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Territorial Restrictions in Vertical Relations

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I. VERTICAL RESTRICTIONS UNDER SCRUTINY

Do exclusive agreements with territorial restrictions have anti-competitive effects? An answer depends on whether they are horizontal or vertical. Horizontal restraints occur when competitors divide territories between themselves and thereby reduce interbrand competition to the detriment of output and prices and in the end also consumer welfare. In contrast vertical agreements ordinarily provide that non-competing parties allocate the work of taking a product to the market as efficiently as possible in competition with other similar products. They focus their attention on certain territories and make commitments to abstain from others. The overall result of a vertical restriction is that output increases, interbrand competition increases, and prices are reduced to the benefit of consumer welfare. Only in markets where competition is not functioning well—most often due to strong market power—may detrimental effects result.

This Chicago-inspired economic view[1] has, however, not been the position of the Commission over the years. Under European theory, competition law has a broader objective than pure efficiency enhancement.[2] The restriction of the freedom of action of the parties to an agreement and of those who are foreclosed from collaborating with the parties becomes important. Referring to leading case-law,[3] intra-brand competition must also be maintained to achieve efficiencies. On this reasoning exclusive agreements have generally been caught by Article 85(1), but subject to mitigating group exemptions.

If the group exemption technique is to apply in the future, this position must be retained. The advantage is predictability and uniformity. But the result is also that form takes precedence over reality.[4]

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1 For an economic discussion on the effects of vertical relations, see e.g. O. Williamson, *Antitrust Economics: Mergers, Contracting and Strategic Behaviour*, Basil Blackwell Inc., New York, 1987, chapter 6.

2 For a presentation of the Commission's view, see H. Schröter, *Antitrust Analysis under Article 85(1) and 85(3)*, Fordham Corporate Law Institute, 1988, p. 645. Compare M. Waelbroeck, *Antitrust Analysis under Article 85(1) and Article 85(3)*, Fordham Corporate Law Institute, 1988, p. 693 at p. 720.

3 ECJ, Case 56 & 58/64, *Etablissement Consten S.A. & Grundig Verkaufs-GmbH v. Commission*, 13 July 1966 [1966] ECR 299.

4 See W. Kirchhoff, *Die kartellrechtliche Beurteiligung vertikaler Vertriebsverträge, Intrabrand- und Interbrand-Wettbeweb als Kriterien in den USA, Deutschland und der EG*, Max-Planck-Institut, Band 82, Berlin, 1990, at p. 266. According to Kirchhoff it is unclear if exclusive distribution agreements fall under Article 85(1), but in view of the group exemptions the question is more academic. Kirchhoff argues at p. 313 against a wider interpretation of Article 85(1) because it is "*systematisch und integrationspolitisch problematisch*". A different approach would risk the common interpretation of the EC competition rules.

However, in all this the European preoccupation with a unified market and indirectly with territorial restrictions remains a problem. The first sentence of the Commission Green Paper of 22 January 1997 on Vertical Restraints in EC Competition Policy[5] reads: "The creation of a Single Market is one of the main objectives of the European Union." This axiom is then repeated again and again. Everything can be discussed, except the market integration aspect. Territorial restrictions are going to be as vigorously pursued in the future as in the past.[6]

The purpose of this article is to examine the handling of territorial restrictions in Community law and how past practices may influence a future position on vertical agreements. Case law development in the European Union is summarized and briefly compared with the parallel United States development. Based on this analysis proposals for the future are discussed.

II. Territorial Restrictions

A territorial restriction can best be described as an obligation not to be active or only to be active in a geographically defined area. The restriction can be explicit or indirect through the use of e.g. intellectual property rights, pricing arrangements, location clauses, customer restrictions and maximum stipulations. Territorial restrictions are possible both in horizontal and vertical collaboration.[7] In the vertical relation they are either (i) an inherent part of the exclusivity; (ii) agreed additional stipulations; or (iii) the result of special measures or legislation.

(a) *Inherent restrictions*

Non-exclusive relations rarely contain territorial restrictions. In contrast, exclusive relations reflect a will by the parties to collaborate more closely in a mutually balanced

[5] The Commission Green Paper of 22 January 1997 on Vertical Restraints in EC Competition Policy, COM(96) 721 Final, [1997] 4 CMLR 519. The Commission is basically presenting economic considerations, reviewing past practices, comparing with other countries, adding results of non-conclusive interviews with industry and presenting alternatives for discussion. All options are left open and if any tendency can be detected it is to leave things as they are.

[6] See the Green Paper, note 5 above, at point 276. It is not surprising that the Commission maintains such a position. It is more worrying if leading commentators prematurely would give in on this hill. Fiona Carlin, *Vertical Restraints: Time for a Change?* [1996] 5 ECLR 283, at p. 285 contrasted with p. 286, noted that protection of parallel trade was more than natural in the past, but now is time for a more mature approach. Yet, in her most likely scenario—a limited relaxation of the *per se* approach—she predicts that hard-core prohibitions, among them price-fixing and export bans, will remain. Likewise, Barry Hawk, *System Failure: Vertical Restraints and EC Competition Law*, 32 CML Rev., 1995, p. 973, concludes that export bans and restrictions on parallel import could appropriately be added to an EC *per se* list because of the market integration goal.

[7] Whether an agreement has a vertical or horizontal character depends less on the legal form—if it is a distribution or a licensing agreement—but rather on whether the parties are active in competing fields or not. Compare P. de la Cruz, *Vertical Restraints under EC Competition Law*, Letters [1996] 7 ECLR 419 and H.H.P. Lugard, *Vertical Restraints under EC Competition Law: A Horizontal Approach* [1966] 3 ECLR 166. There is no economic reason to make any distinction depend on form as it is often determined by the resources available to the parties. A producer with idle production capacity is likely to opt for a distribution relation, but would in the opposite situation be interested in a licensing arrangement. Similar considerations are made by the potential distributor/licensee.

partnership. The producer is seeking a partner who is prepared to give his product the market support it deserves. In return the middleman seeks an assurance that he will be the only person, at his level of distribution, who can sell the product in collaboration with the producer. The producer himself and the representatives appointed for other markets shall keep out of his exclusive territory.

