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THE GEOMETRY OF FRANCHISING


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Franchising is an effective means of distribution and offers many economic benefits. It also poses a threat to the competitive process because of the restrictions that the concept requires the parties to accept. New Zealand’s way of regulating this tension is examined and compared with the treatment accorded franchises under European Community law. After the subject is introduced, Part II addresses definition, finding it a difficult issue because franchising is an evolving concept. Part III details some of the vertical and horizontal restraints found in franchising. Part IV examines three non-price vertical restraints. After a period of controversy the law’s approach is now reasonably settled and, on the basis of the leading New Zealand case, likely to be tolerant. Part V examines vertical price restraints, identifying problematic aspects of the current law. Part VI looks at horizontal restraints, especially market allocation. The potential impact of the proposal to make it illegal per se is considered. Part VII deals with European competition law as a prelude to a consideration of the treatment of key vertical restraints under it in Part VIII. Part IX outlines reforms to the regulation of vertical restraints currently under consideration in Europe. Part X establishes a framework for evaluating the New Zealand and European approaches and that evaluation is presented in Part XI. Part XII concludes that the European search for a system that provides legal certainty is admirable and that the theoretical basis of their intended reforms is sound. Franchising in New Zealand is, nonetheless, better off under the existing system where the focus is on the economic effects of agreements, Europe having proven the futility of an approach based on the form of the distribution arrangement.
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The text of this paper including all footnotes comprises 14,965 words.

The cover, contents page, abstract, and bibliography comprises 839 words.
I  THE FRANCHISING PHENOMENON

A  Origins

Franchising is a phenomenon of post World War II commerce. Its modernity is illustrated by the absence of its commercial meaning from the Shorter Oxford Dictionary.¹ That meaning is derived from the practice of American cities, developed in the early nineteenth century, of granting a monopoly licence or "concession" over a public utility such as a canal or railroad. That, in turn, was an adaption of the practice, dating back to feudal times, of the sovereign granting freedoms or privileges, the term being the Old French for the state of freedom.² The notion of granting a privilege - usually in the form of a licence - is fundamental to franchising although disgruntled franchisees may regard franchising as closer to economic serfdom than economic freedom. The roots of the modern commercial practice are unclear but it possibly emerged as early as the 1850s with Singer sewing machines³ or with the licensing of beer gardens by breweries.⁴ Well established by the turn of the century in the United States, it did not emigrate much until the 1950s.

B  Reasons

A business has achieved success in retailing a good or service. Its outlets are distinctive and it has in place effective management systems. It wants to satisfy unfulfilled demand before competitors enter the market but is concerned about the risk entailed in raising capital. It also has a small management team and worries about how the dynamics will be affected if it is greatly expanded. Franchising offers a means by which rapid growth can be achieved, capital demands reduced and management problems minimised. The business gains a network of motivated owner/operators who work a market that they probably know well because they live in it.⁵ Franchising works because it is an effective marriage of big and small business; both parties benefit.

C  Economic Benefits

Franchising is an effective method of distribution, enabling market penetration to be achieved quickly and flexibly. It enables a firm to respond quickly to a market opportunity where a first mover may be enjoying monopoly profits. It supports innovation and enterprise. Franchises deal in knowledge, the notion of some special knowledge being shared between the parties lying at the heart of the franchising concept: it might, therefore, be considered to be particularly apt in a society aspiring to develop a knowledge economy. It also encourages innovation and enterprise through risk sharing and risk minimisation, franchises escaping the high infant mortality of other small business ventures.⁶ Franchising

¹ 1992 edition; revised 1973, 801
³ Robert W. Emerson, “Franchisee Collective Rights” 43 Vanderbilt LR 1990 1503, 1507
⁴ Harold Brown, Franchising: Realities and Remedies (2nd ed.) 1978, 1.
⁵ "Our people can get up to 50% more sales from a store than we could if there was a manager in there and head office was doing the buying." Colin Taylor, founder of Stirling Sports, quoted in "Franchise Master", New Zealand Business, March 1999 20,22.
⁶ Win Robinson, Chairman of the NZ Franchise Association, claims around 80% of franchises survive the first five years compared with a failure rate of 80% in independent businesses. "Franchise option grows in popularity" The Independent 22 September 1999, 22.
can contribute to consumer welfare by expanding the choice available (the rapid growth in home service being an example) and reducing the costs of goods and services. Streamlined processes that do not have to be developed anew by each operator reduce input costs. Finally, franchising contributes to employment growth. Traditional career employment is in decline. Franchising provides opportunities for self-employment to those made redundant as well as opportunities for employment generally.

D Competition Issues

Set against these economic benefits must be questions about franchising’s compatibility with the competitive process. Franchising involves a network of firms agreeing to operate in the same or similar fashion. The express aim is often to make customers feel like they are dealing with a single enterprise. Achieving this, however, requires highly prescriptive operational methods, usually via a manual, removing much of the franchisee’s choice over how to conduct their business. Franchisees are also often required to supply information, especially about sales, that would normally be confidential to a legally independent owner. It is this element of collaboration that excites competition law’s interest because:

"[the Commerce] Act is based on the premise that society’s resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources". 7

This paper explores whether the tension between these two aspects of franchising is accommodated more effectively under New Zealand or European Community law.
II IN SEARCH OF DEFINITION

A Various Forms

Defining a franchise is more complex than might be assumed from the currency which the term has achieved. First, there can be franchises at different functional levels. Coca-Cola has traditionally franchised both production and distribution to regionally based bottlers. Second, a franchise itself can be implemented organisationally in a multi-level way, with a franchisor licensing a master franchisee who licences franchisees. The biggest difficulty, however, is caused by the fact that franchising is an evolving concept.

B Core Features

Definitions of franchising can be found in texts, in industry codes and in legislation. They all build on three key features.

The first is the ownership by the franchisor of a trademark, brand name or some distinctive sign, presentation or business method. The second is the grant of a licence to legally independent retailers to use the trademark or other special property in return for some form of payment in order to provide retail goods or services. The third is that an ongoing contractual relationship exists between the franchisor and franchisee of significant duration that specifies obligations on each over the way the business operates.

These features provide only the most basic framework, leaving many questions unanswered. There are, however, two main types of franchises recognised in the literature.

C Business Format

The definition of franchising in European Community law is narrow. It limits the special exemption provided for franchising to systems in which the use of the franchisor’s “know-how” and continuing assistance mean franchisees use a common business format specified by the franchisor. Know-how means a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified. The prototype is the fast food chain.

D Product and Trade Name

Usage outside Europe is broader. Almost any arrangement that involves a close relationship between the parties and the extensive use of a name or logo is regarded as a franchise. In practice, it means the term includes other distribution methods, such as

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8 Brown, above n4, 13
10 At least 16 states in the United States have legislation on aspects franchising. See Emerson, above n3, 1509.
12 Regulation 4087/88, above n 11
exclusive distribution\textsuperscript{14} and selective distribution,\textsuperscript{15} which the Europeans are careful to distinguish from franchising. A car dealership qualifies as a franchise in New Zealand whereas in Europe it is regarded as a form of selective distribution.\textsuperscript{16}

\section*{E Agencies}

There seems general acceptance that an agency arrangement is legally incompatible with franchising. By definition, there is no grant of a licence to an agent. This may be too sweeping. Agencies vary in their character. Both TAB and Lotto outlets are conducted on franchising lines notwithstanding that they are technically agents for the statutory principals concerned. In the case of Lotto outlets especially the business is owned by the operator whose goodwill is often determined by lottery sales, indicating that she accepts a high degree of risk. They can hardly be bracketed with dry cleaning agencies and newsagents.

\section*{F Banner Groups}

These are retailers that combine to buy trading goods and promote their activities under a common banner but otherwise have considerable autonomy in the way they do business. Typically they have full freedom over the lines they sell outside some key in-house products. The emphasis is less on service delivery and more on maximising purchasing power and sharing information for mutual benefit. Booksellers (Paper Plus) and pharmacies (Amcal, Unichem) are examples. Clearly, they do not qualify as a business format franchise and it can be queried whether they fall within the definition of a product or trade name franchise, being a collection of horizontal relationships. Eagles, however, has no doubts.

"Sometimes there may be no franchisor, simply a group of independent businesses conducting themselves under a single name in a uniform style.”\textsuperscript{17}

\section*{G Joint Ventures}

It has also been suggested that a franchise is akin to a joint venture.

"In a real sense, a franchise agreement is a joint venture between the franchisor and the franchisee, and sometimes between the franchisee as well. In those circumstances, I wonder whether a normal incident of the organisation of such a business is easily subject to review under the Commerce Act.”\textsuperscript{18}

The comment seems to imply that franchises should enjoy some exemption from competition law. Possibly too much should not be read into the comments given that they were made in dealing with a weak defence.

\textsuperscript{14} Appointment of a single distributor in a territory.
\textsuperscript{15} Appointment of a distributor satisfying specified, usually qualitative, criteria.
\textsuperscript{16} Car dealing is the subject of Regulation 123/85.
\textsuperscript{17} Eagles, Ian, “Franchising and the Commerce Act 1986 (1)” 1986 NZLJ 349, 350.
\textsuperscript{18} Washworld Corporation (Leases) Ltd v Reid (1998) 8 TCLR 372, 387.
Conclusion

The foregoing illustrates the difficulty encountered in giving legal expression to a form of business organisation that is still evolving. Where the boundaries are, in reality, is anyone’s guess.

“Given that franchising is a dynamic and innovative way of doing business, it is inevitable that the boundaries ..... will always be in a state of change or evolution. Thus, trying to identify the precise boundaries at any point of time will be a matter of conjecture and subject to controversy.”

In this paper, “franchise” is taken to encompass both business format and product and trade name types, except where otherwise stated.

