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RECOMMENDATION BY THE INTERNATIONAL DISTRIBUTION INSTITUTE IN VIEW OF THE REVISION OF REGULATION 2790/1999

FRANCHISING, SELECTIVE DISTRIBUTION AND INTERNET

Barcelona, 13 June 2009

1. The International Distribution Institute

The International Distribution Institute (IDI), which groups the experts in distribution law in various countries of the world, is the leading organization dealing with international distribution law, with a website (www.idiproject.com) which keeps its members informed about legislation and case law regarding distribution throughout the world.

The International Distribution Institute organizes each year its annual conference where topical issues regarding international distribution are discussed between selected experts and the participants.

This year IDI has decided to discuss the issue of the relationship between selective distribution and franchising and the use of the Internet by selective distributors and franchisees, also in view of the EC rules on vertical restraints.

Knowing that the European Commission will revise Regulation 2790/1999, IDI has discussed with its members a number of critical issues and has worked out the recommendations set out in § 5 of this document.

2. Selective distribution and franchising before regulation 2790/1999

Before the enactment of Regulation 2790/1999 selective distribution and franchising were subject to substantially different rules.

Selective distribution agreements were not covered by any block exemption, but these systems were considered lawful, provided the selection criteria were not too

strict and provided free circulation of the products between the members of the network was warranted.

Franchising systems have been considered lawful to a great extent by the Court of Justice in the Pronuptia case¹. Thereafter, franchise agreements have been exempted by category by virtue of the block exemption contained in Regulation 4087/88.

Selective distribution systems and most franchising networks regarding the distribution of products at the retail level are "closed" networks, i.e. networks where the members are required not to sell the products to traders who do not belong to the network.

This aspect has been expressly recognized in Article 3.1 (e) of Regulation 4087/88 which exempted the obligation of the franchisee

- (e) to sell the goods which are the subject-matter of the franchise only to end users, to other franchisees and to resellers within other channels of distribution supplied by the manufacturer of these goods or with its consent.

3. Selective distribution and franchising in regulation 2790/1999

Regulation 2790/1999 provides no specific rules for franchising contracts.

On the contrary, it provides a number of special rules for selective distribution systems, which are defined as follows in Article 1 (d):

« ... a distribution system where the supplier undertakes to sell the contract goods or services, either directly or indirectly, only to distributors selected on the basis of specified criteria and where these distributors undertake not to sell such goods or services to unauthorised distributors».

These specific rules are the following:

- (a) Article 4, lit. (a), third dash, authorizes:

« ... the restriction of sales to unauthorised distributors by the members of a selective distribution network».

- (b) Article 4, lit. (c) provides that the distributors belonging to a selective distribution network operating at the retail level must be free to make active and passive sales to end-users, except that they may be prohibited from operating out of an unauthorised place of business.
- (c) cross-supplies between distributors within a selective distribution network, including those between distributors operating at different levels of trade, must remain free (Art. 4 (d)).
- (d) the parties may not agree upon any direct or indirect obligation causing the members of a selective distribution system not to sell the brands of particular competing suppliers (Art. 5 (c)).

As regards franchising contracts, the understanding of the European Commission seems to be that these contracts are governed by the rules on exclusive distribution

¹ Court of Justice, 28 January 1986, case 161-84, *Pronuptia de Paris v. Pronuptia de Paris Irmgard Schilligalis*, ECR 1986, 353.

(in case franchisees are free to resell to any trader) and by the rules on selective distribution, in case the franchisees are prohibited from selling to non members of the network.

However, the conclusion is disputable for the following reasons.

First, it is not at all established that a franchising network whose members are prevented from selling to traders not belonging to the network falls under the definition of selective distribution contained in Article 1, lit. (d).

Second, even admitting that the definition of "selective distribution system" can cover franchising systems which prohibit the sale of the products outside the network, it would be inappropriate to apply all the rules on selective distribution to franchising, because by doing so one would deny the substantial differences between these two distribution systems and would go against the basic principles established by the Court of Justice in the Pronuptia case.

We will examine these two issues separately.

3.1 Is franchising covered by the definition of Art. 1 (d) ?

Article 1 (d) defines selective distribution as a distribution system where the supplier undertakes to sell the contract goods or services only to distributors selected on the basis of specified criteria.

This definition is based on the idea that the supplier selects shops that have certain characteristics which the supplier considers necessary for an optimal sale of his products.

Such criteria certainly apply to selective distribution systems, but not to franchising, where there is actually no selection based on "specified criteria".

In a franchising system the franchisor decides to appoint resellers on the basis of criteria relating to the financial standing of the future franchisee, his capacity to reach the objectives expected by the franchisor, his willingness to assume the obligations required by the franchisor (setting up of the shop, payment of an entrance fee and royalties, etc. And, what is more important, these are not objective criteria, specified in advance, because the franchisor, when deciding to conclude a contract with a prospective franchisee, will take a purely subjective and "commercial" decision, similar to that of a supplier who appoints an exclusive distributor.

