The frequency of these cases and their rates of success rapidly declined following the landmark decision in Continental T.V., Inc. v. GTE Sylvania, Inc. Since then, courts have held in a number of cases that tying was to be considered under a "rule of reason" analysis wherein relevant economic and business justifications could be brought forth.

The Court and Commission have avoided most of this controversy by recognizing that although tying can be used in a way incompatible with Article 85(1), it is often inextricably linked with the imposition of quality control measures, and hence essential to the reputation of the franchisor. This approach has been used consistently with respect to patent licensing since the early 1960s and

---

128 L. Rudnick, Introduction to Franchising, in INTERNATIONAL FRANCHISING—AN OVERVIEW 60 (Mendelsohn ed. 1983).
129 D. Thompson, FRANCHISE OPERATION AND ANTITRUST 77-78 (1971).
has more recently been extended to trademark licensing. Nonetheless, the reservation remains that tying clauses involving products or services unrelated to quality control are still considered contrary to Article 85(1).

The tying agreements utilized in both the Pronuptia and Yves Rocher franchising agreements conformed precisely to the expectations of the Court and Commission. The Pronuptia agreement required the purchasing of goods solely from the franchisor and additionally required the franchisee to stock a full line of products illustrated in the franchisor's catalogue. However, in language tracking that of Article 85(1)(e), "goods not connected with the essential object of the franchise business" were not tied to the franchise agreement and could be obtained from a supplier of the franchisee's choice. Similarly, the Yves Rocher agreement required the purchase of the cosmetics from the franchisor, but the franchisee was free to purchase accessories and furnishings from any supplier. The Court and Commission found that Article 85(1) did not apply to such provisions to the extent that they ensured a uniform range of goods because the tying of the products to the trademarks and full line forcing were "inherent in the very nature of the franchise agreement."

Indeed, the Court takes an even more permissive view of tying than the Commission does regarding licensing agreements. The Commission had previously contended that where quality control standards and technical specifications were possible to quantify objectively, then tying of the goods to the licensing contract was not indispensable to the reputation of the network. In the Pronuptia opinion, though, the Court allowed a further business justification to apply in such cases; if, because of the large number of franchises, monitoring the compliance with specifications would prove too costly, a franchisor could opt to require the purchasing of the tied product solely from itself. A secondary consideration related to the tying clause is the exclusive purchase obligation. Clearly, if a
franchisee is required to obtain all of its supplies from the franchisor, then it is likewise required to sell exclusively the franchisor's products. Generally, the exclusive purchase obligation, like the tying clause, is justifiable because of the need to protect reputation, safeguard confidences and to facilitate efficient distribution.

However, exclusive purchasing obligations may themselves have anticompetitive effects. For example, network-wide exclusive purchasing obligations of long duration imposed by a franchisor with sufficient market power may act as a barrier to entry for aspiring interbrand competitors. Aspiring competitors, in such circumstances, must enter the market at two levels; not only must they produce the competitive product, but, since most of the the competent franchisees have been bound exclusively, the competitors must create their own costly distribution network.  

The Court and Commission have recognized both the benefits of exclusive purchasing arrangements and the potential anticompetitive effects. For the vast number of distribution agreements with duration of five years or less, exemption under Article 85(3) for exclusive purchasing obligations is granted by Commission Regulation 84/83. However, the Court has stated:

Agreements under which an enterprise agrees to obtain its supplies only from one enterprise to the exclusion of all others, do not, merely because of their type, fulfill the conditions for incompatibility with the Common Market contained in Article 85(1) of the Treaty. They may, however, fulfill them where either in isolation or together with others in the economic and legal context in which they were concluded and on the basis of all objective elements of law or of fact, they are likely to impair trade between Member States and their object or effect is to prevent, restrict, or distort competition.  

Thus, the Court requires examination not only of the market power of the franchisor, but also examination of the practices of other existing franchisor or distributors throughout the industry.

In considering the Pronuptia and Yves Rocher franchise networks, neither the Court nor the Commission suggested that the exclusive purchasing obligations might, under certain market conditions, infringe Article 85(1), but rather held them to be outside of the Article's scope altogether. To draw the conclusion that the failure to mention market conditions indicates a more relaxed posture toward franchise exclusive purchasing than toward other distribution systems, however, would be premature since neither Pronuptia nor Yves Rocher had, in fact, more than a modest share of their respective markets.

---

141 See Chard, supra note 58, at 419.
143 Goebel, writing after the Court judgment but before the Commission decision.
E. Noncompetition Covenants

The fact that the Commission and Court view franchising as a sui generis form of distribution is evidenced most distinctly in their treatment of the noncompetition covenants found in both the Pronuptia and Yves Rocher franchise agreements. These covenants restrained the franchisee from competing with the franchisor for the duration of the contract and one year thereafter.