(b) *Additional stipulations*

To increase the protection the parties may contemplate further territorial restrictions. They can agree not to sell products to third parties, who only intend to take them across borders and sell them in other territorities. These could be parallel exporters, who take delivery of the product in the territory of the supplier or parallel importers, who request delivery to their country of operation.

(c) *Other measures*

Furthermore the parties may agree to undertake other measures to prevent third parties, who have been able to acquire the product in the open market, from taking it to another market. These measures could be based on the use of national industrial property legislation or national fair-trading rules. It could also be by more indirect means like producing a product with different properties for different markets or conditioning sales differently depending on where the product has been purchased.

III. PAST PRACTICES

Article 85(1) does not single out territorial restrictions in vertical agreements as unlawful. Agreements which affect trade between Member States shall be prohibited if they "have as their object or effect the prevention, restriction or distortion of competition within the Common Market". The stipulation aims at restrictions of competition and no reference is made to market integrating objectives.[8]

An analysis of case law development relating to territorial restrictions in vertical relations reveals a scattered and inconsistent approach where the question whether a

[8] The list of anti-competitive examples in Article 85(1) refers to agreements (c) "which share markets or sources of supply". This example could be interpreted as promoting market integration which should also cover exclusive agreements. The dual reference to markets and sources of supply hints at "sharing" agreements in horizontal relations—even if the stipulation is far from clear. This very example has been omitted in Article 86. It was probably considered that the sharing of something could not be the result of a unilateral activity. It is, however, perfectly feasible for a dominant company to prevent parallel trade and introduce export bans. See e.g. ECJ, Case 27/76, *United Brands Co. v. Commission*, 14 February 1978 [1978] ECR 207. If the intention of the example had been to cover more than horizontal agreements, the possibility should have been more expressly mentioned in both Articles. In any event the omission has little importance in practice as the list is not exhaustive.

distinction should be made between different types of territorial restrictions has never been profoundly addressed by the Community Courts.[9]

1. *Exclusive Distribution*

In *STM-MBU*[10] the ECJ in 1966 underlined the need to consider all effects of an agreement—obstacles to parallel trade was only one element. Fourteen days later the Court in *Grundig & Consten* used the notion of "absolute territorial protection" to distinguish the unlawful exclusive collaboration from the legal. The Commission had found a mixed exclusive distribution and trademark licensing arrangement illegal.[11] The ECJ agreed that Article 85 also applied to vertical relations, but the infringement committed by the German producer and its exclusive French distributor was not present in the undertaking by Grundig not to make direct deliveries in France except to Consten. The infringement lay in the clauses which, joined to the grant of the sole right, "are intended to impede, *relying upon national law*, parallel import of Grundig products into France by establishing absolute territorial protection in favour of the sole concessionaire".[12]

The territorial protection provided by the exclusivity did not come under Article 85(1). The parties could not, however, on top of this protection agree to create absolute protection by the use of the national trademark legislation.

Grundig & Consten was decided before the ECJ had had the opportunity to develop its exhaustion principle. It resolved the impact of trade mark legislation by referring to the priority of the EC competition rules over national legislation. However, in subsequent cases dealing with the combined effects of an agreement and protective national legislation the Court has followed a similar line of argument.[13]

In 1967 the Commission issued a block exemption for exclusive distribution agreements.[14] In spite of the statement by the ECJ in *Grundig & Consten*, exclusive arrangements were treated as prohibited, but largely exempted. The Commission also

[9] Most commentators conclude that the situation is clear. See e.g. Schröter, note 2 above. See also Bellamy & Child, *Common Market Law of Competition*, (4 edn.), Sweet and Maxwell, London, 1993, at p. 395: "It is a basic principle of Community law that an exclusive distribution agreement falls within the prohibition of Article 85(1) when it impedes, in law or in fact, either re-export of the contract products by the distributor to other Member States or import of such products by third parties from other Member States." I. Van Bael & J.-F. Bellis, *Competition Law of the European Community*, CCH Editions Limited, (4 edn.), 1994, at p. 302 clarifies that "the case-law consistently show that absolute territorial limitations or resale price maintenance provisions are not acceptable". J. Fejø, *EF-konkurrenceret*, Jurist- og Økonomforbundets Forlag, 1993, at pp. 256–263 penetrates a number of cases which allows him to conclude that the case-law is strict and clear. Fejø, however, appears to take a critical approach to this development. For a different view see the extensive analysis made by W.A. Rothnie, in *Parallel Imports*, Sweet & Maxwell, London, 1993, where chapter 7 is devoted to parallel imports in the EC.

[10] ECJ, Case 56/65, *La Société Technique Minière v. Maschinenbau Ulm GmbH* (STM–MBU), 30 June 1966 [1966] ECR 235, at 250.

[11] Commission decision in *Grundig*, 23 September 1964: JO 1964 2545.

[12] ECJ, Case 56 & 58/64, *Consten & Grundig*, note 3 above at p. 344, (emphasis added). The judgment contains several conflicting statements, but the quoted section appears to summarize the position.

[13] ECJ, Case 8/74, *Procureur du Roi v. B. & G. Dassonville*, ("*Dassonville*"), 11 July 1974 [1974] ECR 837, and Case 28/77, *Tepea BV v. Commission*, 20 June 1978 [1978] ECR 1391.