In other words, the "selection" of the franchisee is based on purely discretionary criteria which are not specified in advance (except that the franchisee must be willing to comply with the franchisor's prescriptions in managing the shop).

It should therefore in principle be excluded that franchising networks, where the franchisor does not fix specified criteria for selecting the outlets which can become part of the network, fall under the definition of "selective distribution". True, they may have in common with selective distribution the prohibition to sell outside the network, but this is not enough for considering franchising as being equivalent to selective distribution as defined in Article 1(d) of Regulation 2790/1999.

This means that the special rules of the block exemption regulation on selective distribution should not automatically apply to "selective" franchising.

This conclusion would at first sight seem to imply that the franchisee's obligation to refrain from selling to traders not belonging to the network is not exempted.

It should however be considered that within franchising agreements such clause need not to be exempted under Article 81(3), because it has already been considered not infringing Article 81(1) in the Pronuptia judgment, where the Court affirmed the lawfulness of

« ... the franchisee's obligation to sell the goods covered by the contract only in premises laid out and decorated according to the franchisor's instructions, which is intended to ensure uniform presentation in conformity with certain requirements»².

Now, if it is lawful to request the franchisee to sell only in a shop "laid out and decorated according to the franchisor's instructions", this necessarily implies that the franchisee cannot sell the products to traders not belonging to the network, who would be able to resell them without observing the requirements set out above.

3.2 In any case, franchising should not be treated in the same way as selective distribution.

If we follow the prevailing interpretation of Regulation 2790/1999 according to which the provisions of the block exemption on selective distribution apply to "selective" franchising systems (i.e. franchising systems where the members of the network are prevented from selling the products to traders not belonging to the network), we must stress that this solution is not appropriate because it does not consider the substantial differences which exist between selective distribution and franchising and does not comply with the principles established by the Court of Justice in the Pronuptia case.

It is true that many franchising networks require their members not to sell outside the network, thus implying a prohibition which is a typical characteristic of selective distribution systems. However, the reasons for requiring that the products are sold only in authorised stores are substantially different in these two situations.

While within selective distribution the reason for this limitation is to warrant that the goods are sold only by retailers having certain characteristics or qualifications, in a franchising system such limitation has the purpose of warranting the uniformity and reputation of a network of shops strongly characterized by the franchisor's trademark and image.

In franchising the driving force of the network is the availability of innovative business methods developed by the franchisor and the uniformity and reputation of the network using these methods and bearing the franchisor's business name or symbol.

In selective distribution a "normal" reseller (who distributes a range of competing goods) is selected because of certain objective characteristics of the point of sale.

These two situations cannot be treated in the same way, simply because both imply the creation of a "closed" network.

Of course, the possible impact on competition of a distribution system which is not accessible to traders not belonging to the network must be taken into consideration

² Pronuptia, § 19.

(e.g. by imposing the freedom of cross-supplies), but this does not mean that the rules established in Regulation 2790/1999 for selective distribution should be applied as such to franchising, without considering the substantial differences between these two distribution systems.

The understandable desire of the Commission to establish uniform rules should not go against the need to set different rules for different situations, where this is objectively justified.

In our opinion only the principle that sales to non members of the network may be prohibited and the corresponding principle of freedom of cross-supplies between members of the franchising network should be applied to franchising.

On the contrary, the rule contained in Article 4(c) which prohibits the restriction of active or passive sales to end-users by members of a selective distribution system operating at the retail trade, should not apply to franchising.

In the context of a franchising system the prohibition of active sales towards the territories of other franchisees should be admitted (according to Article 4 (b), first indent), as it was in the past under Article 2 (d) of Regulation 4087/88 which exempted

- (d) an obligation on the franchisee to refrain, outside the contract territory, from seeking customers for the goods or the services which are the subject-matter of the franchise;

4. The problem of Internet sales

If one follows the idea that in case of "selective" franchising the rules on selective distribution apply, the franchisee should be free to (even actively) promote business through Internet, provided he operates out of his authorized shop.

On the contrary, if one follows the theory that rules on selective distribution cannot apply to franchising, the franchisee could be prohibited to actively promote sales through Internet in the territory of other franchisees.

According to the Commission³, the fact that promotion or sales through Internet may have effects outside one's own territory results from the technology, i.e. the easy access from everywhere and cannot be considered as active sale.

