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Franchising and the New EU and UK Vertical Block Exemptions

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This GT Alert covers the following:

- The EU and the UK recently brought into force new rules that exempt certain vertical agreements, including franchise agreements
- For the first time, the UK has its own exemption for vertical agreements
- There are several changes and a number of differences between the EU and the UK exemptions that need to be taken into account to ensure that the enforceability of existing franchise agreements continues beyond the end of the transitional period on May 31, 2023

Separate EU and UK rules from June 1, 2022

On June 1, 2022, the EU and the UK brought into force new rules that exempt vertical agreements, including franchise agreements, from the EU and UK prohibitions on anti-competitive agreements contained in Article 101 of the Treaty on the Functioning of the EU (Article 101) and Chapter I of the UK Competition Act 1998 (Chapter I), respectively. This GT Alert sets out the main provisions of these new exemption rules as they apply to franchise agreements.

The EU exemption is contained in a new vertical agreements block exemption regulation (EU VBER); and for the first time, the UK has its own exemption, in a vertical agreement block exemption order (UK VABEO). Both sets of rules are designed to reflect significant changes in consumers' buying preferences and advancements in related technologies, particularly online sales platforms and digital comparison tools. The EU VBER is accompanied by the EU Verticals Guidelines published by the European Commission on June 30, 2022. At the time of writing, the UK Verticals Guidance to accompany the UK exemption is still in draft (the latest draft is dated March 31, 2022).

The EU VBER and the UK VABEO replace the previous EU block exemption regulation, which until it expired on May 31, 2022, applied both in the EU and, having been retained as part of UK law after the UK and EU legal systems became separate as a result of Brexit on Jan. 1, 2021, also in the UK.

Transitional period for agreements concluded before June 1, 2022

Agreements that were entered into before June 1, 2022, and that comply with the previous EU block exemption regulation will remain exempt in both the EU and the UK for one year, but the parties must ensure that their agreements comply with the new rules starting June 1, 2023.

Increased complexity for franchise systems covering the EU and UK

The existence of two separate sets of rules may complicate the drafting and management of franchise arrangements that cover both the EU and UK and that used to rely solely on the previous EU block exemption. The two sets of rules differ in their approach to a number of issues, despite acknowledgement by the UK regulator, the Competition and Markets Authority (CMA), of the need to limit the extent of UK divergence from the EU rules in order to avoid creating legal uncertainty. In addition, the UK exemption will expire at the end of May 31, 2028, six years before the expiry of the EU exemption at the end of May 31, 2034.

These factors have led a number of franchisors to consider separate agreements for the EU and UK; however, the need for this will depend on the nature of the franchise arrangements in question.

Overview – application of EU and UK competition law to franchise agreements

By way of overview, franchise agreements may infringe the EU and UK competition law prohibitions on anti-competitive agreements where they are found to have the object or effect of significantly restricting competition and trade in the EU and UK, respectively, and do not qualify for exemption, either under the EU and/or UK block exemptions, or because they can be individually justified, by applying the general exemption criteria in Article 101(1) and (3) and/or Chapter I. The block exemptions essentially codify decided cases and guidance from the European Commission and the CMA on the application of the general exemption criteria to particular types of agreements. These criteria are that the agreement must contribute to improving the production or distribution of goods or promoting technical or economic progress while allowing consumers a fair share of the resulting benefit and that the restrictions in the agreement must be indispensable to attaining these objectives and must not enable the parties to the agreement to eliminate competition in respect of a substantial part of the products or services concerned.

Not all restrictions in franchise agreements are anti-competitive. Examples of permissible restrictions are restrictions on conduct that may damage the franchisor’s reputation or compromise the confidentiality of the franchisor’s intellectual property rights, including know-how. These types of restrictions are not treated as limiting competition.

On the other hand, franchise agreements may infringe the EU and UK prohibitions if, for example, they contain restrictions on online sales or on resale pricing, or prohibit sales outside a particular territory, or impose non-competes that are broad in scope. In addition, franchise systems that operate as dual distribution systems, in which the franchisor and franchisee both compete in the supply of products or services to customers in the same markets, may result in exchanges of competitively sensitive information between the franchisor and the franchisee, compromising the competitive

independence each is required by EU and UK competition law to maintain from the other.

An agreement that contains infringing restrictions and does not qualify for individual or block exemption may be treated as void and unenforceable, the parties to it may be fined and sued for damages, and under the UK rules and those of a number of EU Member States there may also be serious consequences for individual directors and employees involved in setting up and implementing the agreement.

