SELECTED ANTITRUST AND OTHER ISSUES INVOLVING FRANCHISEE ASSOCIATIONS AND PURCHASING COOPERATIVES

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October 11-13, 2006
The Westin Copley Place
Boston, MA

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Appendix
I. INTRODUCTION

There was a time, in the early days of franchising within the United States, when the dynamics of franchise systems were simple. The franchisor created the system and solely developed the strategies to move its goods and services to the market place. And, like apostles, the franchises were the vehicles used to implement these strategies and carry the brand message to the public or whatever other group might be the marketing target. Frequently, in these early days, franchisors would also have company outlets that would parallel the efforts of the franchisees. McDonald's provides a solid example, as approximately 15% of its domestic units have typically been company-owned, with the balance being franchised. But altogether, the franchisor, the franchisees, and possibly some company units, comprised the entire distribution system.

Today, in many of the highly developed franchise systems, simplicity has disappeared. The dynamics of the systems are dramatically different. KFC provides one of the best illustrations of a franchise system that has developed into a complex structure. The system consists of not only the franchisor, with company units and franchisees, but a franchise advisory council, an independent franchisee association (which itself is comprised of several independent regional franchise associations), a purchasing cooperative (which is part of a larger co-op that acts on behalf of all of the YUM! brands (KFC, Pizza Hut, Taco Bell, A&W and Long John Silvers)), and an advertising co-operative. Purchasing is totally under the purchasing co-op's control; advertising is primarily under the supervision of the advertising cooperative; and the franchisees are significant participants in the development of the KFC brand and the franchise system, working through the franchise advisory council and the franchisee association.

Few systems are this complex, but nevertheless franchisee participation in the development and decision-making process of a franchise system has noticeably been on the rise over the last two decades. While franchise advisory councils have been quite common within franchise systems since the early days of franchising (i.e., 1960 or so), we have seen an increasing number of independent franchisee associations becoming key elements of the franchise system. On a more limited scale, purchasing cooperatives have become key elements of many large franchise systems, primarily in the quick-service restaurant industry.

This paper will focus on what franchise associations and purchasing cooperatives are, and explain how they function both conceptually, and by way of example, practically, as part of franchise systems, and what are some of the legal and practical elements for consideration in their creation and operation. This paper will also address in considerable detail the antitrust

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1 There are approximately 15,000 domestic restaurants, of which 15% are company-owned according to McDonald's National Customer Service.

2 Franchises are typically categorized as being one of two types: product franchises and business format franchises. Product franchises typically distribute branded items produced by one supplier. Gasoline or automobiles are two products where product franchising is a dominant distribution method. Burger King and Meineke are examples of business format franchises, where it is the presentation of how the goods and services are delivered that is critical. When you walk into a Burger King restaurant, for example, you will find products or services of many suppliers; some are branded and some are not. Nevertheless, these kinds of businesses are frequently engaged in product distribution.
considerations that come into play when franchise associations and purchasing cooperatives exist within the same franchise system.

There are many articles written on franchisee associations, and a more limited selection of articles on purchasing co-operatives, and thus this paper will only highlight some but certainly not all of the features of the two, rather than be duplicative of prior literature. However, the writers believe this is the first paper to discuss the integrative aspects of franchise associations and purchasing cooperatives, and to focus not only on some of the general legal challenges associated with each, but on the antitrust problems that arise when franchisee associations and purchasing cooperatives exist within the same system.

II. THE INDEPENDENT FRANCHISEE ASSOCIATION

A. The History of the Franchisee Association Movement

The emergence of the franchisee association in the context of franchising is not nearly as colorful as the story behind the rise of the labor movement. There were no street riots, no highly debated bills before Congress, and no leaders recognizable nation-wide for their inspirational speeches to the masses. Instead, independent franchisee associations have gained success in most cases through evolution rather than revolution. Usually there has been a triggering event that plants the seed for the association, and after an initial surge of enthusiasm by the franchisee community, the association gradually gains a long standing role of importance within the franchise system’s decision making processes.

The initial seed can take various forms. Often the triggering event is a reaction by the franchisee community to a decision made by the franchisor. The franchisor has introduced a new form of franchise agreement for the system, or is trying to implement a significant change from the way business is currently being conducted. A bankruptcy filing can provide the necessary impetus, as can the sale of the business or a change in ownership.

Once the shock of the triggering event to the franchise system has worn off, the follow-up evolution of the franchisee association is typically less sensational. The franchisor and the franchisee association will more often than not become less adversarial, and slowly develop some level of trust. While some franchise associations will hope for some actual control over the franchise system, more seem to be looking for a seat at the bargaining table, recognizing that the franchisor will have the final vote on all issues. It is this sense of true participation that will often quench franchisee dissatisfaction.

Not all franchise associations, however, trace their roots to monumental events, and in fact, in some cases—though they are rare ones—the franchisor may pre-empt the franchisees’ efforts and be the creator of the independent association in order to initiate franchisee participation in system direction. The International Association of Holiday Inns franchisees provides an interesting case study. The group was formed as a result of a franchisor initiative. It has been brought into major system decision-making process as a matter of practice, which includes contractually enforceable advise and consent roles prior to certain decisions being made concerning the system.

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3 See Appendix to this paper, which lists some of the more impressive articles covering these subjects.
B. Independent Franchisee Association v. Franchise Advisory Council

We made earlier reference to franchise advisory councils (“FACs”). How do they differ from independent franchise associations? The two are often viewed as being two ends of the spectrum, and that is frequently the case. But there are no litmus tests that would conclusively lead one to classify a collection of franchisees as being a council or an independent association.

The primary factor on how the two types of groups differ is control. The franchisor typically exerts a significant amount of control over the activities of the FAC. An FAC will often be created by direction of the franchisor. The franchisor will prepare its governing documents, if there are any, set up the method for the selection of FAC members (appointed, elected by regions, etc.), and promulgate the conditions for membership (e.g., franchisee must not be in default). It will set the meeting schedule, prepare the agendas and send out meeting notices. It will take minutes for these meetings, prepare the versions that may go out to the FAC members, and be responsible for their distribution. It will participate at all meetings of the FAC. As for funding, the franchisor will typically reimburse members for meeting attendance, as well as pick up meeting room charges and related meals. Usually, there will be no FAC activities other than attendance at company-sponsored meetings. That is one end of the spectrum.

At the other end of the franchisee spectrum is the independent franchisee association. Control of an independent franchisee association will project a quite different image. As noted earlier, with limited exceptions, the impetus in the formation of a franchisee association will come directly from a system’s franchisees, who will formulate their own governing rules and organization and constitutional documents for the group. Other responsibilities will include: determining the size of representative board; the terms and other conditions of board membership; the time and place of their meetings; the agendas for these meetings; what items will be discussed; and how the decisions made at meetings will be disseminated to its members. Representatives of the franchisor will be present at meetings only if invited by the franchisee association leadership, and even then company representatives in most cases will not sit in on the entire meeting; commonly there are some closed-door sessions. Financially, independent associations will be self-supporting, with funds coming from either dues or fund-raising activities, such as conventions or association publication advertising.

It is not unusual for the distinction between an independent association and a FAC to become blurred. In the case of at least one independent franchisee association, the franchisor is actually accorded membership privileges and voting rights. It is also not unusual for franchisors to reimburse certain costs of independent associations, including out-of-pocket expenses for attendance at association board meetings, especially when those meetings are held in conjunction with meetings with franchisor representatives.

A second, but equally important, characteristic that distinguishes independent franchisee associations from FACs may be described in terms of influence on the franchise system decision-making process. FACs are, by definition and label, advisory. They are analogous to the King’s Council of earlier times. They exist to insure that at least some consideration is given to the franchisee constituency, and they will also serve as a means of communicating ideas from the franchisees to the franchisor, as well as from the franchisor to the franchisee community, on system-wide issues.

It is more difficult to stereotype what influence an independent franchisee association will have on the franchise system. In contrast to the field of labor relations, where there are certain obligations imposed upon companies once a union has been certified, there is no statutory
equivalent to the concept of “recognition” in franchise relationship matters. While thirteen states have laws that protect franchisees’ rights to associate, there is no requirement that a franchisor must negotiate with or otherwise recognize an organized association. Absent contractual commitments by the franchisor to the contrary, the franchisor does not have to sit down with the franchisees and negotiate, and franchisees have no veto rights on franchisor decision-making or the implementation of any franchisor decisions affecting the system.