The Court and the Commission’s assessment of these clauses was surprising in two regards. First, although the Court and Commission have always viewed noncompetition clauses permissively, they had always required exemption under Article 85(3), recognizing the inherent threat of such clauses to competition. Surprisingly, however, the Court in Pronuptia found the noncompetition clause to be outside the scope of Article 85(1), considering the clause to be essential in preventing the loss of business confidences. The second surprise was that the post-termination covenant was accepted by the Court and Commission. Prior to Pronuptia, it was generally assumed that post-termination covenants were contrary to competition policy and would require substantial justification for exemption. This assumption was founded on the tightening of the Commission’s exclusive dealing regulations from the 1967 version, where one year post-termination covenants were allowed, to the 1983 version, where they were explicitly disallowed. It is apparent that the Court and Commission were once again motivated by the unique relationship of confidentiality between the franchisor and franchisee, and the exposure that the franchisor faces once a franchisee has left the network.

VI. The Emergence of the Rule of Reason

Judge Rene Joilet, the draftsman of the Pronuptia Court decision, authored an article as a law professor in 1984 in which he advocated...
a rule of reason approach to Article 85(1). He stated that the "restriction of competition" prohibited by Article 85(1) could be interpreted in two ways: either strictly, wherein any technical restriction, intrabrand or interbrand, would be prohibited, or more broadly, where only restrictions of market competition could be prohibited, and restrictions with no market effect, e.g., intrabrand restrictions, would be outside the Article's scope. This latter position, he argued, contains a rule of reason approach, requiring the Commission or Court to perform the economic analysis necessary to assess market impact of an agreement prior to the application of competition law, and especially prior to the application of Articles 85(2) and (3).147

In this regard, the Pronuptia Court decision, apart from its applicability to franchising, is a major policy statement of the Court; it is one of the first instances where the Court or Commission have fully embraced the position advocated by Professor Joilet. Indeed, while other cases have experimented with more flexibility in the application of Article 85(1), at least one commentator has compared the significance of the Pronuptia decision to that of the Sylvania decision and its impact on U.S. antitrust law.148

The rule of reason, as the term has developed in the U.S. competition law, is the weighing of competitive harms and benefits of an agreement or conspiracy, taking into account market conditions, business justifications, and effects upon intra- and interbrand competition.149 The antithesis to the rule of reason in the per se approach, namely, the view that an agreement which restricts trade is, by its very existence and irrespective of its impact on the market, illegal. Prior to the 1977 Sylvania case, restraints of trade in the United States were generally analyzed on a per se basis. The Sylvania case changed this; the Supreme Court differentiated between vertical and horizontal restraints of trade, and declared virtually all vertical restraints to be subject to the rule of reason analysis, rather than the per se analysis. The impact of the case was tremendous: tying arrangements, exclusivity, and territoriality have become essentially per se legal. Unless the complainant can demonstrate that the defendant had no legitimate economic or business justification, and further that the defendant can in fact influence the market, the complaint will fail.150

Under traditional EEC legal theory, Article 85(1), is a per se prohibition of all agreements which in any way "prevent, restrict or

147 Joilet, supra note 71.
149 See generally Gyselen, supra note 100, at 658.
150 For a comprehensive article analyzing the application of the rule of reason to a case study, see Stern, Zelek & Dunfee, A Rule of Reason Analysis of Territorial Restrictions in the Soft Drink Industry, 27 Antitrust Bull. 481 (1982).
distort” competition. The Treaty leaves considerations of relevant economic factors, business justifications, and market impact to Article 85(3), where exemptions from the penalties of violation of competition law are provided. The approach that Judge Joilet suggests, and the approach generally adopted in the Pronuptia opinion, provides for the relevant market considerations to be made prior to the application of Article 85(1), altogether removing those agreements justifiable under a rule of reason analysis from the scope and prohibition of Article 85(1). The critical factors for the determination of which agreements fall within Article 85(1) appear to be the same distinctions applied in Sylvania: the distinctions between vertical and horizontal restraints of trade and between intra- and interbrand competition.