[14] "Distribution Regulation 67/67", Commission Regulation 67/67 on the application of Article 85(3) of the Treaty to certain categories of exclusive dealing agreements, JO 1967 57/849.

distinguished between active and passive sales for which neither Article 85(1) nor prior case law had given any express support.[15]

In October 1975 the Court in *Van Vliet Kwasten & Ladderfabriek v. Fratelli Dalle Crode*[16] faced a situation where Dalle Crode promised its Dutch distributor that it would prohibit Italian purchasers from selling the product to Holland. The undertaking was held unlawful in spite of the fact that national property rights were not relied on to reinforce the agreement and notwithstanding that the product could be purchased from other Member States. According to the ECJ, the undertaking made could result in a partitioning of the market contrary to the fundamental principles of Community law. Much of the reasoning of the Court now turned on the interpretation of the Distribution Regulation, rather than the requirements of the Treaty.[17]

Van Vliet was the start of a more restrictive attitude, which was in line with the Commission's position prior to *Grundig & Consten*, where free trade requirements and a general prohibition to prevent parallel trade were underlined. In *Miller*,[18] a smaller German producer of specialized gramophone records exported its products through local distributors at prices lower than on the home market. Presumably in order to prevent re-export of the products, an export ban applied. Without discussing the benefits of exclusive collaboration, the ECJ concluded that an export ban constitutes a restriction on competition and it did not matter if the ban was enforced or not since its very existence "may create a 'visual and psychological background' which...contributes to a more or less rigorous division of the markets".

In *Van Vliet* the producer could not protect the distributor and in *Miller* the producer was unable to protect itself from the impact of parallel trade. In the 1983 *Pioneer*[19] case the Japanese producer of hi-fi equipment had entered into exclusive distribution arrangements in Europe. The agreements did not contain export bans. However, when the German distributor was approached by parallel traders who requested supply for exportation to the high-priced French market it did not deliver. The Court confirmed the findings of the Commission that the distributor had acted in concert with Pioneer and other distributors. The obstacle to parallel export was classified as a serious infringement seeking artificially to maintain price differences. Such prohibitions "jeopardize the freedom of intra-Community trade, which is a fundamental principle of the Treaty, and they prevent one of the objectives, namely the creation of a single market".

The export ban itself had become the infringement,[20] which has hereafter

[15] See D. Deacon, *Vertical Restraints under EU Competition Law: New Directions* (B. Hawk ed.) Fordham Corp. L. Inst., 1995, p. 307, at p. 308.

[16] ECJ, Case 25/75, *Van Vliet Kwasten & Ladderfabriek v. Fratelli Dalle Crode*, 1 October 1975 [1975] ECR 1103.

[17] Case 25/75, *Van Vliet*, note 16 above, para. [10]–[18].

[18] ECJ, Case 19/77, *Miller International Schallplatten GmbH v. Commission*, 1 February 1978 [1978] ECR 131.

[19] ECJ, Case 100-103/80, *SA Musique Diffusion Française and Others v. Commission* ("*Pioneer*"), 7 June 1983 [1983] 1825.

[20] V. Korah, *EEC Competition Law and Practice*, Esc Publishing, (5 edn.), 1994, at 1.2.3 suggests that "market integration has been elevated in competition cases to an aim in itself, and is pursued in a mechanical way, even when it leads to reduced competition and may delay the integration of the market".

repeatedly been confirmed by the Community authorities.[21] Yet, in 1992 the Commission argued a *"per se"* approach in *Dansk Pelsdyravlerforening*,[22] where it suggested that "it is common knowledge that exclusivity and exclusive distribution are incompatible with Article 85(1) of the Treaty". The Court of First Instance did not accept this conclusion which it considered to be circular reasoning based on the Commission's own group exemptions. Whether an exclusive agreement fell under Ariticle 85(1) had to be established by reasoning based on economic considerations.[23]

The position of the CFI raises the question whether a fundamental change has really occurred in the evaluation of case law regarding territorial restrictions in vertical agreements. If not, the question remains where that important dividing line between legal and illegal restrictions should be drawn. In fact, the situation seems as muddy today as it was in the 60s.

2. *Parallel Development Regarding Exclusive Licensing*

In the late 60s and early 70s the ECJ step by step developed a rationale for the handling of intellectual property rights. Under the exhaustion theory the rights-holder could not invoke his property rights once the protected product had been put on the market by himself or with his consent.[24]

This concept is the result of a restrictive interpretation of the rules on free movement of goods, but it also spilled over into the field of competition. It is more than a coincidence that the Commission used the concept in its dealing with licensing arrangements[25] when in the early 70s it made a 180 degree turn from its prior notice on patent licensing agreements.[26] Exclusive licence agreements were caught by Article

[21] Compare e.g. Commission, 90/645/EEC, *Bayer AG (Dental)*, 28 November 1990, OJ 1990 L 351/46; 90/38/EEC, *Bayer AG- "Bayo-n-ox"*, 13 December 1989, OJ 1990 L 21/71; CFI (2nd Ch.), Case T-43/92, *Dunlop Slazenger International Ltd v. Commission*, 7 July 1994 [1994] ECR II-441; ECJ, Case C-70/93, *Bayerische Motorenwerke, AG v. ALD Auto-Leasing D GmbH*, 24 October 1995 [1995] ECR I-3439; Case C-226/94, *Grand Garage Albigeois v. Garage Massol* SARL, 15 February 1996 [1996] 4 CMLR 778; Case C-309/94, *Nissan France SA v. Jean-Luc Dupaquier, Garage Sport Auto*, 15 February 1996 Proceedings 5/96 s.12, [1996] 4 CMLR 778.

[22] CFI (2nd Ch.), Case T-61/89, *Dansk Pelsdyravlerforening v. Commission*, 2 July 1992 [1992] ECR 1931, at paras. [94]-[98].

[23] Case T-61/89, *Dansk Pelsdyravlerforening*, note 22 above, at para. [98]: "...whilst it is true that to grant the benefit of Article 85(3) of the Treaty to a given agreement presupposes that that agreement has already been held to fall within the prohibition imposed by Article 85(1), this does not mean that the possibility provided for in Article 85(3) of granting a block exemption enables it to be inferred that every agreement falling within the category concerned necessarily fulfils, *ipso facto*, the requirements set out in Article 85(1)."

