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Revision of the EU Competition Rules on Cooperation in Research & Development and Production: Scope for Further Improvement

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I. INTRODUCTION

As part of the pending revision of the EU competition rules on horizontal cooperation agreements, the EU Commission has proposed significant amendments to the two block exemption regulations covering research and development agreements (the draft revised R&D BER) and specialization agreements (the draft revised Specialization BER) as well as changes to the corresponding chapters of the *Horizontal Guidelines*.² The proposed amendments aim to improve the existing framework of assessment rather than to radically change it. This has been largely achieved by the Commission expanding, simplifying, and clarifying the application of the two block exemption regulations and by aligning the text of the relevant chapters of the Horizontal Guidelines with the approach expressed in other recent Commission guidance documents, such as the *Horizontal Merger Guidelines* and the *General Guidelines* (previously referred to as the Article 81(3) Guidelines).

However, there remains scope for further improvement before the final versions of the revised texts are adopted later this year. This article identifies 10 aspects where, in the author's view, the Commission's proposed amendments should be further clarified or dropped in order to reach a sound competition policy solution and enhance legal certainty. As decisions and judgments of European competition authorities and courts assessing R&D and production agreements under EU competition law are scarce, clarity of the block exemption regulations and the relevant chapters of the *Horizontal Guidelines* is of particular importance.³

II. RESEARCH AND DEVELOPMENT AGREEMENTS

A. The Proposed Definition of "Specialization in R&D" Should be Broadened

The revised R&D BER will continue to apply to cooperation agreements concerning "joint research and development" with or without joint exploitation. One possible form of joint R&D covered by the BER continues to be "specialisation in R&D," that is, a situation where the R&D tasks are "allocated between the parties by way of specialisation in research and

¹ Arnold & Porter LLP. The views expressed are exclusively those of the author and do not necessarily represent the views of Arnold & Porter LLP or its clients. The author wishes to thank Mark Gardner for his comments on a draft of this paper.

² The proposed revised texts of the two block exemption regulations and the *Horizontal Guidelines*, published in May 2010, are available at http://ec.europa.eu/competition/consultations/2010_horizontals/index.html.

³ Legal clarity is already reduced in this area, because the draft revised *Horizontal Guidelines* do not explain the provisions of the block exemption regulations on R&D and Specialization agreements. This contrasts with the Commission's *Vertical Guidelines* and *Technology Transfer Guidelines*, which both explain the provisions of the corresponding block exemption regulations at a great level of detail.

development.”⁴ Under Article 1 No. 12 of the draft revised R&D BER, the Commission has proposed a new definition, namely that specialization in R&D occurs if “each party carries out some of the research and development activities [...] and focuses on a distinct area of the research and development.”

It is to be welcomed that the Commission proposes a definition to remove the existing uncertainty under the current R&D BER as to when particular ways of splitting the parties’ R&D contributions will qualify as specialization in R&D. However, absent further guidance in the revised *Horizontal Guidelines*, it can be expected that in many situations contracting parties will face uncertainty as to whether the two elements of the new definition are met. For example, there can be debate about what constitutes a “distinct area” of research and development under the proposed definition.

More fundamentally, the proposed definition is also unnecessarily restrictive by excluding those forms of R&D cooperation “where one party carries out all the research and development and the other party merely finances these activities or exploits the results.” Given the financial costs and risks involved in many areas of R&D, there is a practical need for cooperation where one party co-finances the R&D of the other party with a view to benefiting from the R&D results. Such forms of cooperation lead to an efficient combination of resources in the interest of bringing new or improved products to the market quicker, and therefore would appear to be covered by the policy justification underlying the R&D BER.⁵ It is submitted that it would be a better policy choice to include in the definition of specialization in R&D situations where one contracting party co-finances the R&D of another party.