It should be noted that in principle, the EU and UK prohibitions do not apply to any arrangements, including franchise arrangements unless those arrangements have a *significant – i.e.*, an "appreciable" – effect on competition and trade. However, it is not generally safe to rely on this exception without further analysis, especially where there are plans to expand the franchise.

Safe harbour

The EU VBER and the UK VABEO are designed to provide a safe harbour for categories of vertical agreements, including franchise agreements, that contain restrictions on competition but that also meet the conditions for exemption.

Set out below is a summary of the main conditions in the EU VBER and the UK VABEO that apply to franchise agreements, together with the principal similarities and differences between the EU and UK rules.

- **Franchise arrangements with actual or potential competitors – dual distribution and information exchanges**: The categories of franchise arrangements that are covered by both exemptions have been extended. The exemptions now apply to dual distribution systems, including where franchisors sell on the same wholesale and import, as well as retail, markets as their franchisees, but only if
    - the arrangements are non-reciprocal and,
    - in summary, the franchisor and franchisee do not compete with each at the upstream level at which the franchisee buys from the franchisor.

However, the flow of information between the franchisor and franchisee is now restricted in the context of dual distribution, *i.e*., where both parties sell the franchise goods and services on the same downstream markets. The approach of both exemptions is the same. The EU exemption protects, in principle, only those exchanges of information that are "(…) *directly related to the implementation of the [franchise] agreement* (…)" and "(…) *are necessary to improve the production or distribution of the [franchise] goods or services* (…)" (EU Verticals Guidelines, *e.g*., at para. 96). The UK exemption has the same effect. To avoid the risk of collusion between franchisor and franchisee on the downstream markets on which they compete, both exemptions do not protect franchise arrangements that permit, or result in, disclosures between franchisor and franchisee of competitively sensitive information, for example, resale prices and customer-specific data. This may be a particular issue for franchisors who, for example, rely on detailed sales data for monitoring and planning purposes, and specific customer data for marketing, auditing, and loyalty scheme purposes. Both the EU Verticals Guidelines and the UK Verticals Guidance provide non-exhaustive lists of the types of information that may and may not be exchanged to preserve exemption, and they recommend measures that the

parties can implement to manage risks. Care will now be required to ensure that where a franchisor wishes to access a franchisee's information in relation to markets on which they both compete, that information is "(…) *necessary to improve the production or distribution of the [franchise] goods or services* (…)" (EU Verticals Guidelines, *e.g.*, at para. 98).

Under the EU VBER, the dual distribution exemption does not apply to platforms, where suppliers of platform/online intermediation services also sell the same products as those sold by their platform/intermediation customers. This may affect franchisors offering online services.

- **Market share**: The EU and UK exemptions continue the principle of the previous EU exemption and apply only where:
    - the franchisor has a share of 30% or less by value of the market on which it sells the products or services that are the subject-matter of the franchise agreement, and
    - the franchisee has a share of 30% or less by value of the market on which it buys the products or services that are the subject-matter of the franchise agreement.

There are detailed rules for calculation of market shares. An agreement may continue to benefit from exemption for a short period where a party's market share has been 30% or less from the start of the agreement and subsequently rises above this level. It should be noted that, where the market shares of the parties to a franchise agreement exceed 30%, the agreement does not automatically infringe EU or UK competition law and should be assessed for individual exemption.

- **Hardcore restrictions**: The EU and UK exemptions will not apply where the franchise agreement contains so-called "hardcore" restrictions. The types of restriction treated as hardcore are broadly the same in each exemption, and these should be avoided not only in franchise agreements themselves, but also in all other dealings with franchisees. They are as follows.
    - ***Resale price maintenance (RPM)***: A franchisor may not engage in RPM, i.e., direct its franchisees to resell or advertise the franchise goods or services at a specified or minimum price, nor may it incentivise or put pressure on, franchisees to do so. However, it may impose a maximum price and recommend a sale price. RPM is by far the greatest focus of enforcement action by the EU, UK, and national competition authorities in the context of vertical agreements.
    - ***Territorial restrictions***: A franchisor may not restrict the territory into which, or the customers to whom, a franchisee may make active or passive sales, unless the restrictions relate to franchise arrangements that involve the allocation of exclusive territories or customer groups or selective distribution and they meet the conditions in the EU VBER and the UK VABEO, respectively. In a change from the previous EU exemption, the EU VBER permits up to five exclusive distributors per territory / customer group, whilst the UK VABEO is less prescriptive and refers to "*one or a limited number*" of exclusive distributors (UK Verticals Guidance, at para. 10.57). The EU VBER and the EU Verticals Guidelines contain more detailed guidance than the previous EU exemption on the meaning of active and passive sales and examples of restrictions that will be treated as hardcore.

