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"Business Format" Franchising and EEC Competition Law

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"A critical analysis of the European Court of Justice's and the Commission's treatment of franchising contracts and what it can tell us about the aims and purposes of EEC competition law."

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PART I

1. Introduction

Franchising, having originated in the United States of America, is now flourishing and spreading all over Europe today. You can buy an ice-cream or a pet dog - or you can have your car rust-proofed or your suit dry-cleaned, all at franchise outlets. Businessmen apparently love this new marketing technique, and consumers buy enthusiastically in response to it.

However, this happy scenario was from its beginning under the shadow of European national competition laws and EEC competition law itself. These legal systems had the potential to rule that franchising arrangements, or some aspects of them, were anti-competitive - whatever that may mean - and so illegal. As it happens, perhaps surprisingly, before any national court or legislature has ruled specifically on this question, the EEC Commission and European Court of Justice have become involved not only in making decisions in individual cases, but also in laying down general rules in this new and difficult area. So far there

have been the ruling by the European Court in Pronuptia[1], five individual exemptions[2] under a.85(3) of the EEC Treaty, and a block exemption[3] enacted by the Commission.

These developing rules sometimes restrict the freedom of franchisors and franchisees to make the kind of contract with the kind of clauses that they would otherwise have chosen to use. Businessmen, and in particular franchisors, have their own reasons for establishing franchise networks in the ways that they have hitherto chosen, and it is my intention to analyse the approach of the Commission and the Court - as evidenced by the judgment and exemptions mentioned above - to franchising, with particular reference to the aims and purposes behind their decisions.

The treatment of franchising displays a substantial departure from the usual rules applied by the EEC authorities to vertical restraints and distribution systems: therefore the results of the examination should be of interest and value not only for the insights which they provide into EEC franchising law, but also for their wider relevance to the development of EEC law on vertical restraints and competition law generally.

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1. [1986] ECR 353.
2. Yves Rocher OJ 1987 L8/49; Pronuptia OJ 1987 L13/39; Computerland OJ 1987 L222/12; Servicemaster OJ 1988 L332/28; Charles Jourdan OJ 1989 L35/31.
3. OJ 1988 L359/46.

2. Research questions to be studied

Part II of this paper will describe the phenomenon of franchising itself, and its success, and suggest possible reasons for its commercial popularity.

In Part III the different ways in which competition law can apply to franchising are discussed. The starting point is a consideration of the various aims and objectives that may be pursued by competition policy, and this leads to a discussion in each case of the choices that these motives imply for law-making. The list of possible objectives includes economic efficiency, and much of Chapter 8 is devoted to economic analysis of franchising. In this way, different approaches that it is open to the authorities responsible for competition policy to take towards franchise contracts are outlined. Finally, particular reference is made to the possibilities allowed by the framework that exists in the EEC context.

Part IV is a description of EEC competition law on franchising as it has developed so far. Pronuptia, the only EEC jurisprudence as yet on franchising, and the individual exemptions and recently enacted block exemption of the Commission, will be analysed. Emphasis will be laid on aspects of these which are relevant to a discussion of the motivation behind the policy choices, for the most part implicit, inevitably made by the Court and the Commission in their decisions.

Part V draws together the previous two parts in an attempt to suggest what may be the reasons behind the rather special

treatment that has been accorded to franchise contracts by the EEC authorities. The policy choices made are discussed in the light of the possible objectives of competition law discussed previously, and an effort made to connect various aspects of the Court's and the Commission's approach with these different aims. In this way it is possible, finally, to draw some conclusions about the relative importance of different objectives pursued and the way in which the resolution of conflicts between them has affected the development of European competition law policy on franchising and may continue to affect it in the future.

PART II

3. What is "business format" franchising ?

This is simply the term given to the kind of franchising with which I am dealing in my research[4]: that is, a particular method of distributing a product, whether that product be goods or services. It is to be distinguished from "industrial" franchising, which involves the communication of methods of production and is regarded by the EEC authorities rather as a question of intellectual property or know-how law than as franchising. Business format franchising is typified by the networks of retail outlets under names such as "Benetton" and "MacDonalds" but it is by no means confined to the clothes and fast-food industries. It has been applied, for example, to markets as diverse as hairdressing and the sale of computers.

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4. Although it is not possible convincingly to draw a line between franchising and various other distribution methods, the EEC authorities have chosen to put what they call "business format" franchising into a distinct pigeonhole and to give it a separate block exemption and so it is convenient for me to deal with these contracts on that basis. My text explains franchising in simplistic terms, ignoring for the moment that it will often be very difficult to say whether a particular contract falls within the category "franchise" or not.

Rather than attempting to give a technical, legal definition of franchising, I propose to explain the concept by means of an example:

4. How does it work ?

First, imagine a simple scenario[5]: you are a manufacturer of bridal outfits and accessories and your production business is successful and expanding. You already have a few retail outlets from which you sell your products to the public, and in these shops you have succeeded in developing an attractive and distinctive image: this is based on the names used on the shops and on the products, probably including intellectual property such as trademarks and tradenames, as well as the characteristic way in which your outlets are decorated and equipped. All of this has produced a reputation for good value and quality, signalled to the consumer when he sees one of these distinctive shops. You have in addition built up a considerable body of commercial know-how and business acumen which enables you to exploit the market for wedding dresses and accessories very efficiently.

Since your rate of production is increasing, you would like to expand your capacity to distribute the products, at first within your own country but later maybe even to other countries.

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5. The following facts are approximately those of the case Pronuptia, to be discussed infra.

You have essentially a choice of three different ways of doing this:

(a) You may yourself buy a number of further retailing sites in your chosen areas, and so set up many more shops on the model of the original ones. The people working in these new shops will, as in the old ones, be your employees and the shops can be run precisely in the way that you direct.

However, "vertical integration", as this method of business expansion is termed, has the major disadvantage that you yourself must not only provide the necessary capital investment required, but you must also shoulder the financial risk of any or all of these new outlets failing. You may not have access to the sums required, or you may simply be unwilling to take such a risk; alternatively, you may not wish to incur the considerable responsibilities of monitoring that arise when you have many employees working for you[6].

(b) You may conclude simple distribution contracts (with or without devices such as exclusive distribution or exclusive purchase clauses or a selective distribution network) with independent retailers, who buy bridal gowns and accessories from you in order to sell them to the public from their own shops. In this case, each contract amounts to little more than a contract of sale between you and the retailer.

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6. Rubin P.H., in The Theory of the Firm and the Structure of the Franchise Contract 21 Journal of Law and Economics 223 (1978), has argued that borrowing on capital markets should be cheaper than franchising, and that the real reasons that rational businessmen choose franchising must be sought elsewhere.

In this way, you avoid the disadvantages of vertical integration, but there are other, serious drawbacks. Not only do your products no longer benefit from your commercial expertise, your distinctive decor and the associated image and reputation that you have built up, but the latter may even be damaged if your goods are sold in "cheap" surroundings or alongside shoddy goods of noticeably lower quality than your own.

(c) You may set up a franchising network. This is an alternative method of expanding your distribution which can be seen as lying midway between vertical integration and simple distribution contracts, and it can enable you to avoid many of the drawbacks associated with the two previous alternatives.

In a franchising network, the distributors remain financially and legally independent from you, the manufacturer - now the "franchisor" - but the contracts concluded by you with each independent distributor - now a "franchisee" - are not the simple contracts of sale described in (b) above, but are considerably more complex arrangements. The following is an example of the kind of set-up you might agree on:

Say that you marketed your goods under the trademark - by now well-known - of "Pronuptia". You might contract to allow a franchisee not only to use this trademark in a particular area to sell your products, but to be the exclusive dealer in your goods in that area. In other words, he could put all his efforts - including his local knowledge of that area - into promoting your goods and enhancing their reputation, without fearing that an identical shop might open next door to his, and "free-ride" on his promotional work and sell the same products at a lower price. (The free-rider would be able to afford to charge lower prices as he

would not be required to incur the same promotional expenses as your franchisee would be.)

In addition, you would promise to provide commercial assistance to the franchisee in advertising, staff-training, shop lay-out, marketing and inventory selection and control, since you are an expert in these matters and your new franchisee may know little or nothing about such things. He may be, for example, a person who has never run a business before but needs a new job and has a few thousand pounds' redundancy money to spend.

What will you, the franchisor, require in return ? You will probably ask for an initial lump sum plus a percentage of profits made by the business. Also, it is essential that you restrict the use which may be made of the intellectual property rights and know-how that you transfer, or they might be used to promote goods other than your own. You will want to ensure that the requisite standard of presentation of goods and premises is maintained and you may wish to retain considerable control over matters such as retailing prices, advertising and the quality and quantities of goods of other manufacturers which may be sold in the shop alongside your own goods.

The situation can of course be much more complicated: another level of distribution may be inserted - that is, sale by the manufacturer via wholesalers to the retailers - or the franchisor's original business may be not simply one of production, but also perhaps of selection for sale of other people's products, or the provision of certain services. However, the foregoing should make clear the concept with which we are dealing.

5. How popular is it ?[7]

This third alternative, that of the franchise network, is rapidly gaining popularity all over Europe.

Franchising as a method of doing business , hardly surprisingly, originated in the United States of America at the beginning of the 1900's and has only in recent years begun to have a real impact all over the territory of the EEC, having become widespread first in France and, soon after, in the United Kingdom and Germany.

Between 30 and 40% of all retail trade in the United States takes place through franchise outlets: these are clearly a very major part of life for every consumer and for a large number of businesses over there. Already well-established in the seventies, franchising has probably now reached a more or less stable presence in the market.

In Europe the franchising phenomenon apparently has some way to go before it reaches its peak, since in many countries it is only now that the business world is waking up to the potential of franchise networks. Franchising was introduced first to France, and it is there that it is the most widespread, there being around 500 franchisors and 25 000 franchisees in the market. In England, too, it has been very successful: in 1986 there were about 440 franchisors and 20 000 franchisees. The Federal Republic currently

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7. The information in this chapter was taken from the three newspapers listed in the bibliography. Further statistics are given by the Advocate General in his opinion in Pronuptia.

enjoys third place in terms of numbers: however, there is clearly some way to go before the full impact of the phenomenon is felt.

In Italy, 1988 has been referred to as "l'anno del franchising": although there are already over 200 franchisors and more than 10 000 franchisees, the Italians, currently fourth in the European "listing", expect soon to forge ahead. For example, "Peperino" plan to open 200 shops selling children's clothes in the next three years, and 300 outlets marketing "Coca-Cola" clothes will also be appearing. These will join the franchises already in Italy: these include such diverse businesses as "Benetton", "Cacherel", "Armani", "Europcar", "Hertz", "Burgy", "Quick", "Alessi" and "The British School".

6. Why is it so popular ?

Some of the advantages to the franchisor of a franchise network in terms of investment capital required and risks borne have already been mentioned. This in turn means that business expansion can take place much more rapidly than it otherwise could. Also, the franchisee is self-employed: he is thus directly rewarded for the success or otherwise of his shop and by the profits he makes in consequence. So a franchisee may be expected to put in more effort and more hours than an employee who is on a more or less fixed salary. Related to this is the reduction in monitoring and management costs associated with the running of the network compared with those involved in a vertically integrated

organisation[8]: perhaps it also explains why franchising is a marketing formula which is particularly common in sectors such as the fast food industry, which are notorious for the difficulty which they have in keeping staff for any length of time. Another advantage for the franchisor is that he is not subject to employee protection legislation in his dealings with his franchisees.

Further, the franchisor's products continue to be sold under his distinctive name and outlet appearance, thus enhancing still further his reputation, whilst he retains sufficient control to ensure that this reputation does not suffer. Similarly, business know-how and expertise which he has acquired continue to be put to use to the benefit of his product, and yet clauses in the contract ensure that it is not abused in any way.

Another aspect of the appeal of this method must be the existence of the modern media of communication, in particular television, which enable a brand name or image to be advertised and therefore made well-known over a very wide area in a very short space of time. Similarly, increased ease of travel means that there are many consumers, abroad or away from home, who are looking for a signal that they can recognise and rely on.

For the franchisee, a franchise often offers, to a person who might not otherwise have sufficient knowledge and experience in any market to be able to consider setting up on his own, the opportunity to run an independent business. With the continuing help of the franchisor, and the benefit of a name with an already established reputation, he may be able to do so.

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8. See Rubin P.H. loc.cit. at note 6.

The consumer, too, apparently likes franchising: it would appear that the more he travels the world, the more conservative he becomes in his eating and purchasing habits, and the more relieved he is to find a commercial name that he knows. For obvious reasons, the outstanding characteristic of outlets of a franchising network is their uniformity, both in outward appearance and in the type and quality of goods or services provided: whether you buy a MacDonalds cheeseburger in Milan, in Marseilles - or in Miami - not only will the burger taste exactly the same in each place, but you will be served by people wearing identical paper hats in each place, and the design on your paper napkin will probably be the same. This is because these are the kind of details that are laid down in the franchise contract - with the precise aim of preserving that startling uniformity. Judging by the commercial success of franchising as a distribution method, the public clearly very often chooses to enjoy the safety of the devil he knows.

Its success is also almost certainly linked with the modern obsession with and weakness for an "image": once the correct (from the trader's point of view) associations have been made with the franchisor's name or symbol in the consumer's mind, the consumer will often continue to respond positively to the signal given out by the image. This may continue to a certain extent regardless of a change or even a drop in quality.

So much for the attractions for franchisors, franchisees and consumers of franchising: I will be considering later the views of lawyers and economists on the subject, but I will then be confining myself to the realm of EEC competition law.

7. What are the legal issues arising ?

Before turning to competitition law I intend to mention briefly some of the many different legal problems posed by franchising. However, I do not intend to do more than name them. My purpose is merely to signal their existence, lest this narrowly-focused examination of the application of article 85 of the Treaty of Rome were to give the erroneous impression that franchising law is only a part of competition law and does not have other important aspects to it.

For example, consumer groups may be concerned about the spread of franchising for reasons unrelated to competition[9] in the market[10]: although the consumer seems to like it, it may hold hidden dangers. For that very uniformity which appeals to him so much may create the impression that he is dealing with an enormous and stable enterprise. In reality, he may in fact be dealing only with a small outlet on the verge of closing down, and, although it would not normally be in the interests of the franchisor to abandon the disappointed customer, the legal independence of the franchisee from the franchisor could create considerable - if not

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9. Article 85(3) refers to consumers getting a "fair share" of the benefits of agreements exempted under it. For this reason Mr. Peter Sutherland (then Director-General of the Commission's Competition Directorate) said at the 27th Annual Convention of the International Franchise Association that, "...the interests of consumers must also be taken into account in assessing the possibility of an [block] exemption." However, I am concerned here only with relations between franchisors and their franchisees and not with that between franchisees and their customers.

10. For more details of consumer concerns see e.g. the BEUC report Ref.178/86 Franchising, Advantages and Disadvantages for Consumers(1986).

insurmountable - difficulties in the way of holding the franchisor responsible for any loss or damage suffered[11]; linked to this issue are, for example, the questions whether franchisees should be obliged to take out civil liability insurance or whether consumers should have a legal right to redress that could be enforced against the franchisor.

Similarly, it may be seen as important that franchisees are not led, by a lack of information or even by misinformation, into taking on franchises that they have little hope of running successfully: in the United States of America there is detailed Federal legislation[12] imposing heavy duties of disclosure on franchisors, with rules similar to those found in investor protection legislation. Or there may be "unfair" terms in the contract[13]; also there may be a need for particular protection of employees of franchisees if a franchise is liable to be terminated at very short notice for non-observance by the franchisee of certain clauses of his complicated contract with the franchisor.

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11. A case illustrative of the problem is that of the actions brought in France in respect of the franchise "Maisons LARA" which involved the building of pre-fabricated houses. It is descibed in the BEUC report mentioned in note 10.

12. See Sutherland M.S. The Risks and Exposures Associated with Franchise Noncompliance 42 The Business Lawyer 369 (1987) for an idea of the burden that this places on franchisors; see also the address mentioned in note 9: "...in Europe such a "Full Disclosure Act" does not exist yet in spite of the fact that there have been instances of some people being recruited by unscrupulous franchisors for doubtful business activities. We know these problems too, but competition policy cannot solve everything"(my underlining).

13. For an explanation of the "fairness" of, for example, strict termination clauses, in terms of the transaction costs of monitoring and limited information see Klein B. Transaction Cost Determinants of "Unfair" Contractual Arrangements 70 American Economic Association 356 (1980).

Questions of intellectual property law and know-how law are involved too, of course.

All I wish to make clear here is that all sorts of areas of law are relevant to franchising and that the restrictive effects of clauses in franchising contracts on competition and the impact of competition law on franchising is but one of these areas.