[24] See ECJ, Case 78/70, *Deutsche Grammophon GmbH v. Metro-SB-Grossmärkte GmbH & Co KG*, 8 June 1971 [1971] ECR 487, where the ECJ held that "it would conflict with the provisions regarding the free movement of goods in the Common Market if a manufacturer of recordings exercised the exclusive right granted to him by the legislation of a Member State to market the protected articles in order to prohibit the marketing in that Member State of products that had been sold by him himself or with his consent in another Member State solely because this marketing had not occurred in the territory of the first Member State".

[25] The Commission used the existence/exercise notion in its decision 74/494/EEC, *Kabel- und Metallwerke Neumeyer AG & Les Etablissements Luchaire SA*, 18 July 1975, OJ 1975 L222/34. The clearest example of the interaction between the two areas is offered by decision 85/410/EEC, *Velcro SA v. Aplix SA*, 12 July 1985, OJ 1985 L 233/22 in 1985.

[26] Official Notice on Patent Licensing Agreements, JO 1962 No. 139/2922 of 24 December 1962.

85(1) because of the restriction on the parties and the fact that potential licensees were foreclosed from joining the network.[27]

The policy expressed in individual decisions was reduced to a proposal for a block exemption for patent licensing agreements[28] with a similar stance on territorial restrictions as contained in the Distribution Regulation.[29] Industry objected to the Commission's position. The matter remained in a state of flux until the ECJ eventually handed down its landmark judgment in *Nungesser*,[30] where it distinguished between "open" and "closed" licensing arrangements. The "closed" and prohibited relation was characterized by absolute territorial protection, under which the parties to the contract propose "to eliminate all competition from third parties, such as parallel importers or licensees for other territories".

Nungesser is far from clear when it comes to drawing an exact line between the accepted and prohibited territorial restriction. The traditional licence agreement, where an exclusive territory is allotted to the licensee, does not come under the prohibition in Article 85(1) and accordingly does not need to be exempted.[31] Under the quoted section it would be unlawful for a licensor to commit other licensees not to export to the exclusive territory. On the other hand, a licensee who was not certain that he would "not encounter competition from other licensees for the territory granted to it, or from the owner of the right himself, might be deterred from accepting the risk of cultivating and marketing that product".[32] Such a result would be damaging to the dissemination of a new technology and prejudice competition in the Community between the new product and similar existing products.

The ECJ concluded that absolute territorial protection manifestly went beyond what was indispensable for the improvement of production or distribution or the promotion of technical progress. The absolute territorial protection was demonstrated "by the prohibition, agreed to by both parties to the agreement, of any parallel imports of INRA maize seeds into Germany even if those seeds were bred by INRA itself *and marketed in France*".[33]

The Commission in 1984 enacted the Patent Regulation, which contained a

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[27] Commission decisions 72/25/EEC, *Burroughs AG & Ets. Delplanque*, 22 December 1971, OJ 1972 L13/50; 72/26/EEC, *Burroughs AG & Geha-Werke GmbH*, 22 December 1971, OJ 1972 L13/53; 72/237/EEC, *Davidson Rubber Company*, 9 June 1972, OJ 1972 L 143/31; 72/238/EEC, *Raymond & Co. and Nagoya Rubber Co. Ltd.*, 9 June 1972, OJ 1972 L 143/39. According to the new approach by the Commission a rights-holder could cede the use of the rights derived from its patent. However, if it limited the exploitation of its exclusive right to a single undertaking, the power to contract with others was lost. In certain cases such exclusive character of a manufacturing licence could restrict competition and be covered by the prohibition set out in Article 85(1).

[28] Proposal for a Commission Regulation of 3 March 1979 on the application of Article 85(3) of the Treaty to certain categories of patent-licensing agreements, OJ 1979 C 58/12.

[29] Rothnie, note 9 above, at p. 419.

[30] ECJ, Case 258/78, *Nungesser KG & Kurt Eisele v. Commission*, 8 June 1982 [1982] ECR 2015, especially at paras. [53], [57] and [77].

[31] The Commission is interpreting *Nungesser* in a restrictive way by emphasizing the newness of the product and is thereby trying to limit the reach of the judgment.

[32] Case 258/78, *Nungesser*, note 30 above, at para. [57]. Waelbroeck, note 2 above, remarks at p. 714 that: "Indeed, if it is necessary to protect a licensee against competition by the licensor in order to induce him to bear the risks associated with the licence, it is difficult to understand why he should not also be protected against competition by licensees for other territories."

[33] Case 258/78, *Nungesser*, note 30 above, at para. [77] (emphasis added).

limited concession covering a prohibition on passive sales.[34] This concession has been repeated in the Know-How and Technology Transfer Regulations.[35]

In contrast to the situation for exclusive distribution, it appears that the Commission[36] and the Community Courts have approached licensing relations more cautiously. Sometimes the attitude to territorial restrictions in such relations is even permissive.[37]

3. *Hard Position on Other Arguments and Measures*

Over the years authorities have not been susceptible to arguments that the territorial restrictions should be overlooked because of their insignificant effect. Even if *Völk*[38] set a standard and the Commission followed up with "*de minimis*" notice,[39] case law demonstrates a lack of appreciation.[40]

An equally unsuccessful defence has been to suggest that the restrictions on parallel trade are the result of unilateral activity rather than an agreement.[41] The authorities have

[34] "Patent Regulation", Commission Regulation (EEC) No 2349/84 of 23 July 1984 on the application of Article 85(3) of the Treaty to certain categories of patent licensing agreements, OJ 1984 L 219/15, Article 1.1(6). The way the five-year grace period is construed it will in reality rarely grant such a long protection. Often there will be no protection at all for a licensee who is entering the collaboration at a late stage in spite of the fact that he is the entity in need of the protection.

[35] "Know-How Regulation", Commission Regulation (EEC) No 556/89 of 30 November 1988 on the application of Article 85(3) of the Treaty to certain categories of know-how licensing agreements, OJ 1989 L 61/1 and "Technology Transfer Regulation", Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85(3) of the Treaty to certain categories of technology transfer agreements, OJ 1996 L 31/2.