Nevertheless, some franchisors have permitted franchisee associations to have roles or rights that far transcend advisory functions, made at the franchisor’s discretion. Some examples:

- As noted earlier, the Holiday Inn group has contractual rights to be consulted before the franchisor can make certain changes are made to the franchise system.
- The Burger King franchisee association has veto rights on changes to the system’s encroachment policy.
- The Sylvan Learning Center franchisees are accorded half of the ownership and board representation on the entity that accepts advertising fund contributions and supervises advertising expenditures.
- The Pizza Hut franchisee association has entered into an agreement with its franchisor giving the association significant control over advertising expenditures and operations.
- Burger King Corporation has entered into an arrangement with a separate entity that appoints that entity as the purchasing representative for the entire system. The separate entity’s board is controlled by franchisees.

Often the question of “recognition” of a franchisee association is asked. That is, should the franchisor give formal recognition to an association comprised of its franchisees? The question, in itself, is too broad for a meaningful answer, because it is unclear what “recognition” means. As noted, there is no legal obligation to recognize a franchisee association, and some franchisors will have nothing to do with an independent franchisee association. On the other hand, and depending upon how large its constituency may be, a franchisee association, like it or not, becomes part of a system’s dynamics, and to “ignore” a burgeoning association is a questionable way to address the issues that the franchisee association wishes to address. For the most part, the issues raised by a franchisee association are real. Sometimes the group has formed because the advisory council has been or becomes ineffective or non-representative. In other cases, however, the independent franchisee association may only represent a limited sector of the franchisee community and thus cannot adequately speak on behalf of the true community. It is also not uncommon that the group has formed because one or maybe just a very small group of franchisees has an agenda to push, and that agenda does not serve the best interests of franchisees generally. In fact, other franchisees within the system may resent the intrusion of a renegade franchisee association into the affairs of the franchisee community. Therefore, the franchisor must use its best judgment to determine whether recognition of an independent franchisee association will help or hinder the chain-wide franchise relationship.

4 Rupert M. Barkoff & Rochelle B. Spandorf, Close Encounters: Franchisee Associations and Councils, ABA 26th Annual Forum on Franchising (October 22-24, 2003) (listing AR, CA, HI, IL, IA, MI, NE, NJ, MN, WA); 19 Rhode Island Civil Code § 28.1-16 (providing franchisees’ right to associate); New Hampshire Civil Code § 357-C:10 (same); 10 Maine Civil Code § 1250-B (same).
C. Corporate, Tax and Governance Issues for Franchisee Associations

1. The Selection of the Type of Entity

When representing a group that wants to become a franchisee association, the first challenge presented to their legal advisor is typically: how do you put the band together? Ascertaining the best form of legal entity is usually the first step in addressing this challenge.

Most states now have statutes that allow for the creation of non-profit entities (usually corporations) that provide an adequate vehicle in which franchisee associations can function. They contemplate that members, rather than shareholders, will be the community served by the entity, and grant flexibility in deciding what rights, if any, members may have. In at least one jurisdiction—Delaware— noted for having a highly sophisticated corporate code—the distinction between “profit” and “non-profit” is not as significant as is the distinction between “stockholder” and “member”. Thus, Delaware provides for an entity that can serve franchisee associations, which need not have a non-profit objective, in contrast to the requirements of other state corporate statutes.5

While a franchisee association does not have to incorporate, and could function as an unincorporated association, given the relatively low cost to incorporate, such a decision is ill-advised. In most states, there are no codes governing unincorporated associations, and there is, consequently, a key question of what liabilities do the leaders and members of the association assume by their involvement with the association. In contrast, the corporate statutes are generally quite clear that membership, in itself, in a non-profit corporation cannot lead to personal liability; the liability of the directors of the corporation will be limited as long as the directors fulfill their fiduciary duties and play by the rules of the corporate game.

A quick note on taxation: Regardless of the group’s structure--membership v. stockholders, and profit v. nonprofit--for federal income tax purposes an independent franchisee association with membership from a single franchise system will be treated as a taxable entity.6 Where dues and expenditures match in a particular year, this will be a non-issue. However, where there is a profit, that profit will be subject to taxation. This becomes very important where the association is setting up a reserve (for example, to fund litigation) and does not intend to spend its entire income from its various sources, including annual dues and convention fees, during the current tax year. In this scenario, counsel might try to restructure dues so that they might be characterized as loans, or set up a trust into which such contributions may be directed.

2. The Governance Structure

The by-laws of the entity will almost always set forth the governing structure for the franchisee association, although the by-laws will frequently delegate some of the responsibilities for governance to the board; sometimes, some or all of the governance structure may be set forth in the Articles or Certificate of Incorporation, which normally would only be amendable with shareholder/member consent.

While well-formulated by-laws can frequently run ten to fifteen pages, the key and unique issues for franchisee associations include membership eligibility, board structure,

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5 Thus, in Delaware, the entity can be profit oriented, but still have members rather than stockholders.

election of members to the board of directors, financial obligations to the franchisee association and membership rights.

**Membership eligibility:** Who can be a member? The first issue is typically: should units that are owned in whole or in part by the franchisor or any of its affiliates be eligible for membership in the independent franchisee association? For obvious reasons, almost all franchisee association by-laws say no. Although membership by franchisor affiliated franchisees sometimes is permitted, the interests of the non-affiliated franchisees will often differ from those of affiliated ones, and thus membership by franchisor affiliates may compromise the efforts of the independent franchisee association to be truly independent. Moreover, there is an issue of confidentiality. Most franchisees feel that discussions and strategies will be shared with the franchisor if its affiliates participate in franchisee association affairs.

The second issue regarding membership is who, specifically, is the member: To illustrate some of the questions that need to be considered:

- What happens when there are two or more franchisees on the same agreement?
- If a franchisee is an entity, should that entity or the person behind that entity be the member?
- What if one group controls two or more entities, each of which is a party to a separate franchise agreement?

The answers to these questions are typically controversial, but certainly not unsolvable, and there is not one “right” or “wrong” solution. The answer in practice is that if there is not an easily recognizable consensus; there will be trade-offs on board representation and dues commitments, to compensate for whatever decision is made on membership eligibility. More on this point later.

**Board Structure:** Size and composition are the key elements here.

The number of directors must be manageable. If the board is too large, then it will have problems functioning, both practically (e.g., in scheduling meetings as well as in allowing sufficient time for all of the directors to express their views at those meetings) and economically—more directors mean higher meeting costs. If too small, the board may not be truly representative where there are a significant number of constituencies and viewpoints within the franchise community.

Composition is also an important issue. Some of the issues to address include:

- Should the board be elected by the membership generally (one member; one vote)?
- Should directors be elected on a regional basis so that there is a higher likelihood that franchisees will know the person who will represent them, and the representative can better speak of the specific issues in their region?
- Should special seats or classifications be created for large or small franchisees so that there will be assurance that their interests will be represented on the Board?
- What will be the terms for board members?
- May directors be re-elected, and if so, for how many consecutive terms?
• Should board membership be staggered so that there will always be some level of continuity?
• Should there be board eligibility requirements, such as having been a franchisee for so many years, or must the board member be in good standing under his franchise agreements at the time of his or her election to the board and throughout his or her term on the board?

Voting Issues and Dues. As mentioned earlier, often the voting rights of a franchisee in a franchisee association will depend upon the definition of membership. For example, in the situation where one franchisee owns five units in separate entities, while another has five units, but all owned by the same entity: Should either or both of these groups have only one vote, or five votes? There is no simple answer, and usually the issue will be politically brokered. In some groups, there will be strong feelings that each controlled “group” should have only one voice, and that solution more often than not prevails. One alternative is to allow one vote for each unit, but put a maximum number of votes granted to any group.

The amount of dues to be collected and payments terms will, of course, be unique to each franchisee association. In some associations, depending upon the resolution of voting issues, dues may be assessed on a per store basis; in others, they will be equal for all “members”. Where based on a per unit formula, there may be caps to encourage very large franchisees to participate rather than decide not to participate primarily because of the high amount that that franchisee might have to pay as dues.