PART III

8. Is franchising anti-competitive ?

In competition law terms, franchising involves what are called vertical restraints (that is, restraints imposed between economic operators at different stages in production such as a manufacturer and a retailer, as opposed to "horizontal restraints" such as those that might be concluded between two manufacturers or between two retailers), of which it is possible to take some very different views. This is illustrated no less by current controversies than by legal history, both of which will be discussed in this chapter.

It is more or less agreed by the Member States of the EEC that "competition" - whatever that may mean - needs to be regulated at least to a minimal extent: in other words, Adam Smith's "invisible hand" cannot be relied upon alone to preserve competition in the market place. The very concept of the competitive process itself involves the paradox that, unless contolled, it can and will eventually destroy itself.

However, there is much diversity within the different legal systems of Member States: Italy does not yet have any competition law as such, for example, although there are plans to introduce some soon, whereas the United Kingdom and Germany have well-developed but quite different laws. The EEC has its own original system which I shall be looking at in detail later.

Of course, all commercial contracts are anti-competitive in one sense: if A concludes a contract to buy some raw materials from B then there is no longer any opportunity for A to satisfy his needs

from supplier C - even if he later discovers that he can do so twice as cheaply as he could do from B. So not only is A prevented from obtaining his raw materials at the cheapest price offered, but C is prevented from making a sale to A, although he is offering better value than B. And yet without such contracts there would not only be no restrictions on competition - but there would be no trade at all as we know it. On the other hand, there is little argument that an agreement between all the manufacturers of cars to maintain their prices at a very high level, relying on the fact that people would have to continue to buy their product, is not healthy for the economy as a whole and should be discouraged. The problem comes, of course, when we try to draw the line between these two extremes, or, in other words, to define the "competition" that is to be protected by the law.

There is no doubt that franchise contracts restrain (usually, both parties'[14]) freedom to trade in the market exactly as they choose. For example, the franchisor may bind himself not to compete with his franchisee in that franchisee's exclusive territory, and the franchisee may be restrained from buying the goods to sell in his shop more cheaply from other manufacturers. Third parties' opportunities to compete are also reduced, since terms in the contract may prevent competing manufacturers from supplying the franchisee and competing retailers from obtaining the franchisor's goods to sell in the franchisee's area. Thus competition is restrained not only as between parties to the contract, but also with respect to third parties.

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14. Although in the United Kingdom franchise contracts are often drafted so as to impose obligations on one party only, since this is one way of escaping the application of the requirements of the Restrictive Trade Practices Act 1976.

Despite the general agreement over the need for protection of "competition", however, what has not been by any means universally accepted or agreed upon is the exact meaning of "competition" or the precise aims or purposes of these rules.

There is no standard definition of the "competition" that we are trying to preserve by means of competition law, and it is not my intention to suggest one: the problem of definition is a relatively abstract one and I intend rather to concentrate on the question of the aims of competition policy.

Further, one must be aware of the existence of different kinds of competition: some kinds of restriction may increase, say, interbrand competition (that is, competition between products of different brands) at the expense of a loss in intrabrand competition (competition between products of the same brand[15]). The relative importance of inter- and intrabrand competition are controversial issues in some fora, in particular in the EEC institutions. This means that one answer to those who complain that competition between franchisees is being eliminated by restrictive clauses in franchising contracts is to say that, although intrabrand competition is diminished, interbrand competition increases, and the overall result is no net loss of competition in the market as a whole. However, this willingness to sacrifice the one form of competition for the other may be suspect in so far as competition cannot be quantified and so it is hard to be confident that we are gaining at least "as much" as we lose.

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15. In the context of franchising the reference to "brand" must be understood as referring to products sold under a particular franchise.

As far as the object of competition law is concerned, I wish to signal a few of the possible differences of opinion that may arise. This is the main focus of this paper, since it is not possible intelligently to discuss alternative solutions to the problem of how competition law is to treat franchising before we have at least considered the logically anterior question of the aims and purposes of that law. After making explicit the choice of one or more aims, it is possible then to go on to see what policy it or they lead us to pursue.

All sorts of goals and interests apart from pure economic efficiency may be envisaged: consumer interests[16], the populist desire for protection of the small independent businessman, or some special project such as the EEC's political aim of market integration are some of the other most important goals that are often claimed for competition law. Market integration, in particular, is often cited by the European Commission and the Court of Justice in answer to arguments of apparently unassailable economic reasoning. Although these are social or political aims, with no basis or rational explanation in strict economic terms, their importance must not be underestimated, particularly in the EEC, where they are a strong guiding influence in competition law decisions, both for the Commission and for the Court of Justice.

In order to understand the nature of, and so to seek a solution to, the differences of opinion that arise in discussing and

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16. Consumer interests are by no means completely congruent with considerations of pure economic efficiency, for they include, for example, the interest of the consumer in realising that he is dealing with an independent franchisee and appreciating the consequences of this fact. However, the technical term "consumer welfare" is used by many writers as a synonym for economic efficiency, which is to my mind confusing.

criticising competition policy and "anti-competitive" behaviour in the context of vertical restraints in general and franchising contracts in particular, these various possibilities must always be kept in mind.

Before examining the particular case of the way in which the European Community's legal system treats franchising, I intend to conduct a short survey of the attitudes that have in the past been taken to franchising contracts and other contracts involving vertical restraints. I shall be drawing almost exclusively on literature and jurisprudence relating to the law of the United States of America, although I will also be referring, to a limited extent, to EEC sources.

American sources are referred to at some length, not so much because of the concrete similarities that exist between American and EEC competition law, although there are many parallels to be drawn. The main reason is rather that the equivalent law and hence debate in the EEC setting and indeed in that of the individual Member States is not well-developed enough, nor is the reasoning of its jurisprudence explicit or apparently sophisticated enough alone to furnish us with sufficient ideas and material on which to base discussion. The European Court of Justice tends to state its position rather cryptically in comparison with the kind of arguments that we find set out in judgments from the United States. So the American experience of coming to terms with the different aims claimed for antitrust[17] law is instructive, and its literature and jurisprudence on the question of the place that economic analysis should play in judicial decision-making are especially rich and abundant.

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17. "Antitrust" law is simply American for competitition law.

In this context it is particularly instructive to observe the debate - judicial no less than doctrinal - now almost one hundred years old, that has been going on in the United States over the question of what the purpose or aims of their competition law - embodied principally in the Sherman Act - are. The way in which it has been applied to vertical restraints in general[18] and to franchise contracts in particular is very interesting an merits description here.[19]

As mentioned earlier, the question of whether and how competition is harmed by franchising contracts conceals the much more fundamental question of what the aims of competition law are: since "competition" is not in the law of the United States or of the EEC or anywhere else defined, it is therefore uncertain exactly what we are protecting and we are led inevitably to pursue consciously or unconciously, explicitly or implicitly particular goals rather than others. The purpose of what follows is to look at the various aims that have been put forward in the name of competition and of franchising. The different views themselves will be considered, as will their implications for the attitude to be taken to franchising. This is in order that we may later be better able to assess the solution for franchising adopted in the EEC:

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18. Rather than treating them as a separate category of contracts, the American approach has tended to be to apply to franchise contracts the same general principles that apply to all vertical restraints: it is for this reason that the discussion will often refer to vertical restraints instead of confining itself always to franchising.

19. In summarising the following developments I have drawn heavily on an excellent article by Popofsky L. and Bomse S.V.: From Sylvania to Monsanto: No Longer a Free Ride 1985 Antitrust Bulletin 67.

(i) The traditional approach and "populist" claims

The freedom of franchisors to make the contracts they wanted was, for a time, threatened by what is sometimes described in the USA as a "populist" philosophy of competition policy. This is often contrasted with - or even presented as the antithesis of - the goal of economic efficiency. According to this ethic the freedom of the individual businessman - the franchisee, for our purposes - is of paramount importance. In other words, "freedom of competition" is equated with the freedom of the individual trader independently to determine his own commercial strategy.

This idea is closely bound up with the traditional American fear and dislike of excessive concentration of economic power and its consequences such as increased government intervention and powerful political lobbying by big business. Only the older jurisprudence would support the view that smallness for its own sake should be protected by antitrust laws, and the point made by most modern adherents[20] to this "school" is rather that the existence of the competition process should not be sacrificed to the blind pursuit of the greatest output for the lowest price.[21]

With reference to my example, members of this school in the past would have argued that it should be a function of competition law

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20. e.g. Pitofsky R. The Political Content of Antitrust 127 University of Pennsylvania Law Review 1051 at 1058 where he states explicitly that amongst the various goals that he considers should be pursued he does not number smallness for its own sake.
21. e.g. Elzinga K.G. The Goals of Antitrust: other than Competition and Efficiency, what else counts? 125 University of Pennsylvania Law Review 1191.

to preserve the freedom of the many retailers to decide upon their own market strategy for selling wedding dresses and not to be controlled by a single, powerful franchisor. This view, admittedly at the extreme end of the spectrum in current American terms, tending as it does, to the preservation of the small trader's independence, has played a crucial role in the development of American treatment of vertical restraints and is prominent in recent EEC policy.

The Sherman Act 1890 is the cornerstone of American antitrust legislation and it, like article 85 of the Treaty of Rome, is couched in very broad and general terms: it pronounces a blanket condemnation of "...every contract, combination...or conspiracy in restraint of trade or commerce...". Thus judges were left with a wide discretion to interpret the Act as they saw fit. This led over the years to what Gellhorn calls "a kaleidoscope of reactions...including confusion, hostility, expansive application and skepticism"[22]. In the first years, it was interpreted ridiculously broadly and literally, but soon the judges began to search for a more reasonable interpretation of the prohibition.

If we examine the case-law for the seventy years after its introduction it is immediately striking that there is little reference to the notion of searching for the economically most efficient interpretation of the law. The dominant theme is the political - rather than economic - aim described by Popofsky and Bomse as that of preserving "small businessmen against oppression by corporate giants"[23]. This populist ideal was evoked tirelessly

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22. Climbing the Antitrust Staircase 1986 Antitrust Bulletin 341 at 342.
23. Op.cit.(note 19) at p.70.

by judges at all levels throughout those years: for example, in Alcoa[24], Judge Learned Hand explained that Congress, in passing the Sherman Act, "was not necessarily activated by economic motives alone"[25]. He continued:

"It is possible, because of its indirect social or moral effect, to prefer a system of small producers, each dependent for his success on his own skill and character, to one in which the great mass of those engaged must accept the direction of a few".

Later, we will be looking at Sylvania[26], a case concerning the legality of vertical territorial retraints, which probably marks the greatest single step towards judicial recognition of the relevance of arguments based on economic efficiency so far taken in the United States. But it is in that case that we find, not amongst the Supreme Court judgments but at a lower instance, one of the clearest expressions of the old populist sentiment. Judge Browning (dissenting) explained that,

"Legislative history and Supreme Court decisions establish that a principal objective of the Sherman Act was to protect the right of independent business entities to make their own competitive decisions, free of coercion, collusion, or exclusionary practices.

Congress' general purpose in passing the Sherman Act was to limit and restrain accumulated economic power, represented by the trusts, and to restore and preserve a system of free competitive enterprise. The Congressional debates reflect a concern not only with the consumer interest in price, quality, and

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24. United States v. Aluminum Co. of America, 148 F.2d 416,427 (2d Cir.1945).
25. For the contrary view, see Bork R.H. Legislative Intent and the Policy of the Sherman Act 9 Journal of Law and Economics 7 (1966) whose analysis leads him to conclude that economic efficiency was intended as the only aim of the Sherman Act.
26. Continental T.V.,Inc. v. GTE Sylvania,Inc.,433 U.S.36 (1977).

quantity of goods and services, but also with society's interest in the protection of the independent businessman, for reasons of social and political as well as economic policy[27]".

Popofsky and Bomse point out that at this time, the franchisee-franchisor relationship

"was repeatedly viewed as a contest pitting David against Goliath, with the Sherman Act as the slingshot. As the decisions of the time had it, the mandate of the Sherman Act would be fulfilled by assuring small franchisees or distributors the right to determine for themselves their methods of operation..."[28].

I have already mentioned that Sylvania was to mark a decisive change of direction. In it, the Supreme Court, for the first time ever, explicitly overruled one of its previous decisions, Schwinn[29], in order to hold that territorial restraints should be considered under the "rule of reason" rather than held illegal per se[30].

However, nowhere is the influence of the populist ethic more clearly shown than in the fact that in Sylvania, not only the dissenter Judge Browning made use of its rhetoric, but so did Judge Ely, as part of the majority ! He turned it upside down, showing that, in common with many political shibboleths, it is a weapon easily turned against its user. Judge Ely pointed out that,

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27. 537 F.2d at p.1018.
28. Op.cit.(note 19) at p.71.
29. United States v. Arnold, Schwinn & Co. 388 U.S. 365 (1967).
30. A "per se" rule declares a term necessarily illegal if it falls within the category to which the rule applies; a "rule of reason" requires a balancing of the pro- and anticompetitive effects of the term based on the structure of the relevant market and the position of the parties in that market.

"The adoption of the rule of per se illegality in a case such as this would undoubtedly hasten the disappearance from the American market place of the small independent merchant, now often a franchisee, and already an endangered entrepreneur....If we were to adopt the approach of per se illegality, the ultimate result might be to undermine franchising as a tool to enable the small, independent businessman to compete with the large vertically integrated giants of many industries. One danger would be that a single franchisee, allowed to expand into a chain of stores and sell everywhere over the manufacturer's objection and in violation of the contract, might make it impossible for other small single-outlet franchisees of the same manufacturer to compete effectively. Thus the loyal network of small independent businessmen that the manufacturer desired for his franchisees might be supplanted by several "giant" franchisees, each having numerous outlets. Another risk would be that a small manufacturer who could not afford to integrate vertically, if prohibited from offering any degree of territorial protection from intrabrand competition or "elbow room", might not be able to attract dealers and thus might be unable to establish an effective system of distribution for its product. We cannot believe that Congress intended to implement a rigid per se rule of illegality that portends such serious risk to franchising arrangements, methods that have made significantly worthy contributions to our Nation's economy."[31]

In other words, it may be wondered how many franchisees would be able to compete at all as retailers, without the help and support of their franchisor - that is, the franchisee would go out of business or he would become an employee and thus lose entirely any commercial independence he might have had. Also, if the effect of forbidding or making very difficult to establish efficiently franchising networks is to encourage many firms to integrate vertically, then nothing short of a monopoly could be challenged. So it was that the appreciation of this characteristic of franchising - that is, the benefits and strengthening of position that it conferred on small traders - in part, that led to the

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31. 537 F.2d 999.

reversal in policy marked by Sylvania, which of course had repercussions that went far beyond franchising contracts.

It is fascinating to see here such a clear illustration of the truth that in order to justify the legality of certain clauses to be found in franchise contracts, it is possible, instead of rejecting the populist stance, to accept it and show that its position can be destroyed from within. This may be a reason why, far from being seen as an objection to franchising in EEC circles, these considerations have tended to support its cause: they go hand in hand with the protection and promotion of small and medium-sized enterprises (SME's) which have always been considered to deserve some kind of privileged status[32]. However, it may be argued that the degree of real freedom enjoyed by a business franchisee is extremely limited, given the tight control which franchisors tend to exert over their franchisees.

For the sake of clarity, it should be reiterated that the current "traditional" thinkers[33] in the United States no longer support the protection of the small trader as such, but rather plead that antitrust law respect values such as the dispersion of economic power. They are therefore chiefly concerned about monopolies and tight oligopolies and would have little to say

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32. The precise reason for this privileged status is not clear: it is certainly a political decision, and certainly is related in large part to the vulnerable position of small businesses in the face of the opening up of national borders within the Community.

In Europe, at least, the vast majority of franchisees would be characterised as SME's, except when department stores take a franchise which they incorporate into the relevant department in their shop, which often happens with fashion franchises.

33. See e.g. Pitofsky R. op.cit.(note 20).

against franchising itself, provided that interbrand competition were healthy in the relevant market. In the EEC, on the other hand, views very similar to those of the old populist thinkers are strong: happily for franchising, it has their support.

(ii) The new learning and economic efficiency

Lest it should seem more obvious than it really is that economic efficiency is a proper goal of antitrust law, we should again look at legal history. Today it may seem necessary and natural that considerations of economic efficiency should have their place in judicial interpretation and application of antitrust legislation and precedents. After all, competition law is part of "economic law": thus it might at first sight appear difficult seriously to defend the position that arguments based on economic reasoning should be disregarded in this process. This was, nevertheless, the stance adopted by judges in the American Supreme Court and the Federal Trade Commission from the time of the introduction of the Sherman Act in 1890 until comparatively recently.

