

Vertical Restraints in Distribution Contracts



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When selling goods via distributors, the manufacturer always seeks to control the distributor's activity and to protect its business interests. For this purpose, the distribution contracts may include terms limiting a distributor's freedom of trade, such as ability to buy goods from other manufacturers, to sell goods at an independently determined price, or sell goods in certain geographic regions. In some cases, the restraints may be imposed by distributors onto the manufacturers, requiring the latter to sell the entire volume of goods to a certain distributor. Such restrictions are commonly referred to as vertical restraints, i.e., those which are implemented between companies operating at different levels of the production or distribution chain (e.g., between producers and wholesalers or retailers).

Typical restraints used in distribution contracts include resale price maintenance, exclusivity and market allocation arrangements. Such restraints may be classified as anticompetitive concerted actions under Ukrainian competition law and, as such, may be prohibited by the Antimonopoly Committee of Ukraine (the AMCU), if the parties to a distribution agreement fail to obtain a prior approval of the AMCU (AMCU Approval). The parties may refrain from obtaining AMCU approval if the restrictive covenants specified in the distribution contract are permitted subject to application of certain exemptions provided by Ukrainian competition law. Thus, in each particular case restraints in a distribution

contract should be well examined to avoid the AMCU's sanctions for failure to obtain AMCU approval (if required).

In this article we will address the restraints most frequently used in distribution contracts from the perspective of their compliance with the Ukrainian competition legislation.

Exclusivity arrangements

Distribution agreements may be categorized as either exclusive or non-exclusive. In an exclusive distribution agreement, the supplier (who may be a manufacturer itself or a distributor reselling somebody else's goods) will grant to the distributor exclusivity over a particular territory (exclusive distribution) and/or product line and/or sales channel (exclusive purchasing). The usual compensation for exclusivity will be some kind of performance obligations.

Classification under Ukrainian law: (i) restriction of goods' market activity; (ii) sharing of markets or sources of supply by a territory, range of goods, volume of sales, customers, sellers or consumers or other criteria; (iii) entering into an agreement subject to undertaking by a counter party of additional obligations not relating to the subject-matter of the agreement; (iv) significant restriction of competitiveness of other market players in the absence of any justifiable reasons, all of which are deemed anticompetitive concerted actions under Article 6 of the *On Protection of Economic Competition Act of Ukraine of 11 January 2001* (the *Competition Act*).

Thus, exclusivity arrangements constitute anticompetitive

concerted actions under Ukrainian law and, as such, require obtaining of a prior AMCU Approval, unless they fall within one of the available exemptions.

Exemptions: Regulation No.27-p *On the Standard Requirements to Concerted Actions of Business Entities for General Exemptions from Obtaining the AMCU approval of 12 February 2002* (the Regulation No.27-p) envisages that participants of exclusivity arrangements are exempt from the requirement to obtain an AMCU approval if the following requirements are met:

(i) exclusivity arrangements constitute strictly vertical concerted actions; and

(ii) the aggregate market share of the participants of the concerted actions:

a. does not exceed 5% of a certain market; or

b. is less than 20% of a certain market subject to the fact that the following financial thresholds are not exceeded: (i) EUR 12 million of assets and/or sales by concerted actions' participants in aggregate worldwide; and (ii) EUR 1 million of assets and sales per at least two participants each worldwide; and (iii) EUR 1 million of assets and sales by at least one participant in Ukraine.

In addition, the exclusivity arrangements may fall within one of the distribution-specific exemptions related to supply and use of goods established by Article 8 of the *Competition Act* (Article 8 exemptions) which states that restrictions related to purchase of goods from other business entities or sale to other business entities or consumers of another goods may be performed without obtaining AMCU Approval, pro-

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vided that such concerted conduct does not (i) lead to the restriction of competition on the whole market or its substantial part, including the monopolization of the relevant markets; (ii) restrict access of other business entities to the market; (iii) lead to economically unjustifiable price increase and shortage of goods.

The legislation remains unclear, however, whether Article 8 exemptions are applicable only in conjunction with the exemptions established by Regulation No.27-p, thereby allowing exclusivity arrangements to be conducted only by the parties whose market share and financial thresholds do not exceed the ones defined in Regulation No.27-p. In view of the legislation's ambiguity, parties of concerted actions exceeding the stated thresholds may wish to consider obtaining AMCU approval for the avoidance of risk of the AMCU's sanctions.

Market allocation arrangements

Market division or allocation schemes are arrangements in which competitors divide markets among themselves. In such schemes, competing companies allocate specific customers or types of customers, products, or territories among themselves. For example, one competitor will be allowed to sell to certain customers or types of customers. In return, it will not sell to customers allocated to its competitors. In other schemes, competing firms would sell only to customers in certain geographical regions and refuse to sell to or establish intentionally high prices to customers in geographical regions allocated to other companies.

