The Effect of Franchising Agreements on the EEC’s Competition Policy: Do Franchise Agreements Promote the Objectives of Economic Integration within the EEC or Hinder it?

Grant A. Levy

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The Effect of Franchising Agreements on the EEC's Competition Policy: Do Franchise Agreements Promote the Objectives of Economic Integration within the EEC or Hinder it?

I. INTRODUCTION

When the member states of the European Economic Community (EEC) signed the Treaty of Rome (Treaty), they attempted to create a free market system throughout the EEC. Article 85(1) was the main provision designed to prevent anti-competitive behavior created by distribution contracts, exclusive licensing agreements or other business arrangements. Article 85(1) contains prohibitions against restrictions on competition, which either the European Commission (Commission) or a private party, through a court action, can declare void pursuant to Article 85(2). Article 85(3), however, provides exemptions for many business arrangements which Article 85(1) would declare void as a restraint on competition. The Commission extended block exemptions under Article 85(3) to patent licenses and other cooperative arrangements designed to initiate technological breakthroughs. The recent development of franchise agreements in the EEC which affect the competition policy of the EEC, led the Commission to discuss methods for dealing with the spread of franchising in the EEC.

During the early 1970s, European businesses followed the example of U.S. businesses and established franchise networks in the EEC. Franchise agreements are contractual arrangements establishing commercial cooperation between two independent entities. According to such an agreement the franchisor grants either one or a group of franchisees, the right to use the franchisor's

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1 Sutherland, Franchise Agreements under EEC Competition Rules, Common Mkt. Rep. (CCH) ¶ 10,776 at 11,806 (1986) [hereinafter Sutherland].
2 See id.
4 Id. at 401, 403; see Sutherland, supra note 1, at 11,806.
5 Sutherland, supra note 1, at 11,806.
6 Pronuptia de Paris GmbH, Plaintiff v. Pronuptia de Paris Irmgard Schillgalis, Defendant, Common Mkt. Rep. (CCH) ¶ 14,245 at 16,444 (1986). In the Federal Republic of Germany, the number of franchise systems increased from 85 (with 11,000 franchises) in 1978 to 200 (with 120,000 franchises) in 1982. Id. In France, the franchise system grew from 300 franchises in 1981 to 500 franchises in 1985. Id.
trademark or name and other characteristics of its business in the sale of goods and services. The franchisee uses the marketing strategy and business arrangement established by the franchisor to sell goods and in exchange pays the franchisor royalties. The franchisor controls certain aspects of the franchisee's business to provide the public with a uniform quality and presentation of goods and services. Franchises provide the franchisor with a uniform distribution network without the need to invest large sums of money in setting up its own retail outlets. Neither the member states nor the Commission have yet enacted any legislation governing or defining franchise agreements. The recent case of Pronuptia de Paris GmbH v. Firma Pronuptia de Paris Irmgard Schillgalis (Pronuptia), however, seriously questions the validity and use of franchise agreements with respect to the competition policy of the EEC.

This Comment discusses whether franchise agreements promote or hinder the competition policy of the EEC. First, the Comment focuses on the Pronuptia case and briefly discusses the court's decision and analyzes the effects of franchise agreements on the competition policy of the EEC. Second, it discusses the Commission's expected response to the Pronuptia decision. This discussion is based on the speech given by Peter Sutherland, EEC Commissioner of Competition Matters, concerning the compliance of franchise agreements with the competition policy of the EEC. Finally, the Comment concludes with an assessment of whether franchise agreements hinder or promote the competitive aims of the Treaty.

II. THE PRONUPTIA DECISION AND ITS EFFECT ON FRANCHISE AGREEMENTS IN THE EEC

A. Background

The Pronuptia case dealt with a dispute between Pronuptia de Paris GmbH Frankfurt au Main (Franchisor), a subsidiary of the French company of Pronuptia de Paris, and Mrs. Schillgalis (Franchisee), over the franchisee's duty to pay royalties to the franchisor for 1978 through 1980. Pronuptia de Paris, the French parent company of the Franchisor, produces wedding attire under

7 Id. at 16,445.
8 Id.
9 Id.
10 Id.
11 Id. at 16,447.
12 See infra notes 15–83 and accompanying text.
13 See infra notes 84–108 and accompanying text.
14 See infra notes 109–115 and accompanying text.
15 Pronuptia at 16,435.
the name "Pronuptia de Paris." The distribution of the Pronuptia de Paris products in the Federal Republic of Germany is handled by shops operated by the Franchisor, or by independent retailers through franchise agreements with the Franchisor for the parent company. The Franchisee sold bridal attire and other women's clothing products in Hamburg under the name Pronuptia de Paris.