III  FRANCHISING AND THE LAW

A  New Zealand Competition Law Framework

New Zealand evaluates all competition issues within the same analytical framework and according to the same legal standards. The Commerce Act 1986\textsuperscript{20} recognises no distinctions between the production, distribution and retail components of the supply chain and consequently has no need to distinguish between franchising and other forms of distribution. All market behaviour is judged according to two basic tests. The first is whether a dominant market position has been used anti-competitively.\textsuperscript{21} The second is whether contracts, arrangements or understandings entered into (hereafter “agreements”) have the purpose, effect or likely effect of substantially lessening competition.\textsuperscript{22}

B  Substantially Lessening Competition

The test requires a comparative analysis. The state of the market before and after the conduct in question must be examined to determine whether there has been, or is likely to be, a substantial lessening of competition.\textsuperscript{23} “Likely” means “would be likely”, “could well happen”, “more than mere possibility” but the chance need not be more probable than not or more than a 50% chance.\textsuperscript{24} The loss of competition must be “more than trivial or minimal”.\textsuperscript{25} The effect on competition is assessed on a net basis, the pro and anti competition effects being balanced against each other.\textsuperscript{26}

Three practices are identified specifically. Resale price maintenance is declared unlawful in itself\textsuperscript{27} while exclusionary agreements\textsuperscript{28} and price fixing\textsuperscript{29} are “deemed” to substantially lessen competition and therefore breach section 27. All the prohibitions in sections 27, 29, 30 and 37 are mitigated by the availability of the authorisation procedure.\textsuperscript{30}

C  Vertical and Horizontal Restraints

1  Vertical restraints

Vertical restraints are restrictions that apply between parties at different functional levels in the distribution chain. The franchisor may insist that the franchisee deal exclusively in her products. A franchisor may tie the supply of one product to another; a popular product may only be supplied if a less popular one is also taken. The franchisee

\textsuperscript{20} Hereafter referred to as “the Act”. References to sections are those in the Act unless otherwise designated.
\textsuperscript{21} Section 36.
\textsuperscript{22} Section 27.
\textsuperscript{23} Tru Tone, above n7.
\textsuperscript{24} Broadcast Communications Ltd v Commerce Commission (1991) 4 TCLR 537
\textsuperscript{25} Commerce Commission v Port Nelson (1995) 5 NZBLC 103,762
\textsuperscript{26} Fisher & Paykel v Commerce Commission [1990] 2 NZLR 731
\textsuperscript{27} Section 37.
\textsuperscript{28} Section 29.
\textsuperscript{29} Section 30.
\textsuperscript{30} Section 58.
may be allocated a territory within which she is given exclusive rights to deal in the product. Conditions may be imposed on which customers a franchisee can sell to. The franchisor may wish to stipulate the price at which a franchise can sell products or the products that must be excluded from price focused advertising.

2 **Horizontal restraints**

Horizontal restraints, on the other hand, are ones entered into between parties at the same functional level. Examples are agreements between franchisees to prevent a competitor obtaining supply (boycott), divide a market between them (market allocation) or agree on prices or discounts (price fixing).

3 **Horizontal restrictions disguised as vertical.**

The ostensibly neat distinction between vertical and horizontal restraints needs to be approached with care. Competing franchisors can use their systems of vertical arrangements as a means of implementing an anti-competitive arrangement. Or, a restraint may be imposed on a franchisee by a franchisor at the insistence of other franchisees. These are instances of horizontal restraints being imposed in the guise of vertical ones. The search for the horizontal in the ostensibly vertical is an important aspect of the law regarding restrictive practices.

4 **Aggregation**

It is not the individual practices that are important necessarily but the totality of their impact. Many cases will involve a collection of restrictive practices any of which on their own might be innocuous but which in combination have the effect of substantially lessening competition.

**D United States Precedent**

The United States is the font of antitrust jurisprudence and the jurisdiction dominates the subject in terms of cases and commentary. A feature of United States antitrust law is the per se/rule of reason dichotomy. The Supreme Court decided early on that the prohibition under section 1 of the Sherman Act 1890 of “every” agreement in “restraint of trade” prohibited only agreements that unreasonably restrain trade. Evaluating whether the restraint is reasonable or unreasonable has become known as applying the “rule of reason”. However, the law has also developed the doctrine that certain kinds of agreements will so rarely prove justified that the law does not require proof that an agreement of that kind is anti-competitive in the particular circumstances. Such an agreement is regarded as unlawful per se.

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31 Section 3(5)
32 *Standard Oil Co. of New Jersey v United States* (1911) 221 US 1, 55 L. Ed., 619.
33 *Nynex Corporation v Discon, Inc* (1998) 142 L ED 2d 510 is a recent authority.
IV VERTICAL NON-PRICE RESTRAINTS

A The Economics

The proper way for the law to treat vertical non-price restraints has been one of the great debates in antitrust over the last forty years.

1 Structural approach

Traditionally, United States courts drew little distinction between horizontal and vertical arrangements, regarding both as sinister. Economists explained economic behaviour in terms of the exercise of market power\(^{34}\) and any move that increased market power was, accordingly, viewed with suspicion. The courts from the 1940’s onward characterised an increasing number of practices as unlawful per se, the high water mark being the 1967 ruling that all non-price vertical restraints were per se violations of the Sherman Act.\(^{35}\)

2 “Chicago School” approach

During the 1960s, economists associated with the University of Chicago postulated that high market power was often simply the result of improving efficiency, particularly through the elimination of transaction costs. One means of achieving this was to enter into contractual arrangements that were more efficient than direct vertical integration. High market power could not, by itself, be categorised as inevitably leading to reduced competition: rather, each case required specific examination to see whether anti-competitive injury had occurred. In 1977 the Supreme Court reversed its earlier ruling and declared that thereafter non-price vertical restraints would be evaluated under a rule of reason approach because of their potential to be pro-competitive.\(^{36}\) *Sylvania* drew a fundamental distinction between interbrand competition (competition between brands) and intrabrand competition (competition within brands). Vertical non-price restraints generally encourage the former (regarded as more important) but hinder the latter (regarded as less important).

3 Post “Chicago School”

The US courts continue in the *Sylvania* tradition, the Supreme Court recently reaffirming that the general purpose of antitrust laws is the protection of interbrand competition.\(^{37}\) However, a retreat from a strict “Chicago School” approach is also evident.

“Though the treatment of vertical restraints and mergers in the United States historically has not been clear and consistent, I think we have now arrived at a sensible approach. We no longer condemn vertical arrangements without regard to their efficiencies. Neither, however, do we allow theoretical economic efficiencies

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\(^{34}\) For example, J Chamberlain, *Theory of Monopolistic Competition*, (1st ed., 1933)

\(^{35}\) *United States v Arnold, Schwinn & Co* 388 US 365 (1967).


\(^{37}\) *State Oil v Khan* (1997) 139 L Ed 2d 199
to blind us to the possible anticompetitive effects of a vertical restraint or merger."\(^{38}\) (Emphasis added.)

Under this analysis, vertical non-price restraints can cause harm in two basic ways.

"First they can facilitate collusion among competitors by helping competitors to overcome obstacles they would otherwise face in attempting to maintain prices above competitive levels. Second, they can raise competitors' costs. By foreclosing or disadvantaging competing firms, vertical restraints create barriers to entry or expansion, so that rivals can no longer discipline the offending firm's price increases. We accordingly analyse vertical restraints in two categories – those that can lead to \textit{collusion} and those that can lead to \textit{exclusion}."\(^{39}\) (Emphasis added)

Berry\(^{40}\) reaches a similar conclusion in commenting on the vertical aspects of mergers. He notes the acceptance of the United States Department of Justice Merger Guidelines (1984)\(^{41}\) which were tolerant of vertical non-price restraints, citing as an example the recourse had to them by the Commission in \textit{Dunlop}.\(^{42}\)

"It follows, adopting this approach, that there are only two ways that vertical integration can harm competition. The first is by increasing barriers to entry such that (1) the merger must create foreclosure to the extent that a rival must enter both [downstream and upstream] markets to compete, (2) it must be significantly more difficult to enter both markets than just one, and (3) the existing market must be concentrated. The second major concern about vertical integration is that it may facilitate collusion in circumstances where vertical integration is widespread and where market concentration is significant."\(^{43}\)

\textbf{B \hspace{1em} Exclusive Dealing}

Exclusive dealing is an arrangement under which "customer firms agree to deal solely in one supplier's product".\(^{44}\) It is the norm in petrol retailing and used to be common with beer supplied to hotels. Strictly, suppliers may enter into as many such arrangements as they like but in practice they will normally observe some restriction as to territory or type of customer supplied such that the purchaser enjoys a benefit.

\begin{itemize}
\item Pitofsky, above n38.
\item Berry, above n40, 33
\item Rex J Ahdar, "Exclusive Dealing and the \textit{Fisher & Paykel Saga}" 15 NZULR 1,1
\end{itemize}
Effects

Historically, the courts have been hostile to such arrangements for, by definition, they block rival suppliers from access to the customers locked in to them for their term. Another major concern is the potential for facilitating collusion between supplier cartels. When all purchasers are locked in to individual members of the cartel, any increased demand generated by one purchaser reducing prices will quickly be detected by the supplier. The possibility of the purchaser cheating on the cartel is largely eliminated. There are also claims that exclusive arrangements can be harmful because they diminish dealer and consumer choice and that they keep prices higher than would otherwise be the case.

It has also long been recognised that exclusive dealing can enhance efficiency. Buyers can be assured of supply, protected against price rises, avoid the need to hold inventory, and can plan on the basis of known cost. Sellers can reduce their costs and protect themselves against falling markets. In sum, exclusive dealing can establish price certainty and reduce transaction costs. It can also be a means of preventing free riding in circumstances where a supplier invests in special retail equipment to help sell a product and seeks to ensure that rival products do not take advantage of it.