[36] Commission information, Association of Plant Breeders of the EEC, (*Comasso*), 11 January 1990 OJ 1990 C6/3.

[37] See e.g. ECJ, Case 62/79, *SA Compagnie Générale pour la diffusion de la télévision, Coditel v. S.A. Ciné Vog Films*, 18 March 1980 [1980] ECR 881 and Case 27/87, *Louis Erauw-Jacquéry Sprl v. La Hesbignonne Société Coopérative*, 19 April 1988 [1988] ECR 1919. Contrast Case 193/83, *Windsurfing International Inc. v. Commission*, 25 February 1986 [1986] ECR 611.

[38] ECJ, Case 5/69, *Völk v. Ets Vervaecke Sprl*, 9 July 1969 [1969] ECR 295. When considering the level of the fine in Case 28/77 *Tepea*, note 13 above, where the product was record cleaners and the parties to the agreement small, the ECJ took into account that the products only represented a small item in consumers' expenditure and their loss had not been serious.

[39] "*De minimis* Notice", Commission Notice on agreements of minor importance. Last revision published in OJ 1994 C 368/20. The Notice is again under review. See Commission Draft Notice on Agreements of Minor Importance of 30 January 1997, OJ 1997 C 29/3, [1997] 4 CMLR 500.

[40] Mere market share has not been determinative and the 5 percent level established in the "*de minimis*" notice has not been automatically followed when larger organizations are concerned. In ECJ, Case 30/78, *Distillers Company Limited v. Commission*, 10 July 1980 [1980] ECR 2229, the size of the group was more important than the insignificant market impact of the Pimm product. Similarly in Case 100-103/80 *Pioneer*, note 19 above, at para. [86], the parties may only have had a small market share—perhaps as low as 3 percent. Case 19/77, *Miller*, note 18 above, concerned a small company with a small market share, but the Court established that it was large enough to affect market conditions. See also Case T-43/92 *Dunlop*, note 21 above, at para. [170].

[41] In ECJ, Case 107/82, *Allgemeine Elektricitäts-Gesellschaft AEG-Telefunken AG v. Commission*, 25 October 1983 [1983] ECR 3151, a refusal to approve distributors for a selective distribution system was not unilateral conduct, but formed part of a contractual relation. In Case 25 & 26/84, *Ford-Werke AG & Ford of Europe Inc. v. Commission*, 17 September 1985 [1985] ECR 2725, Ford's decision to stop delivery of right-hand vehicles for "export-sales" in Germany was not considered a unilateral decision, but a part of its agreement with the wholesaler network. Compare ECJ, Case 26/76, *Metro v. Commission*, 25 October 1977 [1977] ECR 1875 and Case 86/82, *Hasselblad (GB) Ltd. v. Commission*, 21 February 1984 [1984] ECR 883.

normally found a disguised agreement[42] and the argument is now put at its ultimate test in *Bayer-Adalat*.[43]

The case law further appears to take a negative stance towards indirect measures to prevent parallel trade. For example, the supplier cannot use pricing as a method to discourage parallel trade.[44] He must not initiate buy-back arrangements or agree with potential parallel traders that they will be compensated separately,[45] nor may he compensate for activities undertaken when an exclusive concession risks being undermined.

There does not appear to be a distinction between different levels of distribution. Indications exist to the effect that each independent actor on the market shall be allowed to decide his own strategy without interference from the prior level,[46] but the issue has not been subject to any profound scrutiny.

It has not been necessary to establish that distributors should be allowed to supply other exclusive distributors as has been explicitly required in selective distribution and franchising relation.[47] If they cannot prevent supply to independent traders, *a fortiori* they must meet orders from authorized distributors.

IV. VERTICAL RESTRICTIONS IN THE UNITED STATES OF AMERICA

A review of the longer United States tradition does not reveal a more consistent development than in Europe, even if the general trend is more relaxed.[48] Neither the Sherman Act nor the Clayton Act is precise with respect to territorial restrictions in

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[42] If the supplier inserts an export ban into its conditions for supply—even if the ban is obsolete and not applied—it becomes part and parcel of the relationship and Article 85(1) is applicable. See Commission decision 87/409/EEC, *Sandoz Prodotti Farmaceutici SpA*, 13 July 1987 OJ 1987 L 222/28, and ECJ (6th Ch.), Case C-277/87, *Sandoz Prodotti Farmaceutici SpA v. Commission*, 11 January 1990 [1990] ECR I-45 (Summary publication) and Commission Decision 90/645/EEC, *Bayer-Dental*, note 21 above.

[43] Commission decision 96/478/EC, *Bayer AG-Adalat*, 10 January 1996, OJ 1996 L 201/1 and CFI, (order by the president) T-41/96 R, *Bayer AG v. Commission*, 3 June 1996, Proceedings 15/96, s. 26, [1996] 5 CMLR 290. In line with its general "*per se*" position on territorial restrictions, the Commission held that Bayer had introduced an export ban and the wholesalers' conduct reflected an "implicit acquiescence" which incorporated the ban into the commercial relations between the parties. During the preliminary procedure regarding interim measures the CFI appeared sceptical about the position of the Commission. The matter is still awaiting final judgment.

[44] Commission decision 90/38/EEC, *Bayer AG- "Bayo-n-ox"*, note 21 above and Case 30/78 *Distillers*, note 40 above.

[45] See Case T-43/92 *Dunlop*, note 21 above, at para. [47].

[46] See Case T-43/92 *Dunlop*, note 21 above, at para. [81] and Case T-11/89 *Shell v. Commission* [1992] ECR II-757.

[47] ECJ, Case 86/82, *Hasselblad*, note 41 and Case 161/84, *Pronuptia de Paris GmbH v. Firma Pronuptia de Paris Irmgard Schillgallis*, 28 January 1986 [1986] ECR 353.