D. WHAT DO FRANCHISE ASSOCIATIONS DO?

There is no check list, per se, of what functions franchisee associations may engage in or perform. However, it is possible to identify some of the more common activities of independent franchisee associations.

1. Communications Functions

Almost all franchisee associations serve an important role in system communications. One such function is to channel communications both from the franchisee association to its members, and vice versa. Also, many groups will have the ability to provide communications channels among franchisees, either through the company’s Intranet, or through a message board or similar arrangement established through an association-sponsored web site.

Similar to a FAC, the independent association can provide communications from franchisees on a collective basis to the franchisor, and in the reverse direction as well. From the franchisor’s perspective, this channeling process can be more efficient and effective in ascertaining and crafting solutions to those issues than dealing with franchisees on a one-off basis. When solutions are developed and supported by the franchisee association, the association can then be a valuable tool to disseminate and help implement those solutions for the franchisee community at large.

One of the practical problems in using a franchisee association as a conduit for communications, however, is that unless membership is mandated by the franchisor, the franchisee association will not represent all franchisees in the system, and thus may not be able to communicate message to the entire franchisee community, nor may the opinions and issues it communicates to the franchisor be representative of the entire community.
2. Franchise Agreement Issues

One of the other functions franchisee associations commonly perform is in helping to shape the franchise agreement, and other relevant governing documents including the system’s operations manual. The initial form of franchise agreement will be developed by the franchisor, since at that stage of development of the franchise system, there will have been no franchisees, nor will there be an association. As the system develops, and after an association comes into being, changes to the original franchise agreement are commonly run past the franchise association for comment and in a limited number of systems approval. When the agreement becomes outdated for whatever reason—market changes; changes in competitive circumstances; technological changes and the like—commonly franchisors and their franchisees enter into collective bargaining, much like what occurs in labor-management situations after union recognition or contract expiration. The impetus for these discussions may come from the franchise association if franchisees are not satisfied with the existing contractual provisions, or it may come from the franchisor for any one or more of the reasons cited above. In either case, both parties will have their “wish lists” of changes that will be placed on the bargaining table for consideration.

There is no limit to what issues may be covered in these discussions. However, it is typical not to throw out the base documents that have been used for years, but to build and modify those documents, covering only the points raised by the party and allowing all other provisions to remain status quo.

3. Conventions

Many independent franchisee associations have their own conventions or convocations. In some systems, these conclaves may consist of little more than franchisee association meetings at, or a simple add-on to, the franchisor’s conventions. However, in larger and more established systems, these may be free-standing programs of equal or greater length than what the franchisor provides, and in at least one major system, for many years the franchisee association convention was the only convention.

Conventions, from the franchisee association perspective, can be extraordinarily important events. For one thing, they give the association a platform for presenting and discussing issues. They also provide franchisees with an opportunity to get to know other franchisees better. Of great importance is the additional fact that conventions can provide franchisees with funding opportunities. Most suppliers are willing to pay for the right to exhibit at these programs, in that these conventions provide an opportunity to be before their customers in a manner that is economically efficient.

4. Ancillary Services

Most franchisors pride themselves in providing for their franchisees’ needs. However, sometimes franchisors charge for these services. In other cases, franchisors are not interested in fulfilling certain franchisee needs. In some cases, at least in the case of health insurance, franchisors cannot, by law, directly provide certain franchisee benefits. Thus, franchisee associations are provided with opportunities to fill these vacuums, or where the franchisor charges too much for ancillary services or does a poor job in providing these services, the franchisee association may become a competitor to the franchisor or one of its preferred suppliers.
Insurance is one area where this competition between the franchisor and the franchisee association may be prevalent. Where the franchisor fails or refuses to provide franchisees with sufficient or cost-effective insurance programs, franchisee associations may step into the breach and partner with companies that will provide these services, usually under the auspices of the franchisee association. Utility services, estate planning, legal services, local marketing and local advertising, are only a few of the many areas in which franchisee associations can supplement or compete with franchisors in fulfilling franchisee needs or desires.

Purchasing, of course, is another area where franchisee associations can provide services where the franchisor is unwilling or unable to provide these services. Sometimes these arrangements may be informal, and in other cases they may result in the formation of purchasing co-ops with, or without, the franchisor’s involvement or blessing, as shall be described below.

III. THE PURCHASING COOPERATIVE

A. The Evolving Presence of Purchasing Cooperatives

Like franchise associations, the use of purchasing cooperatives in franchise systems has been slow to evolve. Because co-ops themselves tend to be less confrontational, there is considerably less information available about them. Moreover, there may be no role for them in many franchise systems. For example, one would not expect to see a purchasing co-op in any product franchise, as the suppliers’ product is the very essence of the system and there will usually be only one source of supply. Moreover, many franchise systems are not goods oriented, so that there is no need for mass purchasing, although one should note that purchasing could cover services as well as products (for example, insurance).

B. What is a Purchasing Cooperative?

Distilled to its essence, a purchasing cooperative is simply a means by which persons needing identical goods (or services) pool their purchasing power. By coordinating and consolidating their purchasing activities, they are, in theory, able to obtain better pricing and possibly better or additional service. For the supplier, dealing with one purchaser may result in lower margins. However, there are advantages to suppliers, too. For example, the supplier only has to engage in one set of negotiations in order to obtain an order, thus reducing sales costs. Having a large order also allows the supplier to buy raw materials or ingredients in larger quantities, allowing it to take advantage of economies of scale. And having firm orders allows the supplier to better plan its purchasing, production and distribution schedules.

In many franchise systems, the franchisor performs the functions that a purchasing cooperative might otherwise provide. It selects the suppliers, its staff negotiates the purchase agreements, and it monitors the performance of the supplier. In some cases, it may take title to the goods, and then oversee the distribution function as well.

When the franchisor is performing these functions in an effective manner, there is likely little need for a purchasing cooperative. The McDonald’s system provides a good example. McDonald’s Corporation specs out all of its products, selects approved suppliers and handles the negotiation relating to pricing, specifications, delivery terms and so forth. The supplier will deliver the products to distributors approved by McDonald’s, who in turn deliver the product to the company and franchised outlets.
Other systems have not been as efficient in performing the supply function. In the 1970s, there was considerable concern within the KFC franchise community about the purchasing efficiencies of the system. Consequently, the franchisees and the franchisor formed a purchasing cooperative to replace the franchisor’s purchasing department. The successor of that purchasing co-op now serves not only KFC outlets, but those of other YUM! Brand systems, which include Taco Bell, Pizza Hut, Long John Silvers and A&W.

The history of the Burger King purchasing cooperative, known as Restaurant Services, Inc., or “RSI” is similar. In the early 1990s, the Burger King franchisees expressed strong dissatisfaction about the Burger King purchasing system. With the franchisor’s backing, the franchisees formed RSI, and Burger King Corporation agreed to make RSI the exclusive purchasing agent for all products purchased on a national basis, with the exception of soft drinks. Today, all Burger King restaurants in the United States, whether company or franchisee owned, purchase substantially all of their needed products, including soft drinks, through RSI. Other systems that have purchasing co-ops include Subway, Popeye’s and Dairy Queen.

C. What form of entity to choose

Several states have enacted statutes that permit the formation of purchasing cooperatives. However, purchasing cooperatives can be formed under the regular profit or nonprofit laws in most states as well. Consequently, there are few, if any, advantages, for franchise systems in using the cooperative statutes.

The major purchasing co-ops in franchise systems have followed different paths in their organization. The Yum! Brands Co-op (whose official name is the “Unified Foodservice Purchasing Co-op, LLC”), was formed under the laws of Kentucky as a limited liability company. It is comprised of five business corporations, each incorporated under the laws of Delaware, which represent each of the five major YUM! brands. One of these, the KFC Purchasing Co-op, was initially formed in 1979, and issued stock to its members. In contrast, RSI was formed under the laws of Delaware and is a non-stock corporation, having members rather than stockholders. The Delaware statute, as noted earlier, is very flexible and does not make the clear-line distinction between profit and non-profit entities that is often found in other states’ statutes.