United States approach

Tampa Electric is significant in terms of establishing an analytical approach. After defining the market, the Supreme Court asked the question whether the contract concerned foreclosed competition in a “substantial share of the relevant market”. It said that “opportunities for other traders to enter into or remain in that market must be significantly limited” before it would find the arrangement unlawful. In determining what was “substantial” the relevant factors were the strength of the parties, the percentage of commerce involved and the likely present and future effects of foreclosure on competition in the market. Relief was denied; the dealings involved less than 1% of the market for coal.

Fisher & Paykel Ltd. v Commerce Commission

This is the leading case on exclusive dealing, specifically, and vertical non-price restraints, generally, in New Zealand. It appears to be the only case in which these matters have been subjected to close analysis.

References:

Fisher & Paykel Ltd. ("F&P") operated through exclusive dealing arrangements under which its dealers could not stock competing whiteware products. It was so pre-eminent by the mid-1980s that it had 75% of the market for all whiteware goods and 55% of all whiteware retailers. Its exclusive dealing practice came under challenge prompting it to apply for authorisation.

For the Commission, barriers to entry was the critical issue. Significant factors in this regard included F&P’s securing of the principal nationwide chains and regional retailers; the difficulty that competitors would encounter in securing adequate retail space; the fervent support for F&P of their dealers (making it difficult for a competitor to lure dealers away) and the considerable sunk costs that a competitor would need to risk if it were to seriously challenge F&P. Taken together, these meant competitors faced severe barriers so the exclusive dealing practice had to be regarded as substantially lessening competition. The public benefits did not outweigh the anti-competitive effect meaning the application was declined.

On appeal, the High Court formed a different view. F&P was a major competitor whose market power was diminishing. Rivals were not significantly foreclosed given their other retailing options and because F&P dealers could terminate the exclusive dealing arrangement on three months notice. The exclusive dealing practice did not, therefore, substantially lessen competition.

The judgment has been criticised as wrongly decided and a setback for New Zealand competition law. Market share is not necessarily market power but it is startling that a restrictive practice should be condoned when used by a firm with a market share well beyond the level at which an assumption of dominance arises in a merger context. The high benchmark it establishes is certainly favourable to any New Zealand franchise using the practice. Nonetheless, it cannot be said that decisions or developments in thinking in the decade since it was decided has shown it to be clearly wrong.

It has been suggested that the court was unduly influenced by the Chicago School view of vertical restraints as pro-competitive. The 1990’s have seen a retreat from this benevolence.

“In the 1980s, the federal enforcement agencies viewed all exclusive deals with a generous eye, and brought no cases. But exclusive dealing arrangements are no longer off the enforcement table, at least when large percentages of the market are at stake and the duration is substantial.”

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54 Fisher & Paykel, above n26, 754
55 Ahdar, above n44, 2.
56 Business Acquisition Guidelines, Commerce Commission
57 Ahdar, above n44, 43
58 Pitofsky, above n38
Pitofsky cites the example of two manufacturers that between them shared 90% of the United States' market for water pumps for fire engines. Each had used exclusive dealing contracts for fifty years. The FTC considered the contracts created barriers of entry that effectively foreclosed competitors from the market for fire pumps. The consent orders in those cases prohibited all present and future exclusive dealing arrangements.\(^5^9\) A large percentage of the market was at stake in F&P and the duration of the exclusive dealing was substantial suggesting that the FTC might take a dim view if faced with the case today.\(^6^0\) However, there has been no other case that challenges Fisher & Paykel's findings.

The best test of the soundness of the decision is the market position of F&P today. The Commission and High Court both emphasised the inappropriateness of taking a "snapshot" view of competition. Ahdar, however, points out that focussing on the dynamic aspect of competition carries with it the danger that the timeframe for the expansion or entry of rivals and the decline of the incumbent’s power will be extended too far.\(^6^1\) Attempts to obtain precise information about the company’s current market share of whiteware have been unsuccessful but its annual report suggests it is facing much greater competition than it did a decade ago.

"The New Zealand market remained one of the most competitive in the world: with completely open borders, competition arrives from around the world."\(^6^2\)

Developments such as parallel importing in the period since the case would seem to support its logic.

\(\text{C Tying}\)

Tying can be a consequence of exclusive dealing. The purchaser who deals exclusively with one supplier may be unable to offer customers a choice. The Jefferson Parish hospital in New Orleans used the services of one anaesthesiology practice only. It therefore tied the surgical services it offered to the use of that group of specialists: patients could not choose their own anaesthetist.\(^6^3\)

Tying is not prohibited per se under the Act. The issue is under what circumstances will the action be considered to substantially lessen competition. There are no New Zealand cases and it is necessary to look to the United States and Australia for guidance.

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60 In Waterous, above n59, the FTC also considered the arrangement collusive and amounting to de facto market division. This was not a feature of Fisher & Paykel although it could be argued that F&P, with 85% share in the important lines, had no one to collude with.
61 Ahdar, above n44, 40
62 Fisher & Paykel Industries Limited Annual Report 1999, 8
The difficulty in evaluating the United States cases lies in the fact that tying has long been regarded as illegal per se.\textsuperscript{64} This remains strictly so despite the more tolerant attitude to vertical non-price restraints described above. There are many cases involving franchises. In \textit{Siegel},\textsuperscript{65} a requirement that chicken pieces be sold only in wrapping paper supplied by the franchisor was struck down. The franchisor had unlawfully tied the wrapping to the grant of its trade mark.

The strict application of the per se prohibition is softened by the attitude to characterisation and the admission of a business justification defence.

(a) Characterisation

In \textit{Jefferson Parish} the Supreme Court observed:\textsuperscript{66}

"[T]he Sherman Act does not prohibit “tying”; it prohibits contract(s) .... in restraint of trade.” Thus, in a sense the question whether this case involves “tying” is beside the point.”\textsuperscript{66}

While careful to uphold the per se unlawful status, the Court ruled that the prohibition only applied once it had been established that a substantial potential for impact on competition exists. It said:

"...the essential characteristic of an invalid tying agreement lies in the seller's exploitation of its control over the tying product to force the buyer either into the purchase of a tied product that the buyer did not want at all, or might have preferred to purchase elsewhere on different terms”\textsuperscript{67}

Neither of these applied. The seller (the hospital) could not exploit its control over surgical services because it had less than 30\% of the surgical admissions in New Orleans. The court could not reach the conclusion that buyers (patients) were disadvantaged because it doubted that they regarded surgery and anaesthesia as separate products anyway. The decision has been described as rendering tying a per se violation “in name only”\textsuperscript{68}

(b) Business justification defence

United States courts have accepted a reasonable business justification for tying.\textsuperscript{69} The most often accepted justification is that tying is necessary to ensure quality control. Brown explains this justification in terms of the Lanham Act\textsuperscript{70} under which a licensor is obliged to ensure the quality of the licensed product or process or risk forfeiting her

\textsuperscript{64} \textit{International Salt Co. v United States} (1947) 332 US 392, 92 L. Ed 2d 545
\textsuperscript{65} \textit{Siegel v Chicken Delight Inc.}, (1971) 448 F2d 43, 47 (9th Cir.)
\textsuperscript{66} \textit{Jefferson Parish}, above n63, 19, footnote 34 per Stevens J
\textsuperscript{67} \textit{Jefferson Parish}, above n63, 13 per Stevens J
\textsuperscript{68} Michael P Kenny and William H Jordan, “United States v Microsoft” 47 Emory LR 1998 1352, 1392
\textsuperscript{69} \textit{IBM v United States} (1936) 298 US 131
\textsuperscript{70} 15 USC 1055 (1964)
property interest. However, limits are placed on this exemption from antitrust law. Business justification has been rejected when based on the preservation of goodwill or where the facts demonstrate that a less restrictive way of ensuring quality control is feasible.

2 Australia

In Double Bay Steakhouse the Trade Practices Commission ("TPC") examined in detail the tying practices proposed in extending a restaurant franchise. The arrangements were cleared in relation to steaks, sauces and entrees as being necessary to ensure quality control but the franchiser felt obliged to withdraw restrictions relating to the purchase of equipment and complementary food items. Pengilley comments:

“No one doubts that Kentucky Fried’s eleven original herbs and spices should be a mandatory purchase by Kentucky Fried’s franchisees. There is far less agreement, however, about whether it is appropriate for the franchisor to mandate the purchase of napkins, containers and bags from himself and no other source. These items are not necessary to protect the trade mark or the quality of the product.”

These comments are used to support the conclusion that a franchisor must be able to justify a purchase restraint as being an integral part of the franchised method of business, or necessary for quality control or trade mark purposes.

3 New Zealand

Although there is ample United States precedent for the Australian formulation it is submitted that it is too narrow and should not be adopted in New Zealand. It reflects a view that a franchisor will seek to exploit economic power over a franchisee. While always a possibility, the reality is that what a franchisor desires most is a successful, expanding franchise system. This motivation will normally outweigh any desire to exploit a short term advantage. Franchisors recognise that flexibility in supply arrangements is essential; tying up franchisees in restrictive arrangements will be ultimately self-defeating. Tying arrangements should be evaluated like any other non-price restraint, that is, assessed primarily in terms of foreclosure.

D Territorial Restrictions

Anyone establishing a distribution system must consider how best to achieve market coverage. Territorially based restrictions may be necessary if maximum effect is to be obtained at reasonable cost. Territorial restrictions are common in franchising for this reason and because one of the major inducements a franchisor can offer a franchisee is an exclusive territory in which to operate.