In Sylvania Judge Browning gave reasons for judicial distrust of economics, saying:

"...courts are ill-equipped to resolve the complex economic problems involved in deciding in a given case whether elimination of intrabrand competition among dealers through territorial

restrictions in fact produce[s] compensating gains in interbrand competition among producers"[34].

Whilst it is true that there are two sides to the economic argument, and that the argument in favour of vertical restraints is by no means irresistible, we may say, along with Judge Browning's fellow dissenter, Judge Duniway:

"I am puzzled by the notion that because the courts are not very well equipped to decide between conflicting notions of economic policy, they should pick one side of such an argument and erect it into a rule of per se illegality"[35].

Such an attitude continued to hold sway in the courts despite Judge Duniway's puzzlement and despite the appearance during the sixties of a growing body of literature analysing various rules of antitrust law in economic terms. At this time, however, even dissenting judges did not make use of economics, but tended instead to take an intuitive approach, despite the fact that the negative impact on economic efficiency of such rules could be so clearly shown. Popofsky and Bomse suggest cynically - or perhaps perceptively? - two reasons for this:

"There appeared to be at least an implicit fear that if it was acknowledged that economics had something pertinent to say about the application of the antitrust laws, the judiciary might have to start learning about the shape of elastic demand curves. Or perhaps it was, simply, that the then-prevailing doctrine was difficult to defend in economic terms. Thus, to invite a joining of issues on that ground would have been to undermine the analytical basis of the law as it then existed"[36].

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34. 537 F.2d 1024.
35. Ibid. at 1030.
36. Op.cit.(note 19) at p.72.

In Sylvania[37] economic efficiency - or "consumer welfare", which makes it sound politically more acceptable - was ushered in as the new criterion for interpreting the Sherman Act. From then on, serious restrictions on the freedom of conduct of individual actors on the market were no longer automatically condemned.

So, although neither the economic analysis conducted by the 9th Circuit judges in Sylvania, nor that of the Supreme Court, was particularly thorough or sophisticated, it was revolutionary in that it, in Popofsky and Bomse's words,

"entirely refocused the antitrust laws from an essentially political statute to one grounded in modern welfare economics."[38]

So today in the American courts, although all resistance to vertical restraints has not been broken down - in Monsanto(1984) it was held that vertical price restraints are still per se illegal, despite the absence in economic theory of any fundamental difference between price and non-price restraints - the attitude to them is benevolent, and economic reasoning is generally listened to and treated with respect[39].

However, the acceptance of the relevance of economic analysis is only the beginning of the story: the real question then becomes whether franchising - or, rather, the various clauses

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37. The facts of this case were not unlike those of Pronuptia, although the goods involved were television sets rather than wedding apparrel.
38. Ibid. at note p.86.
39. For an imaginative prediction of the future of American antitrust see Fox E.M. Antitrust in its Second Century: the Phoenix Rises from its Ashes 1986 Antitrust Bulletin 383.

appearing in franchise contracts - promote efficiency in the market place. Here the debate still rages[40], and I can but outline a few of the arguments put forward by some of the different schools of thought.

It has long been recognised, and vast amounts of legal and economic literature[41] have been produced on the subject, that vertical restraints are generally conducive to economic efficiency[42]. It seems a reasonable proposition - and it can be shown by economists using graphs and equations and economic reasoning - that a rational manufacturing enterprise, even if a classical monopolist, will normally benefit financially from encouraging the maximum amount of competition amongst his retailers. It follows from this, it is argued, that a franchisor, for example, will impose on his franchisees only those vertical restraints that maximise his ability to compete and hence his

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40. "The proposal [to make economic efficiency the only goal of antitrust law] offers not the prospect of greater certainty and shorter litigation...but utter confusion. Economists are no more likely to agree than lawyers; only a disillusioned lawyer or a brash economist could believe otherwise." Dirlam J., Kahn A. Fair Competition: The Law and Economics of Antitrust Policy 28 (1954).

41. For a clear and relatively simple economic explanation see White L.J. Vertical Restraints in Antitrust Law: A Coherent Model 1981 Antitrust Bulletin 327. For a more sophisticated analysis which comes to similar conclusions but takes into account transaction costs and the consequences of bounded rationality and opportunism, see Williamson O.E. Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach 127 University of Pennsylvania Law Review 953 (1979).

42. I must leave aside here any discussion of the different definitions of "economic" efficiency which may be employed. The expression refers basically to allocative efficiency or wealth maximisation. Similarly, the difficulties that can arise in distinguishing between horizontal and vertical restraints in some circumstances cannot be gone into here.

economic efficiency. Taking again the example of a franchise network selling wedding dresses, economists can demonstrate, with the aid of certain assumptions, that the franchisor will only be interested in imposing the kind of restraints on his franchisees that enable his goods to be sold in the most efficient way, because he benefits most from a situation in which his goods are being distributed with optimum efficiency.

Reasons advanced for departure in certain circumstances from what would normally produce the most efficient result are almost all variants on the theme of the problem of the "free-rider".

As first made notorious by Telser[43], the free-rider[44] is the distributor who leaves other distributors to incur the expense and trouble of providing well-qualified sales staff and a comprehensive explanation of the products. When potential customers have made their choice at one of these "luxury" outlets, they are able to go to the "free-rider" across the road and obtain

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43. Telser L. Why Should Manufacturers Want Fair Trade? 3 Journal of Law and Economics 86 (1960).
44. Strangely, this term almost always has a pejorative tone when used in the American literature, whereas in the EEC the free-rider has the status of a protected species: see Gyseln L. Vertical Restraints in the Distribution Process: Strength and Weakness of the Free Rider Rationale under EEC Competition Law 21 Common Market Law Review 647 (1984). At p.649 he says "In the EEC Commission's eyes, however, the free-rider is a hero because his sales foster the free movement of the brand within the Common Market and thus contribute to market integration. Consequently, restraints which limit his room for manoeuvre are subject to close scrutiny and will often fail to qualify for an exemption under A.85, para.3 of the EEC Treaty." Even without introducing the market integration aim, however, it can be said in favour of free-riders that they can destabilise or prevent the establishment of cartels.

the same product for a much lower price. The free-rider is able to charge such low prices because he is not providing the services that the "luxury" distributors are. In the end, the more expensive shops will either go out of business - or simply cease to offer pre-sales services of the sort for which they cannot charge potential customers - and an efficient method of distribution becomes unworkable and breaks down, and the customer loses out.

As originally described by Telser, this argument could apply to a relatively narrow range of products: that is, those requiring or benefiting from expert knowledge available at the point of sale. However, before long, it was appreciated that such pre-sales "services" could include not only the obvious, such as a test-drive in a new car, or technical advice about electrical goods, but could extend to the creation of a certain reputation for style or a particular "image". In other words, the expense incurred, for example, in creating the image of Yves Rocher perfume as a high quality, luxury good destined for an elite clientele is susceptible to free-riding by a cheap department store which sells the perfume but without the chic and glossy surroundings that other outlets provide and pay for[45].

If exclusive territories or retail price maintenance are the methods chosen - rather than, for example, advertising done centrally for all areas by the franchisor - this must be because it is the most efficient method. This may mean that, by means of conferring exclusive territories for example, or imposing particular prices, the franchisor sees fit to protect his

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45. See e.g. Marvel H.P.,McCafferty S. Resale Price Maintenance and Quality Certification 15 Rand Journal of Economics 346 (1984).

franchisees from competition with each other, as this will increase his economic efficiency and therefore his ability to compete with sellers of other brands of wedding dresses: that is, intrabrand competition may decrease but interbrand competition is enhanced.

The above is the basic argument for the legality of vertical restrictions such as retail price maintenance and territorial exclusivity, which provide protection against the free-rider, either by making it impossible for him to charge a low price, thus forcing him to compete in other ways if he continues to wish to stock the product, or by preventing him from selling too near the protected distributor's outlet.

Such restrictions also allow price discrimination between different areas, and this may or may not be considered wrong in economic terms. In EEC political terms, however, it tends to be regarded as divisive of the single market without frontiers that it is striving for.

Another justification advanced for such restraints is that restrictions can be used to obtain a sufficient return in large, centrally-positioned outlets to allow the franchisor to continue to be able to afford to supply remote shops which perhaps have a low turnover, too. Also, allocation of territories may increase economic efficiency by avoiding the wastage incurred in duplication of delivery routes and by allowing more accurate sales forecasting. Minimum prices can be used to protect a producer from having his product used as a loss-leader: such use may bring a short-term benefit, but in the long term such a practice is damaging, since other dealers cease to stock it and it loses its quality of being a well-known brand.

This powerful argument, applying to almost any kind of product, from Levis' jeans to lawnmowers and to wedding dresses, is however by no means decisive. Apart from questioning the validity of the unique goal of economic efficiency in itself, it is possible to point to flaws within it in the form of its inherent assumptions and, perhaps most importantly, to the form that its transposition into workable legal rules should take.

For example, one assumption in Telser's argument is that the provision of pre-sales services is economically efficient, in that it is providing customers with a service that they value and are prepared to pay for in the price of the product: otherwise they would buy a cheaper product without the services. But this assumes that customers are undifferentiated, all having the same level of desire for particular services. In fact, as Comanor[46] has pointed out, very often there will be a large number of "certain" customers who are willing to buy the product at the higher price but who have no need for the services. But these services may attract in a small number of "marginal" customers. In this hypothesis it is in the interests of the retailer to provide largely superfluous services - that is, to do the inefficient thing.

A key issue underlying the discussion but not always voiced is the controversy over what factors constitute barriers to entry to the market. If one believes that the only real barriers are government regulations then one will hardly be worried by any behaviour in the market, for one envisages potential entrepreneurs

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46. Comanor W.S. Vertical Price-Fixing, Vertical Market Restrictions, and the New Antitrust Policy 98 Harvard Law Review 983 (1985).

waiting to step into the market and undercut, for example, a cartel which is charging monopoly prices. If, on the other hand, one recognises the difficulties inherent in raising capital and the imperfect and incomplete information held by potential entrants and consumers alike, one will be more suspicious of the ability of the competitive market to preserve itself.

Another consideration is the reason for the adoption of restraints. Resale price maintenance, exclusive territories and similar vertical restrictions that appear in franchising contracts may be the result of pressure exerted on the franchisor by his franchisees: in itself, if it only amounts to pressure to confer sufficient protection on them to allow them to run the business to the standard required by the franchisor, there is little wrong with this: however, it is objectionable if in reality it is a franchisee cartel that is insisting on higher prices than are economically efficient.

Alternatively, the territories or prices may be the result or the means of establishing or maintaining a horizontal cartel between franchisors or manufacturers, in order to restrain production or to maintain prices at monopoly profits levels. Territories help here as they break up large areas into more manageable parts to be cartelized and policed individually, and uniform prices make the detection of cartel-breakers easier and so can help to stabilize and strengthen cartels.

Also in connection with free-riding as a justification for vertical restraints, it is necessary to be aware of the possibility that the "service" in question, whether it is a service in the usual sense of the word, or an "image" or glamour

(sometimes called "quality certification") is either not brand-specific or alternatively is specific to an individual franchisee. In such a case the free-rider justification cannot apply.

Even this brief survey of economic arguments and counter-arguments makes it clear that vertical restraints can be imposed with two essentially different purposes - and two results(the purposes and results not always coinciding, of course); they may serve either to assist in improving the distribution or production of goods and services, or they may be directed towards the creation, allocation or exploitation of economic power.

For the moment accepting that economic efficiency is a legitimate goal of competition policy, it is necessary to take the next step - that is, to decide exactly how to transform these theories into laws, legal presumptions and rules of evidence. For example, are intention or effects to be important, and how are they to be proved? It is notoriously difficult to discover the result of a commercial practice in isolation, as so many other variables affect the data used. It may be claimed too that the genuine "intention" of a franchisor is hard to establish, especially if he is aware of the rules of the game, as businessmen and their lawyers tend to be.

Perhaps it is here that the differences between the schools of thought become most obvious: some seek to discover the possible and likely uses of vertical restraints and to point out that each situation must be looked at individually and judged on its merits. Others, including both some lawyers and some economists, admit that such restraints can be efficient in some circumstances and conducive to inefficiency in others, but prefer a certain, if partly arbitrary rule for or against, depending on

their view as to whether the benefits more often than not outweigh the dangers or vice versa.

Pitofsky, who advocates a per se rule against certain vertical restraints including airtight territories, believes that,

"A standard under which all circumstances are weighed, and violations found only upon demonstration of specific anticompetitive effects, may sound sober and moderate, but in the real world has little deterrent effect, produces trials of inordinate length and expense and often undermines antitrust enforcement. Business practices tested under a full rule of reason, with no presumptions based on any set of facts and with the burden of showing anticompetitive effect on the plaintiff, will usually turn out to be legal".[47]

Similarly, according to Leffler it follows from the point made by Comanor and referred to earlier that,

"A proper efficiency analysis of the use of RPM to call forth services therefore requires detailed information on individual consumers' demand functions with and without the provision of retailer service. Again, economists are unlikely to produce reliable estimates of these empirical quantities, and courts are unlikely to be able to assess the reliability of claims about such empirical studies[48]."

In other words, the person whose economic analysis proves to him that each vertical restraint deserves to be judged on its merits is ignoring the huge losses in efficiency that would then occur through more frequent and lengthier litigation.

The other side of the argument is put by Small, who says of the rule of reason that,

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47. The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions 78 Columbia Law Review 1 (1978) at p.2.
48. 28 Journal of Law and Economics 381 (1985) at p.383.

"This does not mean...that the rule is impossible to apply, nor does it mean that the probability that the trier of fact will face a difficult decision justifies not making that decision on the merits"[49].

Today in the United States the real controversy over economic analysis does not relate to its validity as a tool in understanding market and competition processes but in the use, practically speaking, that can be made of it in the courts without incurring great efficiency losses there. In other words, can we hope to discover the purpose - or the effect - of each restraint, or are we better off on balance with the certainty that a per se rule brings, one way or the other. Especially given the very marginal importance of the "traditional" or "populist" arguments in the context of franchising, this really appears to be the most open and controversial point debated today. Since a choice depends on the perceived actual state of the market, in particular in terms of the proportions of efficient and inefficient vertical restraints present in it, only with the aid of enormous quantities of research into many different markets and collection of empirical data - which in any case would not remain constant over time - could any really authoritative answer be given.

So it does not automatically follow that EEC competition law - or any other system of competition law, for that matter - should smile uncritically on vertical restrictions such as those that appear in franchise contracts, even if economic efficiency is its chief goal. Also, in the EEC, not only is the small trader of much more importance in competition policy than in America, but there is in addition the overriding aim of market integration, unique to the EEC, to be considered.

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49. Sylvania 1977 Wisconsin Law Review 1240 at 1248.

(iii) Market integration

In the EEC context the aim of market integration takes first place: van Bael has stated that

"From its inception the EEC competition policy has been essentially geared to speed up single market integration."[50]

Korah, too, has opened a recent article on this subject with the words

"In the EEC, there is no agreement as to what objectives should be pursued by competition policy. Probably the most important in the view of the Commission and Court of the Communities is the integration of the common market."[51]

Later in the same article she points out that, contrary to what might be understood from the bare words of a.2 of the Treaty, market integration is not simply a means to the end of achieving prosperity and other Community aims, but it is an end in itself. But it is a rather mysterious end: it is not at all clear what it means. It might be thought, for example that anything that made it easier for franchise networks to expand, taking their products to different countries and so allowing consumers all over the Community access to the goods, would be approved of. Instead, almost any form of territorial protection, whether it be in the form of exclusive territories, differential pricing or an export ban, which is often a necessary part of a franchise package, is regarded as intrinsically inimical to market integration.

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50. Heretical Reflections on the Basic Dogma of EEC Antitrust: Single Market Integration 10 Revue Suisse de Droit International de la Concurrence 39 (1980) at p.40.
51. EEC Competition Policy - Legal Form or Economic Efficiency 1986 Current Legal Problems 85.

Market integration is a political aim and it is peculiar to the EEC legal system. Although the conferral of exclusive territories which do not permit parallel imports is considered anathema to a united market by the Commission, in practice it may often be the case that, without franchising, the goods or services simply would not be available to so many consumers or over so wide a geographical area. However, a similar argument was not accepted by the Commission[52] in Distillers in the context of differential pricing (which in pratice did not even amount to an absolute export ban) and in consequence of a refusal of exemption under a.85(3) various brands of whisky disappeared from the continental European market altogether and others from the United Kingdom market.

Markets are said to be "divided" by such terms in the sense that different prices can be charged in different areas. Given that not only do barriers to trade such as discriminatory taxes and regulations continue to exist at national boundaries and are likely to do so even after 1992, but different social and cultural conditions pertain (and, it is fervently to be hoped, will continue to pertain) it is by no means evident that uniform prices and conditions throughout the Community are either indicative of or conducive to a single, barrierless market[53]. However, it is clear that, whatever "market integration" means, it

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52. 1978 OJ L50/16. The Court never pronounced on the question, since the appeal was decided against Distillers on procedural grounds (1980 ECR 2229).