D. Tax Considerations

The Internal Revenue Code has a special section, Chapter T, devoted to purchasing cooperatives. Essentially, purchasing cooperatives are treated like other corporations, except that purchasing cooperatives may pay “patronage dividends” rather than ordinary dividends. Patronage dividends are rebates to the cooperatives’ customers and the amounts paid to customers of the cooperative are usually a function of overall profits of the cooperative and the comparative usage of the cooperative by the customer. For example, if the cooperative had $1mm to distribute and Franchisee X accounted for 2% of the co-op’s volume, that customer might receive a rebate of $20,000. There is no requirement for a co-op to pay patronage dividends. However, these dividends are often what the cooperative’s customer finds appealing and in practice represent in large measure the cost savings achieved by participating in the

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7 As for soft drinks, Burger King Corporation has reserved the right to negotiate a national contract, but RSI actively participates in the negotiations as do representatives from the franchisee association.

cooperative. From a tax standpoint, patronage dividends are attractive because the co-op will receive a deduction for the amount of the patronage dividends, although the recipient of the dividend must include the dividend in its income when received.

E. Securities Issues

Purchasing cooperatives are unlike traditional corporations, which are profit oriented. In contrast to entities that are profit-oriented for their own account, the purpose of the co-op is not to achieve profitability for that entity but, instead, to improve the profitability of its members, by providing them goods and services at lower prices.

Thus, there are strong policy reasons not to make investments in purchasing co-ops—such as furnishing seed or working capital—subject to the same rules as investments in profit-oriented entities or enterprises, and the securities laws, governing investments, are, in fact, in accord. Generally, investments in purchasing co-ops are exempt from securities law regulations. This is a notable advantage to the cooperative because it avoids a vast legal cost as well as the administrative headaches that accompany efforts to comply with the securities laws. Most cooperatives follow this approach, although the original KFC Purchasing Co-op did issue stock to the KFC franchisees who made capital contributions to the co-op, and for many years this co-op maintained a registration statement under the Securities Exchange Act of 1934. It abandoned this practice five years ago.

F. Governance And Membership

In Chapter T and in the Internal Revenue Service’s implementation of the provisions of Chapter T, the IRS subscribes to a one man-one vote policy. Consequently, in reviewing a co-op’s structure, the IRS carefully scrutinizes its election procedures to make sure there is adequate and proportionate representation by the co-op’s members. Disproportionate voting, accordingly, is strongly discouraged.

However, in franchise systems there are valid reasons to elect board membership on bases other than proportionate representation. RSI provides a good illustration. Most of its board members are elected by franchisee votes. Franchisees are assigned to regions and each region elects its representative. The number of franchisees in each region may vary, however, such that an election in this manner does not truly give each franchisee the same weight in the voting process. In addition, the RSI Board includes one representative from Burger King Corporation, one from the franchisee association, and one from the minority franchisee association.

Reluctantly, and after extensive communication between RSI and the IRS, the IRS agreed to this proposed structure, but not without conditions. The primary one is that RSI must every several years review the regions it has set up and, if certain conditions are not met, re-district.

Membership in franchise system sponsored co-ops is generally limited to the franchisor and franchisees within the system. However, that is not to say that participation cannot be extended to others. Other customers may be taken on by the co-op, and such those other customers may be given the right to participate in patronage dividends, even if they are not members of the co-op.
G. Financing

There are several ways in which to fund purchasing cooperative activities. The first is by raising seed capital. This funding source can be accomplished either by selling equity interests in the entity, which is typically to the cooperative’s prospective customers. The seed money could also be provided through loans or debt instruments from these customers. Care must be taken to make sure that any money raised in this manner does not make the investment a security, as described above.

Initial funding may also be provided by traditional financing means, such as bank loans. The Federal Cooperative Bank (which itself is a co-op), located in Washington, D.C., has been a source of financing of start-up capital for cooperatives. The FCB has programs geared to subsidize the formation of purchasing cooperatives.

Working capital financing can also be provided by traditional sources. However, one technique used by several co-ops to obtain working capital is to place a surcharge on one or more items purchased through the co-op, or on aggregate purchasing. For example, a fast-food chain might decide that French fries purchases are indicative of sales made by each co-op customer vis-à-vis the system generally, and thus impose some small amount (e.g., 1/4 cent per pound) on purchased French fries, the proceeds of which will be used to provide working capital for the cooperative. A similar result could be achieved by charging a small percentage on all purchases through the co-op. In either case, a substantial amount of working capital can be raised in this manner. To the extent that revenues are greater than expenses, the difference can be distributed to members and other customers as a patronage dividend.

One of the quirks of being a Chapter T purchasing cooperative is that patronage dividends do not have to be paid until up to 8.5 months after the end of the fiscal year in which the revenues relating to such dividends were received. This allows the cooperative to retain the sums to be used to pay the patronage dividend long enough to provide what could be a healthy cushion of working capital.9

H. Franchisee Associations and Purchasing Cooperatives in the Real World

In the marketplace, purchasing cooperatives that have been franchisee-inspired have not always been readily accepted.

As described earlier, the formation of RSI to service the Burger King system was consensual. It is believed that Burger King Corporation itself was not satisfied with the performance of its purchasing arm and therefore willingly surrendered this function to the franchisee-controlled RSI. Not only did it bless this arrangement, but it provided a substantial seed capital contribution to the new enterprise and made other financial accommodations to the RSI in its formative stages. While physically located near the BKC headquarters in Miami, RSI maintains a rigorously independent relationship with respect to the franchisor, and also, interestingly, maintains a fair level of independence from the National Franchisee Association—the independent franchisee association.

The KFC cooperative was initially received reluctantly, but favorably, by the franchisor, but during the years when KFC and its sister companies, Taco Bell and Pizza Hut, were owned by Pepsico, there was significant competition between the co-op and Pepsi’s purchasing and

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distribution system. When the three franchise systems were eventually purchased by Yum! Brands, then known as Tricon, Yum! Brands eventually elected to participate in the purchasing cooperative rather than be its competitor, once its agreements with the PepsiCo purchasing affiliate expired.

The attempt by the Domino’s franchisees to form an independent purchasing cooperative was considerably more contentious, as evidenced in the Queen City Pizza litigation. The Domino’s supply and distribution system was a major contributor to Domino’s profit. The franchisees felt that the overall margins charged by their franchisor were excessive, and thus, through their association, sought to establish a competitor. The franchisees asserted that Domino’s used its power in the raw dough market to overcharge the franchisees for dough, while selling other goods at competitive prices. To correct this perceived problem, the Domino’s franchisee association tried to form its own independent association, to be managed by the KFC cooperative. The franchisor vigorously resisted the franchisees’ attempt to form the cooperative, which ultimately led to the Queen City Pizza litigation. The attempts to form the cooperative were abandoned after the franchisees’ suit was dismissed on a 12b-6 motion at the trial court level, and that decision was affirmed on appeal by a 2-1 decision from the Third Circuit, which the court later refused to rehear en banc by a 7-5 vote.

And finally, there is the story of the Dairy Queen purchasing system, which is described in the Collins litigation. In Collins, the franchisees in conjunction with the Dairy Queen Operators Association (the franchisee association) and the Dairy Queen Operators Cooperative (a co-op closely aligned to the franchisee association), sued claiming that American Dairy Queen Corporation and its affiliate, International Dairy Queen, Inc., unlawfully restricted the franchisees’ right to purchase required products for use in franchised Dairy Queen restaurants, which resulted in franchisees’ having to pay excessive prices. The litigation lasted some six years, and ultimately resulted in a settlement under which the franchisees and the DQOA and DQOC received approximately $50 million dollars and agreements from the defendants not to engage in specified conduct that would handicap the DQOC’s efforts to be a competitor to the franchisor’s supply system. Today, the DQOC continues to compete with the franchisor’s supply arm, and the situation remains contentious.