On February 24, 1980, the Franchisee obtained franchises through three separate contracts with the Franchisor for the areas of Hamburg, Oldenburg, and Hannover. The Franchisor had three obligations under the contract. First, the Franchisor granted the Franchisee exclusive rights to market her goods and services and the right to advertise under the name of Pronuptia de Paris in a specific territory. Second, the Franchisor promised not to open any shops or provide any goods or services to another person in the specified territory of the franchisee. Finally, the Franchisor agreed to assist the Franchisee with business arrangements, marketing strategy, and other means designed to improve the profitability of the franchisee's business.

More specifically, the Franchisee agreed to assume all the risks of opening a franchise as an independent retailer. The Franchisee also agreed to the following additional business arrangements. First, the Franchisee agreed to sell Pronuptia de Paris goods only in the shop specified in the contract and to decorate and design the shop according to the Franchisor's instructions. Second, the Franchisee agreed to purchase eighty percent of her wedding related attire and accessories and a proportion of her cocktail and evening dresses from the franchisor, and to purchase the rest of her merchandise from only those sellers approved by the Franchisor. Third, the Franchisee agreed to pay a one time entrance fee of DM 15,000 (U.S. $8,205) for exclusive rights to the specified territory and a yearly royalty fee of ten percent of the total sales of Pronuptia products and all other goods. Fourth, the Franchisee agreed to advertise only with the Franchisor's approval in a method which enhances the international reputation of the franchise. Fifth, the Franchisee agreed to make the sale of bridal fashions her main business purpose. Sixth, the Franchisee agreed to
consider the retail price recommendations of the franchisor when freely establishing her own prices.28 Seventh, the Franchisee agreed to refrain from competing directly or indirectly during the contract period or for one year afterward with any Pronuptia shop.29 Specifically, the Franchisee agreed not to open a shop in an area outside the specified territory or within the specified territory after the end of the contract period.30 Eighth, the Franchisee agreed to obtain prior approval of the Franchisor before assigning the rights and obligations arising under this contract to a third party.31

The first court to hear the case ruled in favor of the franchisor in the amount of DM 158,502 (U.S. $86,700) for arrears on royalty payments from 1978 through 1982.32 The Franchisee appealed to the Oberlandesgericht Frankfurt am Main, attempting to reverse the first court's decision, argued that the franchise agreement violated Article 85(1) of the Treaty.33 The Franchisee also argued that the block exemption provided to various exclusive dealing arrangements under Commission Regulation No. 67/67/EEC did not apply to franchise agreements.34 In 1982, the Oberlandesgericht agreed with the Franchisee's argument.

28 Id.
29 Id.
30 Id.
31 Id.
32 Id.
33 Id.
34 Id. The applicable provisions of Regulation No. 67/67 are:
Article 1
1. Pursuant to Article 85(3) of the Treaty and subject to the provisions of this Regulation, it is hereby declared that until 31 December 1982 Article 85(1) of the Treaty shall not apply to agreements to which only two undertakings are a party and whereby:
   (a) one party agrees with the other to supply only to that other certain goods for resale within a defined area of the Common Market; or
   (b) one party agrees with the other to purchase only from that other certain goods for resale; or
   (c) the two undertakings have entered into obligations, as in (a) and (b) above with each other in respect of exclusive supply and purchase for resale.
Article 2
1. Apart from an obligation falling within Article 1 no restriction on competition shall be imposed on the exclusive dealer other than:
   (a) the obligation not to manufacture or distribute, during the duration of the contract or until one year after its expiration, goods which compete with the goods to which the contract relates;
   (b) the obligation to refrain, outside the territory covered by the contract, from seeking customers for the goods to which the contract relates, from establishing any branch, or from maintaining any distribution depot.
2. Article 1 (1) shall apply notwithstanding that the exclusive dealer undertakes all or any of the following obligations:
   (a) to purchase complete ranges of goods or minimum quantities;
   (b) to sell the goods to which the contract relates under trademarks or packed and presented as specified by the manufacturer;
   (c) to take measures for promotion of sales in particular:
      —to advertise
      —to maintain a sales network or stock of goods;
      —to provide aftersale and guarantee services;
      —to employ staff having specialized or technical training.
Empel, supra note 3, at 408.
and declared that the contracts restricted competition. 35 The court held that the contracts failed to permit the Franchisor to distribute to other dealers in the specified territory, because the contracts limited the Franchisee's ability to purchase and sell goods within the member states. 36 The court concluded that Article 85(3) did not exempt the contracts from the prohibitions of Article 85(1) against anticompetitive behavior and declared the contracts void under Article 85(2). 37 The Franchisor appealed the Oberlandesgericht court's decision to the Bundesgerichtshof, the highest court in the Federal Republic of Germany, and argued that the trial court's judgment should be upheld. 38 The Bundesgerichtshof decided that the issues in the case involved EEC law and requested that the European Court decide the preliminary questions involving Community law. 39