[48] For a condensed and helpful overview of US practices regarding vertical non-price restrictions see L. Gyselen, *Vertical restraints in the distribution process: Strength and weakness of the free rider rationale under EEC competition law*, 21 CML Rev. p. 647. See also W.D. Collins, *Efficiency and Equity in Vertical Competition Law: Balancing the tensions in the EEC and the United States*, Fordham Corporate Law Institute, 1983, p. 501, at p. 520.

vertical agreements. Especially, the language of the 1890 Sherman Act is broad and all encompassing[49] and does not distinguish between the good and the evil.

Territorial restrictions in vertical relationships were not addressed until the early 60s when the Supreme Court first found them subject to a *rule of reason* evaluation,[50] then prohibited them *per se*[51] finally to revert to the *rule of reason* approach in *Continental T. V. Inc. v. GTE Sylvania Inc.*[52]

The *Sylvania* case dealt with sales of television equipment where Continental required its retailers to focus their sales efforts on allotted territories. The Supreme Court held that vertical restrictions may reduce intra-brand competition and stimulate interbrand competition simultaneously. A new manufacturer could use the restriction to induce retailers to make investments in capital and labour required in the distribution of products unknown to the consumer. There had been no showing in the case that vertical restrictions had or were likely to have a "pernicious effect on competition" or that they did "lack...any redeeming virtue". Accordingly, the *per se* rule earlier stated in *Schwinn* was overruled. Departure from the rule of reason standard should be based upon demonstrable economic effect rather than—as in *Schwinn*—upon formalistic line drawing.[53]

Similarly the Federal Trade Commission and Justice Department have swayed back and forth in their approaches to vertical restrictions depending on the prevailing political

[49] Sherman Act, 26 Stat. 209 (1890) as amended, 15 U.S.C.A. §§ 1–7 contains the central stipulations: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal...Every person who shall monopolize, or attempt to monopolize,...shall be deemed guilty of a felony...Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce...is declared illegal."

[50] *White Motor Co. v. United States*, 372 U.S. 253 (1963). White Motor worked through exclusive distributors and dealers who were restricted to limited territories and not allowed to sell to governmental agencies. In addition the agreements contained elements of resale price maintenance. The question was if the agreements came under a *per se* restriction, which could be handled in a summary procedure or rather should be handled as a *rule of reason* restriction which required full hearing. The Court underlined, with references to its prior case law, that *horizontal* territorial limitations, like group boycotts, or concerted refusals to deal were naked restraints of trade with no purpose except the stifling of competition. A *vertical* territorial limitation should not necessarily be handled similarly and the case was remanded to the lower Court for full trial.

[51] In *United States v. Arnold, Schwinn & Co*, 388 U.S. 365 (1967) the Court reversed its prior holding in *White Motor*. Schwinn prohibited both distributors and retailers from selling Schwinn bicycles to non-franchised retailers. At the retail level, therefore, Schwinn was able to control the number of retailers of its bicycles in a given area. Emphasizing the reach of control that could be exercised by a producer, the Court only accepted that the rule of reason governed when a manufacturer retained title, dominion, and risk with respect to the product. Only dealers indistinguishable from agents or salesmen of the manufacturer would come under the rule, "Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it."

[52] *Continental T. V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, (1977).

[53] *Continental v. Slyvania*, note 52 above, at p. 58. Compare *Beltone Electronics Corp.*, 100 FTC 68 (1982), where the FTC upheld the legality of territorial restrictions. Gyselen, note 48 above, at p. 653, shows that "Post-*Sylvania* courts implement the intricate rule of reason rather crudely and, in doing so, they make it more manageable and more predictable standard. They often narrow down the broad-ranging inquiry called for by the rule of reason by insisting, at the threshold, that a plaintiff attacking vertical non-price restraints establish market power of the defendant who enacted them. [Ref] They feel that they need not worry about these restraints when the manufacturer has little or no market power because such a manufacturer can do no harm to the interbrand competition. By the same token, courts assume that these restraints can serve consumer welfare in accordance with the basic assumption behind the free rider rationale."

situation. Presently the guidelines applicable to licensing agreements[54] do not single out territorial restrictions as especially evil and the equally forgiving guidelines on vertical relations have now been replaced by an intelligent rule of reason approach.[55]

The United States Supreme Court has in several instances underlined that there is a limit on how far the holder of an intellectual property right can exercise his monopoly. Once the product has left his sphere of control he can no longer decide the terms and conditions for its further resale. In *Dr Miles Medical Company v. John D. Park and Sons Co.*[56] the Court held that resale price maintenance was unlawful when the product had passed into the channels of trade and was owned by the dealers. Similarly, in 1942 in *United States v. Univis Lens Co.*[57] it was held that the sale of a know-how protected article exhausts the monopoly. Once the sale is made, the seller has parted with title, possession, control, and authority over the licensed product sold. The purchaser is free to do with the product what he wants.

V. Appraisal

Review of the past teaches that case-law has been neither coherent nor precise. The Community Courts have cleared the ordinary exclusive relation and outlawed absolute territorial protection which hinders any trade in the product. The problem is that the notions have never been exactly defined or delimited against one another.

The notion "absolute territorial protection" could be interpreted as only prohibiting measures eliminating *all* trade in the product—even if it has been freely marketed. Under this interpretation the parties cannot effectively stop all cross-border trade through a combination of contractual obligations and the use of a national legal monopoly right. Given this restriction they still have some latitude and can create a protection for the distributor against free-riding parallel traders. There is support in the case-law for such a narrow interpretation of the concept.