The European Court’s requirement of an Article 85(3) “rule of reason” analysis as a prerequisite to any consideration of whether the franchise agreement restrains trade contrary to Article 85(1) effectively limits initial scrutiny of the franchise network’s effect on competition to the area where franchising is actually beneficial, that of overall market competition. The Court has expressed its approval of commercial arrangements, like franchising, that promote consumer choice and interbrand competition; franchising, which threatens mainly interbrand competition, is primarily only a vertical restraint of trade.151

In Pronuptia, while the Court did not go so far as to say that all vertical agreements were to be subject to rule of reason analysis, it did hold that a subset of vertical agreements, namely those agreements forming franchise networks, are outside of Article 85(1). In this regard Pronuptia joins a limited number of other cases where the Court experimented with a similar approach regarding selective distributorships,152 exclusive plant breeding rights,153 and exclusive film copyright licenses.154 In each of these cases, the Court, after conducting a degree of economic analysis, concluded that the relationships promoted interbrand competition. These arrangements’ lack of effect on actual market competition was more important than their tendency to restrain trade as “trade” is technically defined. This school of thought contrasts strongly with the approach taken in the 1966 Consten & Grundig case, where the Court rejected the argument that agreements, in this case exclusive distribution agreements which promoted interbrand competition at the sake of intrabrand

151 See supra note 42 and accompanying text.
competition, should be outside of Article 85(1).155

The Pronuptia Court did, however, warn that while franchise agreements themselves did not restrict competition, exceptional cases might contain independently anticompetitive clauses that might be subject to Article 85(1). For example, where an exclusivity and location clause together amounted to absolute territorial protection, as they would in the Pronuptia and Yves Rocher situations considering the insignificance of passive sales of fashion goods,156 the Court was unwilling to exclude those clauses from the scope of Article 85(1). But even with regard to these clauses, it is important that the clauses were not automatically considered per se violations of Article 85(1) as similar clauses have been treated in the past. Moreover, since the franchisee was arguing that the agreement was void, and the absolute territorial protection was established primarily for its sake, there was no one with an interest in persuading the Court that such protection was reasonable under a rule of reason analysis.157 Perhaps in subsequent cases, such clauses will be included in an exclusion from the prohibition of Article 85(1).

But where the Court may have erred on the side of caution regarding territoriality and location clauses, it seemed to err on the side of precipitance in its rush to embrace the rule of reason. In the Pronuptia opinion, the Court’s initial precedent on franchising and the rule of reason, it would have been prudent to insist upon an analysis of the market context of franchise agreements prior to concluding that such agreements fall outside of competition law. Nowhere does the Court examine whether the Pronuptia franchise erects undue barriers to entry on the part of competitors, whether the franchisor is dominant in a local market, whether the market has any parallel importers, or whether the franchise requires special consideration due to its position in a declining or infant industry.158

One can only speculate as to where the rule of reason will lead the Court and Commission in the future with regard to franchising. One area already ripe for development is a clarification and enumeration of those restraints of competition which, while sometimes vertical in nature, will be considered per se violations of Article 85(1). Two instances come to mind: namely resale price maintenance and absolute territorial protection. While the Court and Commission remain adamant regarding their prohibition of these restraints notwithstanding a rule of reason analysis, EEC legal scholars are beginning to argue that under certain conditions, even these restraints

155 Établissements Consten SARL and Grundig-Verkaufs-GmbH v. Commission, 1966
156 Korah, supra note 15, at 100, n.7.
157 Id. at 100.
158 Goebel, supra note 15, at 693-94.
may be justifiable and thus should be considered under a rule of rea-
son as well.159

One such legal scholar, Advocate General van Themaat, in his
opinion regarding the Pronuptia case, suggested that Article 85(1)
should be applied only to the horizontal effects of vertical agree-
ments. As he stated: "With regard to such vertical obligations I think
Article 85(1) can only apply when it can be shown in a particular case
that they cause injury to third parties (competitors, suppliers, or pur-
chasers), which will seldom be the case where there are adequate al-
ternative chains of distribution for similar products."160 In the case
of franchising, the horizontal effects which the Advocate-General
suggested should be of particular concern are (i) whether barriers to
entry are erected, (ii) whether injury is caused to parallel importers,
or (iii) whether the agreement results in price increases or concerted
price-fixing.161 Absent from the list is resale price maintenance,
which van Themaat believes will have a horizontal effect only in the
cases where a franchisee is dominant on a local market or where
competitors also practice price maintenance.162

While van Themaat’s position has not yet become the Court or
Commission’s official stance, it is not as idealistic as it may seem. In
the Maize Seed case, the Court itself indicated a similar analytical
framework when it held that:

having regard to the specific nature of the products in question, the
Court concludes that . . . the grant of an open exclusive license, that
is to say a license which does not affect the position of third parties
such as parallel importers and licensees for other territories, is not
in itself incompatible with Article 85(1) of the Treaty.163