The Bundesgerichtshof sent three questions to the European Court concerning the applicability of EEC competition policy to franchise agreements. The first question dealt with the applicability of Article 85(1) to franchise agreements defining a special distribution system. 40 The second question, if the court affirmatively answered the first question, was whether Regulation No. 67/67/EEC applied to exempt certain exclusive dealings such as the Pronuptia contract from the restrictions on competition contained in Article 85(1). 41 If the court responded positively to the second question, the third question dealt with the specific application of Regulation No. 67/67/EEC to contracts similar to the Pronuptia franchise agreement. 42 These questions forced the court to decide

35 Pronuptia at 16,436-37.
36 Id. at 16,437.
37 Id.
38 Id.
39 Id.
40 Id. The first question specifically asked the following:
1. Is Article 85(1) of the EEC Treaty applicable to franchise agreements such as the contracts between the parties, which have as their object the establishment of a special distribution system whereby the franchisor provides to the franchisee, in addition to goods, certain trade names, trademarks, merchandising material and services?

Id.
41 Id. The second question specifically asked the following:
2. If the first question is answered in the affirmative: Is Commission Regulation No. 67/67/EEC of March 22, 1967, on the application of Article 85(3) of the Treaty to certain categories of exclusive dealing agreements (block exemption) applicable to such contracts?

Id.
42 Id. The third question specifically asked the following:
3. If the second question is answered in the affirmative:
(a) Is Regulation No. 67/67 still applicable if several undertakings which, though legally independent, are bound together by commercial ties and form a single economic entity for the purposes of the contract participate on one side of the agreement?
(b) Does Regulation No. 67/67, and in particular Article 2(2)(c) thereof, apply to an obligation on the part of the franchisee to advertise solely with the prior agreement of the franchisor and in a manner that is in keeping with the latter's advertising, using the publicity material supplied by him, and in general to use the same business methods? Is it relevant in this connection that the franchisor's publicity material contains price recommendations which are not binding?
whether franchise agreements hinder or promote the competition policy of the EEC contained in the treaty.

B. The Court's Analysis

1. Franchise Agreements Compatibility with the Competition Policy of Article 85(1)

The European Court declared that the applicability of Article 85(1) restrictions against competition to distribution franchise agreements depends on the provisions of the contract. The court recognized that franchise agreements are not designed to restrict competition, but that the provisions of the agreement could restrict competition. It held that for a franchisee to succeed the following elements must be present.

First, the franchisees must receive the necessary knowledge about the franchisor's business practices and trade secrets, and the franchisor should provide the necessary assistance to enable the franchisees to operate their businesses according to the franchisor's business practices. In return, the agreement should provide the franchisor with provisions that protect the trade secrets and business practices of the franchisor from benefiting its competitors. These provisions are essential for the success of the franchise and do not violate Article 85(1).

Second, the European Court allowed the franchisor to control the franchisee in order to protect the name and reputation of the network bearing its business name or symbol without restricting competition and violating Article 85(1).

(c) Does Regulation No. 67/67, and in particular Articles 1(1)(b), 2(1)(a), and 2(2)(b) thereof, apply to an obligation on the part of the franchisee to confine the sale of the contract goods exclusively or at least for the most part to particular business premises specifically adapted for the purpose?

