To Market, to Market: The Pros and Cons of Alternative Methods of Distribution
(European Perspective)

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1. INTRODUCTION

This presentation is a brief overview of various manners for manufacturers to expand their business into new markets and will focus on the most common "traditional" types of distribution contracts – agency, concession/independent distributors and franchise.

These traditional forms of distribution are appealing means to enter into new markets through independent local players, allowing the manufacturer to expand its business without the need of setting-up a local structure, thus reducing (or avoiding) fixed costs, requiring less investment and involving less risk.

However, each of these alternatives has advantages and disadvantages that must be duly taken into account by the manufacturer and counsel to determine the best option available.

2. TRADITIONAL TYPES OF DISTRIBUTION CONTRACTS

A. Agency

a. Definition

Article 1, sub-clause 2 of EU Directive 86/653/CEE defines "commercial agent" as a "*self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person, hereinafter called the 'principal', or to negotiate and conclude such transactions on behalf of and in the name of that principal.*"

In other words, under an "agency" contract the agent is an independent party who promotes sales of the goods on behalf of the producer/supplier (referred to as "principal"). The agent does not take title to the goods, nor is he/she/it a party to the final sale agreement concluded between the principal and the purchaser and, consequently, it is the principal who bears the risk of the sale and of collection of payment.

In most EU jurisdictions, agency agreements are not subject to special formalities and may be entered into both verbally or in writing; however, upon request of either party the other has to cooperate in formalizing the content of the agreement in writing. Furthermore, while there may be no specific formalities, there are certain clauses that must be in writing, such as exclusivity rights, *del credere* clauses and non-competition duties.

b. Brief overview of main rights and duties

In addition to the general duty to look after the principal's interests and act dutifully and in good faith, the Agent's main duties are to (i) make proper efforts to negotiate deals, (ii) provide the principal with all necessary information and (iii) comply with reasonable instructions given by the principal. However, other legal duties may be established by contract, such as duty of collection, local publicity and merchandising, post-sales support etc.

It should be noted that the Agent is responsible for all costs associated to its activity and for setting up the necessary resources and structures to perform its duties. As consideration for these services, the Agent receives a commission on sales he/she/it has helped to obtain in the territory.

In turn, the principal also has general duties to act in good faith and to cooperate with the agent, including the duty to (i) provide the agent with the information necessary for the latter to perform the agency contract, including any product documentation, (ii) inform the agent of the acceptance or refusal of potential commercial transactions and, naturally, (iii) pay the consideration due to the Agent.

While EU countries have a specific legal regime for agency agreements as a result of the transposition of Council Directive 86/653/CEE, the existing legislation allows parties a certain degree of contractual freedom to govern their

relationship and to establish other contractual duties, such as "*del credere*" duties (whereby the agent assumes the risk of good collection and is entitled to receive special consideration) and non-competition clauses, within what is allowed by the respective legal regime and by EU competition regulation on vertical restraints. We also draw your attention to the fact that, contrary to what has happened in the past, exclusivity, whether for a certain geographic territory or clients, is not an automatic characteristic of an agency agreement and should be granted in writing.

B. Independent Distributor

a. Definition

Concession or Independent Distributor agreements take the separation between producer and the distribution chain one step further. Unlike the agent, in a concession agreement the independent distributor buys the goods from the producer and then resells them in the local market in its own name and at its own risk. However, due to the continuing relationship established between the parties and the element of control of the distribution activity, the distribution contract goes beyond a mere succession of "sales agreements".

Distribution agreements are essentially characterized by three aspects[1]:

(i) Duty to purchase from the producer for resale in the local market;
(ii) Distributor acts in his own name, on his own account and risk;
(iii) Integration of the distributor in the producer's distribution network as a result of other duties that are established between the parties;

b. Brief overview of main rights and duties

As discussed in further detail below, generally speaking the concession agreements do not have a specific legal regime in most European countries and, therefore, it is essential that the parties expressly and carefully set out their respective rights and duties in the agreement.