71 Brown, above n4, 305.
72 Capra, Inc. v Ward Foods, Inc (5th Cir. 1976), 536 F.2d 39.
73 Double Bay Steak House Providores Pty Ltd (1976-1977) ATPR (Com.) 15,737.
75 J G Collinge and B R Clarke (Eds.) Law of Marketing in Australia and New Zealand, 2nd ed. [15.56].
Since Sylvania in 1977, United States Courts have assessed territorial restrictions with a generous heart. In 1962, Sylvania’s share of the United States market for television sets had fallen to 2%. It initiated distribution through a limited number of franchisees and each was allowed to sell from specified locations only. Continental was one of the franchisees. Against Continental’s wishes, Sylvania granted a new franchise to a dealer close to a Continental outlet in San Francisco. It also refused to grant Continental’s new outlet in Sacramento a franchise. Continental claimed the territorial limitations were a per se breach of the Sherman Act, relying on Schwinn.76 In 1965 Sylvania’s national market share had recovered to 5%. The Supreme Court, in a landmark judgment, held that the restrictions had to be evaluated on a rule of reason approach, recognising that they could be pro-competitive.

The restrictions in Sylvania were relatively simple; the franchisees were restricted to designated locations and needed approval to change. Evaluation becomes more difficult when other restrictions are added. For example, only one franchisee may be appointed in a territory. For certain types of products and services, such as restaurants, intrabrand competition within the territory will be eliminated. The franchisee may be required to confine promotional and selling efforts to within the territory but be permitted to supply customers from outside the territory who approach her. Alternatively, “passive selling” may be prohibited, with the franchisee expected to redirect the customer to the franchisee within the customer’s area of residence. Then again, franchisees may be obliged by their agreement not to sell to competitors of the franchisor or to supply other resellers. These latter arrangements graft further restrictive requirements onto the territorial framework.

Exclusivity clauses were examined by the Commerce Commission in an inquiry into motor vehicle franchise agreements.77 All the agreements examined contained clauses allocating the dealer an exclusive territory.78 The Commission considered that “if anything, this type of restriction is likely to promote the competition which the dealer provides” 79 It was more concerned, however, about restrictions on the dealer’s place of business.

“Ideally, we think the manufacturer’s discretion to withhold consent should be limited, so that the dealer can change the location of his premises unless there are legitimate reasons, such as location, display, storage, security, general appearance and facilities.”80

Despite the critical tone of the comment, the list is fairly extensive.

Eagles suggests that a franchise for the whole of New Zealand unconnected with intellectual property rights would be looked at “askance”.81

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76 Schwinn, above n35
77 Inquiry Into The Terms of Motor Vehicle Franchise Agreements, Commerce Commission 1985.
78 Inquiry, above n77, 21. One agreement provided for an “infringement commission” on breach, the amount determined by the franchisor at its discretion.
79 Inquiry, above n77, 22
80 Inquiry, above n77, 30
81 Eagles, above n17, 383
It is submitted that two factors will be salient in evaluating whether a vertically imposed territorial restraint is unacceptable. The first is the strength of interbrand competition: if this is strong, the more likely the clause will not be anti-competitive.\(^{82}\) The second is the extent to which the territorial restraint is accompanied by other restrictions. The Australian Coca-Cola\(^{83}\) case illustrates the first point, if not the second. The case involved both exclusive dealing and territorial exclusivity. Franchisees could only sell within their own defined territory; they could not supply customers outside of it. The TPC found the pro-competitive effects outweighed any anti-competitive injury, noting that interbrand competition in soft drinks was particularly strong. It authorised the agreement accordingly.

E Summary

The law is more tolerant of vertical non-price restraints today than it was 25 years ago. Jefferson Parish can be interpreted broadly as creating a safe harbour for exclusive dealing up to a level of 30% market share in the United States and Fisher & Paykel accepted the practice when market share was much higher. Tying remains per se unlawful in the United States but the characterisation approach in Jefferson Parish limits its impact. Arguments can be made, regardless, that a more tolerant approach should be adopted. Territorial restrictions are treated generously in the United States at least when they are not laden with other restraints. Recent support can be found for the view that restraints in franchising can assist the competitive process.\(^{84}\) Franchising has little to fear from the treatment of non-price vertical restraints under current law.

\(^{82}\) Eagles, above n17, 383

\(^{83}\) (1977-78) ATPR Commission Decisions

\(^{84}\) Washworld, above n18, 387.
V \textbf{VERTICAL PRICE RESTRAINTS}

Unlawful in the United States since 1911,\footnote{Dr Miles Medical Co v John D Park and Sons 220 US 373} resale price maintenance ("RPM") has only been prohibited in New Zealand since 1975.

A \textbf{The Economics}

The per se treatment of RPM is controversial because many economists regard vertical price restraints in the same way as non-price ones, that is, they can be either pro- or anti-competitive depending on the circumstances.\footnote{Herbert Hovenkamp, \textit{Antitrust}, 2nd ed., 177} It is claimed that RPM can advance competition in three ways.

First, a minimum retail price set by a franchisor can induce franchisees to compete aggressively on non-price criteria such as service and promotion in pursuing the supernormal profits available.\footnote{E. Gelhorn, \textit{Antitrust Law and Economics in a Nutshell}, 4th ed., 295} Second, a minimum price may facilitate entry into a market by new firms and new products. Third, RPM can combat "free riding".\footnote{Hovenkamp, above n86, 181.} A firm may be a late entrant in the market and thereby avoid the development costs incurred by others or they may avoid the pre- and post-sale obligations of others who carry the cost of maintaining a product's reputation.

Countering these views is the argument that there are ways of overcoming inefficiency problems that are less damaging to competition than RPM. Free riding, for example, can be overcome by exclusive distribution.\footnote{Communication on the Application of the Community competition rules to vertical restraints-Follow-up to the Green Paper on Vertical Restraints, COM(98) 544, 19.}

B \textbf{Troublesome Features}

There are several troublesome features of RPM. First, it only applies to goods supplied for resale, not to goods that are merged or transformed. It is strange that the price of the output can be stipulated when the franchisor supplies the sauces but not the chicken.\footnote{Section 33(b)} Secondly, it does not apply to services. A franchisor in a lawn mowing franchise can set standard prices. (Franchisees in these circumstances might still be found to be at fault under section 27.) Nor does it apply in an agency setting. An agent cannot sell at a discount against the wishes of the principal even when the discount is funded out of the agent’s commission. Lottery and betting agents face termination of their agreements if they indulge in such practices, yet they operate on franchising principles. Finally, the Act permits the joint advertising of the price for resupply of collectively acquired goods.\footnote{Penny Catley and Tanya Thompson, “Franchising and the Commerce Act” 1999 NZLJ 246, 247} This is not dissimilar to what a franchise network does in substance although it will not usually fall within the terms of the exemption. (It has been pointed out that the parties can agree on a price at which the goods will be advertised but not on the price at which they will be sold.\footnote{Not only is this distinction a fine one, as the authors acknowledge, it is also one which few business people could be expected to appreciate.} Not only is this distinction a fine one, as the authors acknowledge, it is also one which few business people could be expected to appreciate.)
C  Summary

Strong views are held on whether RPM should be illegal per se. Notable authorities fall in each camp. US Antitrust Attorney General William Baxter filed a brief on behalf of the Department of Justice in Monsanto\(^2\) urging a review of the ban. On the other hand, Pengilley\(^3\) and most legislatures world-wide, consider it an entirely appropriate stance.\(^4\) It is doubtful whether a franchise in a competitive environment that employs RPM poses any threat to competition. The Commission has, in the past, acknowledged that RPM is not always pernicious\(^5\) but it is clear that the prohibition is unlikely to be relaxed.

\(^1\) Monsanto Co. v Spray-Rite Co., (1984) 465 US 752
\(^2\) Pengilley, W, “Resale Price Maintenance law and dealership problems: Recent trends” 1990 NZLJ 66
VI HORIZONTAL RESTRAINTS

A The Economics

Economic opinion holds horizontal restraints to have few redeeming features. Such restraints almost always exist because the parties have, or believe they have, some market power that they can exercise to their advantage. The effect is to maintain prices above the competitive level and restrict output. Economists therefore support the per se illegal status that is usually accorded such arrangements.

B Market Allocation

Competitors may agree to divide a market between them. In a territorial division scheme, each firm will only sell or provide services within its assigned territory. In a customer division scheme, firms agree upon the customers each will deal with. Markets can also be divided along functional, product and time of sale lines. Rarer forms of market allocation include market share agreements (firms agree on the percentage of sales each will make in a market) or output reduction schemes.

In the United States such restraints are illegal per se. The rule against horizontal territorial division was reaffirmed by the Supreme Court in 1990 when it struck down a territorial arrangement between two bodies over the bar review courses each offered.

"One of the classic examples of a per se violation of s1 (of the Sherman Act) is an agreement between competitors at the same level of the market structure to allocate territories in order to minimise competition." 99

This case affirmed Topco, in which the arrangements applying within an association of small supermarkets included agreements over exclusive territories. The claim that such an arrangement was pro-competitive because it enabled the supermarkets involved to compete with their much larger competition was rejected. Palmer and Topco involved territorial restraints but United States courts have applied the per se prohibition to customer, product, supplier and time of sale agreements.

Under United States law franchises can infringe the prohibition on market allocation in the following ways.

96 Tui Foods Ltd v NZ Milk Corporation (1993) 5 TCLR 406 had elements of this. Some franchisees supplied the route trade (dairies and supermarkets), others the home consumers.
98 Hovenkamp, above n86, 76
101 Scott, above n97, lists numerous citations at 25-26.
1 Restraints agreed between franchisees

Any overt or tacit arrangement between franchisees dividing a market is unlawful. In *Sealy*, Topco and *Palmer* courts found that franchisees had colluded with each other. In each case only intrabrand competition was affected suggesting that in this area the distinction between interbrand and intrabrand competition is not significant. *Palmer* also illustrates that the per se rule applies even though the parties had not been competitors prior to the agreement. It did not matter “whether the parties split a market within which both do business or whether they merely reserve one market for one and another for the other”. However, agreements between franchisees who operate in the same product market but in a different geographic market would not be caught. Such agreements would seem to be unnecessary in any case.