(d) Does Regulation No. 67/67, and in particular Article 1(1)(b) thereof, apply to an obligation on the part of the franchisee—who is bound to purchase most of his supplies from the franchisor—to make the rest of his purchase of goods covered by the contract solely from suppliers approved by the franchisor?

(e) Does Regulation No. 67/67 sanction an obligation on the franchisor to give the franchisee commercial, advertising and professional support?

Id.

43 See Pronuptia at 16,437–38.
44 Id. at 16,438.
45 Id.
46 Id.
47 Id.
48 Id. at 16,439.
prohibitions against such restrictions. The franchise's reputation depends on the consumer's perception of it. This is why provisions governing the decoration and layout to create a similar atmosphere in each store of the franchise are not restrictions on competition under Article 85(1). In addition, the franchisee's location can and does affect the reputation of the franchise. Consequently, the court held that any provision requiring franchisor's approval of a change in location is designed to protect the reputation of the franchise and is not anticompetitive under Article 85(1).

In addition, the ownership of a franchise can affect the franchise's reputation. Thus, the provision requiring the franchisee to obtain prior approval of the franchisor before assigning the rights and obligations under the contract to a third party protects the reputation of the franchise and is not anticompetitive. The public expects the same quality and selection of goods provided by each franchise in the network, and thus provisions designed to give the franchisor control over the franchisee's goods available for sale, enhance the reputation of the franchise and are not anticompetitive. Finally, the advertising of a franchise reflects the image the franchise wants to portray for itself, and thus any provision requiring the franchisor to approve the nature of the franchisee's advertising does not affect competition. Thus, many of the restrictions placed on the franchisee by the franchisor do not violate the competitive policy of the EEC, but instead enhance the franchise system and consumer satisfaction.

2. Provisions Which Restrict Competition and Violate Article 85(1)

Prohibitions against Restraints on Competition

In answering the first question presented to it by the Bundesgerichtshof, the European Court held that any provision in a franchise agreement designed to prevent franchisees from competing in the same market or from offering goods at different prices restricts competition. The Pronuptia franchise agreement contains the following provisions affecting the territorial competition of the franchise. First, the franchise agreement prohibited the franchisee from selling goods in a shop other than the one specified in the contract. Second, the franchise agreement granted exclusive rights to the franchisee to market the

49 Id.
50 Id.
51 Id.
52 Id.
53 Id.
54 Id.
55 Id.
56 Id.
57 Id.
58 Id.
products of the franchise in a specific territory. 59 When viewed together, these provisions divide the market between the franchisor and franchisee and between the franchisees and inhibit intrabrand competition. 60 The European Court cited *Consten and Grudging v. Commission* 61 as support for the declaration that restrictions on intrabrand competition concerning a commonly known business name or symbol violates the competition policy of Article 85(1). 62 In addition, provisions which share markets even when the franchise is located in only one member state affect trade throughout the EEC. 63 This is because such provisions restrict the franchisees from establishing commercial outlets in other member states. 64

The European Court also recognized that providing a franchise with a specified territory free from intrabrand competition creates sufficient incentives for the prospective franchisee to justify the risk of being part of the franchise network. 65 The prospective franchise must invest substantial sums of its own money, pay an entrance fee, and pay a specified royalty each year to join the franchise network. 66 The requirements necessary to open a franchise would deter any prospective franchisee from joining the franchise network, if the franchisee faced competition from other franchises in the network. 67

The European Court declared that any provisions granting the franchisor control over the franchisee’s freedom to choose his own price is a restraint on competition. 68 The Pronuptia franchise agreement, however, did not force the franchisee to blindly follow the franchisor’s price, but only to consider the price recommendation of the franchisor in choosing its price. 69 Price recommendations do not constitute price fixing between the franchisor and franchisee or among the franchisees. 70 The court, however, left the determination of whether the Pronuptia contract involved price recommendations or a concerted price movement between the franchisor and franchisee, and among the franchisees, to the national court. 71 The provisions of the franchise agreement which restrict

59 *Id.*
60 *Id.*
62 *Pronuptia* at 16,439.
63 *Id.* at 16,440.
64 *Id.*
65 *Id.* at 16,439.
66 *Id.*
67 *Id.*
68 *Id.* at 16,440.
69 See *id.*
70 *Id.*
71 *Id.*
price determination by the franchisees and partition markets are restrictions on competition under Article 85(1).  