[1] ANTÓNIO PINTO MONTEIRO, *Contratos de Distribuição Comericial, Almedina (2002), pg. 108- 110*

Although the distributor is an independent party who is responsible for the resale of the goods in the local market, the manufacturer may have interest in ensuring it maintains some control over the distribution activity and, as a result, establish certain obligations - such as sales targets, product packaging and presentation requirements and post-sales duties - that contribute to the "integration" of the distributor in the manufacturer's network and to the harmonization of the latter's commercial policy.

On the other hand, a concession scheme requires greater investment and risk on behalf of the distributor, who will also seek to protect its interests and minimize risks and seek to establish contractual safeguards such as minimum contract duration, territorial exclusivity, product warranties and indemnity provisions from the producer.

Given the absence of a specific legal regime, parties should also anticipate future problems that may arise with the termination of their relationship, particularly in regards to compensation, unsold stock and non-competition duties.

We will discuss the matter of "compensation" in further detail below, however, we point out that this is one of the aspects in which case-law in various EU jurisdictions have allowed the analogical application of the rules of termination established in the agency regime.

Another important aspect of termination is the matter of unsold stock - should the producer be required to repurchase the goods if they are in proper condition and at what price? should the distributor be allowed to continue to sell the goods for a certain defined period after termination? Or should the distributor, as the rightful owner of the goods, be entitled to sell them at his own discretion and at any price? The matter of unsold stock is a key issue the parties should address contractually to minimize their losses and to avoid further damages.

As for the matter of non-competition, although the manufacturer is not directly involved in the resale of the goods in the local market, it is in its interest to protect its market share and avoid that the distributor undermine the market by using its acquired knowledge and experience to promote a competitor

brand. However, it should be noted that while these non-competition clauses are generally allowed for smaller players, they raise sensitive competition issues and must be both reasonable and limited in time, otherwise, they may be considered "anti-competitive" and in violation of both national and EU competition rules[2].

C. Franchise

a. Definition

Franchise Agreements are by far those that allow the manufacturer the greatest level of control and uniformity of its international distribution network. Under a franchise agreement, independent economic agents (franchisees), acting in their own name and at their own account and risk, adopt the corporate image of the franchisor and present the goods/services in the local market "*as if*" they were the franchisor.

Franchise Agreements generate significant economic benefits for both parties: on one hand, they allow the franchisor to expand its commercial network, on the basis of a certain business method or specific know-how, without incurring substantial investments and, on the other hand, they allow the franchisee to enter the local market while benefitting from the support and assistance of a third party whose business has already been tested.

According to the European Court of Justice in *"Pronuptia[3]"*, franchise agreements should be distinguished between:

(i) Service Franchise – franchisee offers the service under the franchisor's business name/trademark in accordance with franchisor's instructions;

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[2] Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, Official Journal L 102, 23.4.2010, p.1-7, pursuant to which certain vertical agreements can be regarded as normally satisfying the requirements of Article 101 (3) and, therefore, benefit from a presumption of legality, provided the involved undertakings do not hold a market share exceeding 30% of the relevant market and do not contain any so called "*hardcore*" restrictions ("Block Exemption"). The "Block Exemption" recognizes that non-compete clauses may have an efficiency- enhancing effect and establishes the criterion necessary for such non-compete clauses to benefit from the exemption, such as, in what concerns their duration, a five-year limit to their overall duration and a one-year limit for post-term non-compete provisions.

3 Judgment of the European Court of Justice 28.1.1986 in case n.º 161/84 - Pronuptia de Paris GmbH vs. Pronuptia de Paris Irmgard Schillgalis

(ii) Production Franchise - franchisee manufactures the goods according to the franchisor's instructions and sells them under the latter's business name/trademark

(iii) Distribution Franchise – franchisee sells goods in a commercial establishment that bears the franchisor's name and according to the franchisor's business methods;

b. Brief overview of main rights and duties

While there is relevant EU Regulation concerning competition matters that touches upon franchise agreements4 this does not deter from the fact that, generally speaking, franchise contracts do not have a specific legal regime in most of EU member-states.