Classification under Ukrainian law: sharing of markets by a territory, range of goods, volume of sales or purchases, customers, sellers or consumers is deemed an anticompetitive concerted action under Article 6 of the *Competition Act* often requiring obtaining

prior AMCU Approval, unless an arrangement is subject to one of the available exemptions envisaged by law.

Exemptions: In respect of market allocation arrangements Regulation No.27-p provides for the same list of exemptions which applies to the exclusivity arrangements addressed above, i.e., the market allocation scheme must be vertical and must not exceed the stated market share and financial thresholds requirements.

It appears that Article 8 exemptions do not provide specific carve-outs in case of market allocation arrangements and, therefore, do not seem to be applicable.

Thus, if the parties to a distribution contract find that their market allocation arrangement falls outside of any available exemptions, they must apply for AMCU approval to validate their concerted conduct. For this purpose the parties must provide the AMCU with strong arguments confirming that a concerted arrangement is justified by pro-competitive, technology or efficiency gains which outweigh any anticompetitive effect.

Resale price maintenance

In a resale price maintenance (RPM) scheme a producer of goods and its distributors agree that the latter will sell the former's product at a certain price. Minimum RPM provides for a producer fixing a price at or above a price floor, while maximum RPM provides for a producer fixing a price at or below a price ceiling. The manufacturer is interested in RPM because it wishes to keep resellers profitable which will in turn ensure the manufacturer's own profitability. Failure by a reseller to maintain prices at a fixed level may result in the manufacturer's stopping business with the latter.

Classification under Ukrainian law: a price or tariff fixing is deemed an anticompetitive

concerted action under Article 6 of the *Competition Act* which is generally subject to AMCU Approval, unless any of the exemptions apply.

Exemptions: As in the case of the exclusivity arrangements, resale price maintenance provisions may be subject to the exemptions provided by Regulation No.27-p and Article 8 exemptions. In particular, the latter envisages that restrictions related to the formation of prices or the terms of the agreement with respect to the goods supplied to business entities or customers may be implemented without obtaining AMCU Approval, unless they lead to significant restriction of competition, restrict access of other players to the market or lead to unjustifiable price increases or product deficiency.

As stated above, due to ambiguity of the application of Article 8 exemption in case of the parties with the market share and financial thresholds exceeding the ones set by Regulation No.27-p, participants of concerted actions may consider applying for AMCU approval to avoid risk of imposition of penalties by the AMCU.

Liability

According to the *Competition Act*, failure by the parties to a distribution contract to obtain prior AMCU approval (if required) will constitute a violation of Ukrainian antimonopoly legislation, which is punishable by a fine in the amount of up to 10% of the combined annual revenue of the breaching entity's group for the most recent reporting year. If the profit resulting from the concerted arrangement exceeds 10% of the combined group's revenue, an additional fine may be applied in the amount not exceeding a triple amount of unlawfully earned profit.

The *Competition Act* also establishes a fine in the amount of up to 1% of the combined revenue of the breaching party's group for

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provision of untrue information to the AMCU.

The statute of limitation for concerted conduct constitutes five years from the date of the violation, and in the event of a continuing violation — five years from the date of the termination of the violation. The violation is generally deemed to have been committed starting from the date of a distribution contract or from the date of the actual commencement of the concerted conduct, as the case may be.

The *Competition Act* provides that during five years from the date of its decision to grant AMCU approval the AMCU may re-consider the decision if: (i) the AMCU was not and could not have been aware of material circumstances prior to the adoption of an unlawful and unjustifiable decision; or (ii) the decision was made on the basis of untrue information which resulted in adopting an un-

lawful and unjustifiable decision. The AMCU may also re-consider its decision during the term of the validity of AMCU approval if: (i) concerted actions' parties failed to comply with the terms envisaged by AMCU Approval; or (ii) the circumstances on the basis of which AMCU approval was granted have ceased to exist. As a result of such re-consideration, the AMCU may (i) confirm its decision on the issuance of the AMCU Approval; or (ii) recall its decision in whole or in part; or (iii) make a new decision with respect to a concerted arrangement.

Conclusion

While vertical restraints may have certain anticompetitive effects, they are generally less harmful than horizontal ones and may provide for significant economic efficiency and technology gains, such as enhancing of

inter-brand competition, eliminating double marginalization, which will in turn increase sales volumes and improve production of goods on the affected market, thereby offsetting any or some negative anticompetitive effects of the restraints. Thus, parties to a distribution contract containing non-excessive trade restraints aimed at making a contract commercially viable without primarily seeking to restrict competition should not view the requirements of Ukrainian competition legislation as an obstacle to entering into a distribution contract. It is recommended, however, that the parties carefully analyze the restraints and the applicability of the available exemptions and, if required, validate them by obtaining AMCU Approval.

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