3. The Applicability of the Block Exemption Provided under Regulation No. 67/67/EEC through Article 85(3) to Franchise Agreements

After deciding that the provisions restricting the territory of the franchise violated Article 85(1) as a restraint on competition, the European Court considered the second question presented to it by the Bundesgerichtshof. The second question concerned whether a block exemption under Regulation No. 67/67/EEC applied to the Pronuptia franchise agreement.  

If the block exemption applied to the franchise agreement, then the entire franchise agreement would be valid despite the violation of Article 85(1). The court carefully evaluated several aspects of Regulation No. 67/67/EEC with respect to franchise agreements and concluded as follows. First, the court held that the block exemption applied to contracts specified in terms which covered obligations of supply and purchase. The court, however, declared that the block exemption did not extend to contracts which covered the use of a single business name or symbol, or established uniform business practices, or created a distribution franchise arrangement.  

Second, the language of Article 2 of Regulation No. 67/67/EEC states that it applies to exclusive dealing arrangements, and not to franchise agreements similar to the Pronuptia agreement. Third, Article 2 provides restraints only on the exclusive dealer and not on the other party to the contract. A franchise agreement, however, places an obligation on the franchisor to provide knowledge and assistance to the franchisee.  

Fourth, the requirements of Article 2(2) of Regulation No. 67/67/EEC do not require a distributee to pay royalties or permit the distributor to exercise the control necessary to maintain the identity and reputation of the network. The court followed the opinion of the Commission and the French government and declared the block exemption under Regulation No. 67/67/EEC inapplicable to franchise agreements. Thus, the court's determination that Regulation No. 67/67/EEC did not apply to franchise agreements meant that the court did not need to decide the particular application of the block exemption to the Pronuptia franchise
agreement. This decision requires the Commission to examine any agreement with a territorial partitioning or price setting provision to determine if the franchise agreement restricts competition under Article 85(1). The decision of the court compels the Commission to establish a policy which clarifies the continued existence and effective use of franchise agreements in the EEC.

III. THE COMMISSION’S EXPECTED PROPOSAL CONCERNING FRANCHISE AGREEMENTS STATUS IN RELATION TO EEC COMPETITION POLICY AS PROPOSED BY COMMISSIONER PETER SUTHERLAND

Commissioner Sutherland maintains that the EEC’s competition policy must be flexible and accommodate the economic reality of the EEC’s business community. Sutherland recognizes that franchise agreements provide advantages to consumers by establishing a uniform distribution system with independent retailers running their own shop in an efficient manner. Franchise agreements permit firms to develop across the borders of the member states of the EEC and create a common marketplace throughout the EEC. While Commissioner Sutherland recognizes the advantages associated with franchise agreements, he also acknowledges their limitations. Franchise agreements hinder competition when they include market share and resale price constraint provisions.

Commissioner Sutherland explains that the Commission is considering a block exemption regulation for franchise agreements under Article 85(3). The Pronuptia court decision stated that Regulation No. 67/67/EEC did not apply to franchise agreements, but left room for the Commission to create exemptions, under Article 85(3), pertaining to franchise agreements. The recently enacted Regulations No. 1983/83 and 1984/84 are similar to Regulation No. 67/67/EEC and will not exempt franchise agreements from the Article 85(1) prohibitions against restrictions on competition. Commissioner Sutherland, in his speech at the Euro Conference in Brussels, Belgium on March 25, 1986, did not outline a specific proposal, but instead gave a general orientation concerning the Commission’s plans for a block exemption concerning franchise agreements.