Hence, once again, the agreement entered into between the parties is essential to define their respective rights and duties and, naturally, the content thereof will depend on the type of franchise (service, production or distribution) that is entered into. However, common clauses to all franchise agreements include license to use the franchisor's intellectual property – such as its trade name or trademark and, particularly in the case of production franchises, patents – as well as the latter's know-how and access to technical or business support. In exchange, the franchisee will pay the franchisor fees that may take the form of a lump sum ("front money") or royalties on sales, or a combination of both.

The use of the Franchisor's "corporate image" is an essential element of the franchise agreement (and a key characteristic that distinguishes the franchise from a mere transfer of know-how or license agreement) and while it allows the franchisee to benefit from an established trademark/trade name and tried business method, it can also raise liability issues as the franchisee is portrayed to the public as the apparent or presumed manufacturer. On the other hand, because of this "corporate identity", the franchisor will seek to ensure that the

[4] We refer to Council Regulations n.º 4087/88, subsequently replaced by Regulation n.º 2790/1099 and now by Council Regulation n.º 330/2010 on the application of Article 101(3) on the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, Official Journal L 102, 23.4.2010, p.1-7.

franchisee complies with its instructions, so as to maintain a good reputation and ensure the quality of the goods/services and thus maintain uniform quality standards throughout the franchise network.

Similarly to concession agreements, the parties should also be concerned with establishing clear rules regarding sales targets, territorial exclusivity, product warranties and indemnity provisions and, again, strive to anticipate problems that may arise with the termination of the agreement.

3. LEGAL FRAMEWORK & PRACTICAL CONSIDERATIONS

A. Agency Contracts

As referred above, agency contracts have a specific legal regime within EU member-states as a result of the transposition of Council Directive 86/653/EEC. However, although the aforementioned Directive harmonizes the concept and basic rules of agency agreement, it also results from "compromise" among the various member-states and, to such extent, allows them sufficient flexibility to adopt solutions in line with their respective internal jurisdiction and practice.

For example, Article 17[5] of Council Directive 86/653/EEC which relates to termination is clearly a result of "compromise" between the German and French position and allows each member-state to choose between the German model of an "indemnification[6]" or the French-model of "compensation[7]" that may be due to

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[5] Article 17, paragraph 1 of Council Directive 86/653 establishes *"Member States shall take the measures necessary to ensure that the commercial agent is, after termination of the agency contract, indemnified in accordance with paragraph 2 or compensated for damages in accordance with paragraph 3".*

[6] Article 17, paragraph 2 of Council Directive 86/653 establishes as follows:
"(a) The commercial agent shall be entitled to an indemnity if and to the extent that:

- *He has brought the principal new customers or has significantly increased the volume of business with existing customers and the principal continues to derive substantial benefits from the business and such customers; and*
- *The payment of the indemnity is equitable having regard to all the circumstances and, in particular, the commission lost by the commercial agent on the business transacted with such customers. Member States may also provide for such circumstances also to include the application or otherwise of a restraint of trade clause, within the meaning of Article 20;*

(b) The amount of indemnity may not exceed a figure equivalent to an indemnity for one year calculated from the commercial agent's average annual remuneration over the preceding five years and if the contract goes back less than five years the indemnity shall be calculated on the average for the period in question;
(c) The grant of such an indemnity shall not prevent the commercial agent from seeking damages."

[7] Article 17, paragraph 2 of Council Directive 86/653 establishes as follows: "*The commercial agent shall be entitled to compensation for the damages he suffers as a result of the termination of his relationship with the principal. Such damages shall be deemed to occur particularly when the termination takes place in circumstances:*

- *depriving the commercial agent of the commission which proper performance of the agency contract would have procured him whilst providing the principal with substantial benefits linked to the commercial agent's activities,*

the agent upon termination of the agency agreement and provided the requirements established by law are verified[8].

Under the "indemnification" model, the amount of the indemnity is determined equitably and must not exceed a figure equivalent to an indemnity for one year calculated from the commercial agent's average annual remuneration over the preceding five years or, if the contract is of lesser duration, average for the period in question.