53. Van Bael I. op.cit.(note 46) at p.53: "...a uniform price...should be viewed as legally suspect and not the other way round; such a uniform price could well reflect the real market power of the company in question since that company is in a position to set the price at a uniform level irrespective of differing demand factors...".

is an aim that will generally override that of economic efficiency in EEC policy-making. Its importance in that context cannot be overstated.

Other objects for competition law such as consumer protection from being deceived into believing that the franchisee is legally part of a substantial, stable firm, fairness of contract, franchisee protection, full employment and income redistribution have from time to time been suggested. Although intrinsically very important, their role in the formation of competition policy is at most peripheral and will not be discussed further.

So it is obvious that the answer to the question, "Is franchising anti-competitive ?" depends not only on the specific terms of the franchise contract and on our definition of the "competition" (interbrand or intrabrand: franchising tends to enhance the former at the expense of the latter) that is to be protected. It is also a function of our choice of what interests and values we see competition law as working to protect. And even if we are sure of our aims, it is often of course in practice by no means clear what is the best strategy to achieve them.

9. EEC competition law.

The Treaty of Rome is founded on the assumption of a market (the "common market") economy and it deals with freedom of competition as a fundamental part of the economic community which it sets up. In article 3(f) it provides for

"the institution of a system ensuring that competition in the common market is not distorted".

Later on in the Treaty, articles 85 to 94 provide more details of the EEC's competition policy. However, the only ones which apply to private undertakings and therefore to franchisors are articles 85 and 86. Article 86 prohibits the abuse of a dominant position in the market and the control of certain mergers, but the problems raised by this prohibition will not be discussed further since there is little to distinguish the application of article 86 to a franchisor from its application to any other sort of undertaking. Nor has article 86 yet been applied by the Commission or the Court of Justice to a franchisor.

Instead, I shall concentrate on article 85, whose application to franchise contracts raises all sorts of questions. Many important questions arise in relation to the application of a.85 to all kinds of agreements, but I intend to deal only with problems with special relevance to franchise contracts.

Before looking at the details of EEC competition law and its interpretation and application, one should step back and notice the peculiarities that distinguish the European Community's legal and economic orders from those of states such as the United States of America or of the individual Member States of the EEC. These distinctive characteristics lead to corresponding features in competition law.

Firstly, European law is very young and so relatively undeveloped: many finer points can therefore be expected to remain undecided.

Secondly, the Common Market being made up of separate sovereign states, there is a need positively to encourage market integration in a way which is simply not comparable with the situation in countries which introduced their competition law long after their territory was united and there was relative ease of flow of trade from one area of the country to another. As already stated, this is an exceptionally important factor, whose importance cannot be over-emphasized and one of whose most notable effects has been to lead to a very harsh treatment being meeted out in reaction to firms whose commercial arrangements tend to divide up markets along national boundaries.

Other factors that should be borne in mind include the absence of political and economic unity in the EEC, the importance attached to the protection of small businesses - and also the use, whether or not legitimate, of competition law to shape industrial growth and direct transport policy and the like.[54] This multitude of goals makes for very unclear pointers to policy: all these factors and more will colour the approach taken to controversies to be resolved in the field of competition law, and the question of franchising is an excellent illustration of this.

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54. For a discussion of the diverse policies that may currently be being pursued in the name of competition policy, see Hornsby S.B. Competition Policy in the 80's: More Policy Less Competition? 12 European Law Review 79 (1987).

10. Article 85 of the Treaty of Rome.

This article begins by laying down in its first paragraph a prohibition as broad and general as that contained in the Sherman Act. Article 85(1) prohibits

" ...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 common market..."

and it then goes on to give a non-exhaustive list of examples of contracts which violate this prohibition.

Article 85(2) declares that contracts infringing this rule are void. It was confirmed very early on by the European Court of Justice that this paragraph is automatically effective, without the need for the Commission to take any kind of decision to this effect - or indeed to know of the existence of the infringing agreement or concerted practice: national courts are competent to declare such nullity[55].

Notice what this meant for a business such as that of the wedding-dress franchisor, before first Pronuptia clarified the legal status of franchise contracts to a certain extent and then the block exemption Regulation was enacted: suppose that he decided to expand his business in the wedding-dress trade by means of a franchise network and that, subsequently, some disagreement arose between him and a franchisee who refused to pay him the percentage of profits due to him under the contract. If he had

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55. BRT v. SABAM No.1 1974 ECR 51.

taken the franchisee to court and sued him for the sum owed, the franchisee might have claimed before the national court that the contract is void by virtue of article 85(2) for infringement of article 85(1) and if this were held to be so (either with or without the benefit of the answer to a preliminary reference to Luxembourg) any arguments on the merits of the case, according to the terms of the contract freely entered into, would be to no avail.

The last paragraph is the counter-balance to the sweeping prohibition in the first: article 85(3) allows exemption from such invalidity if the arrangement

"...contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:

(a) impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;

(b) afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question"[56].

It is also provided that, as well as granting individual exemptions upon application to it by one or more parties to a particular contract, the Commission also has the competence, of its own initiative, to issue a "block exemption". This is a regulation giving automatic exemption to certain types of contracts that are considered to be "a good thing" in terms of efficiency and consumer welfare, but which would otherwise be prohibited by article 85(1). This has already been done for

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56. This is not a "rule of reason" in the American sense, since it introduces other considerations apart from that of competition.

several types of agreement including franchise agreements.[57]

But the crucial point here is that - in the absence of the block exemption - exemption could only be granted by the Commission. Therefore, however cogent the explanation to the national court of the economic advantages and benefits to the consumer provided by the system in question, these arguments were irrelevant if such an exemption had not only been applied for but also granted by the Commission.

It was thus crucial to decide whether franchise contracts fell within a.85(1). A franchise contract has the potential to be considered anti-competitive for the reasons explained above. The answer must depend on the choices made in EEC law as regards the definition of competition and the aims of competition law.

The bare words of the Treaty, like those of the Sherman Act, are so all-encompassing that it was necessary to look at how the Commission and the European Court had interpreted this provision in the past if there was to be any chance of predicting what their attitude to franchising might be. Although previous case law on vertical restraints gave some guidance as to the kind of ruling the Court of Justice might be expected to make, its characteristically free and teleological method of interpretation meant that, in such a controversial area as this, it was very uncertain how a.85 would be interpreted and applied, and when it was known that the reference in Pronuptia was to be decided by the

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57.The others are for agreements relating to exclusive distribution, exclusive purchasing, patent licencing, specialisation, research and development cooperation, selective distribution for motor vehicles and know-how licencing.

Court, the business community awaited the decision with considerable apprehension and anxiety[58].

58. For detailed speculation on the possible outcome of the case see Goebel R.J. The Uneasy Fate of Franchising under EEC Antitrust Laws 1985 European Law Review 87. Of particular interest is a part of an answer from the Commission to a Parliamentary Question (No.1694/79 OJ 1980 C131/33) which he cites: the Commission was at that time of the opinion that franchises were "difficult to define precisely" and that their assessment would depend "less on their actual designation and form than on their scope and economic context". For that reason no guidelines or special rules were envisaged at the time. One wonders to what the Commission's change of heart a few years on is attributable.

PART IV

11. Pronuptia and individual and block exemptions.

In this chapter the existing European competition law on franchising will be described. However, what follows does not purport to be a full description and analysis of the law, but rather a discussion of particular aspects of the law as it has so far developed which are of special relevance to my search for the motivation behind the policy.

First, the Pronuptia[59] case and the block exemption[60] will be described briefly[61]. Next, the way in which the European Court of Justice and the Commission characterise and define franchising generally will be examined, and this will be followed by a look at the sub-division of franchising into different categories that they have made. Then the clauses considered "good" and "bad" will be looked at in turn. Comment will next be made on the part played by market analysis, and finally various miscellaneous points will be dealt with.

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59. See note 1.
60. See note 3.
61. For full accounts see articles listed in the bibliography, in particular those by Korah V.

(a) Pronuptia

The facts of Pronuptia were similar to those of the example evoked earlier. The plaintiff before the German court was a German subsidiary of the French franchisor "Pronuptia de Paris", a distributor of wedding dresses and other wedding clothes and accessories. This subsidiary, Pronuptia de Paris Gmbh, had not only a franchise network but also shops of its own. It had granted a franchise to a German franchisee, Mrs. Schillgalis, for three separate territories in the Federal Republic,and a dispute had subsequently arisen over unpaid royalties claimed as due by the franchisor and contested by the franchisee.

The case brought in the German national courts by Pronuptia de Paris Gmbh against Mrs Schillgalis reached the Bundesgerichtshof. She had won her case in the court below, thereby avoiding the contractual obligation to pay royalties, by invoking article 85 of the Treaty of Rome and claiming that the contract was void for violation of a. 85(1).

However, before deciding the case, the Bundesgerichtshof (the Federal Court of Justice) put a preliminary question to the Court of Justice[62] on the way in which, if at all, a. 85 should be applied to this kind of franchising agreement.

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62. By the procedure provided for in article 177 of the EEC Treaty.

The terms of the contract were approximately those described before: the franchisor granted the franchisee the right to use its trademark in a defined territory and promised to provide continuing assistance and advice to the franchisee on many aspects of running the business. The franchisor also agreed not to open a shop itself or by any other means supply third parties in the territory, nor to grant a trademark licence to anyone else in the territory.

The franchisee for her part promised to pay a 10% royalty on all sales made, to use the trademark only in connection with the retail shop in the specified territory, to conduct business only from that specified retail shop, which was to conform to the specifications of the franchisor, to purchase at least 80% of stocks from the franchisor and the rest only from suppliers approved by it, to cooperate over advertising, including that giving recommended but not obligatory prices, not to compete with the franchisor anywhere in West Germany for one year after the end of the contract and not to assign the franchise without the franchisor's consent.

The Court held that most of the clauses in this, fairly typical, franchise contract, were inherent in the nature of franchising itself, which could not function without them. Since franchising was perceived as a useful and desirable commercial device, these clauses were held not even to violate a.85(1). However, territorial restrictions, in particular where combined with a location clause, that led to market division, as well as price-fixing, were found to be contrary to a.85(1), although it was suggested that a degree of territorial protection might be permitted in consequence of an exemption under a.85(3). It was said that the agreement could not benefit from the exclusive

distribultion block exemption[63]. Resale price maintenance was declared illegal, although recommended prices were not prohibited. Broadly speaking, the judgment came as a relief to franchisors, although some would have wished that it might have gone further in the direction of permitting vertical restraints than it did.

This decision of the Court of Justice was perhaps surprising in that in the past it had often tended to interpret article 85(1) broadly in order to give the Commission the power to put pressure on the parties to the contract to change its terms in order to win from it an exemption under article 85(3). As a result of this decision, many franchise contracts were now beyond the control of the Commission. This decision was extremely important, for it formed the basis on which the Commission - which is bound to follow the Court's rulings - built the block exemption Regulation for franchising contracts.

(b)The block exemption

Although the Pronuptia judgment was a step in the right direction, confirming as it did that franchising is " a good thing", it was cautious and narrowly confined, and it left many questions unanswered. Even before judgment had been given the European Franchise Federation had asked that a block exemption be prepared. Commissioner Sutherland indicated as early as March 1986 that a block exemption could be expected in the near future.

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63. At that time, Regulation 67/67; now embodied in Regulation 1983/83.

Since then, five individual exemptions have been granted, and on the 1st February 1989 Commission Regulation No.4087/88[64] came into force, exempting automatically certain types of franchising agreements from a.85(1). Clearly an improvement on the Pronuptia guidelines, of wider and automatic application, essentially it exempts certain types of territorial restrictions in franchise agreements from the application of a.85(1); at the same time it takes the opportunity to give an explicitly non-exhaustive list of clauses which, when used in the context of a franchising agreement, will not normally fall within the prohibition in a. 85(1) at all.

Despite a certain amount of discussion, notably by Valentine Korah[65] regarding the existence of competence in the Commission to enact such a Regulation by virtue of the powers conferred on it by Council Regulation No. 19/65, there is little real likelihood in practice of any official challenge being made to its validity, now that it is in force, and even less of such a challenge being successful in the European Court of Justice. Korah's main point is that, "all the reasons given by the Court in Pronuptia for holding that Reg. 67/67 does not apply to franchising apply equally to the vires for exempting exclusive distribution under Article 1(1)(a) of Regulation 19/65 which empowers the Commission to grant a group exemption for exclusive distribution and purchasing." This is true, but Korah has argued elsewhere[66] that this reasoning is not convincing, so she is

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64. OJ 1988 L359/46.
65. Franchising and the Draft Group Exemption 1987 European Competition Law Review 124 at 127.
66. Pronuptia; Franchising: The Marriage of reason and the EEC Competition Rules 1986 European Intellectual Property Review 99 at 101.

pointing to an inconsistency rather than to a blatant exceeding by the Commission of its powers.

As mentioned earlier, the Commission takes the position that franchising is "a good thing" in economic terms, and with this in mind, it set out to provide as favourable as possible a regime as it dared, under which franchisors might establish, develop and run their business format franchises, to which this regulation is confined: in other words, the Commission, as it was obliged to do, followed the Court's lead in treating franchising more or less benevolently.

In the preamble to the Regulation the advantages to be gained from franchising are listed: in paras. 7 and 8 the benefits to small and medium-sized enterprises and to independent traders, increased interbrand competition and benefits to consumers are mentioned.

Later come the limiting factors: in para. 12 it is specified that the regulation cannot apply where competition will be substantially eliminated and that parallel imports must remain possible. It is apparently not contemplated that interbrand competition alone might suffice, however fierce that might be. In any case, by exempting even this limited degree of territorial exclusivity, the Commission is accepting a division of the market: parallel importing of hamburgers, for example, is unlikely to be a profitable activity for any entrepreneur. This is in keeping with the usual obsessive protection by the EEC of parallel importers, although in practice these are not likely to be very important in the context of franchising networks since they cannot work with

service franchises, and there is little to be gained from transporting cheap pizzas from one country to another[67].

Turning to the body of the Regulation, a.1 gives definitions which define its scope; these matters will be examined in detail later in this chapter; a.1(2) extends the application of the exemption to a "master franchisee" to whom the franchisor may delegate his functions: this may be particularly important in the context of the Common Market since the markets and therefore the "commercial or technical assistance" required may vary considerably between one Member State and another, because of cultural and social differences. This provision enables a franchisor to employ a resident and indigenous agent to do the job in a particular country, for example.

As suggested in Pronuptia, an open exclusive territory is exempted by a.2(a), where it applies to a given area of the Common Market. The franchisor may agree within that area not to "grant the right to exploit all or part of the franchise to third parties" or to "itself exploit the franchise, or itself market the goods or services which are the subject-matter of the franchise under a similar formula" or to "itself supply the franchisor's goods to third parties". A.2(d) allows active selling outside the territory to be forbidden.

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67. This truth is recognised by Mr. Sutherland: in the address cited in note 9 he referred to the first two individual exemptions granted by the Commission to franchising contracts including territorial restrictions, saying that,"...the contracts do lead to a degree of market sharing between those involved...". He thus clearly recognises that in respect of many products (in these instances, wedding dresses and cosmetics respectively) where transport costs are relatively high or the goods perishable - or for services - parallel trading is not a realistic possibility.

The obligations allowed on the franchisee, on the other hand, are that he exploit the franchise "only from the contract premises" (a.2(c)) - this despite the fact that the Court in Pronuptia suggests that this is against a.85(1) only in combination with an exclusive territory, that is, when (a) and (c) are both present: it would seem more appropriate following Pronuptia that (c) appear in the "white list" in a.3.

According to a.1(1), only "one or more" of the restrictions listed in a.2 are required to be included. This would appear to suggest, for example, that territorial exclusivity is not necessary before a contract can benefit from exemption under this Regulation: restriction (e), which exempts "an obligation on the franchisee not to manufacture, sell or use in the course of provision of services, goods competing with the franchisor's goods which are the subject- matter of the franchise..." alone, say, would be sufficient, and the territory in question could be allocated to a number of different franchisees[68].

A.4 sets out a number of conditions for exemption: cross-delivery between franchisees must be allowed (a.4(a)), as must delivery to and from approved dealers if the goods in question are also distributed through a selective distribution network. Similarly, franchisor guarantees must be honoured by all franchisees (a.4(b)), regardless of where the product was first bought; further, exemption applies on condition that " the

68. Although there is apparently no reason why this should be considered undesirable, the Commission held in Junghans GmbH 1977 OJ L30/10 that Reg.67/67 (the predecessor to Reg.83/83, the block exemption for exclusive distribution) could not apply when a territory was allotted to a limited number of dealers instead of to a single dealer.

franchisee is obliged to indicate his status as an independent undertaking..."[69].