- ***Internet sales***: A franchisor may not prevent a franchisee from making effective use of the internet to make sales. However, in a softening of approach since the previous EU exemption, both the EU and UK exemptions permit other restrictions on online sales (e.g., use of specific online marketplaces or price comparison tools) and may restrict online advertising, as long this restriction does not prevent the franchisee "(…) *from using an entire online advertising channel* (…)" (EU Verticals Guidelines, at para. 206).

Discrimination between online and offline sales no longer hardcore: In a further change from the previous EU exemption, online sellers no longer benefit from preferential treatment under the EU and UK exemptions. It is now not a hardcore restriction for a franchisor to charge different prices or impose different obligations depending on whether the franchisee is selling online or offline, as long as the objective is to reward or incentivise investment and use of the internet is not restricted.

Parity – difference in treatment as hardcore: Finally, the EU VBER and the UK VABEO differ in their approach to parity / most favoured nation obligations. In both cases, there is a change from the permissive approach in the previous EU exemption. Under the UK VABEO, a wide retail parity obligation, requiring a franchisee not to offer its goods or services to end users at better prices or on better terms through another channel (online or offline), is a hardcore restriction and the agreement loses the benefit of the block exemption. Under the EU VBER, however, there is a stricter approach only to across-platform parity provisions that restrict a buyer of online intermediation services from selling to end users on more favourable terms through a competing platform. These provisions are not protected by the EU exemption, but their existence in the agreement does not lift the exemption from the rest of the agreement, so that they need to be assessed for individual exemption. Under both the EU and UK exemptions, other parity obligations are exempt.

- **Non-competes**: As before, certain non-compete provisions in franchise agreements are excluded from the protection afforded by the exemptions, but if a franchise agreement contains an excluded non-compete, that agreement as a whole will not lose the benefit of the EU or UK exemption unless the non-compete cannot be severed from the agreement. In general, in-term non-competes should be for no more than 5 years and no longer than 1 year for permitted post-term non-competes (relating to the supply of products and services that compete with the franchise products and services from the premises/land from which the franchisee operated). In particular, the EU Vertical Guidelines acknowledge the specific characteristics of franchising and the need to maintain the common identity and reputation of the franchise network, so will protect non-compete obligations relating to the goods or services purchased by a franchisee that apply for the entire duration of the franchise agreement.

- **Withdrawal**: The benefit of the EU and UK exemptions can be withdrawn from agreements that are found to have a restrictive effect on competition notwithstanding the fact that they comply with the terms of the relevant exemption.

- **Provision of information to the regulator**: The UK VABEO empowers the CMA to obtain information on vertical agreements for the purposes of assessing their compatibility with the UK block exemption. The VABEO specifies that the information must be supplied within 10 days. There is no similar, specific power in the EU VBER, but the European Commission has other information-gathering powers it can use.

- **Duration**: The duration of the exemptions differs. The EU VBER will expire on May 31, 2034; the UK VABEO will expire six years earlier, on May 31, 2028.

Conclusion and checklist

While the structure and principles of the previous EU exemption have been carried over to the new EU and UK exemptions, there are several changes and a number of differences between the two exemptions that should be taken into account to ensure that the enforceability of existing franchise agreements continues beyond the end of the transitional period on May 31, 2023.

For both existing and new agreements, here is a checklist of the principal questions to consider:

1. Is it appropriate for this franchise system to be based on separate agreements for the EU and UK? If not, how should the different durations of the EU and UK exemptions and the differences between the two exemptions be managed?
2. Is the franchisee an actual or potential competitor at the level at which it buys the franchise goods/services?
3. If the franchisee is an actual or potential competitor at any level, is the agreement part of a reciprocal arrangement? Will the block exemptions apply?
4. If the franchisor and franchisee both sell the franchise goods or services at import, wholesale, or retail level, how can the franchisor justify having access to competitively sensitive information belonging to franchisees and what measures can be put in place to protect this information from over-disclosure to/inappropriate use by the franchisor?
5. Are the market shares of the franchisor and franchisee 30% or less? If not, the arrangements will need to be self-assessed for individual exemption.
6. Does the agreement contain any hardcore restrictions? If so, the

	block exemption will not apply, and it may be difficult to meet the conditions for individual exemption.
7.	Is the duration of any *in-term* non-compete indefinite or for longer than five years? Or is a permitted *post-term* non-compete for longer than one year? If so, is it severable from the remainder of the agreement so that the exemption may be preserved?

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