Whereas under the "compensation" model, the Directive refers no limit and the amount of compensation is based on the actual damages suffered. However, while there is no statutory limit to the "compensation" granted to the agent, in France, for example, the courts have generally upheld an indemnification in the amount equivalent to two years of commissions.

In Portugal, agency agreements are governed under Decree-Law DL 178/86 of 3 July, subsequently altered by DL 118/93 of 13 April, as a result of the transposition of EU Directive 86/653/CEE), and the options made by the Portuguese legislator clearly follow the German- model[9].

B. Concession & Franchise Agreements

In general, most European countries do not have a specific legal regime for concession agreements; however, there are certain exceptions, as is the case of Belgium[10]. The same is true of franchise agreements, with the exception of Italy and to a certain extent France (in light of the "Loi Doubin[11]" that imposes certain duties of information), despite the existence of relevant EU regulations concerning competition matters that touch upon these contracts.

- *and/or which have not enabled the commercial agent to amortise the costs and expenses that he had occurred for the performance of the agency contract on the principal's advice."*

[8] It should be noted that the payment of the indemnification or compensation is dependent upon the verification of the legal requirements established under national law and no indemnity or compensation is due to the agent upon termination if (i) the agreement is terminated by the principal as a result of the default attributable to the agent, (ii) there is unjustified termination of the agreement by the agent or (iii) if the agent has assigned his rights/duties to another person, with the principal's consent.

[9] The German-model was also followed by Austria, Belgium, Holland and Italy, among others.

[10] Law of 27.07.1961, subsequently altered by law of 13.04.1971

[11] The designated "Loi Doubin" was passed on 31.12.1989 and was subsequently complemented by Decree n.º 91-337 of 04.04.1991 and imposes a duty on the franchisor to provide the potential franchisee with certain preliminary information concerning the franchisor's business and experience, the possible market growth and key terms of the agreement relating to exclusivity, term, renewal and termination, thus enabling the franchisee to make an informed decision.

While the generality of member-states do not have a specific legal regime for concession and franchise agreements, case-law has supported the analogical application of certain agency rules to concession agreements – particularly in what concerns termination. However, the application of the agency rules to other forms of contract is not "automatic" and the grounds for "analogy" should be determined on a case-by-case basis and raise challenging questions.

For example, in what concerns the right to compensation/indemnification on termination, the courts often weigh whether the activities of the individual distributor contributed to obtaining new clients or increasing sales to existing clients and to the degree of their integration in the producer's distribution network. The analogy it even more difficult to uphold in relation to franchise agreements, where the franchisee is acting under the corporate name/corporate image of the franchisor, leading significant authors and case-law to deny the analogical application of the agency rules to these contracts.

Another challenge relates to the calculation of the compensation/indemnification due - while the agent receives commissions, independent distributors and franchisees receive margins and there is no uniform case-law on whether gross margins or net margins should be used for purposes of determining the compensation/indemnification due.

Under Article 15 of Council Directive 86/653/EEC an agency agreement that is concluded for indefinite period may be terminated by either party with a prior notice of one, two or three months, depending on the duration of the contract. However, such short notice periods are unreasonable for concession/franchise agreements where a greater investment is made by the independent distributor/franchisee.

These are some of the challenges that are faced by courts and which lead to conflicting decisions and to legal uncertainty that could be prevented by the parties through cautious drafting of their agreement.

4. BASIC INSIGHTS ON EU COMPETITION POLICY ON "VERTICAL AGREEMENTS"

From a competition perspective the distribution agreements we have been discussing constitute forms of "vertical agreements", as they govern the relationship between entities at different levels of the distribution chain. These agreements often include restrictions on each party's activity, such as exclusivity clauses, territorial exclusivity, restrictions on suppliers and the terms of sale, restrictions on "parallel" imports and non-competition duties etc.

Some of these restrictive terms are frowned upon by the EU and Member-State competition laws, but because they form such important characteristics of distribution contracts and have the potential to enhance efficiency and benefit the market, they may, in certain circumstances, be excluded from the general prohibition, as long as the clauses remain within certain limits and the healthy competition of the market can still be ensured.