The "white" and "black" lists will be described in detail later in this chapter: they list in aa.3 and 5 respectively clauses that do not usually fall within a.85(1) at all and those whose presence always prevent an agreement from benefitting from the block exemption.

The exemption may be withdrawn in certain circumstances, examples of which are given in a.8: the two most important relate to the state of the relevant market; if the cumulative effect of similar networks is to restrict competition in or access to that market significantly, or if for some other reason the goods in question do not face sufficient competition, the exemption may be withdrawn. However, it is not certain whether this will apply to an established network whose position on the market changed because of the actions of new arrivals, or the disappearance of competitors, or whether it would only affect new entrants.

(c) Characterisation and definition of franchising

The first question addressed to the Court of Justice in Pronuptia was:

"Is Article 85(1) of the EEC Treaty applicable to franchise agreements such as the contracts between the parties, which have

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69. Though it is not clear by which party such a clause (presumably a measure of consumer protection) is likely to be enforced: it may not be in the interests of either the franchisor or his franchisee to take any notice of it.

as their object the establishment of a special distribution system whereby the franchisor provides to the franchisee, in addition to goods, certain trade names, trade-marks, merchandising material and services ?"

The Court referred to the franchisor's arguments based on increased interbrand competition which could not otherwise be established, that is, that the system "reinforces the franchisor's competitive power at the horizontal level, that is to say, with regard to other forms of distribution". Arguments referring to the facilitating of entry onto the market by many small, independent enterprises and the fact that it made it possible for a franchisor to create outlets that would not otherwise exist were also cited. Finally, it was claimed by the franchisor that these advantages could not be obtained without the minimal restrictions on commercial liberty imposed by a franchise contract of this sort.

The franchisee, of course, placed heavy emphasis on the territorial exclusivity conferred by the contracts, and on the fact that Pronuptia itself claimed to be the world's leading French supplier of wedding dresses and accessories.

First, the Court stated that franchising contracts could not be judged "in abstracto" but that their individual clauses had to be considered, which seems obvious enough. As Burst and Kovar so succinctly express it, it has often been considered "que le contrat de franchise se caractérisait précisément par son hétérogénéité"[70], and it was hardly to be expected that the whole realm of franchising be dealt with by one all-encompassing rule.

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70. La Mariée est en Blanc 1986 Gazette du Palais 392.

Instead of taking a traditional approach and addressing the sorts of arguments put forward by the franchisee, the Court, apparently deciding to start afresh, and, avoiding any attempt to give a comprehensive definition of "franchising" itself, characterised it in the following, rather sweeping statement:

"Rather than a method of distribution, it is a way for an undertaking to derive financial benefit from its expertise without investing its own capital. Moreover, the system gives traders who do not have the necessary experience access to methods which they could not have learned without considerable effort and allows them to benefit from the reputation of the franchisor's business name...Such a system, which allows the franchisor to profit from his success, does not in itself interfere with competition..."(my underlining).

One comment may be made immediately: first, some recent research[71] suggests that it can be cheaper for franchisees to obtain capital from the capital markets than to set up a franchise network and it is not by any means clear that the Court has any good evidence for describing franchising in this way; it has been suggested that reduction in monitoring costs is a much stronger incentive to use franchising than difficulty or expense of raising capital. This is important, since if it could be shown that a firm could integrate vertically as easily as it could franchise independent retailers, the indispensability criterion of a.85(3) would not be satisfied: not only would individual exemptions not be justified, but a fortiori the block exemption would not be valid, given the existence of a viable alternative.

In the same paragraph the Court distinguishes franchising from agreements "which incorporate approved retailers into a selective distribution system", perhaps suggesting that

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71. See Rubin P.H. op.cit.(note 6).

franchisees tend to be new entrants to the market as opposed to established retailers. This may well be true on the whole in the EEC, but is not always the case, as, for example, when franchises are given to department stores.

This way of looking at franchising presents it as a form of quasi intellectual property: that is, it is seen as the way in which a franchisor reaps the benefit of something that belongs to him, much in the way that he might exploit a patent or trademark. In essence, the Court of Justice is inventing a new kind of intellectual property right, just as it has invented the concept of "know-how" as a protectable kind of property; one can be forgiven for wondering if there are any limits to what it may invent in this field in the future. One might almost expect the Court to go on to say that EEC law would not interfere with the existence of the expertise, but would intervene to control its exploitation or exercise[72]. On this basis one could also be forgiven for expecting the Court to go on to apply by analogy the rules applicable to patent licences. However, no such parallel is drawn, beyond this indirect and implicit allusion quoted above, nor is franchising compared with exclusive distribution systems: instead the Court goes on to treat it as sui generis, purporting to reason from first principles.

Such a way of looking at franchise networks - that is, as a kind of intellectual property licence - is perhaps the most apt in the case of what the Court called "production franchises",

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72. This is a rather unhelpful distinction used by the Court in cases such as Parke-Davis v. Probel 1968 ECR 55 to describe the extent of the EEC's competence to rule through free movement of goods law on intellectual property matters.

(when they may be compared to a series of patent licences), "service franchising", and the kind of "distribution franchise" in which the franchisee sells goods selected by the franchisor. However, when the franchisee is selling goods produced by the franchisor himself, the network is clearly, in economic terms, nothing more or less than a distribution method. This distinction is based on the fact that, in the latter case, in the absence of the possibility of establishing a franchise network - or of "integrating vertically" - the manufacturer could resort to some alternative method of distribution, whereas in the other cases he would instead be left only with the alternative of, for example, trying to license his know-how or trademark or even running training courses for which he could charge fees. It should be noticed that the Court in Pronuptia expressly refused to rule on what it called "industrial franchising" and the Commission in its draft block exemption excluded production franchises from the ambit of the regulation, apparently because it saw that as more akin to intellectual property licensing. Yet the way in which the Court expresses itself here sounds as though it wants to characterise all franchising as a kind of intellectual property licensing.

In any case, the classification of franchising in general provided a starting point for the novel approach that was taken. After all, had the Court characterised the Pronuptia network as a particular form of selective distribution, very different considerations would have applied. Instead it took the opposite course, and more or less invented a new kind of intellectual property deemed worthy of explicit legal protection. Legally, it would surely have been much neater to have applied the existing rules, instead of starting afresh with franchising. This is the first and chief instance in the judgment where the Court makes a deliberate policy choice - in this case, to give

franchising the special and in many ways privileged status of a new kind of property right, rather than judging it by the strict rules applying, for example, to selective distribution networks and the car industry.

Adams and Mendelsohn say of franchising almost in the same breath that it is "a marketing method" and that it

"from a legal point of view, is simply a particular form of the licensing of intellectual property rights. Trademarks, trade names, copyrights, designs, patents, trade secrets and know-how may all be involved in different mixtures in the "package" to be licensed. In structuring franchise packages other areas of law also become relevant, e.g. competition (or antitrust) law, company law...landlord and tenant law."[73]

This is an illustration of the fact that it is of little real significance to say as the Court does that franchising is not a distribution method but a means of exploiting property, for some eminent writers, if they do not use the expressions interchangeably, certainly do not consider that the one excludes the other: however the Court uses the terms to disguise its policy choice as the inevitable result of an inexorable line of legal reasoning.

Saying, after describing franchising in positive terms, that "Such a system, which allows the franchisor to profit from his success, does not in itself interfere with competition" can only be understood as meaning that it does not interfere with competition to an undesirable extent. The Court might equally convincingly from a legal standpoint - but maybe more objectionably economically-speaking - have concluded regretfully

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73. Recent Developments in Franchising 1986 Journal of Business Law 206 at 207.

that these vertical restrictions, hindering as they do intrabrand competition, were clearly prohibited by a.85(1) and that any arguments relating to the economic efficiency of such a system could be relevant only, if at all, in the context of a.85(3).

Whether this acceptance of franchising as not falling within a.85(1) is characterised as the introduction or further development of a "rule of reason", however that may be defined, is not, as I have already said, my concern here, for that goes to the form of the decision rather than its motivation. What is important is that the Court, departing radically from a legalistic interpretation of a.85(1)'s prohibition, was led to allow all sorts of restrictive contract clauses which, under its previous approach, would have been declared void and refused an exemption, regardless of cogent arguments based on economics of the kind put to it even as long ago as 1966 in Consten v. Grundig[74].

Turning now to the Regulation, the preamble describes franchising agreements as consisting "essentially of licences of industrial or intellectual property rights relating to trade marks or signs and know-how, which can be combined with restrictions relating to supply or purchase of goods" [my underlining] (recital 2). Here we find the Commission echoing the Court's emphasis on the intellectual property analogy as opposed to the system of distribution analogy.

It is of fundamental importance to be sure of the exact scope of the Regulation, since, as is always the case with block exemptions, the consequences of falling outside its terms can be very serious. In this particular case it is all the more important

74. 1966 ECR 299.

since in many ways the regime allowed by the regulation is much less strict than, for example, the rules on the distribution of motor vehicles and spare parts and those on exclusive distribution including that of beer and petrol. However, the scope is by no means clearly defined, as the following examination illustrates.

A first and obvious point to make is that the scope of the Regulation, though of course considerably wider than that of the judgment given in Pronuptia, is narrow: it includes only franchises accorded by one party (the "franchisor") to one other party (the "franchisee") - a.1(2)(a), in return for "direct or indirect financial consideration" (a.1(3)(b)).

The "franchise" which the franchisee gains the right to exploit in return for such consideration is defined in terms of a

"package of industrial or intellectual property rights relating to trademarks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users" (a.1(3)(a)).

A "franchise agreement" must include

"...at least obligations relating to:
-the use of a common name or shop sign and a uniform presentation of contract premises and/or means of transport,

-the communication by the franchisor to the franchisee of know-how,

- the continuous provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement." (a.1(3)(b)).

"Know-how" is defined as "a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified."

(a.1(3)(f)). The latter three terms are defined in aa.1(3)(g), (h) and (i) respectively.

The idea of "know-how" is of crucial importance because it seems to have been seized upon by the Commission and Court as the fundamental distinguishing characteristic of franchising: as has already been discussed, it has enabled franchising to be elevated to the status of a new type of intellectual property. Article 1(3)(i) of the Regulation requires that the know-how involved be described in detail, in writing.

The term "substantial" is defined rather vaguely, although it is consistent with the Court and Commission's conception of the essence of franchising being in the transfer of certain business know-how: presumably it is intended to prevent abuse of the Regulation by the construction of distribution agreements (for cars, for example), which might "artificially" be made to come within the terms of the exemption, and in which only "token" know-how is transferred, but the definition given is likely to raise as many questions as it answers: for example, there may be much argument over whether the know-how is "capable" of conferring a competitive advantage: this may well vary according to the experience possessed by the individual franchisee. Perhaps an "intention" to confer such an advantage would have been a better criterion - although subjective criteria relating to state of mind bring their own difficulties.

"Secret" is defined so as to make clear that it is often the exact compilation of the information rather than the individual pieces of information themselves which are secret. It is not provided that the unauthorised disclosure of know-how to the public does not prevent its continuing protection, although a.5(d) suggests that a franchisee may be prevented from using such

know-how after the termination of his contract if it became public as a result of a breach of confidentiality by that franchisee.

These minimum requirements ("at least") amount to the necessity for the use of a commercial "identity" in the form of a name or sign and in the appearance of the outlets, and the initial and continuing assistance of the franchisee by the franchisor in running his outlet.

The restriction of the Regulation's application to retail outlets ("end users") betrays a cautiousness which is probably due to the view that the limiting of the freedom of action of retail outlets is less likely to harm competition significantly than limitations attaching to wholesalers, who will by definition already be fewer in number. Had the Commission been more experienced in this field it might have felt confident enough to extend this aspect of the exemption; the same may be said about the exclusion of "industrial franchises", and this creates problems of definition already alluded to: can a fast food franchise be seen as predominantly an industrial franchise in the sense that it transfers (technical) know-how enabling the franchisee to manufacture a hamburger to precise specifications? It would be stretching the definition to claim that the franchise consisted essentially of the activity of providing services, especially if the food was to be taken away rather than eaten on the premises, and it is certainly not the "resale" of goods.

The franchise is required to be granted for "direct or indirect financial consideration" (a.1(3)(b)). Clearly, a lump sum is not necessary: very often there is no such sum demanded, and a provision for royalties on a fixed percentage basis should be sufficient. However, as has also been mentioned, it can happen that the franchisor's profit is included in the price that he

charges to his franchisees when he sells his merchandise to them wholesale. Presumably this too would constitute "financial consideration". Although it might be thought desirable that the Regulation be drafted to allow as much flexibility as possible to franchisors it may be that in this case a good argument could have been made for the desirability of the profit being taken by the franchisor being made explicit to the franchisee - although this could always have been circumvented by the imposition of a purely nominal charge.

As has already been stated, it is unfortunate that the scope of the Regulation is unclear: if the Commission is to insist on building separate pigeonholes for each type of agreement rather than relying on a uniform set of principles that apply to all contracts, it is imperative that it make the nature of the divisions clear. Since it is conceivable that those suppliers who are currently subject to the older regulations might try to bring themselves within this new, more advantageous exemption, it was of the utmost importance that this was prevented - unless it is a result that the Commission desires, in which case it is still necessary to define the boundaries clearly. The association representing the Italian car distributors, for example, made formal representations about its worries in this respect known to the Commission.

Before leaving the subject of the characterisation of franchise contracts, it should be mentioned that in response to the second question[75] posed to it in Pronuptia the Court stated

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75. It was not in the event necessary for the Court to answer the third and final question addressed to it, since it asked about the status of various clauses under Reg.67/67.

that the block exemption 67/67 did not apply to the contracts in question, despite the elements of exclusive distribution present. It stated that the emphasis in definition of the contracts to which Reg. 67/67 applies is on obligations of supply and purchase rather than on the use of a particular business symbol, specific business methods and the payment of royalties. However, if the clauses that take it outside Reg. 67/67 are said at the same time not to infringe a.85(1) it is hard to understand how they can have this effect.

The second reason given is that the exemption is stated only to apply to exclusive dealing agreements, Thirdly, the absence of any mention in the Regulation of obligations that may be imposed on the supplier and fourthly the absence of any reference to other clauses such as the obligation to pay royalties apparently led the Court to conclude that,

"Regulation No.67/67 is not applicable to franchise agreements for the distribution of goods such as those considered in these proceedings."

These three further reasons do not appear to add anything substantial to the first one. The reasoning is consistent, however, with the desire of the Court of Justice, so blatant that it is all but explicit, at all costs to treat franchising in a way different from that in which it has treated other distribution methods in the past and different also from the treatment that strict legal reasoning would perhaps require. The Court clearly wanted franchising to remain largely within the Commission's control, in such a way that it had the freedom to create a special regime for franchise contracts.

(d) different categories of franchise

In Pronuptia the Court distinguishes between three types of franchise agreement which are,

"(i) service franchises, under which the franchisee offers a service under the business name or symbol and sometimes the trademark of the franchisor, in accordance with the franchisor's instructions,

(ii) production franchises, under which the franchisee manufactures products according to the instructions of the franchisor, and sells tham under the franchisor's trademark, and

(iii) distribution franchises, under which the franchisee simply sells certain products in a shop which bears the franchisor's business name or symbol."

It then stated that it would deal only with the third.

The classification itself is strange , since it is not at all clear where it came from - it does not seem to have been derived from any national approach or academic discussion - and very many "real-life" franchises do not fit neatly into such divisions: for example, a pizza restaurant such as "Pizza Hut" may be seen as a service franchise when it serves food and drink in the restaurant or delivers pizzas to customers' homes, as a production franchise when it is manufacturing pizzas to the franchisor's exact specifications, or as a distribution franchise when it sells fizzy drinks selected by the franchisor and sold under his business name or symbol, or as combining elements of all three categories.

This arbitrary classification looks like the result of an urgent desire to confine the exact ruling as closely as possible, whilst at the same time appearing to deal with

franchising in a logical and principled way: Advocate General Verloren van Themaat had preceded the substance of his opinion with the reminder to the Court that, even if they were to confine themselves to giving an answer relating specifically to the particular type of franchising involved in this case, this would "have repercussions for the validity of tens of thousands of contracts", and noted that the Commission had not as yet adopted a clear policy in the matter: it may well be that the task of, in effect, legislating on such an important matter with so little experience by which to be guided, was a task that the Court would have preferred to have avoided. Since it could hardly confine itself to the facts of the case - in other words, to wedding-dress franchises - it did the best it could to narrow the range of application of its ruling[76].