VII. Conclusions: The Future of Franchising in the Common Market

The Pronuptia and Yves Rocher Court of Justice and Commission
decisions have provided the impetus for the rapid development of
franchising in the Common Market. The institutions of the Commu-
nity have expressed their overwhelming approval of the method of
distribution; its perceived benefits to consumer welfare, employ-
ment, risk minimization, and uniform marketing concepts are viewed
as positive economic and unification forces for the European Com-

159 Id. See generally Chard, supra note 58.
160 Pronuptia de Paris GmbH v. Pronuptia de Paris Irmgard Schillgalis, 4 Common
van Themaat).
161 Id.
162 Id.
ternative for European businesses or foreign businesses seeking to develop markets within the Common Market.

But the potential surge of franchising in the Common Market may be accompanied by difficulties as well. The favorable treatment which franchising is receiving may lead businesses to reorganize their EEC distribution networks into franchising networks merely to take advantage of these legal benefits, and such a trend may distort the development of European marketing.

An inevitable consequence of a rapid growth in franchising will be the legal problems arising during the life span of the franchise relationship. While generally outside of the competence of the Commission and Court, the contractual relationship between the franchisor and franchisee presents unique legal questions which the present contract laws of the Member States may be ill-equipped to entertain. In the United States’ experience with franchising, the troublesome points of the franchise relationship are the creation and the termination points. In the creation of franchises, policy-makers and courts are concerned that potential franchisees receive adequate, honest, and full disclosure of all relevant risks and liabilities. Likewise, the injustice of the termination of a hard-working franchisee for sometimes spurious reasons has perplexed policy-makers and courts for years. For a period, especially prior to the Sylvania case, antitrust laws seemed to provide remedies for franchisees where contract law proved unsatisfactory. Since Sylvania, with its favorable treatment of vertical restraints of trade, franchisees have sought relief from oppressive tactics from a number of laws and regulations at both the state and federal level, most of which were enacted soon after Sylvania.

The Pronuptia and Yves Rocher decisions have left the same void

---

164 See, e.g., Fern & Klein, Restrictions on Terminations and Nonrenewal of Franchises: A Policy Analysis, 36 Bus. Law. 1041 (1981); Gellhorn, Limitations on Contract Termination Rights—Franchise Cancellations, 1967 Duke L.J. 465; Geotz & Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089 (1981). Commentators have noted that U.S. contract law as applied to franchising generally fails to be adequate for two primary reasons: First, the inequity in bargaining power (contract law ignores this unless coercion or duress is alleged) and second, the quasi-fiduciary relationship formed by the partners to a franchise agreement, which entails the parties to rights beyond those found in the strict terms of the contract.

in remedies for franchisees that the Sylvania case did for U.S. franchisees. On the one hand, it is commendable that the Court and Commission avoided being perceived as the intervenor for bad-faith franchisees seeking to relieve themselves of their contractual obligations. However, the disparity in bargaining power between franchisor and franchisee is a reality. Where Community competition law still applies to franchising, as where a franchisee is terminated for engaging in parallel trading, the institutions of the Community should vigorously protect the franchisee. Apart from that, if the Community is serious about fostering a positive environment for franchising, it should urge Member States to enact laws requiring full disclosure in the sale of franchises and remedies upon termination.

It is gratifying to see the Commission and Court view franchising in such a positive light; a view clearly inspired by the tremendous potential for franchising in the Common Market. Although various questions remain unanswered, and future developments lie yet undiscovered, the infrastructure set out by the Pronuptia and Yves Rocher decisions is a solid foundation for a healthy future. Franchises modeled after the Pronuptia or Yves Rocher contracts can be assured of their compatibility with EEC competition policies and franchises with special requirements can proceed with the assurance of the rule of reason and the doctrine of ancillary restraints. Without a doubt, the dynamism that franchising has displayed in recent years will continue, and franchising will grow into a dominant force in Community distribution.

166 Van Empel, supra note 15, at 414.
167 Only Belgium has legislation which provides a measure of relief for terminated franchisees. The Law of July 27, 1961, as amended by the Law of April 13, 1971, and applicable to exclusive distributorships and perhaps franchises, providing for reasonable notice prior to termination and "just indemnity." It is designed to compensate the distributor for the enrichment of the supplier upon termination since the supplier may gain unjustly from increased clientele, expenses incurred by the terminated distributor, and further compensates employees dismissed. This law is typical of the most recent of franchise regulations in the United States, which attempt to make termination of franchises equitable to both parties without hampering their business freedom. See Survey of Foreign Laws & Regulations, Belgium, supra note 124, at 5-6.