IV. ANTITRUST ISSUES

As has already been discussed, franchisee associations can serve a wide variety of functions and serve its member franchisees, as well as the franchisor, in a variety of ways. Franchisee associations increasingly have operated to influence their franchise systems, sometimes in a cooperative fashion and sometimes in an adversarial manner. However,


11 Queen City Pizza, Inc. v. Domino’s Pizza, Inc., 124 F.3d 430 (3d Cir. 1997).


14 “Franchisees are organizing into independent groups like never before . . . and for the first time, a national group of franchisees—the American Franchisee Association—was established.” Marilyn Alva, Strength in Numbers; Fast Food Franchise Holders Form Franchise Associations; The Top 50: RB’s 28th Annual Franchising Report, Restaurant Bus Mag, June 10, 1993, at 80.
because a franchisee association is comprised of competitors or potential competitors, the actions of the franchisee association may raise antitrust issues. This section provides an overview of antitrust principles that may place limits on the actions of franchisee associations. While many of the cases discussed below challenge conduct involving groups of franchisees not necessarily as members of a franchisee association, the cases are instructive and apply to franchisee associations where the facts show that the association is merely the vehicle through which its members engage in coordinated activity.

A. **Overview of Section 1 of the Sherman Act**

Section 1 of the Sherman Act prohibits “contracts, combinations and conspiracies” that unreasonably restrain trade. The purpose of Section 1 is to preserve for consumers the benefits that the law presumes will result from free and open competition by prohibiting agreements among competitors or other independent business entities that have an unreasonable anticompetitive effect.

1. **Proof of a Conspiracy**

To violate Section 1 of the Sherman Act, the challenged business practice must derive from a “contract, combination . . . or conspiracy” in restraint of trade. Section 1 prohibits concerted conduct, not the unilateral action of a single business entity.

Thus, when a franchisor takes action after receiving input from the franchisee association, the first question that arises in any Section 1 challenge is whether it is the action of a single business enterprise, or whether the franchisor and the franchisees constitute separate actors that are legally capable of conspiring among themselves.

The courts have rejected Section 1 claims involving alleged “conspiracies” among the various components of a single business enterprise, such as an “agreement” between a corporation and its unincorporated division, or its employees, agents and officers. Such conduct is not the type of conduct that Section 1 was designed to police because it does not involve separate economic entities that previously pursued disparate economic goals.

Further, In *Copperweld v. Independence Tube Corp.*, the United States Supreme Court held that a parent corporation and its wholly owned subsidiary are not independent actors for purposes of Section 1 of the Sherman Act. Notwithstanding their separate legal forms, parent

15 “Every contract, combination . . . , or conspiracy, in restraint of trade . . . is declared to be illegal.”
18 *Bailey's, Inc. v. Windsor America, Inc.*, 948 F.2d 1018, 1029 (6th Cir. 1991).
21 Id. at 767-71.
corporations and their wholly owned subsidiaries “have a complete unity of interest. Their objectives are common, not disparate; their general corporate actions are guided or determined not by two separate corporate consciousnesses, but one.”

Therefore the coordinated activity of a parent corporation and its wholly owned subsidiary does not constitute concerted conduct within the meaning of Section 1 of the Sherman Act.

Following the decision in *Copperweld*, the U.S. Court of Appeals for the Fourth Circuit held that sister corporations (i.e., two subsidiaries that are wholly owned by a single parent corporation) were not capable of conspiring with each other for purposes of Section 1. The Sixth Circuit relied upon *Copperweld* to dismiss a Section 1 complaint against two closely held corporations owned by the same two shareholders holding that the two corporations were not capable of conspiring with each other. Similarly, the Eighth Circuit held that coordinated conduct between two corporations that had agreed to merge, but had not yet done so, did not constitute a Section 1 conspiracy. In each of these cases, the courts determined that the different corporate entities that were alleged to have conspired actually constituted a unified economic entity and thus were incapable of conspiring for purposes of Section 1 of the Sherman Act.

The *Copperweld* doctrine has been applied to conduct of related corporations, even in the absence of common ownership – a circumstance that may be present in a franchisor/franchisee relationship. In *Williams v. I.B. Fischer Nevada*, the U.S. Court of Appeals for the Ninth Circuit held that a franchisor and franchisee not sharing common ownership constituted a single actor for purposes of Section 1, and therefore could not conspire with each other. There, a fast food restaurant franchise agreement contained a “no-switch” provision, which prohibited the franchisee from hiring the manager of any other restaurant in the franchise system within six months of the manager’s termination of employment at another restaurant in the same system, unless the franchisee obtained a waiver from the manager’s previous employer. The plaintiff, a manager of a franchised restaurant located in Nevada, procured an offer of employment from a franchisee located in Arizona, and thereafter gave notice of resignation to his employer. The Nevada franchisee refused to grant a waiver, so the Arizona franchisee rescinded the offer of employment and the plaintiff was left unemployed.

The former manager sued alleging that the “no-switch” agreement between the franchisor and its franchisees unreasonably restrained trade in violation of Section 1 of the Sherman Act, because it had an adverse impact on the supply of labor within the franchise system, as well as on the products supplied by that labor. The manager also alleged that the “no-switch” provision constituted a group boycott in violation of Section 1.

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24 Id. at 771.
25 *Advanced Health-Care Services v. Radford Community Hospital*, 910 F.2d 139, 146 (4th Cir. 1990).
27 *International Travel Arrangers v. NWA, Inc.*, 991 F.2d 1389, 1398 (8th Cir. 1993).
29 *Williams v. Nevada*, 999 F.2d 445 (9th Cir. 1993).
30 *Williams*, 794 F. Supp. at 1030.
31 Id. at 1032. See Part IV.B.2., *infra*, for a discussion of group boycotts.
Finding that the undisputed facts failed to establish a conspiracy, the district court granted summary judgment in favor of defendants on the Section 1 claim. The district court held that competition did not exist between the franchisor and franchisee because they operated as a single economic enterprise— they shared a “commonality of interest” and there was a high “degree of control exercised by the [franchisor].” In support of that conclusion, the court noted that: (1) the franchisor received royalties and marketing fees based on the franchisee’s gross sales; (2) the franchisor required uniformity and granted exclusive geographical territories, thus minimizing competition among franchisees;34 and (3) the franchisor exercised control over its franchisees through franchise agreements which governed, inter alia, the restaurant’s hours of operation, the type of equipment to be used by the franchisee, the type and amount of insurance the franchisee must purchase and even how far from the franchised restaurant the owner may live. The district court thus concluded that the franchisor and its franchisee were a single economic enterprise for purposes of Section 1 and that they could not legally conspire, notwithstanding the lack of common ownership.

Because the franchisee and franchisor were legally incapable of conspiring for purposes of Section 1, the district court concluded that the challenged “no switch” provision did not unreasonably restrain trade. Significantly, the “no-switch” provision did not involve any entity outside of the franchise system. In a footnote, the court noted that “[a]ctions of affiliated corporations which touch only on internal operations and have no anti-competitive consequences cannot violate § 1.”

While the decision in Williams appears to remove from antitrust scrutiny the coordinated conduct between a franchisor and its franchisees or franchisee association, it has not been widely followed. A franchisor and a franchisee association are independent economic entities which, if working towards a common interest and have “an ‘independent interest’ in participating in the conspiracy,” may find their coordinated conduct the subject to Section 1 scrutiny.

For example, in an analogous situation, members of a pilots’ association were held to be legally capable of an illegal conspiracy among themselves, as well as with the association, for purposes of Section 1. In Spence v. Southeastern Alaska Pilots’ Association, the pilots’ association arranged all boat pilotage with vessels entering certain Alaskan ports, handled all dealings between pilots and ship agents and/or the pilot board, pooled all income earned and expenses incurred by the pilots, and made distributions based on dispatch classifications. One pilot had been suspended from participation in the association, and then sued alleging, inter alia, violations of Section 1 of the Sherman Act, by the association and its members. Specifically, the plaintiff alleged that the association and its members conspired to limit the

32 Id.
33 Williams, 794 F. Supp. at 1031-32.
34 The court noted that the franchisor made great efforts to promote uniformity among franchisees:

Each franchise serves substantially the same products; the products are served to the public in the same manner; the franchisor develops products and services for all franchises; the employees dress alike; the decor of each franchise is similar; the franchises are advertised as a single enterprise with a single logo; and the franchisor contracts with each franchise for exclusivity within a certain geographic area to minimize competition between the franchises. Williams, 794 F. Supp. at 1031.
35 Id. at 1032.
36 Williams, 794 F. Supp. at 1032.
number of individuals who could qualify for pilot licenses, to fix prices for pilotage, and to boycott plaintiff by placing him on suspension.