The definition should also include agreements under which one party does not itself carry out R&D work but licenses know-how or intellectual property rights that the other party needs to carry out the R&D work. Under the proposed definition, such agreements appear to fall outside the revised R&D BER.⁶

B. The Proposed Definition of “Specialisation in Exploitation” Should Also be Broadened

It is to be welcomed that the draft revised R&D BER also contains a new definition of “specialisation in exploitation,” clarifying that this occurs not only if the cooperation agreement explicitly allocates specific exploitation tasks to each party, but also if the agreement restricts a party’s exploitation rights.⁷

Regrettably, this definition is similarly unnecessarily narrow in that it requires that each party “carry out some of the exploitation of the results in the internal market.” Unless parties choose other forms of exploitation in the EU, for example by granting licenses to third parties, this means that all parties must “carry out in the internal market some distribution activities regarding the contract products,” for example in relation to specific territories, customers, or fields of use.

⁴ Art. 1 No. 11(c) of the draft revised R&D BER, which is identical to Article 2 No. 11(c) of the current R&D BER.

⁵ Compare Recitals 8 and 10 of the draft revised R&D BER.

⁶ The Technology Transfer Block Exemption Regulation can apply to such licenses only if the license agreement defines the contract products (paragraph 45 of the *Technology Transfer Guidelines*) and provides for the production of the contract products by the licensee (Article 2(1) of the Technology Transfer BER).

⁷ Article 1 No. 13 of the draft revised R&D BER.

It would be better if joint R&D agreements providing for exploitation of the results by only one party in the EU were covered by BER, as this would facilitate R&D cooperation between European and non-European companies that want to limit exploitation rights to their normal areas of operation. Moreover, it casts doubts on the definition's appropriateness that it can be satisfied by circumvention structures; for example, if the parties allocate to one party exploitation rights for a single small EU Member State or for a field of use that is of little commercial interest. Finally, it can be expected that joint R&D agreements that comply with Article 4 of the draft revised R&D BER (that is, the parties are non-competitors or competitors with a combined market share not exceeding 25 percent) will normally lead to efficiencies but not to significant anticompetitive effects even if they provide for exclusive exploitation rights in the EU.

If the requirement that each party must engage in some exploitation of the R&D results within the EU is not removed from the final version of Article 1 No. 13 of the revised R&D BER, the wording of this provision should be modified to make clear that it is sufficient that the R&D agreement provides for (or allows) some exploitation activity of each party in the internal market. The proposed wording (each party "must carry out") could be understood to mean that the relevant question is whether or not a party actually carries out exploitation of the R&D results in the EU. This would lead to significant legal uncertainty for contracting parties, as they may not be in a position to verify whether or not the other party is actually carrying out exploitation activity in the EU, and in any event this may not be known at the time when the parties are entering into the agreement and assessing the applicability of the R&D BER.

C. The Proposed Obligation that the Parties Disclose to Each Other Their Relevant Intellectual Property Rights Before Starting the Joint R&D Work Should Not be Adopted

Article 3(2) of the draft revised R&D BER introduces a new condition for the application of the BER, requiring that the "parties must agree that prior to starting the research and development all the parties will disclose all their existing and pending intellectual property rights in as far as they are relevant for the exploitation of the results by the other parties." The goal of the disclosure obligation is to avoid situations where a contracting party intends to exploit the R&D results but later finds out that it is prevented from doing so by pre-existing background intellectual property rights of another contracting party. This situation is similar to a "patent ambush" known from the standard setting context.

The proposal of an IP disclosure requirement is somewhat surprising given that the Commission has not pointed to any evidence showing that the lack of such an obligation under the current R&D BER has led to anticompetitive outcomes. Parties to an R&D agreement can normally be expected to anticipate and address in their cooperation agreement IP-related barriers to the exploitation of the R&D results so that situations where one party is barred from exploiting R&D results—because it was unaware of pre-existing background IP rights of the other party—probably do not arise often. Even if such situations were to arise, the absence of the disclosure obligation probably would not result in significant anticompetitive outcomes given that, in any event, the R&D BER only applies if the parties are non-competitors or competitors with a combined market share not exceeding 25 percent. Finally, the practical usefulness of the disclosure obligation is doubtful, because it requires disclosure to take place only before the R&D work starts, which in most cases will be subsequent to the signing of the R&D agreement. At that

stage, it will often no longer be possible to modify the parties' contractual obligations, so that the disclosure may well remain without any practical consequences.