A distinction could equally obviously and justifiably have been drawn between distribution franchises in which it is the franchisor himself who manufactures the goods to be distributed, and those in which he buys or selects them from a third party: this last could also be divided, for example, into the arrangement in which the franchisor buys the goods and sells them on to the franchisee and that in which the franchisee buys goods designated or authorized by the franchisor directly from a third party. At

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76. This view is shared by Burst and Kovar, who consider that,

"Le souci de la Cour de faire coincider sa décision avec les particularités qui peuvent exister à l'intérieur meme de la catégorie de contrats de franchise de distribution, l'amène a restreindre la portée de son arret aux seuls contrats ayant un contenu identique à celui qui lui était soumis." op.cit.(note 66) at p.392.

least one writer[77] has cited the following as the two chief categories: "package franchises" in which the franchisee produces goods and provides services, making use of the franchisor's image, intellectual property and know-how and is under his control and "product franchises" in which the franchisee is selling goods actually produced by the franchisor. This distinction has a certain logic to it, in particular in the light of the discussion[78] regarding the validity of seeing franchises as a quasi-intellectual property licensing: the analogy seems much more appropriate to the former category than to the latter[79].

The network in Pronuptia was a combination of the alternative categories that have just been discussed: 80% of goods bought in by Mrs. Schillgalis were to be produced by Pronuptia itself and the remaining 20% were to come from approved suppliers. So, although the arrangement in respect of this latter 20% was

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77. Galan Corona E. "...se distingue entre el franchising de estilo empresarial o "Package Franchise" en la que el franchisee adopta el estilo empresarial establecido por el franchisor e identificado por su marca, fabricando productos o prestando servicios bajo la misma con sujeciòn al control o asistencia del franchisor, y el franchising de distribuciòn o "Product Franchise", en el que el franchisee distribuye productos fabricados por el franchisor, provisto de la marca de éste, y también bajo su control o asistencia." Los Contratos de "Franchising" ante el Derecho Comunitario Protector de la Libre Competencia 13 Revista de Instituciones Europeas 687 (1986) at p.689.

78. See supra p.64.

79. Indeed, Galan Corona E. makes the same point. After making the distinction described, he comments on the Court's statement that franchising is not really a method of distribution so much as a way of reaping the benefit of expertise, saying, "...pero no cabe duda de que, descendiendo a la franquicia de distribuciòn, la finalidad de comercializaciòn no puede ser marginada, màxime cuando con frecuencia no es facil discriminar el franchising de distribuciòn de la figura de la concesiòn mercantil." Op.cit. (note 74) at p.691.

clearly an exchange of royalties in return for what may be regarded as a kind of business know-how, in respect of the other 80% the dominant element is that of the distribution system. Since the franchise therefore consisted of a mixture of elements from these various categories suggested, the chosen distinctions were clearly more convenient in the present case, and it looks suspiciously as though the particular case governed the selection of the general rule, rather than vice versa.

In any case, the Court's classification disguises the fact that franchising could quite easily have been dealt with under existing rules of the type applied in the past to selective distribution systems, intellectual property licensing and other contracts involving vertical restraints. The European Court instead wanted a free rein to deal with franchising and so invented this new, mysterious set of categories, to which it was then able to attribute a kind of uniqueness, which allows departure from the usual rules. In other words, this kind of labelling paved the way for a new approach with very different consequences from those that would have followed from the application of the existing rules mentioned above.

The same three-fold classification into industrial, distribution and service franchises is made in the preamble to the Regulation. In an earlier draft of that Regulation[80] distribution franchises were further sub-divided into "producer's franchise, concerning the retail of goods manufactured or selected by the franchisor or on its behalf and bearing the franchisor's name or trademark" and "distributor's franchise, concerning the retail of

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80. OJ 1987 C229/3.

goods manufactured by third parties and selected by the franchisee in collaboration with the franchisor". As already explained, this is perhaps a distinction of more substance than that made between service and distribution franchises. However, it has disappeared from the final text of the Regulation.

The exemption is said to apply only to distribution and service franchises, but no attempt is made to make it any easier to decide whether, for example, a franchise for the production and sale of hamburgers might , at a certain point, if, say the recipe for their preparation became complicated enough, become an industrial franchise. Industrial franchises are said to "govern relationships between producers" (recital 4). It is not clear either what this means, if anything, whether it bears any relation to a.5(a): this article would in any case have excluded from the exemption agreements between competing manufacturers.

The motivation, already alluded to, behind the creation of this new classification system will be discussed later.

(e) The Good

In any case, in Pronuptia, having analysed franchising in a way that established it as "a good thing", being the way in which the just rewards of invention and ownership are reaped and this form of know-how, which is valuable to society, is disseminated, the Court of Justice went on to state that:

"In order for the system to work two conditions must be met...First, the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods, without running the risk that that know-how and assistance might benefit competitors, even indirectly...Secondly, the franchisor must be able to take the measures necessary for maintaining the identity and reputation of the network bearing his business name or symbol..."

As a result of the existence of these two necessary conditions, provisions essential to their fulfilment are legitimate: thus, clauses protecting know-how, non-competition clauses - even after the contract has come to an end - , non-alienation terms, and terms giving the franchisor control over the franchisee's business methods, the appearance of his premises, goods sold in the shop and advertising do not infringe a.85(1).

It is not clear how the Court sees such clauses in precise legal terms: strangely, it states clearly that there is no interference with competition, although no economist would dispute that intrabrand competition between franchisees is restricted. It might be that the Court is saying that in the absence of the franchise network these retailers would not exist and so no competition that would otherwise exist is affected, as it held in Nungesser[81].However, if this is the explanation, it is not clear why territorial restrictions did not receive the same favourable treatment that they did in Nungesser, given the admission by the

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81. L.C. Nungesser KG and M. Kurt Eisele v. Commission 1982 ECR 2015, in which, on the facts of the case of plant breeders rights, it was held that "open" exclusive territories did not come within a.85(1) at all.

Court that such a clause might be necessary sometimes to attract franchisees to the network in the first place.

If, on the other hand, the restraints are seen as what are known in America as "ancillary" (that is, permissible because necessary and only ancillary to the attainment of a legitimate commercial objective[82]) it is surely not accurate to say that competition is not affected: the point is, rather, that the clauses are restrictive of competition but they are allowed as they are a necessary part of a permissible agreement. In any case, the doctrine of ancillary restraints does not sit easily in a.85, since one of the requirements for exemption under a.85(3) is that the restriction be indispensable for the attainment of the benefits alleged to flow from it. From the point of view of strict legal analysis, the resulting situation is very unsatisfactory: it should mean that if a restraint is necessary to attain some legitimate commercial objective then it will escape a.85(1), and if it is not,it is not eligible for exemption, and a.85(3) is rendered redundant.

A "white list" is given in a.3 of the draft block exemption: restrictions listed here are considered generally not restrictive of competition at all (that is, not prohibited by a.85(1)) but exempted, if in particular circumstances they are considered anti-competitive. A.3 is divided into two parts, the first of which lists restrictions which are exempted only "in so far as they are necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity

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82. For an example of the application of this doctrine by the European Court see e.g. Remia BV and Others v. Commission 1985 ECR 2545.

and reputation of the franchised network. This first part includes best endeavours clauses, quality specifications, non-competition clauses, minimum stocks, minimum turnover and advertising stipulations. Unconditional exemption is granted for clauses in a.3(2): these include terms regarding confidentiality, training, location of premises and assignment of the contract.

Many of these clauses seem to go further than necessary: for example, it might well be sufficient to authorise a "best endeavours" clause, rather than allowing fixed minimum turnovers and stocks to be laid down. Similarly, it should not be allowed for the franchisor to withold his consent to assignment unreasonably, particularly on the death or incapacitation of the franchisee. Also, it is difficult to see how restraints such as the obligation to attain a minimum turnover, which clearly restrict the franchisee's freedom, can ever be justified as necessary for the protection either of the reputation of the network or the franchisor's intellectual property or know-how.

A reasonable post-term restriction on competition with the franchise network is allowed (conditionally) up to a maximum of one year, which is strange to say the least, given that such an exemption appeared in Reg. 67/67 but was removed when Reg.1983/83 replaced it. It is also possible that such a term would be illegal undr some national laws.

(f) The bad

The Pronuptia judgment divides fairly clearly into two parts: the benevolent attitude taken towards franchising generally and to the many clauses just described does not extend to clauses of territorial restraint. When these are discussed, the tone changes abruptly. Territorial restraints are condemned, in particular when combined with a location clause (which, alone, is apparently not within a.85(1) in the Court's view), on the grounds that they restrain competition between franchisees: the possibility that without territorial protection a prospective franchisee would not take the risk of joining the network might suggest logically that a third condition for the working of the system might well be that the terms of the contract should be sufficiently favourable to attract franchisees, and that in certain circumstances this would necessitate exclusive territories, at least for a certain period of time[83]. However, this possibility is described by the Court as being "relevant only to an examination of the agreement in the light of conditions laid down in Article 85(3)", despite the fact that they admit that such a clause may be indispensable to the formation of the network !

Not only this, but it is expressed in this way:

"...far from being necessary for the protection of the know-how provided or the maintenance of the network's identity and reputation, certain provisions restrict competition between members of the network."

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83. In the block exemption for patent licensing absolute territorial exclusivity is allowed for the first five years from the product's being put on the market: Reg.2349/84 1984 OJ L219/15 a.1(1)(6).

Even those fully in favour of vertical restraints of the sort approved by the Court earlier in the judgment would admit that they restrict competition within the network. Their point, however, is that competition with other brands and networks is increased. So this statement appears a little nonsensical, unless we are to read into it that it means that certain provisions are more restrictive than others.

Even more illogical, in the individual exemption granted by the Commission to Pronuptia shortly after the Court decision, it states that certain obligations regarding minimum stocks and royalties fall outside a.85(1), and explains that although such clauses might fall within a.85(1) if used in the context of selective distribution, franchising is different: "The exclusion of any others from the territory allotted to the franchisee is therefore a consequence which is inherent in the very system of franchising." This is a strange explanation, given the Court's statement in Pronuptia that exclusive territories were not inherent to franchising.

Another point to notice is that the same attitude is taken to the argument that interbrand competition is increased as a result of the restraint as was taken as far back as 1966 in Consten v Grundig. In that case, the Court stated quite unambiguously, that once the restriction on intrabrand competition by the imposition of territorial restraints was established, further examination of the effects on the market became irrelevant:

"...although competition between producers is generally more noticeable than that between distributors of products of the same make, it does not thereby follow that an agreement tending to restrict the latter kind of competition should escape the prohibition of Article 85(1) merely because it might increase the former...there is no need to take account of the concrete effects of an agreement once it appears that it has as its object the

prevention, restriction or distortion of competition. Therefore, the absence in the contested decision of any analysis of the effects of the agreement on competition between similar products of different makes does not, of itself, constitute a defect in the decision."

Although this line has since been softened sometimes, as for example in Nungesser, territorial restraints have generally been held to infringe a.85(1), and here in Pronuptia the Court cites Consten v. Grundig itself for this proposition. But strangely, the justification that seems to have been applied, at least as part of the reasoning, to save many franchise contract clauses from nullity under a.85(2) - that is, that interbrand competition is being increased, even if intrabrand competition is diminished - is suddenly apparently no longer acceptable in the context of exclusive territories. Furthermore, in Pronuptia there was no absolute export ban as there was effectively in Consten v. Grundig, so it was not inevitable that the Court apply this rule.

The result is of course justifiable on various grounds, such as the conflicting claims of the objective of market integration, but to say that some clauses do not restrict competition while exclusive territories do, is a muddled and ambiguous way of making the distinction. In contrast, the Advocate General points out, after having observed the benevolent application of the rule of reason to vertical restraints including territorial protection in America, that,

"...in the United States the problem to the EEC of separate national markets with prices which are often widely divergent does not exist. A single internal market was achieved long ago in the United States, so that the problem of obstacles to parallel imports does not arise".

He thus makes a much more explicit and convincing link, admitting that there is some kind of conflict between the need to

integrate the market on the one hand and the fostering of efficient franchise networks on the other.

Although strictly speaking of no legal value, the opinion of the Advocate General can give us a good picture of the ideas presented to the Court before they made their decision: this is particularly valuable in attempting to see behind the judgment to the aims and objects motivating it, in that it shows us some of the policy choices that the Court must consciously have rejected. Also, his discussion of the characteristics of franchising may have made it easier for the Court to treat territorial exclusivity differently from clauses protecting the know-how transferred and the reputation of the network.

The Advocate General described "[t]he development of the franchising system as a new distribution system" (my underlining). He discussed the recent and rapid growth of franchising in Europe, noted the complete absence of any national legislation in this area, and observed the following characteristics of distribution franchises in all Member States:

"(1) although they remain independent and bear their own risks, franchisees are integrated to a considerable extent in the franchisor's distribution network;
(2) marketing strategy is based on a chain effect, brought about by the use, in return for payment, of a common business name, trade-mark, sign or symbol, and - in many cases - uniform arrangement of shop premises;
(3) exclusive rights are granted to the franchisee within a defined area and for defined products, and exclusive rights that vary in scope are granted to the franchisor with regard to the supply or selection of the products to be sold by the franchisee".

It is noteworthy that territorial rights are included in this list of the identifying characteristics of a franchise network: he then cites other descriptions, one of which talks of exclusive territories and the other of which does not. Later it is

mentioned in respect of the French jurisprudence that exclusive territorial rights - in contrast with most of the other commonly occurring elements of a franchise system - are not always regarded as essential. Also he mentions that territorial exclusivity is allowed in the United States of America under the rule of reason provided interbrand competition in the relevant market is healthy.

The Advocate General summed up this part of his opinion by listing the significant distinguishing features of a franchise agreement that he has derived from an investigation of the available literature and jurisprudence, and territorial exclusivity is notable by its absence. But he says also that both in Europe and in the United States of America, "the specific circumstances of the relevant market...[are] particularly relevant with regard to the various exclusivity clauses to be found in franchise agreements".

The Court may have been influenced by the apparent difference in importance attached in practice to territorial exclusivity as compared with other restraints. Burst and Kovar express it in the legalistic language of the Court's jurisprudence: they perceive a certain "objet specifique" of a franchise, and explain that territorial restrictions are amongst "les stipulations qui sont étrangères a cet objet spécifique du contrat de franchise..."[84]. However, this is a classification which, as when it is used in the context of intellectual property rights[85], has no predictive use and can be applied only after the Court has ruled on the content of the "objet specifique" of any

84. Op.cit.(note 66) at p.394.
85. e.g. Windsurfer 193/83.

given right. It cannot provide guidance, since it can only classify after the event.

Further, although the condemnation Pronuptia is restricted to "a business name or symbol which is already well-known"[86] it may be imperative when entering a new geographical market - in particular a new country - that the franchisor be able to offer exclusive territories, at least for a limited period of time, even if the name or symbol is already well-known in other places. No allowance is made for the fact that in franchising, it is not possible to strike out into different Member States without considerable preparation and probably some kind of pilot scheme: this is a result of the divers languages, laws, cultures and social and purchasing habits of consumers in different parts of the Community. However, the practical importance of this proviso is limited in franchising, since the franchisor's name or sign almost always is well-known, since this is a large part of what will enable him to attract franchisees to his network in the first place: however, it could make a difference if the fact that the name was not well-known in a new geographical market could be taken into account.

The individual exemptions so far granted by the Commission are for the most part unexceptionable, but they illustrate that territorial restraints will only fall outside a.85(1) - if ever - when the market share is very tiny indeed.

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86. Some consider this to be no more than the restatement of the "de minimis" rule, first stated in Volk v. Vervaecke 1969 ECR 295: see e.g. Dubois J. Franchising under EEC Competition Law: Implications of the Pronuptia Judgment and the Proposed Block Exemption 1986 Antitrust and Trade Policies in International Trade (Fordham Corporate Law Institute 13th Annual Meeting) 117 at 132.

The first exemption, Yves Rocher, involved an exclusive territory combined with a specific location clause, although the franchisor reserved the right to sell by mail order, shows and fairs within the territory.

This decision illustrates that the prohibition on territorial restraints applies even if the market structure is "healthy" in competition terms and the market share involved is small: even in France, where Yves Rocher has a relatively well-established and widespread network, it had only just over 5% of the cosmetics market and no more than 15% of any individual product market - yet an exemption was held necessary. And this despite the fact that the territorial exclusivity provided no form of protection against sales by mail order or other methods into that territory by the franchisor.