2 Franchisor imposed restraints

As has been seen, where these are genuinely imposed by the franchisor they will be treated as vertical restraints and generally tolerated unless shown to result in exclusion or collusion. The FTC investigation in *Waterous* concluded that the use of the exclusive dealing arrangements had created barriers to entry of such magnitude as to amount to de facto market allocation.

3 Horizontal restraints in the form of vertical

United States courts recognise three situations in which an ostensibly vertical restraint will be treated as horizontal, and therefore illegal per se. The first is where the restraint is imposed at the behest of the franchisees. The second is where the franchisees own the franchisor. The interrelationship between the parties means that they must be taken to be operating at the same level of the market.

The third is in circumstances of split-level franchising. This occurs when a franchisor directly operates outlets competing with franchisees. It may happen for several reasons. A franchisor may want remain close to the market; the franchisor may wish to experiment with new products or methods; she may wish to establish quality standards; or she may have trouble finding a new franchisee and be forced to operate the business herself.

The danger in the practice is that courts may consider that any restrictions in place have the character of an agreement between competitors, that is, a horizontal arrangement and not a vertical one. *Holiday Inns* had a “company town” policy under which it would operate hotels itself in certain towns rather than grant franchises. It was also a condition of its franchise agreement that a franchisee would not operate a hotel in a town containing a

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102 *United States v Sealy Inc.*, (1967) 388 US 350
103 It may be relevant to the matter of characterisation referred to page 23.
104 *Palmer*, above n99, 49-50
105 Part IV above.
106 *Waterous*, above n59.
107 *Sylvania*, above n36, 58: *Ryko Manufacturing Co. v Eden Services* (1987) 823 F.2d 1215 (8th Cir.)
108 *Sealy*, above n102
109 Also referred to as “dual distribution”.
110 *American Motor Inns Inc. v Holiday Inns, Inc* (1975) 521 F. 2d 1230 (3rd Cir.)
Holiday Inn. The court held that Holiday Inns had entered into a horizontal conspiracy (agreement) with its franchisees.

"...[S]ince Holiday Inns, in one of its capacities, was dealing on the same market level as its franchisees, its contracts that, in effect, foreclosed such franchisees from operating either Holiday Inns on non-Holiday Inns in cities where Holiday Inns operated an inn, except with Holiday Inns' permission, constitute market allocation agreements between competitors."\textsuperscript{111}

In a later case,\textsuperscript{112} a KFC franchisee sued the franchisor (KFCC) after it decided to run new express outlets in Las Vegas itself, reversing earlier indications that it would allow the franchisee to expand its operation to do so. Las Vegas was a designated "company market" and KFCC had a "non-KFC" clause in its agreements prohibiting most franchisees, including the plaintiff, from any interest in another fast food operation while they remained a franchisee. The court's crucial finding was that both terms were imposed unilaterally: "the actions were implemented unilaterally by the franchisor, without involvement of any franchisees, and did not involve any type of concerted action"\textsuperscript{113} It was a vertical restraint and thus not a per se infringement.

In New Zealand, the argument that the restraints could not be regarded as anti-competitive because they were imposed unilaterally would not be available. In Port Nelson\textsuperscript{114} the Court of Appeal held unilateral purpose was sufficient to establish purpose under section 27. Irrespective, it is unsatisfactory that the result in St. Martin should be reached by such a tortuous route. The character of the arrangement was virtually identical in the two cases yet in one it was rejected because of a perceived element of agreement between the franchisor, in her capacity as operator, and fellow franchisees. The focus should be on whether the practice in all the circumstances substantially lessened competition by foreclosing entry to competitors.

Generally, United States courts examine the restraints closely in instances of split level franchising, considering factors such as the percentage of sales conducted through the franchisor's outlets and the limits placed on interbrand competition\textsuperscript{115} before pronouncing the restraints horizontal or vertical.

4 Proposed Amendment

Currently, market allocation agreements are judged under section 27 but clause 3 of the Commerce Amendment Bill 1999 would deem them to substantially lessen competition. Given the consensus of economic opinion about the impact of such arrangements and their treatment in the United States, it might be thought that a court would have little difficulty in arriving at that conclusion anyway. However, precisely the same reasoning can be used to justify the Amendment. It is, in fact, the process that United States courts have gone through in classifying certain practices per se violations.

\textsuperscript{111} Holiday Inns, above n110, 1253-54
\textsuperscript{112} St. Martin v KFC Corporation (W D Ky. 1996) 935 F. Supp. 898
\textsuperscript{113} St. Martin, above n112, 906
\textsuperscript{114} Port Nelson Ltd v Commerce Commission [1996] 3 NZLR 554
\textsuperscript{115} Holiday Inns, above n110
There is concern that the Amendment will have major impact on franchises, despite the clear intention that franchises should not be affected. Will franchisors and franchisees be at any greater risk under the Amendment than their American equivalents currently are? If it is interpreted literally the answer will be yes. There is nothing in the wording of the new provision that necessarily requires a court to distinguish between different types of restrictive agreements, whether on the basis of a vertical or horizontal dichotomy or otherwise. As drafted, it could be applied very widely.

This will not occur, however, if courts interpret the provisions in keeping with the Act's intention.

"[The Act] is legislation of a type where the Courts should not hesitate to adopt necessary purposive approaches in line with Northland Milk Vendors Association Inc v Northern Milk Ltd [1988] 1 NZLR 530 paying due respect to legislative policy."117

Agreements that help rather than hinder competition should not be prohibited. The way of achieving such a result would be for the court to consider characterisation. This has been invoked in connection with tying118 and price fixing.119 It would be possible for courts to exclude certain territorial restraints, for example, from the prohibition on the basis that they are not the type of restraint that the provision is intended to cover.

If this interpretative approach cannot be guaranteed, the provision would seem to require amendment if it is to be restricted to the activities of hard core cartels as intended. This will pose a drafting challenge. If the exemption is to be limited to franchising alone there will be difficulty in arriving at a satisfactory definition.120 It is also likely to be contentious. Why should franchising alone among distribution methods be accorded special treatment? It would create the danger of franchising being used by those whose objective is, in fact, market allocation. Conversely, if the amendment is drawn in terms of exempting agreements between parties at different functional levels of the market, it will need to take account of the possibility of horizontal arrangements being disguised as vertical ones, such as in Waterous.121 The formulation is likely to be complex.

A problem will also exist in respect of split-level franchising. Under the present section 30(1)(a) "any bodies corporate that are interconnected with" any of the parties to an agreement are considered to be party to it also. As Scott points out,122 this may have the effect of introducing a horizontal dimension to a vertical arrangement. An agreement with territorial provisions in it between a franchisor and her franchisees (vertical) will be considered one between franchisees (horizontal) when the franchisor is interconnected with one of the franchisees (for example when the latter is a subsidiary company). This removes the court's discretion to determine the nature of the restraint in the circumstances.

116 Cabinet Paper ECO (98) 248, paragraph 21.
117 Union Shipping NZ Ltd v Port Nelson Ltd [1990] 2 NZLR 662, 700.
118 Part IV above.
119 Part VI D below.
120 Part II above.
121 Waterous, above n59
122 Scott, above n97
C Boycotts

Section 29 was amended in 1990 by the addition of a requirement that at least one of those party to the exclusionary agreement also be in competition with the object of the action. The section would catch behaviour by a group of franchisees or a combination of franchisor and franchisees that tried to harm a competitor. But, would it also catch concerted action by franchisees against their franchisor, for example, where they wished to negotiate better terms for themselves? What if F&P dealers, with stock in hand, conspired to cut-off the company’s supply of raw materials for a period? An unlikely scenario admittedly but one not without relevance in the United States. It appears that such action would not be caught in New Zealand because the franchisor would probably be regarded as being in a different market and therefore not in competition with her franchisees. In contrast, the action would be regarded as unlawful in the United States, the qualifying requirements for a boycott not requiring the parties to be in competition.

D Price fixing

Franchisees are vulnerable to price fixing. Their interest in “standardising” prices will facilitate the conclusion that they have colluded when an issue arises. Moreover, the frequent networking common among franchisees provides them with the opportunity to conspire. In 1996, seven Toyota dealers in Auckland were fined $350,000 for standardising discounts discussed at regular dealer meetings. “Parallelism” (following the market leader) within a franchise network is also unlikely to be plausible in the absence of movement in the wider product market.

The severity of the per se illegal status has been mitigated by the use of characterisation. Firstly, in Radio 2UE two radio stations that marketed themselves via a joint rate card were held not to have fixed prices largely, it seems, because they were free to change their individual prices. The court seemed to be influenced by the stations’ small share of the market and that the combined rate card was likely to enhance their competitiveness. The Commission in The Insurance Council concerning knock for knock arrangements between insurance companies, adopted a similar approach. Both cases have been questioned for appearing to introduce by a side door a section 27 test into a provision considered to be a statutory embodiment of the US’s per se prohibition. It is claimed the existence of a price fixing arrangement has been confused with its effects, a distinction carefully drawn in Taylor Preston.
D Summary

The impact of the proposed amendment on franchising is uncertain and potentially significant. Similarly, the operation of section 29 is uncertain but it is now so narrowly drawn that it is unlikely to be a serious problem to a franchise network except in cases of blatant exclusionary conduct. Price fixing can pose a problem for franchisees because of their close interrelationship but retailers generally are more aware of the prohibition.

6 Competition Law Framework

The heart of European Community competition law lies in Articles 81 and 82 of the Treaty of Rome 1957.23. The former declares, in part, that "all agreements, decisions 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, are to be "incompatible with the common market". Article 82 is directed against the misuse of dominant positions. They are similar in substance to sections 57 and 58 of the Act in their focus.

