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Restrictions on Producers' Rights to Manage Distribution Chains Loosened Under New Amendments to Russia's Antimonopoly Legislation

On August 23, 2009 a series of amendments to Federal Law No. 135-FZ, "On Protection of Competition" (the Competition Law), went into effect, which, among other things [1], substantially broadened the permissible rights of producers over their distributors in Russia, provided such producers do not engage in direct sales in Russia. In conjunction with the adoption of the amendments, Russia's government issued Resolution No. 583, "On Cases of Permissible Agreements Between Economic Entities" (the Resolution), which went into effect on July 31, 2009 and has a five-year sunset provision.

The Benefits of Vertical Agreements

Prior to this most recent set of amendments to the Competition Law, manufacturers were bedeviled by a laundry list of provisions common to distribution agreements that constituted *per se* violations of the Competition Law (i.e., no anticompetition effect needs to be proven to constitute a violation of law). The breach of such *per se* violations exposed market participants to administrative fines, among other penalties.

Each of the following is defined as a *per se* violation:

- **Price Fixing:** fixing or maintaining prices

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(tariffs), discounts, bonuses or markups.

- **Tender Price Manipulation:** depressing, inflating or fixing tender prices.
- **Market and Customer Division:** dividing markets on the basis of the geography, volume of product sales or purchases, range of products being sold or composition of sellers or purchasers (customers).
- **Boycotting:** refusing to make agreements with certain sellers or purchasers without economic or technological justification, unless such refusal is permitted under applicable law.
- **Supply Manipulation:** causing a reduction or termination of a product's production that is not economically or technologically substantiated, if such product is in demand or orders to supply it have been placed and it is possible to manufacture it on a profitable basis.
- **Reciprocal Dealings/Tying:** imposing agreement terms and conditions on a counterparty that are not favorable to the counterparty or do not pertain to the subject of the agreement, such as conditioning the agreement on the counterparty agreeing to purchase other products it does not need (for example, requiring a purchaser of soft drinks to purchase refrigerators as a condition to the sale of the soft drinks).
- **Price Discrimination:** fixing different prices for the same product without an economic or technological justification, unless otherwise permitted under applicable law.
- **Discriminatory Activities:** impeding access to or withdrawal from a market by other market participants.

The breadth and rigidity of the *per se* violations prohibited the inclusion of legitimate distribution chain management tools in distribution agreements regardless of whether they had a negative impact on competition. The amendments provide that the foregoing limitations no longer apply to **vertical agreements.** The *per se* violations, however, continue to apply to all other types of agreements that do not qualify as vertical agreements (e.g., agreements among competitors) or permissible agreements.

Vertical Agreements and the 20-Percent Rule

Vertical agreements are defined as "agreements between commercial entities not competing with each other, one of which acquires a product or is its potential acquirer, while another one supplies the product or is its potential seller." Franchise agreements may also qualify as vertical agreements. The key is that the parties to the vertical agreement are not competitors, which is a common characteristic of distribution agreements between non-Russia-based manufacturers and Russia-based distributors.

Under the amended Competition Law, none of the enumerated *per se* violations apply to vertical agreements if each of the parties (excluding financial organizations that are subject to different regulations) holds **less than 20 percent** of its respective market. If a party holds **more than 20 percent** of its respective market and is party to a vertical agreement, the Competition Law imposes only two prohibitions:

- The party may not include provisions that lead or could lead to setting **resale prices** of a product; and
- The party may not prohibit a purchaser's sale of a competitor's product (unless the purchaser sells under a registered trademark or logo of the seller or producer).

However, the Resolution establishes additional limitations discussed below.

Permissible Agreements and the 35-Percent Rule

In addition to the *per se* violations (if applicable), the Competition Law continues to bar agreements, joint actions or coordinated economic activities that have an anticompetitive effect on the market, unless such agreements or joint actions are identified as permissible. The Competition Law expressly provides that franchise agreements (without reference to a party's market share) and vertical agreements among parties that do not hold more than 20 percent of their given market are permissible. The Competition Law further provides that Russia's government may define additional permissible agreements by resolution.