D. The Access Condition Should be Further Clarified

The draft R&D BER continues to include the "access" condition for the application of the BER, pursuant to which the BER only applies if each party is given access to the results of the joint R&D for purposes of further R&D and exploitation. Article 3(3) of the draft revised R&D BER modifies the access condition by specifying that such access must be "equal."

It is submitted that the access condition should not preclude the parties from agreeing on differentiated financial conditions for the provision of access to the R&D results, for example in the form of differently calculated royalties. This is necessary to allow sufficient flexibility in the contractual reward structure to compensate for different contributions to the R&D work, and thus to incentivize the parties to engage in flexible forms of cooperation. Accordingly, the notion that access must be equal should be removed from Article 3(3) of the final revised R&D BER, or the Commission should clarify that the requirement of "equal access" does not exclude differentiated financial compensation.

Moreover, the Commission should seize the opportunity of the present revision to clarify that access to the R&D results for purposes of further R&D and exploitation must be granted only after any period of joint exploitation has ended. The structure of the R&D BER calls for this interpretation, but commentators have expressed different views on this issue meaning that uncertainty persists.

Finally, the Commission proposes to delete the second sentence of Article 3(3) of the current R&D BER, which states that non-competitors that enter into an R&D agreement not providing for joint exploitation can comply with the access requirement even if they limit each party's exploitation rights to certain technical fields of application. The Commission has not explained the reasons for removing this sentence. It is submitted that a split of access rights by technical field of application should be allowed in R&D agreements not providing for joint exploitation if the parties are non-competitors.

E. Some Types of Passive Sales Restrictions Should be Treated as Non-Hardcore

The hardcore list contained in Article 5 of the R&D BER has been significantly improved. Two restrictions have been moved from the current hardcore list into a new Article 6 defining excluded restrictions; that is, restrictions that are never covered by the R&D BER and therefore require an individual assessment (without being presumed to restrict competition) but do not affect the applicability of the R&D BER to the remainder of the R&D agreement. The other hardcore restrictions have been revised, making their application clearer and easier in practice.

Regrettably, Article 5(d) of the draft revised R&D BER continues to treat as hardcore restrictions all types of territorial and customer passive sales restrictions that the parties impose on each other with regard to the commercialization of the R&D results. By contrast, Articles 4(1)(c)(iv) and 4(2)(b) of the Technology Transfer BER treat certain types of passive sales restrictions in technology transfer agreements as non-hardcore. Similarly, paragraph 61 of the *Vertical Guidelines* states with regard to vertical agreements that passive sales restrictions for a period of two years that protect the territory or customers allocated to a distributor who

introduces a new product on a market are not normally restrictive of competition. The Commission should similarly treat as non-hardcore some forms of passive sales restrictions under the R&D BER, at least in agreements between non-competitors.

III. PRODUCTION AGREEMENTS

A. It Should be Clarified Whether a Reduction of Production Volumes Suffices as a Partial Cessation of Production Under the Definition of Specialization Agreements

Article 2(1)(a) and (b) of the draft revised Specialization BER extends the scope of the BER to unilateral and reciprocal specialization agreements under which the parties partly cease to manufacture a product, thus no longer requiring that the parties fully cease to manufacture the product in question. This change is significant and can be expected to multiply the situations in which companies can benefit from the Specialization BER. For reasons of legal certainty, the final text of the revised Specialization BER or of the *Horizontal Guidelines* should clarify whether a contractual agreement to reduce production quantities qualifies as a partial cessation of production in this sense, or whether a reduction of existing capacity is required.