81 Id.
82 Id.; Sutherland, supra note 1, at 11,808.
83 Sutherland, supra note 1, at 11,806.
84 Id. at 11,807.
85 Id.
86 Id.
87 Id.
88 Id.
89 Id. at 11,808.
90 Id.
91 Id.
92 Id.
First, the block exemption would comply with the decision of the *Promuptia* court.93 The regulation would follow the court's decision.94 Thus, it would exempt an agreement which allows the franchisor to provide commercial know-how and assistance to the franchisee, and in exchange provide the franchisor with sufficient control to protect the reputation and identity of the franchise system bearing his name or sign.95 The exemption would also apply to the provisions that the European Court did not consider restrictions on competition.96

Second, resale price maintenance would never be included in a block exemption, since price competition is a basic feature of the free market system.97 Such franchisor control of the franchisee's price would restrict intrabrand competition and burden the consumer by having a price set either artificially high or low by the franchisor.98 If the franchisor allowed the franchisee to set the price, then the franchisee would set the price according to the supply and demand for the product in the particular market.99

Third, the block exemption would extend to provisions which prevent the franchisee from selling goods other than in its shop or prohibit it from opening a second shop.100 Such a provision might restrict competition between the franchisor and the franchisees or between the franchisees.101 These provisions, however, provide incentives for franchisees to enter franchise agreements without the risk of losing money because of competition from the franchisor or other franchisees in the franchisee's market.102 In order for the block exemption to comply with Article 85(3) and contain restrictive sales provisions, the franchisor must select franchisees based on "objective, non-discriminatory and uniformly applied criteria."103

Fourth, the franchise agreement should allow franchisees to sell and purchase goods from each other anywhere in the EEC.104 A restriction on the resale provision between franchisees would violate the conditions of Article 85(3) and prevent the application of a block exemption to franchise agreements.105 Likewise, a restriction on the freedom of franchisees to purchase and sell merchan-

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93 Id. at 11,809.
94 Id.
95 Id.
96 Id.
97 Id.
98 See id. at 11,807, 11,809.
99 See id. at 11,809.
100 Id.
101 See id.
102 See id.
103 Id.
104 Id.
105 Id.
dise throughout the EEC would prevent the exercise of warranties on the products sold by the franchisees. 106

Finally, Sutherland recognized that a number of provisions could be placed in the Commission's regulation, but he explained that the Commission instead will probably utilize the mechanism of opposition procedure. 107 The guidelines given by Sutherland present a fragmented picture of the Commission's intentions concerning a regulation regarding franchise agreements. 108 The regulation suggested would permit franchise agreements containing provisions restricting the franchisee to the single outlet provided in the contract in order to promote competition in the EEC.

IV. Conclusion

Franchise agreements promote and hinder the EEC's competition policy. Commissioner Sutherland, as mentioned earlier, recognized that franchise agreements permit business expansion without the risks associated with opening up subsidiaries. 109 He also recognized that franchise agreements can contain resale price maintenance clauses and territorial partitioning provisions which restrict competition. 110 The block exemption advocated by Sutherland would not permit resale price maintenance. 111 It would, however, allow provisions in the franchise agreement which forbid the franchisee from opening a shop other than the one provided for in the franchise agreement. 112

The Pronuptia court ruled that any provision partitioning markets between the franchisor and the franchisee, or between franchisees, constituted a restriction of competition for the purposes of Article 85(1). 113 The court did recognize that partitioning the market provides an incentive to prospective franchisees to join the network and take the financial risk associated with joining it, without fearing competition from the franchisor or other franchisees. 114 The Pronuptia court's view that market partitioning restricts competition under Article 85(1) does not prevent the Commission from establishing a block exemption which satisfies the conditions of Article 85(3), as long as the franchises are chosen on "objective, non-discriminatory and uniformly applied criteria." 115 Thus, the pro-
posed block exemption's only anticompetitive feature is its allowance of provisions restricting the franchisee from opening a second shop.

The proposed block exemption will deal with the lack of competition within the franchise network, by requiring the franchise agreements to allow for the free flow of goods between franchisees. Thus, while franchisees will not be able to compete with each other, they will be able to sell goods to one another. In addition, one franchisee will be able to sell the goods of another franchisee in its store. Thus, the franchise network, as established under the block exemption proposal, resembles the distribution system of a large chain operation. A large chain is interested in competing with the other manufacturers producing competing goods and not with itself. Thus it establishes its outlets in locations where they will not compete with each other. The Commission will formulate the proposed block exemption to achieve the same goal of large chain organizations, which is to promote interbrand competition between franchises instead of intrabrand competition between a franchisor and its franchisees, or among its franchisees. Thus, the block exemption for franchise agreements will hinder intrabrand competition in the EEC, while promoting interbrand competition throughout the EEC in compliance with the competitive policy of the Treaty.

Grant A. Levy