Defendants filed a motion for summary judgment on the conspiracy claim, relying on the Copperweld doctrine.\(^{38}\) They asserted that because association members combined their resources to pursue common unified economic goals and agreed not to compete with each other, they operated as a single economic enterprise and therefore were incapable of conspiring within the meaning of Section 1 of the Sherman Act.\(^{39}\)

The court rejected the defendants’ argument finding that each pilot had interests that were independent of those of the other pilots and of the association.\(^{40}\) The undisputed facts showed that each pilot contracted directly with the employing vessel and operated as an independent contractor. Thus the pilots were in direct competition with each other, notwithstanding their membership in the association. The court concluded that the defendants failed to show that the association and its members operated as a single entity, and therefore, they were capable of conspiring among themselves.\(^{41}\)

In another comparable situation, the U.S. Court of Appeals for the Sixth Circuit held that coordinated conduct between a hospital and certain of its staff physicians did not constitute a conspiracy for purposes of Section 1 of the Sherman Act.\(^{42}\) In Nurse Midwifery Associates v. Hibbett, the court held that the hospital’s staff obstetricians, but not its staff pediatricians, were capable of illegally conspiring to deny hospital privileges to nurse midwives. There, the staff physicians made recommendations to the hospital about whether to grant hospital privileges to nurse midwives. The court held that the staff pediatricians did not compete with the nurse midwives and therefore acted as mere agents of the hospital when making recommendations on whether to grant hospital privileges to nurse midwives.\(^{43}\) However, because staff obstetricians competed with the nurse midwives, their recommendation regarding whether to grant hospital privileges to the midwives constituted concerted conduct in restraint of trade. In Nurse Midwifery Associates, the Court applied an exception to Copperweld recognized by other courts, whereby a corporation and its employees or agents are capable of conspiring in violation of Section 1 when the employee or agent has an interest in the conspiracy that is independent of the interest of the corporation.\(^{44}\) The Court found that the obstetricians had an interest in barring the nurse midwives (because they competed for the same patients) that was independent of the interests of the hospital in ensuring that it granted privileges only to competent health care providers. In those circumstances, the Copperweld doctrine did not shield the alleged coordinated conduct.

Members of a franchisee association at times have independent business interests similar to those of the pilots in Spence, and at times their actions more closely resemble those of the staff pediatricians in Nurse Midwifery Associates. For example, when a franchisee

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\(^{38}\) Spence, 789 F. Supp. at 1021.

\(^{39}\) Id. at 1022.

\(^{40}\) Id.

\(^{41}\) Id.


\(^{43}\) Nurse Midwifery, 918 F.2d at 614.

\(^{44}\) Id. at 613.
association or franchisee advisory group recommends that the franchisor develop a new product, it arguably acts as an agent of the franchisor in pursuit of a unified economic goal. In that situation the coordinated conduct of the franchisor and its franchisees resembles the pediatricians in *Nurse Midwifery Associates* and does not constitute concerted conduct within the meaning of Section 1. In contrast, if a franchisee association suggests the termination of a franchisee for failure to meet quality standards, the concerted conduct more closely resembles the obstetricians in *Nurse Midwifery Associates* and the pilots in *Spence*.\(^\text{45}\) Likely the nature of the issues will control whether, in the franchise context, a court applies the reasoning in *Copperweld* in the manner in which the courts did in *Williams*. Further, the question of whether franchisees actually compete with each other may depend, in part, on the nature of the franchised business (i.e., restaurant vs. service business) and on whether the franchisees operate in exclusive geographic territories. Arguably, a restaurant franchisee in Chicago does not compete with a franchisee in the same franchise system located in Boston. However, a house cleaning service franchisee in Chicago may compete with another such franchisee in a suburb of Chicago, provided there as no contractual territory restrictions on the franchisees’ service area.

Even if the defendants in a Section 1 case are legally capable of conspiring among themselves within the purview of Section 1, an antitrust plaintiff still must prove the existence of an actual agreement in order to establish an unlawful conspiracy in restraint of trade.\(^\text{46}\) Direct evidence of the existence of an unlawful conspiracy is often not available. More likely, the existence of the agreement must be inferred from conduct, and therefore is proved by circumstantial evidence. As one court stated: “Where the circumstances are such as to warrant (the trier of fact) in finding that the (alleged) conspirators had a unity of purpose or a common design and understanding, or a meeting of the minds in an unlawful arrangement, the conclusion that a conspiracy is established is justified.”\(^\text{47}\)

The Supreme Court has defined the type of circumstances in which a finder of fact may conclude that a manufacturer and its dealers have engaged in concerted conduct based on circumstantial evidence.\(^\text{48}\) The Court has recognized that the mere exchange of information between distributors and manufacturers, or between franchisees and franchisors, does not necessarily support a conclusion that the parties to that exchange have conspired with each other. Such information gathering is valuable to facilitate efficiency in a distribution or franchise system.\(^\text{49}\) Specifically, the Supreme Court has emphasized that, “[t]o bar a manufacturer from acting solely because the information upon which it acts originated as a . . . complaint [from one or more distributors] would create an irrational dislocation in the market.”\(^\text{50}\) The Supreme Court has cautioned that it is impermissible to infer a conspiracy based on ambiguous evidence: there must be “something more” than mere information gathering by a manufacturer/franchisor to establish an unlawful agreement between the parties exchanging information. The mere fact

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\(^{45}\) Similarly, in *Appraisers Coalition*, members of a nonresidential real estate appraisers professional association was determined to be legally capable of conspiring with its members for purposes of section 1 of the Sherman Act. *Appraisers Coalition*, 845 F. Supp. at 605.


\(^{47}\) *American Motors Inn, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230, 1243 (3rd Cir. 1975) (citing *American Tobacco Co. v. United States*, 328 U.S. 781, 810 (1946)).

\(^{48}\) See *Monsanto*, 465 U.S. at 764.

\(^{49}\) *Id.* at 763. See Part IV.B.5., *infra*, for a more detailed decision of the antitrust issues relating to benchmarking and related information sharing.

\(^{50}\) *Id.* at 764.
that a manufacturer (or franchisor) terminates a distributor (or franchisee) following complaints by other distributors to the manufacturer (or by other franchisees to the franchisor) does not establish a conspiracy between the manufacturer and the complaining distributors.\footnote{Monsanto, 465 U.S. at 763; Big Apple BMW, Inc. v. BMW of North America, Inc., 974 F.2d 1358, 1364 (3rd Cir. 1992).} To prove a conspiracy, the plaintiff must show a causal connection between the distributor complaints and the resulting termination.\footnote{Big Apple BMW, 974 F.2d at 1364.}

It is not sufficient to show merely that the conduct of antitrust defendants is consistent with the existence of an illegal conspiracy.\footnote{Monsanto, 465 U.S. at 764.} To establish a conspiracy, an antitrust plaintiff must present evidence “that tends to exclude the possibility of independent action . . . .” and that reveals that the parties to the conspiracy “had a conscious commitment to a common scheme designed to achieve an unlawful objective.”\footnote{Id. at 768.} An antitrust plaintiff need not “eliminate all possible ‘independent’ justifications by the manufacturer, [so that] only evidence of concerted action would be left in the record.” Rather, the plaintiff must produce “evidence that tends to exclude the possibility of independent action.”\footnote{Id.}

For example, in \textit{Nurse Midwifery Associates}, discussed above, the plaintiff midwives alleged that a hospital staff obstetrician sought to remove the midwives from competition with him and his colleagues by recommending that the Hospital not grant hospital privileges to the nurse midwives.\footnote{Nurse Midwifery, 918 F.2d at 607.} In opposition to the motion for summary judgment filed by the hospital and the staff obstetrician on the issue of whether there was a conspiracy, the plaintiffs produced circumstantial evidence that supported the inference of concerted conduct between the hospital and the staff obstetrician which tended to “exclude the possibility of independent action.”\footnote{Id. at 617.} They alleged that the defendants had both a motive and an opportunity to conspire. The defendant obstetrician, who was an outspoken opponent of midwifery, was an influential staff physician at another hospital, Baptist Hospital, where many of the defendant hospital’s medical students trained as residents. The plaintiffs alleged that the hospital denied them privileges because it wanted to ensure that the obstetrician would exercise his influence to maintain the hospital’s advantageous relationship with Baptist Hospital for the benefit of the residency program. Because the defendant obstetrician had conversations with staff physicians at the hospital, the midwives alleged that they had opportunities to conspire.\footnote{Id.}