Article 81(1) is drawn very widely. Agreements falling within it are null and24 but the severity of this is mitigated in two ways. First, the Commission does declare ex ante that they are not compatible with competition. The Commission has produced guidelines that provide a safe harbour for vertical agreements between parties holding less than 10 per cent of the relevant market.25 Second, there is provision for agreements to be exempted if they satisfy two positive and two negative conditions. An agreement can be exempted if:

(i) "contributes to improving the production or distribution of goods or to promoting technical or economic progress while

(ii) allowing consumers a fair share of the benefit".

If these criteria are met, the agreement can be exempted only if it is also:

(iii) does not "impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives" and

(iv) does not "afford such undertakings the possibility of eliminating competition with respect to a substantial part of the products in question".

The Commission has the exclusive power to grant individual26 and block exemptions.27

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23 Originally Articles 52 and 57 were contained in Article 52 of the Treaty of Amsterdam 1993.
24 Article 81(2).
26 Article 81(4).
27 Regulation 1/2003
28 Regulation 12/2003
VII THE EUROPEAN APPROACH

A A Different Approach

The European approach to distribution arrangements is different to New Zealand’s. European law specifically recognises certain types of distribution systems, within defined limits, and accords them exemption from competition law. A seminal difference is the right of the regulator, the European Commission,\textsuperscript{130} to exempt such arrangements en bloc.

B Competition Law Framework

The heart of European Community competition law lies in Articles 81 and 82 of the Treaty of Rome 1957.\textsuperscript{131} The former declares, in part, that “all agreements..decisions..and concerted practices which may effect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition..” to be “incompatible with the common market”. Article 82 is directed against the misuse of dominant positions. They are similar to sections 27 and 36 of the Act in their focus.

Article 81(1) is drawn very widely. Agreements falling within it are void\textsuperscript{132} but the severity of this is mitigated in two ways. First, the de minimis doctrine excludes agreements that clearly pose no threat to competition. The Commission has produced guidelines that provide a safe harbour for vertical agreements between parties holding less than 10 per cent of the relevant market.\textsuperscript{133} Second, there is provision for agreements to be exempted if they satisfy two positive and two negative conditions. An agreement can be exempted if it:

(i) “contributes to improving the production or distribution of goods or to promoting technical or economic progress while

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If these criteria are met, the agreement can be exempted only if it also

(iii) does not “impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives” and

(iv) does not “afford such undertakings the possibility of eliminating competition with respect to a substantial part of the products in question”.\textsuperscript{134}

The Commission has the exclusive power to grant individual\textsuperscript{135} and block exemptions.\textsuperscript{136}

\textsuperscript{130} In the sections dealing with Europe the European Commission is referred to as “the Commission”.

\textsuperscript{131} Originally Articles 85 and 86 but renumbered by Article 12 of the Treaty of Amsterdam 1998

\textsuperscript{132} Article 81(2)

\textsuperscript{133} Commission Notice on Agreements of Minor Importance [1997] OJ C 372/13

\textsuperscript{134} Article 81(3)

\textsuperscript{135} Regulation 17/62

\textsuperscript{136} Regulation 19/65
C Case Law

Franchising first became subject to judicial scrutiny in *Pronuptia*\(^{137}\) when the European Court of Justice held that clauses in a franchise agreement that were necessary to support the two essential ingredients of the franchising relationship fell outside the scope of Article 81(1). The first of these was the protection of know-how and expertise; the franchisor must be able to provide these to the franchisee with confidence that they will not fall into the hands of a competitor. On that ground, a franchisee could be prevented from opening a shop of the same or similar nature in an area where she might compete with another member of the network during the term of the agreement. The franchisee could also be prevented transferring her shop to another without the franchisor’s approval.

The second ingredient was the protection of the franchise’s reputation. This justified terms requiring the franchisee to apply the franchisor’s business methods and know-how, and to set up the premises in a prescribed fashion. The interest in uniform quality justified tying arrangements in circumstances where it was impractical to lay down objective quality specifications.

In the two years following *Pronuptia*, the Commission issued decisions approving franchise agreements for *Yves Rocher*,\(^{138}\) *Computerland*,\(^{139}\) *ServiceMaster*,\(^{140}\) and *Charles Jourdan*\(^{141}\) and granting exemptions. In each case, the market share of the franchise was low, not exceeding 10%, and it faced strong competition. Barriers to entry were also low.

D Franchising Block Exemption

Franchising is one of three types of distribution system covered by a block exemption (the other two are exclusive distribution and exclusive purchasing). Regulation 4087/88\(^{142}\) is in two parts. The preamble presents franchising in a positive light and explains why it satisfies the four requirements of Article 81(3). Of the nine articles that define the precise terms and extent of the exemption the following are the most important.

Article 1 confers the exemption of franchising agreements and contains the key definitions.

Article 2 identifies five types of obligations that would normally be regarded as restrictions of competition but are within the exemption. Included are obligations on a franchisee to operate only from the contract premises and to refrain from active selling outside the allocated territory.

\(^{137}\) *Pronuptia de Paris v. Schillgalis Case* 164/84
\(^{138}\) OJEC No. L 8/49 10 January 1987
\(^{139}\) OJEC No. L 222/12 10 August 1987
\(^{140}\) OJEC No. L 332/28 3 December 1988
\(^{141}\) OJEC No. L 35/31 7 February 1989
\(^{142}\) Full title given in above n11
Article 3 contains the so-called “white clauses” that are not normally considered as restricting competition. There are two sets. One set concerns restrictions that a franchisor might use to maintain control over the use of her know-how or over the franchise’s reputation. Examples include obligations on a franchisee to comply with standards for the presentation of premises and to ensure staff attend training courses. These are unconditionally permitted in agreements. The other set are obligations that will not prevent exemption if they are “necessary” to protect the franchisor’s intellectual property rights or “to maintain the common identity and reputation” of the franchise. Examples include restrictions requiring the franchisee to sell the franchised goods only to end users or other franchisees and to offer for sale a minimum range of goods.

Article 4 lays down three conditions that must be complied with before an agreement qualifies for exemption. One is that the franchisee is obliged to indicate its status as an independent undertaking.

Article 5 contains a “blacklist” of seven provisions, including resale price maintenance.

Article 8 empowers the Commission to withdraw an agreement’s exemption where the agreement would have effects incompatible with Article 81(3). Specifically, withdrawal is provided for in cases where territorial protection is awarded to the franchisee and other features are present that are conducive to market sharing.

The Regulation is largely a codification of the case law that had developed based on Pronuptia.¹⁴³

¹⁴³ OECD Report, above n13, 89.
VIII  VERTICAL RESTRAINTS UNDER THE BLOCK EXEMPTION

It must be remembered that the exemption applies only to agreements that would be considered business format franchises in New Zealand. It is also notable that there is little judicial authority on the application of the franchising exemption.

A  Exclusive Dealing

Exclusive dealing is permitted but it is subject to conditions. A franchisee can be required not to sell or use goods competing with the franchisor’s goods that are the subject matter of the franchise although this cannot be extended to spare parts or accessories. However, this must be read in conjunction with the first of the conditions contained in Article 4, namely, that a franchisee must be free to obtain the franchised goods from other franchisees or from another authorised distributor where the goods are distributed through a parallel network. Further, a blacklisted clause must also be considered. A franchisee cannot be prevented from obtaining supplies of goods of a quality equivalent to those offered by the franchisor from an independent source unless the restriction can be justified under Article 2-e, that is, the goods compete with those that are the subject matter of the franchise.

In *Yves Rocher*, the franchisee was required to stock only the franchisor’s products and was restricted in the source of supply. The Commission accepted that that the obligation to sell only the franchisor’s products was inherent in the nature of the distribution system.

Outside a franchising context, the European approach to exclusive dealing has been more stringent than the American. In the *Spices* case, an exclusive dealing agreement that involved no more than 30% of the market for spices in Belgium was held to foreclose competition unduly. This can be compared to the result in *Jefferson Parish*.

B  Tying

Tying has not been the subject of specific judicial attention in Europe. However, it is covered in the regulation. A franchisee can be required to sell goods manufactured by a third party designated by the franchisor in circumstances where it is impractical to apply objective quality specifications that another manufacturer could satisfy. Also, a franchisee can be required to offer for sale a minimum range of goods. However, both restrictions are permitted only in so far as they are necessary to protect the franchisor’s intellectual property rights or maintain the identity and reputation of the franchise.

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144 Article 2-e.
145 Article 4-a.
146 Article 5-b.
147 Ahdar, above n44, 24.
148 *The Community v Brooke Bond Liebig Ltd* [1978] 2 CMLR 116
149 *Jefferson Parish*, above n63
150 Article 3-1-b.
151 Article 3-1-f.
C Territorial Restrictions

Since 1957 market integration has been an important objective of all Community law, competition law included. There is particular concern with “absolute territorial protection” in any system of exclusivity. The reason for this is not hard to appreciate.

“[A]n agreement between producer and distributor which might tend to restore the national divisions in trade between Member States might be such as to frustrate the most fundamental objectives of the Community.”\(^{152}\)

This concern has informed the European approach to territorial restraints which have proved a problem generally. However, franchising is an exception, it being recognised that “the limited territorial protection granted to the franchisees is indispensable to protect their investment”.\(^{153}\) Three restrictions on competition are permitted in a franchising context. First, territorial protection may be accorded to a franchisee by a franchisor.\(^{154}\) Second, location clauses may restrict the franchisee to specified premises.\(^{155}\) Third, the franchisee may be prevented from actively seeking customers outside the contract territory.\(^{156}\) However, there is also provision for the Community to withdraw the exemption if users are unable to obtain franchise goods because of their place of residence.\(^{157}\)

D Resale price maintenance

RPM is one of the blacklisted clauses. Article 5e prevents the exemption applying when the franchisee is restricted in the determination of the sale prices of the goods or services which are the subject matter of the franchise. Recommended prices are acceptable. The approach appears identical to that in New Zealand.