There is, however, also support for an interpretation that "absolute territorial protection" (in a certain conflict with the usual meaning of the word "absolute") should be read as a general prohibition on preventing parallel trade in the product. The parties can on the one hand agree on restrictions between themselves. On the other they must

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[54] In April 1995 the Justice Department in collaboration with the FTC issued guidelines for licensing which confirm the lenient attitude to territorial restrictions in vertical relations: Department of Justice and the FTC, 6 April 1995, *US Antitrust Guidelines for the Licensing of Intellectual Property, Antitrust Enforcement Guidelines for International Operations*; *Antitrust & Trade Regulation*; Report Vol. 68, No. 1708. Nothing in a distribution or licensing relation is inherently horizontal or vertical. An arrangement has a vertical component when it affects activities that are in a complementary relationship, as is typically the case in a licensing arrangement. The licensor manufactures and the licensees primarily handles distribution and marketing. In addition to this vertical component, the licensor and its licensees may also have a horizontal relationship. For analytical purposes, the Agencies ordinarily will treat a relationship as horizontal when the parties would have been actual or likely potential competitors in a relevant market in the absence of the agreement. The horizontal relationship does not by itself make the arrangement anti-competitive.

[55] See F. Carlin, note 6 above, with references to remarks made by the Assistant Attorney General Anne K. Bingaman to ABA Antitrust Section.

[56] *Dr Miles Medical Company v. John D. Park and Sons Co.*, 220 U.S. 37, (1911).

[57] *United States v. Univis Lens Co.*, 316 U.S. 241 (1942).

not make any commitments or otherwise do anything that could affect relations to third parties and indeed not rely on exhausted intellectual property rights.

The Commission has seized the opportunity offered by the lack of precision and developed a position that is more restrictive than the case-law would merit: The parties to the agreement cannot hinder parallel trade. They even have a positive obligation to supply parallel exporters.[58] The result is achieved by formally holding that all vertical agreements fall under Article 85(1), granting exemption for certain territorial restrictions, but especially blacklisting refusal to deal with parallel exporters.

The effect is that the benefit of the block exemptions is lost if the parties agree as a part of their exclusive arrangement not to supply parallel traders. For the manufacturing license an extremely brief period of prohibition on passive sales (rarely the five years indicated) has been exempted—but only where the buyer requests delivery in the country of destination. No exception is allowed if the buyer accepts delivery in the supplier's territory. A similar distinction is made in the Distribution Notice.[59]

A reason for the position taken by the Commission is its use of the competition rules to promote market integration.[60] But, and this is crucial, the systematic attack on indirect and passive sales is not decisive on the issue of whether the Community shall be regarded as an open or a closed market. As the parties are unable to prevent free circulation of a marketed product there is always the possibility of parallel trade.

The question is merely what protection it is fair to grant an exclusive representative. Under the Commission's position, only a limited advantage will be given. In *Delta Chemie*,[61] the accepted advantage was held to be equal to the transportation cost. This is a questionable concession. A new representative will either have to import the product and cover transportation costs or carry the investment in a production facility. At least during an initial period he must add substantial investments in marketing activities and he must then recover them during the term of the contract.[62] In line with the opinion expressed in *Nungesser* such an exclusive representative will be cautious about making any investment if he risks having a free-riding parallel importer

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[58] In the Technology Transfer Regulation, note 35 above, a certain hesitation is apparent in the preamble (point 11) where the Commission states: "The exemption of export bans on the licensor and on the licensees does not prejudice any developments in the case law of the Court of Justice in relation to such agreements, notably with respect to Articles 30 to 36 and Article 85(1). This is also the case, in particular, regarding the prohibition on the licensee from selling the licensed product in territories granted to other licensees (passive competition)."

[59] Commission Notice concerning Commission Regulation (EEC) No 1983/83 and (EEC) 1984/83 of 22 June 1983 on the application of Article 85(3) of the Treaty to categories of exclusive distribution and exclusive purchasing agreements. Amended by Commission Notice 92/C 121/02, OJ 1984 L 101/2.

[60] See Schröter, note 2 above, at p. 659.

[61] Decision 88/563/EEC, *DDD Ltd. & Delta Chemie*, 13 October 1988, OJ 1988 L 309/34, at para. [25]: "...In particular, this advantage (the exclusivity for the licensee) consists of a reduction in transport costs and of the possibility of directly adapting production capacity to local demand as well as to requirements of national laws and regulations."

[62] See Korah, note 20 above, at p. 169.

picking up the product directly from the producer and shipping it to the exclusive territory.[63] There will simply not be a margin for undertaking the efforts required.

To allow a prohibition on passive sales on the other hand, would mean that the product has to pass through an additional sales level before it can enter the parallel trade. This may offer the required margin for the investing middle man, but it will not prevent parallel importation where the parties impose excessive prices. When the price difference exceeds the purchase price at the level where the product can be regarded as put into free circulation plus a reasonable margin for the parallel trader, such competition is likely to occur.

The general attitude among economists is that vertical collaboration is beneficial and pro-competitive. This ought to be reflected in the legislation. The present tough stance from the Commission leads to technical breaches of Community law where all parties involved are trying to deter damaging parallel trade or are finding ways of integrating forwards or backwards to seize control over the entire distribution chain.[64] This latter development is especially deplorable. Continued concentration is hardly an improvement of the competitive climate in Europe.[65]

VI. In Search of a Balanced Approach

Two points of departure lead in opposite directions. Under an economic evaluation vertical collaboration should generally be viewed favourably and there are limited reasons to control territorial restrictions that do not lead to absolute isolation of national markets. The other is that every agreement restrains and under this theory also a vertical agreement—with or without territorial restrictions—comes under the prohibition in Article 85(1). Competition is about economics and not form, but the wish of the Commission to control the legal development can hardly be overlooked and the formal reasoning therefore becomes important.

If industry is not prepared to accept this latter point of departure, the only sensible activity is to lobby the Council to have Regulation 19/65 withdrawn. This could allow for a more profound discussion of the entire competition system in the European Union and would most likely lead to a reduction of the influence of the Commission in competition matters. The focus of the competition rules would be on whether a certain situation could be regarded as unlawful under Article 85(1) or not. This would be for the courts to decide on a case-by-case basis. Such a system would closely resemble the United States system. Whether this would lead to a better competition system in Europe can be doubted.