Article 101º of the Treaty on the Functioning of the European Union (former Article 81 TEC) applies to vertical agreements that may affect trade between Member-States and that prevent, restrict or distort competition on the market and are detrimental to consumers. Article 101.º (1) prohibits those agreements that are considered anti-competitive:

"1. The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of 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 internal market, and in particular those which:

(a) directly or indirectly fix purchase or selling prices or any other trading conditions;

(b) limit or control production, markets, technical development, or investment;

(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

However, the prohibition contained in Article 101(1) may be cast aside, and the agreement in question exempted, if all the four cumulative conditions for exemption set out in Article 101(3) are satisfied, and the agreement in question:

(i) Contributes to improving the production or distribution of goods or to promoting technical or economic progress;

(ii) Allows consumes a fair share of the resulting benefit;

(iii) Does not impose on the parties restrictions which are not indispensable to the attainment of these objectives;

(iv) Does not afford the parties the possibility of eliminating competition in respect of a substantial part of the products in question.

The structure of Article 101 thus provides for a general prohibition of distribution agreements containing anti-competitive clauses but also allows for the possibility that an agreement may be exempted and the prohibition inapplicable, if the conditions of Article 101(3) are satisfied.

Generally speaking, it is for the parties to a distribution agreement to analyze the potential anti-competitive effects of their agreement and to weigh them against the countervailing factors which may confer exemption. This means that the parties carry out a self-assessment of the competitive implications of their agreement without the intervention of any competition authority – exemption is not conferred by an administrative act but as a result of the agreement's compliance with all conditions of article 101(3) (legal exception system).

The EU legislator obviously sought to strike a balance between the restrictions to competition and the benefits that certain "vertical agreements" confer which outweigh their anti-competitive effects, provided these "vertical agreements" do not contain any "hard-core restrictions".

In some cases, depending on the market share of the buyer and the supplier, the distribution agreements in question may benefit from a presumption of legality as a result of Commission Regulation 330/2010 (the "Block Exemption Regulation")[12].

Under this "Block Exemption Regulation" it is assumed that when the market share held by each of the involved undertakings does not exceed 30% and the agreement does not contain severe restrictions to competition, then such vertical agreements generally

[12] Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices, Official Journal L 102, 23.4.2010, p.1-7

lead to an improvement in the distribution chain that ultimately benefits consumers. This provides a safe haven for undertakings who are party to a vertical agreement.

However, agreements that contain severe restrictions, such as minimum and fixed resale prices, as well as certain restrictions concerning territories a distributor may sell in or groups of clients it may sell to, do not benefit from the "Block Exemption" under any circumstances, regardless of the market share held by each of the involved undertakings.

Even if the conditions for an agreement to be exempted are not satisfied, for example the 30% limit on market shares, this does not automatically mean that a vertical agreement containing some form of competitive restriction will fall under the prohibition of Article 101(1). A case-by-case analysis must be carried out by the parties (self-assessment) to determine whether the agreement in question may individually benefit from the exemption under Article 101(3).

The application of Article 101 is also the object of the European Commission Guidelines on Vertical restraints[13] which seek to provide additional clarity and legal certainty to undertakings involved in distribution relationships in the EU and assist parties in their self-assessment. For such purpose, it may be relevant to point out a few final considerations:

(i) Firstly, Article 101 only applies to agreements that affect trade between Member-States and restrict competition;

(ii) Secondly, Article 101 only applies when independent undertakings are involved – this means agreements between members of a single group of companies will not be caught by Article 81(1), unless the individual companies enjoy a high degree of independence in determining their actions on the market. According to the "single economic unit" doctrine, legally autonomous undertakings which form part of the same corporate group will generally be treated as a single undertaking.

(iii) In what concerns agency agreements, the agreement will be qualified as an agency agreement if the agent does not bear any substantial financial risk, or bears only insignificant financial risks, in relation to the contracts concluded and/or negotiated on behalf of the principal. Article 101 will not apply to agreements between genuine agents and their respective principals in what regards those agreements concluded by the agent on behalf of the principal.

[13] Commission Notice "Guidelines on Vertical Restraints", Official Journal C 130, 19.05.2010, p. 1