The Resolution is the first time that the government has exercised its power to define permissible agreements. The Resolution provides that a product sales agreement may be permissible if **each** of the following conditions is met:

- The seller sells a product to two or more purchasers and its share of the market for that product is **less than 35 percent,** or the seller sells the product to a single purchaser whose market share is **less than 35 percent;**

- The seller and the purchaser do not compete with each other in the resale or acquisition of the product; and

- The purchaser does not produce products equivalent to those it acquires under the agreement.

A person or group of persons may be found to occupy a **dominant position** if they can collectively (i) exert an influence on the general terms of circulation of a product in a given market, (ii) force other market players out of a given market or (iii) hinder access to a given market by other market players. A person who exercises control of more than 50 percent of a given market is presumed to have a dominant position. A person who exercises control over less than 35 percent of a given market cannot be found to occupy a dominant position except in limited circumstances.

Thus, the Resolution provides greater clarity to the scope of permissible agreements, including vertical agreements, among market participants that hold significant market share. However, the Resolution at the same time expands the list of prohibited contractual provisions in such agreements.

Additional Limitations on Product Sales Agreements

The Resolution further enumerates the following provisions that may not be included in product sales agreements including vertical agreements if one of the parties to the agreement holds more than 20 percent of the relevant market:

- Restrictions on a purchaser's right to conduct sales in territories unless such territories are serviced by another purchaser or the seller itself. The Resolution also provides that if a product sales agreement includes an exclusive territory provision, such agreement must also include a provision obligating the purchaser to refrain from entering into other agreements to purchase equivalent products within the same territory. This provision presumably is required to minimize the opportunity for a distributor or retailer to

obtain exclusive rights to sell a certain class or type of product produced by different manufacturers within a territory and, as a result, control pricing;

- Restrictions on the seller's right to sell spare parts on a retail basis or to special repair and service organizations unaffiliated with the purchaser;

- Restrictions on a purchaser's right to sell equivalent products or restrictions that require the purchaser to acquire an amount of product from the seller that constitutes more than 50 percent of the purchaser's annual turnover, unless:

    - Such prohibition was contained in an agreement that predates the Resolution, in which case the provision shall survive for the length of the agreement or three years from the effective date of the Resolution, whichever is shorter;

    - Such prohibition does not exceed three years (unless the purchaser is a retail sales organization), provided a prior agreement between the parties did not have the same prohibition (i.e., the prohibition cannot be extended); or

    - The purchaser operates from land or premises provided to it by the seller; and

- Inclusion of terms requiring that the purchaser include prohibitions on resale of the product in its own sales agreements (i.e., inclusion of prohibitions on subdistribution arrangements).

Grace Period Upon Exceeding 35-Percent Threshold

Finally, the Resolution provides that if a market participant's market share grows to exceed the 35-percent threshold, the strictures of the Resolution shall become applicable to the participant's operation on July 1 of the following year.

Conclusion

The most recent set of amendments to the Competition Law and the Resolution provides welcome relief and helpful guidance to manufacturers and distributors alike and should allow for more normalized and flexible distribution chain management in Russia by providing significantly reduced limitations on small and medium-

sized businesses operating in highly competitive markets.

Notwithstanding the positive legislative strides, the interpretation and application of the Competition Law remains complex and fact-intensive, and the case law is very limited, making conclusions difficult to predict. Moreover, defining the applicable market remains ambiguous under the Competition Law. Therefore, making determinative market share calculations is challenging and businesses lack clear safe harbors.

Despite these uncertainties the most recent set of amendments to the Competition Law and the Resolution reflects responsive governmental action to provide useful guideposts to market participants while minimizing some of the more restrictive provisions of the law as applied to small and medium-sized market businesses. These actions are particularly welcome given the Federal Antimonopoly Service's (FAS) increased enforcement activity in recent years.

If you have any questions about the foregoing or how best to benefit from these changes in your distribution relationships, please contact your principal Squire Sanders lawyer or one of the individuals listed in this update.

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[1] Notably, the amendments also set higher monetary triggers for when preapprovals for acquisitions of shares or assets of Russia-based enterprises are required. Please see our updated Quick Reference Guide No. 1.