E Summary

The extent of exclusive dealing in a franchising context is clearly defined as is the permitted degree of tying. The latter is treated similarly to the view of Australian authorities discussed above. The permissible territorial restrictions are also well and reasonably generously defined, but are subject to the possibility of being overridden when accompanied by other restrictions favouring market allocation. Overall, it is doubtful whether their treatment is, in the end, more generous than in New Zealand.

\(^{152}\) Consten and Grundig v Commission, Joined Cases 56 and 58/64, 13 July 1966, 339.
\(^{153}\) Preamble, paragraph 10.
\(^{154}\) Article 2-a.
\(^{155}\) Article 2-c.
\(^{156}\) Article 2-e.
\(^{157}\) Article 8-c.
IX REFORM IN EUROPE

A OECD Report

This 1994 report was a major review of the economic effects of vertical restraints in franchising in member states. One of its conclusions was that competition policy should have regard to market structure in deciding when a vertical restraint is acceptable. Vertical restraints “are very unlikely to harm economic efficiency or reduce competition in a properly defined market when its structure – its level of concentration, conditions of entry, and dynamics – insure that the franchise will face vigorous competition from other franchise systems or from products or services distributed in other ways.” It recommended that policy towards franchising should recognise three distinct market situations:

- Franchisors with small market shares in unconcentrated upstream and downstream markets, and new or established franchisors attempting to enter a new market, could have quasi-automatic permission to include either non-price or price restrictions in their agreements.

- Franchise systems that are non-negligible and well established in their market could face a more detailed inquiry into the extent of competition in their market and, if then necessary, into the effects of proposed vertical restraints.

- Franchise systems with a dominant position in their market could require a more detailed justification to show that proposed vertical restraints do not pose substantial risks for interbrand competition, would enhance efficiency, and that comparable efficiency benefits cannot be realised with lower risks for interbrand competition.

B Green Paper

The OECD report was one factor causing a rethink in Europe on vertical restraints. Another was the turnaround in American thinking that had occurred. Academic criticism of the European approach was a further influence. The most pressing factor, however, was the need to determine the action to be taken when the various block exemptions expired at the end of 1999. The Commission, therefore, published a Green Paper on Vertical Restraints in 1997. The most significant possible reform mooted involved the following market share ladder:

- Below 10% market share, the agreement would be de minimis and Article 81(1) would not apply;

- Between 10 and 20%, the agreement would be covered by a rebuttable presumption of compatibility with Article 81(1) unless it contained a minimum resale price

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158 OECD Report, above n13
159 OECD Report, above n13, 14.
161 Green Paper on Vertical Restraints in EC Competition Policy, January 1997
162 Green Paper, above n161, paragraph 280
restriction, impediments to parallel trade or passive sales, or if the distribution agreement was concluded between competitors;\textsuperscript{163}

- Between 20 and 40\% market share, the agreement would be exempted pursuant to Article 81(3);
- Between 40 and 50\% market share, the agreement would not be covered by the block exemptions; the parties would have to file a notification;
- The same would be true above 50\% market share; a party with more than 50 per cent market share would normally be presumed dominant.

The proposals were consistent with the OECD report but introduced market share as the criterion for assessing competition in the market.

\textbf{C \quad Follow Up Communication}

The extensive consultation that occurred over the Green Paper led to a further Communication in September 1998.\textsuperscript{164} This signalled a dramatic change of approach.

First, the specific Block Exemption Regulations would be replaced by a single regulation covering all forms of vertical restraints.

Second, whereas the existing Regulations contained “white lists” of the types of clauses in agreements that would be exempted, the new approach will be based exclusively on a “black list” of the clauses that cannot be exempted. Seven such clauses were specified, the principal ones being RPM, restrictions on exports or imports and restrictions on passive sales.

Third, despite a lack of agreement among those consulted about the efficacy of market share tests, the Commission decided to use market share as the basic criterion for deciding whether an agreement can claim the benefit of the block exemption. The Communication was silent on what the threshold level would be because of disagreement among its Member States at that time but it has since confirmed that it will be set at 30\%.\textsuperscript{165}

Fourth, the Commission intends to issue guidelines on how agreements above the 30\% threshold will be treated if submitted for clearance. It will also issue guidelines on how the exemption under the regulation may be withdrawn in certain cases. There is the suggestion that ultimately, in ten or fifteen years time, the regulation may simply be replaced by guidelines.\textsuperscript{166}

\textsuperscript{163} \textit{Green Paper}, above n161, paragraph 295
\textsuperscript{164} \textit{Communication}, above n89
\textsuperscript{165} IP/99/286, 30 April 1999, <http://europa.eu.int/rapid/start/cgi/guesten.kshp>
In summary, the system means that any agreement, including a franchise agreement, containing vertical restraints will be considered outside the scope of Article 81(1) provided it does not contain any blacklisted clauses and the parties’ combined market share does not exceed 30%.

D Current Status

On 30 April 1999 the European Council announced that it had reached “political agreement” on the two new regulations necessary to enable the Commission to complete the reform of policy “along the lines” set out in its Communication. The first of these was adopted on 10 June 1999. The draft Block Exemption was to be released for public consultation in July 1999 but it has yet to appear on the Internet. The stated intention is that the new rules should be applicable as from the beginning of 2000 but there is also speculation that the existing block exemptions will need to be extended.

167 IP/99/286, above n165
169 Nazerali and Cowan, above n166, 168.
POLICY OBJECTIVES

An appropriate policy framework for the development of an approach to franchising should be based on the following primary objectives.

A  Certainty

Certainty, clarity and predictability are goals sought in relation to all law but it applies especially in relation to commerce. First, as a matter of equity, competition law and other commercial law should be explicable to the operators of Ma and Pa businesses as well as to those with the capacity to obtain specialist legal advice. Second, legal certainty and predictability encourage the taking of commercial risk because the legal risk is eliminated or minimised. Thirdly, certainty reduces transaction costs. Consultation over the Green Paper revealed legal certainty to be industry’s highest priority.

B  Getting It Right

The law should have the objective of ensuring that the line dividing permissible and prohibited conduct is drawn properly. This is the most important goal but also the hardest to achieve.

First, it requires some agreement on what the goal of competition law is. Should the objective be the promotion of economic efficiency, the restraint of economic power, protection of independent businesses, or the promotion of consumer welfare? If there is a mix of goals, what is the appropriate balance between them?

Second, the law should be capable of accommodating new forms of business operation. Business is dynamic, with technology and globalisation driving change. Competition law should allow sufficient scope for new developments to be assessed on their merits. For example, our competition law has developed against the background of product power, where the party higher up in the supply chain has been assumed to have the greater power (manufacturer over distributor, distributor over retailer). This decade has seen the emergence of retailer power, or product pull, where the large retailers as often as not dictate to the supplier and manufacturer.
C Enforcement

Ideally, enforcement should be both effective and efficient. The law has to be able to deal with individual cases promptly and provide sufficient deterrence that practices clearly unacceptable are recognised as high risk by those contemplating them.

D Administrative Efficiency

Where interaction with the regulator is necessary it should be able to be completed quickly and at reasonable cost. This is related to the issue of certainty.

E Secondary Objectives

Treatment of franchising under competition law should be compatible with the way it is treated elsewhere. The most relevant other field is intellectual property, given that franchises often deal in intellectual property. Our law should also be as consistent as possible with Australian law.

F Trade-Offs

The reality is that all the above objectives cannot be satisfied. Very restrictive per se prohibitions promote certainty and enforcement efficiency but they do not serve the goal of drawing the boundaries correctly. Conversely, the latter goal is better served by an approach that evaluates each case on its facts to establish the actual impact on competition. The price of this, however, is a degree of uncertainty because it depends ultimately on the decisions of courts that are often poorly equipped to assess the issues involved. The corollary of a high degree of certainty is that only the most difficult cases will be referred to the regulator, meaning they are unlikely to be dealt with quickly.
XI THE APPROACHES EVALUATED

A Certainty

In New Zealand, three nominated practices excepted, agreements containing vertical restraints are only unlawful if they substantially limit competition. This superficial simplicity disguises the complexity of the analysis required to determine what constitutes substantial lessening of competition. Cases like F&P illustrate the difficulty that lawyers, economists and adjudicators have in evaluating the issues: what hope does the average business person have? A franchisee is likely to see fellow franchisees as part of her commercial whanau. The fact that the law regards them as being in competition comes as a considerable surprise.\footnote{Catley and Thomson, above n91, 246}

The rationale for the European block exemption approach is that it is the best way to provide certainty.\footnote{Green Paper, paragraph 161, 55} The system’s purpose is to enable those entering distribution arrangements to know where they stand. It would seem largely to have achieved that objective. The lack of legal certainty under the system did not emerge as a problem in the consultation on the Green Paper. If so, this is a considerable achievement, and a necessary one given the size and scale of the European market.

This certainty has come at a price. To qualify for the exemption, the European franchisor has had to ensure that the agreement satisfied all the provisions required by the Regulation. This has resulted in an emphasis on form rather than substance. Much of the drafting effort is aimed at ensuring that an agreement’s form brings it within the exemption: much of the enforcement effort is directed at determining whether this has been achieved. The analysis of the economic impact of the agreement in total is pushed into the background. The result has been a straitjacketing of franchising as an organisational form.\footnote{Communication, above n89, 27} The move to a single, comprehensive Regulation containing a black rather than a white and black list is seen as the way to overcome this problem. With these changes, the new system will establish a relatively simple, transparent framework likely to be understood by a reasonably intelligent and interested business person. This will be further enhanced if the guidelines promised by the Commission are of good quality.