However, the court determined that the alleged conduct was equally consistent with the hospital’s assertion that it had two independent business reasons for denying privileges to the plaintiffs. First, members of the hospital’s medical staff had historically been employees of the institution; the midwives were not. Second, the hospital argued that granting privileges to the midwives would have been inconsistent with the hospital’s commitment to tertiary care and quality medical education and the quality residency program.\footnote{Id.} The court found that plaintiffs

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\begin{itemize}
\item \footnote{Monsanto, 465 U.S. at 763; Big Apple BMW, Inc. v. BMW of North America, Inc., 974 F.2d 1358, 1364 (3rd Cir. 1992).}
\item \footnote{Big Apple BMW, 974 F.2d at 1364.}
\item \footnote{Monsanto, 465 U.S. at 764.}
\item \footnote{Id. at 768.}
\item \footnote{Id.}
\item \footnote{Monsanto, 465 U.S. at 764.}
\item \footnote{Id.}
\item \footnote{Nurse Midwifery, 918 F.2d at 607.}
\item \footnote{Id. at 617.}
\item \footnote{Nurse Midwifery, 918 F.2d at 617.}
\item \footnote{Id.}
\end{itemize}
}
had failed to explain how their evidence excluded the possibility that the hospital acted unilaterally, and therefore, granted summary judgment in favor of the defendant obstetrician.

Under the evidentiary standard described above, a franchisee challenging a franchisor’s decision made after consultation with a franchisee association, will be able to prove a conspiracy for purposes of Section 1 of the Sherman Act only if the evidence tends to exclude the possibility that the defendant franchisor acted independently and unilaterally. Such a case may arise, for example, in a situation in which the franchisor has a policy of soliciting input regarding new franchisee placements. The fact that the franchisor rejects an applicant after receiving comments from franchisees will not be enough to exclude the possibility that the franchisor acted independently. If, however, the franchisor has a well known policy of denying a new applicant whenever a nearby franchisee objects, that evidence may be sufficient to support a conclusion that the franchisor did not act unilaterally in denying a particular application.60

2. Unreasonable Restraints of Trade: Per Se Rule or Rule of Reason Analysis

Once a conspiracy is established in a Section 1 case, the antitrust plaintiff must then show that the concerted conduct “unreasonably restrains trade.”61 The Supreme Court has applied a conclusive presumption of illegality to certain challenged business arrangements. Such business relationships are per se violations of the Sherman Act without regard to a consideration of their reasonableness.62 Accordingly, if the challenged business practice is per se illegal, the antitrust plaintiff need not introduce specific evidence of anticompetitive impact on the relevant market.63 The application of this presumption of illegality has been limited primarily to price fixing, certain types of group boycotts, certain tying arrangements, some output contracts and horizontal allocations of markets.64 A business arrangement that is not per se unlawful, is examined under what is referred to as the “rule of reason” analysis. The rule of reason analysis requires a factual analysis of the anticompetitive effect of the business arrangement in the relevant market.65 Under the rule of reason, “[t]he true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition.”66

Whether a particular restraint of competition is per se illegal or subject to the rule of reason often depends on whether it is a horizontal or a vertical restraint.67 Concerted conduct between entities at different levels of distribution, such as between a manufacturer and a

64 Arizona v. Maricopa County Medical Society, 457 U.S. 322, 344 n.15 (1982). See Part IV.B. for more detailed discussions of cases involving claims of price fixing, group boycotts and horizontal allocations of markets.
66 Maricopa, 457 U.S. at 343, n. 13 (quoting Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918).
distributor (or franchisor and franchisee), constitutes a vertical restraint.\textsuperscript{68} The Supreme Court has recognized that there are pro-competitive (or neutral) reasons for non-price vertical restrictions. Therefore, such restraints generally require a rule of reason analysis, unless they constitute vertical price-fixing agreements.\textsuperscript{69} “[W]hile vertical restrictions may reduce intrabrand competition by limiting the number of sellers of a particular product, competing for a given group of buyers, they also promote interbrand competition by allowing a manufacturer to achieve efficiencies in the distribution of its products. . .”\textsuperscript{70} In contrast, coordinated activity between businesses at the same level of distribution, such as competing manufacturers, distributors or franchisees, constitute horizontal restraints that generally are not defensible as having any pro-competitive effects.\textsuperscript{71}

Franchisees compete at the same level of distribution, so coordinated activity within the context of participation in a franchisee association may raise concerns as to whether their action is the result of a horizontal restraint. Likewise, when a franchisor takes action solely based on the suggestion of a franchisee association, such action may be viewed as the product of a horizontal restraint, and may constitute per se violations of Section 1 of the Sherman Act.

B. Antitrust Issues Arising In A Franchise Setting

1. Price fixing Among Competitors

Since the late 1800’s, price-fixing arrangements have been considered to be per se illegal.\textsuperscript{72} A price-fixing arrangement is presumptively illegal, irrespective of whether it is a vertical\textsuperscript{73} or horizontal agreement\textsuperscript{74}, and whether it sets minimum or maximum prices.\textsuperscript{75} “It is no excuse that the prices fixed are themselves reasonable.”\textsuperscript{76} According to the Supreme Court, “Congress has not left with us the determination of whether or not particular price-fixing schemes are wise or unwise, healthy or destructive.”\textsuperscript{77} Thus, once an antitrust plaintiff proves

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\textsuperscript{68} Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717, 730 (1988); Bailey’s, 948 F.2d at 1027. However, to the extent that the franchisor has company owned stores, the franchisor may also be in a horizontal relationship with its franchisees.

\textsuperscript{69} See Business Electronics, 485 U.S. at 733-35.

\textsuperscript{70} Bailey’s, 948 F.2d at 1028 (quoting Oreck Corp. v. Whirlpool Corp., 579 F.2d 126, 131 (2d Cir.), cert. denied, 439 U.S. 946 (1978)). See also Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 51-2 (1977) (“The market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of interbrand competition.”).

\textsuperscript{71} Maricopa, 457 U.S. at 348 n.18.

\textsuperscript{72} See United States v. Trenton Potteries Co., 273 U.S. 392, 396-402 (1927) (noting that the presumption of illegality of price-fixing arrangements has been recognized since the Supreme Court decision in United States v. Joint Traffic Association, 171 U.S. 505 (1898)).

\textsuperscript{73} Monsanto, 465 U.S. at 765.

\textsuperscript{74} Maricopa, 457 U.S. at 346.

\textsuperscript{75} Maricopa, 457 U.S. at 346.

The aim and result of every price-fixing agreement, if effective, is the elimination of one form of competition. The power to fix prices, whether reasonably exercised or not, involves power to control the market and to fix arbitrary and unreasonable prices. The reasonable price fixed today may through economic and business changes become the unreasonable price of tomorrow.

Trenton Potteries, 273 U.S. 392, 397-98 (1927).

\textsuperscript{76} Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 647 (1980).

\textsuperscript{77} Maricopa, 457 U.S. at 346.
an agreement to fix prices, no procompetitive justification in defense of the practice, however reasonable, will be considered. Further, no proof of actual or likely anticompetitive impact on the relevant market is required.

Arguably, most coordinated activities among competitors in which there is an exchange of information affect prices in some way. Because an exchange of information "affects the parties' knowledge, costs, or product," it impacts on output and therefore on price. Nevertheless, as discussed more fully in Part VII.B.5, infra, it is lawful for a industry or trade association to gather and share information and statistics concerning "production costs, output, past prices, merchandise on hand, specific job contracts, [and] freight rates, so long as the Association [does] these things without attempts to foster agreements or concerted action with reference to prices, production, or terms of sale."