[63] Deacon, note 15 above, at p. 319, shows (in spite of being a Commission official) that there could be other efficiency oriented reasons related to new IT technology and "just-in-time" practices why a prohibition on preventing parallel trade does not always make sense.

[64] In CFI (order by the president), T-41/96 R, *Bayer AG-Adalat*, note 43 above, the company argued that one alternative it had been considering was to integrate forwards and thereby avoiding having to deal with independent wholesalers.

[65] *Sylvania*, note 52 above, at p. 57. Compare the General Advocate in Case 30/78, *Distillers*, note 40 above, at p. 2288.

On the other hand, if it is accepted that vertical agreements formally come under Article 85(1) a group exemption must be clear, broad and not allow for protracted administrative procedures in front of the Commission and especially not open up endless legal suits on the national level, where unclear anti-trust rules are now used to enable parties to get free of uncomfortable relationships. Unless vertical agreements contravene clear and precise rules, industrial partners shall be entitled to rely on the freedom to contract and that such agreements will be respected.

Based on the earlier discussion, the following could be a balanced future approach to territorial restrictions in exclusive agreements:

(a) *Inherent territorial restrictions*

Non-competing partners in a mutually exclusive distribution arrangement should be allowed to concentrate on their respective territories and agree to abstain from actively working in other areas.

In order to secure a reasonable margin for the middleman, he must furthermore always be assured that the supplier does not sell to any trader who intends to take the product to the protected territory. The moment the principal oversteps this undertaking, the economic benefit of the exclusivity is lost for the concessionaire.

Without these restrictions the middleman will be reluctant to make investments. Such territorial restrictions are an inherent part of a system that has pro-competitive advantages. If formally prohibited, they shall be exempted without any snags or limitations. In case such restrictions cause harmful effects in a particular case, the Commission will have to withdraw the benefit of the block exemption, but then carries the burden of proof for the harm caused.[66]

(b) *Additional territorial restrictions*

The question is if further territorial restrictions can be imposed on the middleman—i.e. that he shall not supply parallel traders who only intend to take the product to another territory—are such restrictions ancillary to the exclusive agreement and consequently to be dealt with in the same way as the underlying agreement?

It could be argued that such a contractual restriction is unobjectionable. The producer's interest in building a network of independent distributors for his product must also be protected or he will simply strive for integration and concentration. The producer shall be allowed in collaboration with others to do what he could have done

[66] This burden of proof for harmful effects of non-price vertical restraints is difficult to carry. See Gyselen, note 48 above, at p. 666.

alone by integrating backwards or forward. He is competing with other brands, not creating competition for his own product.[67]

It is also reasonable to allow the middleman a significant margin to cover his investments and secure a return. He is responsible for producing (production licence) and/or importing (marketing licence or distribution arrangement) the product; he must secure local marketing authorizations and make required adaptations; and he is above all shouldering the costly marketing and sales efforts required to introduce a new brand on the market. He is not operating in a vacuum, but must undertake his efforts efficiently in order to meet competition from other similar brands. There are limited reasons to promote the interest of free-riding parallel traders over such efforts.

The other side of the coin is that the agreed territorial protection also requires the middleman to abstain from opportunities to export the product through the assistance of parallel traders. It could be argued that each independent trade level should be entitled to pursue its own strategy without receiving instructions from the prior level.[68] However, such restriction is the consequence of a freely negotiated contract and the middleman cannot have it both ways. His freedom of action is reduced to his own territory.

The inherent and additional territorial restrictions allow for a priority relationship between the partners. If the market is characterized by interbrand competition the relationship will be pro-competitive and there is no need to control such activities by rigid competition rules.

Yet it must be recognized that in certain situations also the vertical collaboration may have detrimental effects. This could be so in cases of weak competition with a lack of substitutable products. The determining test should accordingly not be the restriction itself, but rather a market power one. Option IV as suggested by the Commission in the Green Paper is much in line with this reasoning. The 20 percent market share is debatable. More important is that the benefit of the group exemption is not automatically lost above a certain figure (40 percent under the proposal). To allow the Commission insight into industry practices it may be more relevant to stipulate notification of the agreement under an opposition procedure.

[67] At the limit he should not be allowed to insulate different exclusive territories and maintain different prices. A way to balance such risk is to allow distributors to sell between themselves. Compare ECJ Case 161/84, *Pronuptia*, note 47 above, and Case 86/82, *Hasselblad*, note 41 above.

[68] Compare ECJ, Case 319/82, *Société de vente de Ciments et Bétons* [1983] ECR 4173; CFI, Case T-11/89, *Shell v. Commission*, 10 March 1992 [1992] ECR II-757; and Case T-61/89, *Dansk Pelsdyravlerforening*, note 22 above, para. [81]: "...the criteria of co-ordination and co-operation previously laid down by that case-law must be understood in the light of the concept inherent in the competition provisions of the EEC Treaty according to which each economic operator must determine independently the policy which he intends to adopt on the common market." See Kirchhoff, note 4 above, at p. 316.

(c) *Absolute territorial protection*

Once the product has passed from the middleman to his buyer it is freely available[69] and can be traded across borders. It should remain *per se* prohibited to reach agreements to use means to prevent a lawfully marketed product from being so traded.[70] No group exemption should be made applicable for such practices.[71] In case the parties should consider such a restriction vital to their collaboration, they must seek an individual exemption.

[69] Provided that the middleman in turn has not designed a marketing strategy for his territory—e.g. franchising or selective distribution—then the product would not be free until it has left the subsequent level.

[70] This is not primarily an anti-trust concern, but follows already from the concept of free movement of goods. In Case 258/78, *Nungesser*, note 30 above, at paras. [62]–[63] the UK Government advanced the view that the contract between two undertakings could not impede the freedom of importers under the exhaustion theory. Therefore, the agreement could not be regarded as prohibited by Article 85(1). In an answer slightly beside the point, the ECJ did not accept the logic of the British argument.

[71] Accordingly there should be no need to open up for possibilities of withdrawing the benefits of an exemption as is presently the case.