The use of market share as a fundamental tool has also been motivated partly by need to provide certainty. The claim is that a franchise will be able easily to gauge whether it qualifies for exemption or not. However, there are reasons to believe the certainty may be illusory. First, market definition precedes assessment of market share and it can be determinative. Du Pont’s 75% share of the cellophane market became 20% of the market for “flexible packaging materials”.\footnote{United States v E.I.Dupont de Nemours & Co., 351 U.S. 377 (1956).} Second, market share information is not always clear cut and can be challenged. Third, markets are dynamic and market shares can change quickly. A franchise in a safe harbour today can be in hostile seas tomorrow.
The European Commission acknowledges that market share is not a substitute for market power. Nevertheless, it claims that some rule of thumb mechanism is necessary in the interests of legal certainty and market share is the best construct available. The only alternative would be to issue comprehensive guidelines that would make it possible to use the full set of market factors for the assessment of vertical restraints, a change it considers "too radical". It points out the use of market share thresholds in other contexts, such as mergers; and proposes special measures to accommodate some of the problems. Moreover, it points to the detailed guidelines on market definition it has produced. Only time will tell whether the confidence in market share thresholds is justified.

It is noted that the scope for formalism has not been entirely eliminated. One of the items on the black list is the combination of selective and exclusive distribution with a ban on active sales. Translated into more ordinary language this prohibits an arrangement whereby a distributor chosen by the supplier on specific criteria is appointed as the sole distributor in an area outside of which she is prohibited from selling the good or service concerned. At least three components of this exception are open to interpretation, namely, selective distribution, exclusive distribution and active sales. For example, selective distribution normally involves dealers being chosen on qualitative criteria but exceptions where selection has been based on quantitative criteria have been recognised. Careful drafting will still be needed.

The Commission’s view is the vast majority of franchise agreements will obtain automatic exemption under the new system. It describes franchising as "usually" a combination of selective distribution and obligations not to compete, with "sometimes" location clauses or territorial exclusivity added. These combinations will be able to be assessed according to the general criteria contained in the new Regulation. However, it is difficult to reconcile this view with the terms of the blacklisted form of distribution described in the preceding paragraph. As the Commission itself states, many franchises use specific criteria in selecting franchisees; home electronics, perfume and motor vehicle dealerships are examples. Many franchisors also impose territorial restrictions for the reasons covered in Sylvania and other cases. It would seem that these arrangements would be caught by the black list. The possible treatment of location clauses and non-competition clauses is also raising concern. It seems that, in the short term at least, franchising may be exposed to a reduction in legal certainty.

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174 Communication, above n89, 21.
175 Communication, above n89, 22.
176 Communication above n89, 22.
177 For example, an exemption will continue for two years when the threshold is exceeded by less than 5%.
178 Communication, above n89.
179 An example might be a Chanel distributor appointed for, and confined to, Belgium.
180 Nazerali and Cowan, above n166, 167.
181 Communication, above n89, 32.
182 Sylvania, above n36.
183 Nazerali and Cowan, above n166, 166-7.
B Getting It Right

The New Zealand approach is effects based. An agreement is evaluated in terms of its actual or potential effects on competition in the market. Decisions are made on real issues. This approach means that, generally, the correct decision will be made in each individual case. It also increases the possibility of new forms of distribution being permitted because they will be specifically evaluated in terms of their impact, taking account of their pro-competitive effects and the public benefit. Moreover, the landmark case, *Fisher & Paykel*,\(^{184}\) demonstrated a tolerant attitude.

In contrast, the European system has only partly been effects based. This is illustrated by the fact that a firm with a clearly dominant position in a market (market share approaching 100%) could nonetheless be exempted under the system if its agreement satisfied the requirements of the Regulation. Conversely, a firm with no market power could be denied exemption under the block arrangements if one of the clauses in its agreement infringed. The system provided for decisions to be made on individual cases but the reality has been that the time and cost involved in making an application has meant that the emphasis is always placed on trying to come within the block exemption. Perversely, therefore, a system that was intended to help business has hindered it because of its inflexibility.

This tendency to "straitjacket" distribution systems, thus stifling innovation, emerged as the major criticism in the consultation on the Green Paper.\(^{185}\) A strong consensus emerged for a change to an economic effects system, a change that the Community has now agreed to. This move, described as "profound",\(^{186}\) is an acknowledgement of the failure of the formalistic line drawing that the previous system encouraged. (Nonetheless, as indicated, the scope for line drawing has not been eliminated and old habits can be expected to die hard, especially in the European Community bureaucracy.)

It should also be noted that the treatment of vertical restraints is likely to remain controversial, notwithstanding the reform. The United Kingdom’s new Competition Act 1998 contains a provision empowering the Secretary of the Board of Trade to exclude or exempt vertical agreements from the equivalent of our section 27. The United Kingdom Government’s view is that all vertical restraints except resale price maintenance should be exempted. It has already released a draft Order in which it has not followed the Commission’s approach by avoiding any use of market share thresholds. It aims to have this in place when the Act comes into force in March 2000.\(^{187}\) This is possibly a position adopted for the purposes of the negotiations that must occur over the final shape of the new European system.

\(^{184}\) *Fisher & Paykel*, above n26.
\(^{185}\) *Communication*, above n89, Section II, 7
\(^{186}\) *Communication*, above n89, 27
\(^{187}\) Nazerali and Cowan, above n166, 168.
C Administrative Efficiency

The difference in scale between New Zealand and Europe is shown in the fact that the Commerce Commission has received around 60 applications for authorisation of a restrictive trade practice since the Act came into effect in 1987. By contrast, the competition arm of the European Commission, DGIV, is currently facing a backlog of over 1,000 claims for exemption from Article 81(1) with the prospect of more as the Union increases its Eastern European membership. Streamlining the system administratively is one of the main goals of the reforms being implemented. The main change is that whereas currently agreements can only be exempted from the date of notification, in future they will be able to be exempted from the date of the agreement. It will enable companies to enter into agreements and notify subsequently, with the possibility of any exemption being backdated. Both positions contrast with the New Zealand situation where a practice can only be authorised from the date of a determination.188

D Enforcement

The creation of a reasonably high threshold in Europe should reduce the number of cases that will require enforcement attention. Generally, the reforms represent a move toward a level of permissiveness not dissimilar to New Zealand.

188 Section 59.
XII CONCLUSIONS

The European Union is a market of over 300 million people, New Zealand’s market is under 4 million. Europe continues to strive for an integrated market whereas New Zealand already has a single market. Care is obviously needed in drawing lessons from Europe for application in New Zealand. With this caveat, the following conclusions are advanced.

Firstly, European experience is confirmation that an economic effects-based approach is the appropriate one. Ultimately, the necessity to evaluate the effect of agreements on competition cannot be avoided. An effects-based approach is the one most likely to yield the correct decision in individual cases. A jurisprudence developed on the basis of decisions on the effects in specific cases is also more likely to accommodate changes in distribution systems over time.

Secondly, the converse is that a form-based approach will ultimately fail. Such an approach has attractions because of the legal certainty it offers but the European experience demonstrates how the focus inevitably shifts to form rather than substance. Attention is distracted from the primary issue to the secondary.

Thirdly, definitions are the Achilles heel of a form-based approach. The first problem is in finding workable definitions. The classification of distribution systems in economic terms is difficult and their translation into law even harder. The definition of joint venture in our Act illustrates this.\(^{189}\) It is drawn very narrowly and almost certainly excludes ventures that should receive the benefit of the exemption from the price fixing it offers.\(^{190}\) The second problem is that enshrining definitions in law tends to freeze them in time. The law is unable to adjust adequately to changes in commerce. These problems are by-passed if the focus is on effects. Classifications of distribution systems may be helpful in analysis but are unsuitable as the basis of law or policy.

Fourthly, the European experience illustrates the trade-offs that need to be made between desirable policy objectives. The objective of legal certainty has necessitated the use of a market share threshold rather than the publication of a comprehensive list of the factors that would be taken into account in determining the effects of an agreement. Administrative efficiency has required the introduction of a power to backdate exemptions although it risks tolerating for a period agreements that are subsequently found to be anti-competitive.

Fifthly, the reforms are based on a sound theoretical underpinning. The Europeans have accepted the economic learning of recent years that the acceptability of vertical restraints depends on the strength of competition in the market concerned. The emphasis placed on assessing the market power of the parties is correct, in the author’s opinion. If the method of implementation is open to challenge, the conceptual basis is not.

\(^{189}\) Section 31 (1)(a).
\(^{190}\) Scott, above n97
Sixthly, the reforms show an admirable concern for legal certainty. The architects have set out to establish a safe harbour. The framework they have produced is relatively simple, using a bright-line threshold and a black list of prohibitions. Market share, the mechanism used to define the safe harbour, is a well-established concept used in other areas of competition policy. The promised guidelines may further enhance legal certainty.

Seventhly, little emerges from the reforms in terms of enforcement or administrative efficiency. The streamlining that is occurring with the latter appears to be driven by necessity rather than principle. It is not a model to be adopted in New Zealand.

Overall, the judgment is that the restrictive practices found in franchising would not be better regulated in New Zealand by the adoption of the proposed European system. Although the issue of a satisfactory definition of franchising will henceforth be avoided, the European system is still complex. The effectiveness of market share thresholds is likely to be limited in our environment where high concentration of market power tends to occur. Franchises in New Zealand are better off under our type of effects based system, especially while Fisher & Paykel remains the leading authority. Guidelines would be useful, however, especially as franchising can be expected to continue growing rapidly. They exist in New Zealand for business acquisitions. It seems reasonable that guidelines be formulated for restrictive practices.
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