B. “Joint Production” Should be Defined

As with the current Specialization BER, the draft revised Specialization BER not only applies to unilateral and reciprocal specialization agreements but also to “joint production agreements, by virtue of which two or more parties agree to produce certain products jointly.”⁸ The final version of the revised BER or of the revised *Horizontal Guidelines* should define the requirements that must be met to allow the conclusion that there is joint production in this sense. Some passages of the draft *Horizontal Guidelines* suggest that joint production can only take place in the form of a jointly controlled joint venture company, an approach that would be unnecessarily restrictive.

C. Field of Use Restrictions Should Explicitly be Excluded From the List of Hardcore Restrictions

Under the current wording of Article 4(b) of the draft revised Specialization BER (“limitation of output or sales”), field of use restrictions that the parties agree to with regard to the commercialization of the products that are subject to the specialization agreement arguably constitute hardcore restrictions. To align the approach of the Specialization BER with the approach taken in the Technology Transfer rules and the draft revised R&D BER, the final text of the Specialization BER or of the *Horizontal Guidelines* should clarify that field of use restrictions agreed to in the context of specialization agreements do not constitute hardcore restrictions.

D. The Guidance on the Assessment of Commonality of Costs Should be Improved

Two modifications should be made to paragraphs 169-173 of the draft revised *Horizontal Guidelines*, which explain the relevance of cost commonalities caused by the production agreement for its assessment under Article 101 TFEU outside the Specialization BER.

First, the Commission’s proposition in paragraph 173 of the draft revised *Horizontal Guidelines* that an agreement under which a manufacturer supplies a product to a competitor leads to cost commonalities between the parties should be questioned. Paragraph 169 of the draft

⁸ Article 2(1)(c) of the draft revised Specialization BER.

revised *Horizontal Guidelines* rightly defines cost commonality as the proportion of costs that the parties have in common. A supply agreement does not lead to any cost commonality in this sense. It merely provides the supplying party with knowledge about (parts of) the other parties' input costs. It is possible that such knowledge may lead to anticompetitive effects, but they are much less likely to arise in these situations of one-way cost transparency than in situations of genuine cost commonality. The final version of the revised *Horizontal Guidelines* should recognize this difference.

Second, the draft revised *Horizontal Guidelines* exclusively focus on commonalities in variable costs. The Commission should explain which costs it would treat as variable as compared to fix, and also whether or not a commonality in fixed costs can lead to a restriction of competition under the revised *Horizontal Guidelines*.

IV. GENERAL COMMENT

The Horizontal Guidelines' Explanations on Establishing the "Counterfactual" Should be Amended to Recognize the Importance of Financial Risk

The draft revised *Horizontal Guidelines* rightly emphasize the importance of establishing a "counterfactual" when assessing whether or not an agreement between competitors leads to a restriction of competition by effect.⁹ However, the guidance provided for defining the counterfactual can be improved. The wording of the draft revised *Horizontal Guidelines* suggests that the controlling question is whether or not parties to the agreement would be able to independently carry out the project with regard to which they choose to cooperate.¹⁰ In other words, a restriction of competition by effect can only be excluded at this stage of the assessment if the parties are unable to carry out the project independently, according to the draft revised *Horizontal Guidelines*.

However, the correct controlling question should be whether or not the parties are likely to individually carry out the project in question if they do not cooperate. In answering this question, the parties' ability to carry out the project individually is relevant, but so are the financial risks that the parties would incur when implementing the project independently. If the financial risks are unreasonably high, the parties cannot be expected to independently carry out the project in question even if, arguably, they have the ability to do so. A restriction of competition by effect should be excluded in such situations.

If the Commission does not change from an "ability" standard to one of "likelihood," the final revised *Horizontal Guidelines* should at least repeat the wording of paragraph 18(1) of the Article 81(3) *Guidelines* (now referred to as the *General Guidelines*), which recognizes that the financial risk associated with the independent implementation of the project plays a role also in the assessment of the parties' ability to carry out the project independently.

⁹ The counterfactual is relevant to all types of agreements discussed in the *Horizontal Guidelines*, but the issue is of particular relevance to R&D and production agreements.

¹⁰ See, notably, ¶¶ 28, 124 and 157 of the draft revised *Horizontal Guidelines*.