The Commission states in particular the following (§ 51 of the Guidelines):

«If a customer visits the web site of a distributor and contacts the distributor and if such contact leads to a sale, including delivery, then that is considered passive selling. The language used on the website or in the communication plays normally no role in that respect. Insofar as a web site is not specifically targeted at customers primarily inside the territory or customer group exclusively allocated to another distributor, for instance with the use of banners or links in pages of providers specifically available to these exclusively allocated customers, the website is not considered a form of active selling. However, unsolicited e-mails sent to individual customers or specific customer groups are considered active selling.»

There is at present no case law clearly confirming the Commission's view on this issue, which consistently widens the notion of passive sales.

³ Guidelines, § 51.

However, apart from this purely territorial aspect, there is another issue which is of special importance whenever the distributor has to comply with certain conditions regarding the way he promotes and resells the goods.

Here the problem is to decide if and to what extent the supplier may require the observance of certain conditions regarding the use of the Internet or, even, prohibit any sales through the Internet, where this would be inconsistent with the criteria that the reseller has to respect when selling the goods.

In selective distribution, where the reseller has to meet certain conditions regarding mainly the appearance of the shop and the qualifications of his personnel, the anti-trust authorities have taken the view that an outright prohibition of sales through the Internet, even if apparently justified by the aim of warranting an adequate pre-sale service, is a restriction of competition which excludes the selective distribution contract from the benefit of the block exemption. Thus, in a recent case⁴ the French Competition Authority has decided that the prohibition imposed upon the distributors of cosmetic products not to sell through the Internet (but only in the authorised outlet), was a breach of Article 81, although the producer justified the prohibition by the need to provide the customers with the advice of a qualified chemist.

It is important to stress that this approach cannot be automatically extended to franchising systems, where it is necessary to warrant that the business methods developed by the franchisor are fully respected and that the image and reputation of the network are upheld.

In other words, within a franchising system there is the additional need to make sure that the image and reputation of the network are preserved, such reputation being the main reason for the willingness of the franchisees to become part of the network and even to pay for it.

Furthermore, it should be considered that the franchisor develops a "concept" which is previously tested through pilot units. If this concept has been developed for shops and not for Internet websites, there is no way for the franchisee to apply a concept that does not exist. Moreover, the franchisor cannot warrant the effectiveness of his system under conditions he has not considered when developing it.

All this has been recognized by in the Pronuptia judgment, where the Court of Justice affirmed the lawfulness of

« ... the franchisee's obligation to sell the goods covered by the contract only in premises laid out and decorated according to the franchisor's instructions, which is intended to ensure uniform presentation in conformity with certain requirements»⁵.

This implies that within a franchising system the franchisor must retain a much greater freedom in deciding what may be permitted to franchisees who wish to operate through the Internet.

Thus, if the reputation of the network requires that goods are sold only in the franchised shops, the franchisor will be entitled to require that the franchisees refrain from selling on the Internet, while they may be authorized to promote sales - to be carried out in their shop - through the Internet.

⁴ Decision 08-D-25 of 29 October 2008 (*Distribution des produits cosmétiques et d'hygiène corporelle vendus sur conseils pharmaceutiques*).

⁵ Pronuptia, § 19.

And, in more general terms, the franchisor must retain the right to impose upon the franchisees all the limitations and restrictions which are necessary for the preservation of the image of the network.

Of course such limitations must actually be justified, and this will depend upon the circumstances of each case, but it should be stressed that such evaluation cannot be based on the same criteria which apply to a simple selective distribution system.

5. The notion of franchising

It is important to stress that the considerations developed above are based upon the assumption that franchising is defined in such a way as to cover only situations where the franchisee receives secret, substantial and identified know-how, with the exclusion of distribution system based only on the uniform image of the network.

In order to maintain a clear distinction between franchising systems which deserve a "special" treatment and distribution systems which (although sometimes called "franchising") do not justify a derogation from the general rules, we recommend to maintain the definition of know-how contained in Article 1(f).

6. Final conclusions

On the basis of the above considerations the International Distribution Institute submits the following observations and recommendations to the European Commissions in view of the revision of Regulation 2790/1999.

- 6.1 The new regulation (or the guidelines) should make clear that franchising is different from selective distribution and that consequently the rules on selective distribution do not apply to franchising, except where this is expressly stated in the Regulation.
- 6.2 The new regulation (or the guidelines) should specify that the following principles apply to franchising networks which prohibit their members to sell to traders not belonging to the network:
 - the lawfulness of clauses prohibiting the sale to traders not belonging to the network;
 - the lawfulness of the franchisor's obligation to sell only in the franchised shop;
 - the freedom of the members of the network to carry out cross-supplies between members of the network.
- 6.3 The new regulation (or the guidelines) should state that Article 4(d) which restricts passive and active sales to end users does not apply to franchising.
- 6.4 The new regulation (or the guidelines) should state that the need to protect the identity and reputation of a franchising network and to apply the know-how has to be taken into account when deciding the lawfulness of possible restrictions to the use of the Internet by franchisees.

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