The Pronuptia contract exempted was similar: Pronuptia were asked by the Commission to make it clear in the contracts that cross-supplying between franchisees was allowed and also that goods not related to the "essential object" of the franchise might be obtained from sources other than the franchisor, who would have only an a posteriori control in case these goods should be such as to damage the network's reputation. An exclusive zone was granted and a location specified. Here, although Pronuptia had 30% of the bridal wear market in France, its share in other Member States was much smaller.

The third exemption granted by the Commission under a.85(3) was to Computerland: again it was confirmed that a small market share will rarely if ever allow a network to escape the Comission's control. Computerland, a distributor's franchise, accounted for only 3,3 % of sales of micro-computer products in the Community as a whole, and for no more than 4% in any

individual Member State, although it had much larger shares in other parts of the world. Otherwise the terms were relatively liberal: the franchisee could open "satellite" stores anywhere apart from in another franchisee's area, and approved products could be obtained from any source available.

Turning to the Regulation, a.2 implies that franchise contracts containing territorial protection of any sort fall under a.85(1). No mention of the requirement of the Court in Pronuptia that the sign or name be "well-known..." is made. The Commission is thus apparently purporting to assume control over a greater range of networks than the Court would have intended to allow and than is justified, unless it really is only a statement of the "de minimis" rule: as we have seen, the market share will have to be very small indeed before this exception will be held by the Commission to apply.

As well as territorial exclusivity, price-fixing was stated by the Court not to be inherent to franchising. Price-fixing has always been subject to a more or less per se prohibition although the Court did suggest in Binon[87], in the context of the sale of newspapers and magazines, that in some special circumstances an a.85(3) exemption might be envisaged for such a clause: however, the general rule is reiterated in respect of franchising contracts, despite Advocate General Vanloren van Themaat's suggestion to the contrary.

The Pronuptia contract notified to the Commission for exemption under a.85(3) contained a clause stating that the franchisee was not to harm the brand image of the franchisor by

87. Binon & Cie v. Agence de la Presse 1985 ECR 2015.

his pricing level. The Commission was apparently prepared to exempt such a clause: it was only in response to third parties' objections that this was deleted from the contract, although it looks like a very thinly veiled minimum price clause. In the Pronuptia exemption the Commission makes its position clear on recommended prices, showing a markedly more liberal attitude[88] than has hitherto characterised its approach to the subject:

"With regard to the circulation of retail prices by the franchisor, the Commission has no evidence of any concerted practice between the franchisor and franchisees or between franchisees inter se to maintain these prices. In these circumstances the mere suggestion of prices for the guidance of franchisees cannot be regarded as restrictive of competition..."

Turning to the draft regulation, the "black list" in a.5 of clauses that will prevent the exemption applying includes

"(e) the franchisee is restricted by the franchisor, directly or indirectly, in the determination of sale prices for the goods or services which are the subject-matter of the franchise without prejudice to the possibility for the franchisor of recommending sale prices".

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88. The cases in which a very strict attitude has been taken even to suggested prices are distinguishable since they involve horizontal rather than vertical agreements. It is probable that even in the context of franchising, if it were shown that a franchisee had had his franchise terminated because he had departed from the recommended prices, the term would be considered illegal. For further discussion of this point see Waelbroeck M.'s contribution to the panel discussion on Franchising and Selective Distribution under EEC Competition Law 1986 Antitrust and Trade Policies in International Trade (Fordham Corporate Law Institute 13th Annual Meeting) at p.233.

The Consumer Consultative Committee[89] takes the position that even price recommendation should not be permitted, but this is in clear contradiction of the Court of Justice in Pronuptia, and of the Commission's individual exemption of the same name. However, the CCC maintains that the practical effect of such "recommended" prices is in franchising the same as that of formal retail price fixing[90].

The CCC also point out that a prohibition on price-fixing is of little value in view of the other, non-price, restraints that are permitted - in particular the restrictions on sources of supply and the lack of freedom for the franchisee to develop the business.

The black list also outlaws horizontal market-sharing agreements, clauses preventing challenge to the validity of intellectual property rights, customer restrictions, post-term use ban on know-how which is in the public domain, and foreclosure of supplies except for legitimate purposes.

(g)market analysis

When the Court begins its judgment in Pronuptia by stressing that each franchising contract must be judged according

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89. Consumer Consultative Committee Opinion on the draft exemption regulation for franchising CCC/54/87.
90. This was also claimed by the franchisee in her submissions in the Court case of Pronuptia: see the Rapport d'Audience, Case No.161/84 at p.22.

to its individual terms, it strangely makes no reference whatsoever to the relevant market or to Pronuptia's position on that market. This would perhaps have been the easiest way for the Court to dispose of the case without effectively legislating for franchise contracts: it could have said that, given the structure of the market and Pronuptia's position on it, competition was not appreciably affected by the clauses in the contract. Instead, it chose virtually to ignore this aspect of the case and to take the innovative approach already described.

When the answer to this first question, on the application of a. 85 to franchising agreements is summed up by the Court in the form of six brief numbered points, it is noteworthy that the legality of the various prima facie "good" clauses is said to be dependent on "their economic context"[91] although the Court does not in its reasoning refer to the nature and quantity of the products, nor to market positions, nor to the extent of the network: there is not even a passing reference to the state of the market for wedding dresses or of Pronuptia's place on it. The judgment contains only a single line, reporting that the franchisee lays emphasis on the fact that Pronuptia is,"as it itself asserts, the world's leading French supplier of wedding dresses and accessories". The Court does not discuss, for example, whether Pronuptia is a small or a large concern, whether it is new or well-established, nor whether there exists an oligopoly of franchisors in the wedding-dress market.

When it comes to the "bad" clauses, the Court does not at any point mention market structure as an important - or even

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91. The Commission has followed this in the caveats included in the draft block exemption regulation in a.8.

relevant - factor. Instead, it seems to take a rather formalistic approach, condemning territorial restrictions and price-fixing without reference to market analysis. No.4 of the listed points prohibits market-sharing in absolute terms again, no mention being made either of the economic context or of the requirement that the name or symbol be well-known.

The Advocate General had come to the conclusion that:

"Article 85(1) of the EEC Treaty is applicable to franchise aggreements such as those concluded between the parties in this case in so far as, inter alia

(a) they are concluded between a franchisor from one Member State, or its subsidiary as referred to in Question 3(a), and one or more franchisees in one or more other Member States, and

(b) by way of its subsidiaries and franchisees in one or more of those Member States or in a significant part of their territory the franchisor has a substantial share of the market for the relevant product;

and either

(c) the agreements prevent or restrict, or are intended to prevent or restrict, parallel imports of the products covered by the contract into the contract territory or exports of those products by the franchisee to other Member States,

or

(d) the agreements result - in particular through the establishment of local or regional monopolies for the products covered by the contract, through royalty provisions and contractual provisions or concerted practices with regard to the setting of prices and on account of the absence of effective competition from similar products - in the setting of unreasonably high retail prices, that is to say, prices which could not be charged if effective competition existed, even allowing for the superior quality of the products covered by the contract".

He goes on to comment that (c) will - except where negligible market shares are involved - always be fulfilled where

absolute territorial protection of national markets is given. This position is considerably more liberal than that eventually assumed by the Court of Justice. He appears here to have in mind perhaps the distinction drawn by the Court in Nungesser between "open" and "closed" protection. In any case, it is clear that for him market analysis is crucial to the determination of the status of a franchise contract.

The Advocate General had cited a passage from Societe Technique Miniere v. Maschinenbau Ulm [1966] on exclusive distribution which he considered relevant by analogy:

"...In order to decide whether an agreement containing a clause 'granting an exclusive right of sale' is to be considered as prohibited by reason of its object or of its effect, it is appropriate to take into account, in particular the nature and quantity, limited or otherwise, of the products covered by the agreement, the position and importance of the grantor and the concessionnaire on the market for the products concerned, the position in a series of agreements, the severity of the clauses intended to protect the exclusive dealership or, alternatively, the opportunities allowed for other commercial competitors in the same products by way of parallel re-exportation and importation".

Although the Court might be argued implicitly to have rejected the relevance of market analysis, presumably we must take it that market analysis is relevant in most cases. If not, the judgment would be going far beyond even the American position, which still at any rate in theory requires an examination of market structure and a sort of balancing of the competitive and anti-competitive effects involved, rather than a blanket acceptance of all such restraints. Certainly this is the way in which the Commission has interpreted it, as shown by the care with

which market share and structure have been examined and described in granting individual exemptions under a.85(3).

(h) miscellaneous points

One discussion conspicuous by its absence is that of the question of the apparently complete freedom to select franchisees on qualitative, quantitative or any other grounds. The point is glossed over by the Court which says that,

"The prohibition of the assignment by the franchisee of his rights and obligations under the contract without the franchisor's approval protects the latter's right freely to choose the franchisees, on whose business qualifications the establishment and maintenance of the network's reputation depend" (my underlining).

Apart from the fact that the franchisee's business qualifications will often be negligible, this freedom should surely be limited to the extent necessary for the protection of the network, if only to avoid radically different treatment of distribution networks depending on whether they happen to be classified as selective distribution or franchising.

A general point about the interpretation of a. 85(1) is raised regarding the meaning of "liable to affect trade between member states". Its scope is in Pronuptia extensively defined, so that a purely domestic network may infringe this article if it prevents franchisees from establishing themselves in another Member State : presumably this means that at least any franchise contract that includes a location clause or territorial protection will fall potentially within the ambit of a.85(1). Again, Advocate

General Verloren van Themaat was more liberal in his opinion: he would require at least a "cross-border" contract before a.85 was applicable.

Another point of general interest arising out of this decision is the development of a European "rule of reason" and, related to this, the growing role of national courts in this area.[92]

So we have arrived at the position that many franchise contract clauses do not fall under article 85(1)'s prohibition at all and others can be exempted, either on an individual basis, or automatically under a block exemption Regulation.

Before going on in the next section to examine the thinking and motivation behind the new rules described above, it may be useful to outline briefly the way in which they depart in principle from previous regulations and decisions in the area of vertical restraints, for it is essentially the existence of these new departures that make it interesting to look at what may be behind the largely unexplained new approach.

First, the franchisor is allowed a much tighter control over the products sold in the outlets than is the case, say, for the car manufacturer's control over spare parts offered by his distributors. Also, there is no maximum duration of contract set as there is for exclusive distribution (5 years), beer (5 years)

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92. It is not dealt with here as it is a general question and in any case has more to do with legal form and labelling than with motivation. For a taste of the variety of different views existing on this topic see articles cited in the bibliography, in particular those of Gyseln L., Kovar R. and Steindorff E.

and petrol (10 years) although the Yves Rocher individual exemption included a 5 year maximum. Then there is no reference to the selection of franchisees on other than qualitative grounds, although this has always been a chief concern of the Court and the Commission in their dealings with selective distribution networks. We have already mentioned the anomalous permitting of a non-competition clause extending for a year after the contract is ended; it is also the case that many of the restraints listed in a.3 are harsher than have been allowed before: for example, permitting the imposing of obligations of result in respect of turnover rather than of "best endeavours". Similarly, for example, there may be an absolute prohibition on assignment without the franchisor's consent, although abuse of such a clause should be curbed by a.8(e), which provides that exemption may be withdrawn as a result of such conduct.

As for restrictions on the location of the dealer's outlet, in the context of selective distribution these have not even been exempted under a.85(3), let alone held to fall outside a.85(1). Then there is the right to control the franchisee's advertising activities that can be reserved by the franchisor: in Hasselblad[93] this kind of clause was held by the Court to be contrary to a.85(1).

In the final part of this paper I intend to attempt to shed some light on the possible motives behind the approach observed in this part.

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93. Hasselblad (GB) Ltd. v. Commission 1984 ECR 883.

PART V

12. What aims and objectives have influenced EEC competition policy on franchising ?

In this Part the previous two Parts will be drawn together, in an attempt to connect the existing EEC competition policy on franchising with the motives and aims that may have inspired it. It will be necessary to discuss in turn the main aspects of the policy choices that have been made so far and are described in Part IV, in the light of the possible aims of competition law considered in Part III. First, the question of the motivation behind the generally benevolent attitude shown towards franchising is discussed, and then the reasons for the relative severity brought to certain clauses are sought.

(a) Why the favourable treatment?

Now what is behind this decision to treat franchising so generously ? A first and obvious source of influence to be considered is that of economic analysis: at first sight it is plausible that, seeing economic advantages in this distribution technique, the Court took the opportunity to present it as sui generis and thus deserving of special, liberal treatment. The favourable attitude taken, generally speaking, by the Community authorities, to franchising, conforms with the more or less unanimous view of economists that vertical restraints should not

be treated with the severity that the EEC has brought to some of its previous dealings with other forms of distribution methods.

However, this coincidence could be no more than that: we are a long way from establishing that economic reasoning was the main, or even an influential, factor in reaching this result. The sparse evidence that there is would point to the conclusion that, although economic analysis dictates a lenient approach to franchise contracts, and this may well have encouraged the Court, there is at least as much emphasis in the decisions on the benefits to the small trader as there is on "consumer welfare" in the technical sense.

For example, in Judge Joliet's rapport d'audience (only available in French) for Pronuptia, he states that,

"...les petites et les moyennes entreprises peuvent participer à un réseau de distribution supra-régional sans perdre leur indépendance...de petits commerçants peuvent ainsi retirer de nombreux bénéfices dont ne profitent normalement que de grandes entreprises de commerce de détail."

Later, he refers to, "l'intégration de petites et moyennes entreprises, par le renforcement de la capacité concurrentielle de celles-ci...".

The Pronuptia judgment and the preamble of the Regulation make similar statements; also the Commissioner responsible for competition, Mr. Peter Sutherland, made two statements that are telling; at a Euro-Conference (on 25th March, immediately after the Pronuptia judgment was issued) he said that franchising,

"...can stimulate economic activity throughout the Community, particularly by small and medium-sized enterprises..."

and at another conference[92] he told an international audience that,

"...the European Commission intends to adopt a generally favourable attitude towards franchising, not only in applying the rules of competition...but also in the context of developing its policy towards small and medium-sized enterprises."

Thus heavy emphasis is laid by all concerned on the advantages of franchising for SME's[93] and no explicit mention whatsoever is made of any form of economic analysis. Nowhere are Telser or Bork - let alone the legitimate interest of a manufacturer in protecting his dealers against free-riders - nor any other aspects of the economic analysis discussed in Chapter 8, even mentioned expressly by these writers and speakers. In fact, when "economic advantages" are mentioned, closer scrutiny usually reveals that this refers to the benefits to SME's. It seems very likely that, had franchising not presented these advantages, it might well have been treated very differently.

(b)Why are territorial exclusivity and RPM treated so severely?

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92. See conference named in note 9.
93. Corabi L. considers that this is the motive for the favourable attitude: "Il motivo del favore della Corte risiede, come essa stessa precisa, nella possibilità che questo sistema offre ai piccoli imprenditori di penetrare mercati ed acquisire conoscenze tecnico-commerciali che altrimenti resterebbero a loro precluse se non a costo di enormi rischi economici." Franchising: La Difficile Convivenza della "Rule of Reason" con l'Illegalità "per se" nello Sviluppo della Giurisprudenza Comunitaria 25 Diritto Comunitario e degli Scambi Internazionali 684 (1986) at 687.

Once the initial policy choice had been taken, another arose for decision: whatever the reason for deciding initially to take a benevolent approach, how far could it be allowed to lead the European Court away from its old rules on vertical restraints?

Now here, an arbitrary - in terms of pure economic analysis - line is drawn: protection of the "know-how" transferred and maintenance of the identity and reputation of the network are said to be essential to the working of the system, whereas territorial protection is not, despite the acceptance by the Court that it is "..of course possible that a prospective franchisee would not take the risk of becoming part of the chain.." in such circumstances.

Various reasons can be suggested for this apparent inconsistency in the Pronuptia judgment: it has been suggested that the continuing objection to territorial protection is more likely to stem from a reluctance to overrule Consten v. Grundig rather than from any objection of principle[94]. Indeed, it is suggested by the Court in its next breath that exemption may be available for such a clause, the net result being that a certain degree of territorial protection can be regarded as legal under

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94. Korah V. makes this suggestion in Pronuptia; Franchising: The Marriage of Reason and the EEC Competition Rules 1986 European Intellectual Property Review 99. Interestingly, Bork R.H. makes the identical point in the context of an analysis of the Sylvania case in Vertical Restraints: Schwinn Overruled 1977 Supreme Court Review 171: "The trouble with the current analysis of vertical restraints is that it appeared in the literature long after the law had to deal with the phenomenon, so that now the courts are asked to rethink and abandon an entire body of doctrine of many years standing." The difference is, of course, that economic analysis was available to the European Court and Commission at the outset but it was more or less ignored for the sake of market integration.

Community law, even if permission must be sought if the block exemption Regulation does not apply.

Some commentators have been harsh in their judgment of the decision, seeing it as the religious perpetuation of mistaken precedent or as a meaningless compromise between disagreeing judges: Demaret, writing on the subject of this seemingly contradictory approach, says that,

"The force of precedents is the most likely explanation for the Court's not entirely consistent attitude with regard to distribution franchises. The Court was not ready to turn its back on more than twenty years of case law. Since the mid-1960's, territorial exclusivities, at least when they have a bilateral character, have been dealt with in the context of Article 85(3). All the regulations adopted with regard to distribution agreements rest upon that very idea. The legitimation of territorial restrictions in distribution franchises would have forced the Commission to reconsider the foundation of its policy towards vertial restraints."[95]

Pescatore, the former judge of the European Court, has interpreted the decision as follows:

"It looks to me as if this expressed a sort of minority opinion in the Court...The minority said: "Well, if you do not have in the franchise agreement some territorial protection, it is rendered senseless and nobody would invest his money in that." This argument, which in my opinion makes sense, really is brushed away...I think this is a very unhappy piece of case law of the European Court: a general statement unsustained by any analytical reasoning and leading to a profoundly unjust result that of freeing the franchisee from her obligation to pay royalties due|"[96].

95. Selective Distribution and EEC Law after the Ford, Pronuptia and Metro II Judgments 1986 Antitrust and Trade Policies in International Trade (Fordham Corporate Law Institute 13th Annual Meeting) 151 at 181.
96. See the panel discussion cited at note 84 at p.237.

This is an insight of particular interest, in the light of the personal experience of the speaker of the way in which a "unanimous" decision of the judges is reached in practice.

Similarly, vertical price-fixing is forbidden, although price "recommendation" is permitted. Whether this is a meaningful distinction at all in the context of franchise networks is extremely questionable in itself. However, the important point made in this connection by many economists is that, in terms of pure economic theory, there is no difference in kind between price and non-price vertical restraints and that they should all therefore be treated in the same way: some explanation other than this kind of economic analysis must be looked for.

I have already cited some outraged reactions to this approach to territorial restraints, and in pure, Chicagoan economic terms it certainly looks anomalous. However, it is quite possible that although the Court was aware of the economic advantages of franchising, either these considerations were by no means paramount, for when they clashed with other concerns, a compromise was sought, or a different kind of economics was applied.

In other words, it is not inconsistent of the Court to be aware of possible advantages in terms of economic efficiency of vertical restraints including exclusive territories and retail price maintenance and yet at the same time to take the course that it did. Such a policy can be explained either in terms of competing economic views, including practical or procedural considerations, or of the other objectives that may be pursued by competition law. Any one or more of these explanations may make it perfectly reasonable that the Commission should retain close control over the use made of exclusive territories, both on

economic grounds and in order to ensure as far as possible that the Community enjoys the improvements in efficiency stemming from them, without sacrificing its other objectives in the process.

So there are essentially two different kinds of explanation that may account for departure from the path that many economists - and American doctrine and jurisprudence today - would recommend.

For now I turn to examine the possibility that it may in fact be explained by economics itself - and perhaps even a more "realistic" and helpful economics than that propounded by the Chicago school and even the Harvard school, whose ideas are now accepted by the United States courts.

As was discussed at length in Chapter 8, there are many counter-arguments to be raised against making vertical restraints per se legal or even subject to the rule of reason.

First, there are the arguments such as those of Comanor, relating to the different requirements of different customers and the greater weight which it pays the manufacturer to accord to the preferences of marginal customers, which certainly suggest that per se legality should not be the rule for all vertical restraints. Similarly, there is the potential use of such restraints to create or sustain horizontal dealer or manufacturer cartels which militates against such a solution.

There are even very good reasons for not even introducing the rule of reason into this area of the law. First, it may be doubted whether free-rider problems cannot be coped with adequately by less restrictive clauses such as those defining an "area of primary responsibility" on which a franchisee is obliged

to spend a certain percentage of his time and money:even if such solutions are not ultimately the economically most efficient in Bork's or Telser's terms, a paramount consideration in this area is, of course, that we are discussing rules that are to be used in a practical context.

Those who call for the application of a rule of reason in this area of the law assume that it is always possible and practicable to ascertain the true object or effect of any given agreement. Once the difficulties of detection and proof of horizontal cartels, for example, are taken into account, there is much to be said in for the prohibition of practices that contribute substantially to their stability.

Horizontal cartels are very difficult to detect, and we may win much more by prohibiting absolute territorial protection and price-fixing, without which such cartels are almost bound to be unstable, than we lose in efficiency by forcing franchisors to adopt a "second-best" solution to the free-rider problem such as centralised fiancing of advertising: to put it another way, some economists appreciate parallel traders as performing a useful role in destabilising and discouraging cartels and do not view them as the meritless parasites that Chicago economists see them as.

The severely limited resources that the EEC has for policing, enforcement and decision-making make it crucial that such factors be borne in mind. A rule of reason would require the effect of each agreement on the relevant market to be judged, which cannot but make for complex and lengthy litigation and the

presentation of large amounts of probably conflicting and inconclusive evidence.[97]

One of the most cogent explanations of why some vertical restraints should be forbidden per se rather than a rule of reason applied comes from Pitofsky[98], who points out that per se rules are designed to outlaw conduct that "almost always results in adverse competitive effects, and almost never is justified by business reasons sufficiently persuasive to counteract those adverse effects". In other words, it is by no means the case that the theoretical potential of a contract to do more harm than good should always mean that it escapes a per se prohibition. More generally, Pitofsky's thesis is that:

"It is possible to give full scope to economic insights into supplier interests in imposing non-price vertical restrictions and the nature of the trade off in pro- and anticompetitive effects, and still advocate selective per se treatment of some categories of vertical restrictions - if one takes into account...some practical considerations about how cartels are initiated and administered, alternative methods of achieving the legitimate business needs of suppliers, and the limitations of the judicial process in isolating and measuring complicated supplier motives and economic effect."

He concludes, as a result of taking into account the factors listed, that airtight territorial restraints should be forbidden per se.

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97. There are two sides to the practical efficiency argument too, of course: if some claim that the rule of reason provokes lengthy and complex litigation over the alleged benefits and dangers of agreements, others say that a per se rule leads to equally long drawn out arguments over classification.

98. The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions 78 Columbia Law Review 1 (1978) at p.3.

The above suggestions simply amount to the result of taking as an economic model of the business world a system where there is not perfect information available and transaction costs exist: that is, the practical problems that face business and law-enforcement agencies are taken into account. To put it another way, as a result of taking a different - and arguably more realistic - economic model, it is perfectly possible reasonably to take the view that more often than not territorial exclusivity is harmful to the economy and therefore should be prohibited per se or at least only allowed under strict control, as is the case in EEC law.

Alternatively, as indicated above, one way of approaching the Court's suspicion of certain vertical restraints but not others, is to wonder whether a policy of deliberately sacrificing a degree of economic efficiency for the sake of other goals is being adopted: after all, nowhere is it written that the purpose of competition policy is solely to further economic efficiency in the strict, economic sense of the word[99]. Indeed, in recent times it has been suggested even that matters such as industrial planning and transport policy are properly considered in forming competition policy[10].

Disposing first of concern for small businesses, it seems fairly clear in many contexts that these are still dear to the heart of the EEC, and this has already been discussed. However, for the EEC, the franchisee is seen as the small trader

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99. Indeed, it is possible to see a.85(3) as allowing for exceptions to be made to the usual competition rules in special circumstances in order that a conflicting aim of economic efficiency be fostered.
10. See article cited at note 53.

enabled to run his independent business helped rather than hindered by the bonds of the franchise contract. So in this context, far from being in conflict with arguments of economics, populist rhetoric backs it up. For this reason, the resulting policy can tell us nothing definitive about any preference the EEC authorities may have as between economic efficiency and small traders, although the quotations cited above may be of some help.

By far the most important competing concern must be that of market integration: it is the only reason expressly given by the Court in Pronuptia for the illegality under a.85(1) of territorial restraints. Although I come to mention it only now, it may well be that the aim of market integration should take first place: its influence in the EEC is paramount.

But in both the block exemption and the Court decision the use of market integration reasoning is strange. In allowing exemption for exclusive territorial clauses under a.85(3), they purport to strike a balance between the competing claims only of market integration and the protection and promotion of SME's in the market. Nowhere is protection from free-riders cited as a justification. In any case, it is almost inevitably going to be the case that if the degree of territorial protection allowed is sufficient to protect the franchisee from freeriders, it will be sufficient to partition the market to an appreciable extent. That is to say, if noone else but me is allowed actively to sell Pronuptia wedding dresses in my assigned territory and the nearest competing retailer is far enough away for me to be substantially protected from his freeriding on my promotional efforts, surely he is far enough away for me to be able to raise my prices somewhat, without fear that too many of my potential customers will know about or be prepared to make the journey to the cheaper retailer. In other words, the exemption of exclusive territories means that

lip-service is paid to the market integration goal: the uselessness of parallel importing as far as services and goods such as pizzas is concerned has already been evoked.

So although one might be tempted to see this rather "mixed" approach as an attempt to allow the Community to enjoy the potential economic advantages of vertical restraints and yet to retain sufficient control for the Community authorities to be able to step in in the event that the use made of them is endangering other Community goals, in particular market integration, the language of the Court and the Commission is disappointing. The rational economic explanation suggested above for retaining control over territorial restraints is nowhere suggested by their words, and is but a speculative suggestion on my part as to how they might have chosen to justify laying down the rules that they did.

13. Conclusions

The main problem that one has in performing this analysis is, of course, the lack of hard argument presented by the Court and Commission in their decisions. The Commission, those arguing before the Court and the Court itself are aware of the different arguments of economic analysis that can be applied in the case of such vertical restraints, but they do not deal with them explicitly, either to accept or reject them.

So to sum up intelligibly the parts that different aims and objectives have played in the formation of European franchising law as it has developed so far is no easy task. Populism and economic efficiency happily coincide and market integration reasoning seems to move in such a mysterious way that its importance in the process of coming to a decision is hard to guage.

Although economic analysis is capable of backing up the liberal approach taken by the Court to franchising quite as well as is the social aim of protecting the small trader, the latter is given far more emphasis than the former. In fact, not once is reference made to the arguments I outlined above, such as the free-rider rationale for vertical restraints, although all this and more would have been before the Court. On the other hand, it is noticeable that the protection of the independent businessman is clearly of very great importance indeed[10].

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10. However, it is open to question how meaningful this legal but otherwise often rather nominal "independence" is: see Rubin P.H. loc.cit. at note 6 for a description of franchising as, in economic terms, a form mid-way between independence and employment.

Whether this "reasoning" is used because the judges shy away from expressing themselves in economic terms or rather because they are expressing a sense that priority should be given to social considerations before considerations of economic efficiency, is hard to say. Although their reticence on the matter is to some extent understandable, given the political nature of the choices to be made, the complete absence of mention of any such reasoning does suggest that it is of very little primary importance, even if it does play a subsidiary role.

For this reason - that is, because populist and economic goals appear to coincide so neatly in the context of franchising - it is not possible with confidence to ascribe the liberal approach taken to a sort of economic "enlightenment". I tend to the view that economic analysis plays an extremely limited role in forming competition policy in the EEC. "Economic" advantages to SME's are very much more important than the kind of economics put forward, for example, by Telser, and the free-rider remains a hero on this side of the Atlantic.

Also, a strong impression is created that franchising is being treated as a very special case since its image - and, very largely, its reality - is so bound up with the picture of the small man and the family-run business that it could hardly fail to capture the imagination of the EEC authorities. It is a topical subject, discussed in popular newspapers all over Europe and often in the form of instructions to the individual on how best to go about setting up as a franchisee. In this climate, a liberal approach was almost inevitable and, heretical though the suggestion may be, the legal reasoning - to the extent that there is any real, rigorous legal argument - employed was very much secondary to the result. It can be seen as economic in the sense that franchising and the vast majority of restrictions imposed in

franchise contracts are seen as efficient, bona fide commercial methods and the prohibition on airtight territorial restraints is not incompatible with economics; it is populist in the importance it attaches to the small trader and in this instance these concerns fitted in nicely with the dictates of economic analysis; market integration aims are cited to justify a degree of caution in the formulation of the rules.

The most extraordinary aspect of all, however, is that the Court and Commission should choose to express and justify their rules in the way that they do. As we have seen, the actual rules developed are easily justified on economic, practical and other grounds, yet they are instead backed up with vague mention of SME's and confusing references to clauses deemed essential to franchising and those not so considered.

It seems unlikely that this is best understood as a perverse manifestation of the unconscious genius of the Community institutions: it looks as though the similarity of the result reached by the Court and Commission to a result that can be reached by a convincing form of economic reasoning is little more than a happy coincidence.

A coherent explanation of the given rules in the terms suggested above would have been far preferable, not only from an intellectual point of view, but more importantly because it would have allowed businessmen and lawyers more accurately to judge the legality or otherwise of a given contract. The law is becoming more and more complex in this area, and this is quite unnecessary. The results that the Court and Commission apparently want to achieve are easily justifiable on various rational grounds: there is simply no need for such a confused and sometimes incoherent path to be followed in order to reach them.

The tentative conclusions reached above allow one or two general comments about the future of EEC law on franchising and on distribution systems generally to be made.

First, the goodwill evidenced by the Community authorities towards franchising is clearly largely reliant on its advantages for the existing or potential small trader, and its perceived benefits in encouraging independent enterprise on a small scale. This means that if it is to continue to enjoy its present privileged status, it must continue to play this role: if it is considered by the Commission that too many franchisees are in fact , say, large discount or department stores or subsidiaries of substantial businesses, "the party will be over".

Also following from the above is the fact that the extent to which the new block exemption is perceived to be being "abused" by car manufacturers, for example, will affect future policy.

It remains to be seen whether the restrictions placed on a franchisor wishing to include some form of territorial protection in his franchise contracts will act as a significant incentive to integrate vertically rather than to set up a franchising network: Grundig bought up Consten after the agreement between them was held void under a.85(3). If the EEC authorities were to see that its policy was having the effect of destroying networks of small, independent networks in this way, it is possible that it might adapt its policy to try and prevent this.

However, as suggested earlier, there are reasons other than limited capital for choosing the franchising option: many large and rich firms choose to do it, mainly because hierarchies bring their own problems in the form of transaction costs that

increase considerably as the firm grows in size. The evidence so far available suggests that franchising will continue to be very widely used, and as the law becomes more certain and exemptions can be granted more swiftly to agreements falling outside the terms of the block exemption, the climate for franchising can only improve; this will be true despite the usual disadvantage inherent in block exemptions that forms of contract may become more uniform and less innovative[10].

As intimated above, extreme caution is necessary if any generalisations are to be made on the basis of the above findings. If not in economic terms, then certainly in other ways, franchising is sui generis: it is perceived by Community institutions and the general public alike as providing opportunities for small individual enterprise to those to whom such a chance would otherwise not be available. Unlike, for example, selective distribution, it enjoys a unique association with populist concerns, which has enabled it to claim what can only be described as "special treatment".

The chief lesson for competition lawyers is, perhaps, that it is by no means inevitable that a contract clause will be condemned under a.85(1) simply for formalistic legal reasons: if there is merit, and, above all, political or social merit, in a type of agreement, the Court is clearly prepared to take an imaginative approach and the Commission will follow. It will

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10. For example, Benetton franchises are currently granted by a "stretta di mano" contract - a sort of gentlemen's agreement. In order to benefit from the block exemption as it stands this system would have to be replaced with a detailed written agreement, at least as far as the description of the know-how transferred goes.

achieve the outcome it wants, treating the reasoning used to arrive at the result as secondary to that result. As to the lesson for advocates before the Court of Justice or the Commission, the tone of the Court's judgment in Pronuptia suggests that emotive, populist arguments will succeed more readily than dry and rigorous economic analysis.

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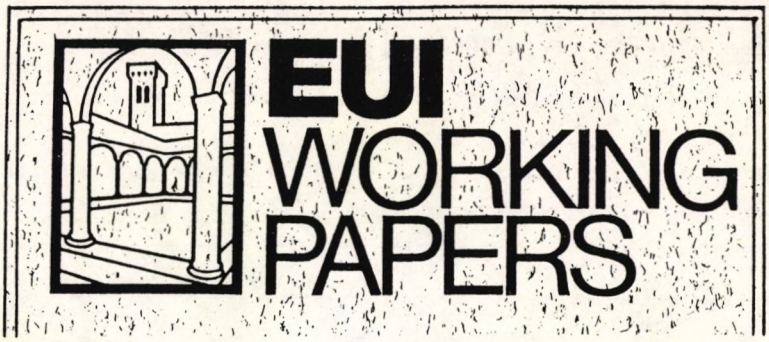

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