Presumably, the same applies to a franchisee association. In a franchise system where unit sales or margins are not growing, it is possible that these concerns will be topics of discussion at franchisee association meetings. Franchisees may suggest ways to increase sales or profits, develop and price new products, and structure favorable credit terms for customers. Section 1 of the Sherman Act does not by itself prohibit such communications or exchanges of information among competitors. However, the law is well established, that the fact that such communications/exchanges have taken place may serve as circumstantial evidence that the participants have had a "meeting of the minds in an unlawful arrangement." The law is clear that where price uniformity or parallel pricing follows discussions among competitors regarding price at trade association meetings (or otherwise), the finder of fact may conclude that the parties entered into an unlawful price fixing conspiracy.

The U.S. Court of Appeals for the Seventh Circuit applied the foregoing principles in Denny's Marina, Inc. v. Renfro Productions, Inc., when it reversed a summary judgment in favor of the defendants after finding that the plaintiff had raised issues of fact to establish a horizontal

78 Maricopa, 457 U.S. at 345.
79 Socony-Vacuum Oil, 310 U.S. at 223-24.
80 See 7 Phillip E. Areeda, Antitrust Law ¶ 1510, at 422 (1986).
81 Id. In many cases, the impact of an exchange of information among competitors is actually procompetitive. Id.
84 See Esco Corporation v. United States, 340 F.2d 1000, 1008 (9th Cir. 1965) (holding that mutual assent may be inferred when one competitor suggests a course of action in the presence of competitors which is subsequently followed by all of the competitors, even though there may be some variation in the action); Pittsburgh Plate Glass Company v. United States, 260 F.2d 397, 401 (4th Cir. 1958), aff'd, 360 U.S. 395 (1959)(finding that the defendant's "conscious parallelism" coupled with its participation in discussions was enough evidence from which the jury could infer the existence of a price-fixing conspiracy). Moreover, evidence of a price fixing agreement may instigate a government criminal prosecution, which carries with it a possible felony conviction, jail sentence and/or significant fines. See 15 U.S.C. § 1 (providing that "every" person who engages in a conspiracy declared to be illegal thereunder "shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding $10,000,000 if a corporation, or, if any other person, $350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court."). That prospect, coupled with the evidentiary standard which permits a fact finder to infer an agreement on price based on evidence of price related discussions followed by parallel pricing behavior, demonstrates the risks that any such discussions at franchisee association meetings create when they relate to price.
price-fixing agreement. There, the plaintiff (a marine dealer), sued a marine dealers association (the “Association”), member dealers who competed with the plaintiff (the “Members”), and two entities that produced the primary boat shows in the United States (the “Boat Show Producers”), alleging that the defendants had engaged in an illegal horizontal price-fixing agreement by excluding plaintiff from participation in boat shows. The plaintiff had participated in boat shows sponsored by the Boat Show Producers. At these shows, the plaintiff would suggest to customers that they first visit the other displaying dealers booths and then come back to the plaintiff, who would “meet or beat” their prices. The other dealers complained to the Boat Show Producers about the plaintiff’s sales tactics; thereafter, the Boat Show Producers told the plaintiff that it could not participate in future shows. The plaintiff filed suit alleging that its exclusion was the result of a conspiracy among the Members, the Association and the Boat Show Producers to fix prices by eliminating a discounter.

The district court granted the defendant’s motion for summary judgment, finding that the plaintiff had failed to show that the arrangement had a “potential” for anticompetitive impact. The Seventh Circuit reversed, ruling that the agreement, if proven, would constitute a horizontal price-fixing agreement.

In their defense, the Boat Show Producers had argued that their decision to exclude the plaintiff from future boat show participation was justified to prevent the plaintiff’s “free-riding on other exhibitors’ elaborate displays,” which allegedly would damage their shows. However, the Seventh Circuit rejected that argument concluding that the agreement was “the product of a horizontal agreement” among the Members and the Association, notwithstanding the participation of the Boat Show Producers. “That the conspiracy was joined by the operators of the . . . boat shows does not transform it into a vertical agreement.”

Further, the court determined that the alleged conspiracy was to fix prices. It noted that a price-fixing agreement need not be explicit. Any arrangement entered into “for the purpose and with the effect of raising, depressing, fixing, pegging or stabilizing the price of a commodity . . . is illegal per se.” The Court of Appeals ruled that a conspiracy among dealers to protect against competition from a price-cutting dealer constitutes horizontal price-fixing. Because the plaintiff presented enough evidence to demonstrate a horizontal price-fixing agreement, the Seventh Circuit concluded that the district court had erred in requiring that the plaintiff make a showing of anticompetitive effect and reversed the grant of summary judgment.

85 8 F.3d 1217 (7th Cir. 1993).
86  Id. at 1219.
87  Id. at 1221, n.7.
88  Denny’s Marina, 8 F.3d at 1220.
89  Id. at 1221, n.5.
90  Id. at 1220. Had the agreement constituted a vertical restraint, Section 1 scrutiny under a rule of reason would be warranted. See Part IV.B.4.
91  Id.
92  But see Part II.B.4., infra, for the more stringent requirements for establishing a per se unlawful vertical price-fixing agreement, which requires proof of an explicit or implicit agreement to set resale price levels.
93  Denny’s Marina, 8 F.3d at 1221 (quoting Socony-Vacuum Oil, 310 U.S. at 223).
94  Denny’s Marina, 8 F.3d at 1221 (citing United States v. General Motors, 384 U.S. 127, 147 (1966).
As the foregoing demonstrates, there is a risk of *per se* illegality inherent in coordinated activities among franchisees when it relates to price. Because franchisee members of a franchise association may compete within the same geographical market, mere discussions concerning price may raise an inference of an unlawful horizontal price-fixing agreement. In many instances, however, franchisees may operate in separate geographical markets, and therefore do not actually compete with each other. It thus may be possible to argue that coordinated activities regarding prices by such franchisees is not a horizontal agreement among competitors and does not violate of Section 1 of the Sherman Act.

Further, as the court in *Williams* recognized, franchisees and franchisors have a common interest in collectively working for the common good of the franchise system. They share an interest in the continuing success of a franchise system and its ability to grow and change. The exchange of ideas among franchisees and franchisors may help to serve a changing market. In this context, it is difficult to refute that franchisors and franchisees share a “unity of interest.” Franchisees may work with the franchisor to develop and test new products. A franchisor benefits greatly from the suggestions of franchisees who have direct contact with consumers and can provide valuable feedback. However, the development of a new product also involves establishing its price. It is the participation of franchisees, often through the franchisee association, in establishing new product prices followed by price uniformity that raises an inference of a horizontal conspiracy.

2. **Group Boycott Claims**

In addition to the risk of engaging in price-fixing, a franchisee association risks other antitrust violations when it uses its collective power to induce action. The Supreme Court has long held that group boycotts are *per se* violations of section 1 of the Sherman Act. “[S]uch agreements, no less than those to fix minimum prices, cripple the freedom of traders and thereby restrain their ability to sell in accordance with their own judgment.” In *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, the Supreme Court held that the *per se* rule applies where the refusal to deal denies a competitor access to something that it needs to compete in the relevant market, or where the boycotting firms possess dominant market power and there are no “plausible arguments that [the boycott was] intended to enhance overall efficiency and make markets more competitive.”

The Third Circuit decision in *Big Apple BMW, Inc. v. BMW of North America, Inc.* illustrates the risks inherent in a situation in which the franchisee influence over a licensing decision, possibly through a franchisee association, may constitute an unlawful group boycott. In *Big Apple BMW*, the Third Circuit reversed the entry of summary judgment in favor of defendants, finding that the plaintiffs raised issues of material fact sufficient to exclude the

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95 See supra Part IV.A.1. for an in-depth discussion of *Williams*.
98 *Northwest Stationers*, 472 U.S. at 294.
99 974 F.2d 1358 (3rd Cir. 1992).
possibility of independent action in licensing decisions. The plaintiffs, the Potamkins, alleged that in 1981 BMW of North America ("BMW NA") initially encouraged them to purchase a BMW dealership, and only after "strenuous opposition to Potamkin competition" from area dealerships, BMW NA denied the Potamkins’ application on three separate occasions and in three different geographical markets. The Potamkins, who were known to be discounters, alleged that BMW NA conspired with some of its dealers to fix the prices of BMW automobiles in the United States, and as a part of the conspiracy, engaged in a group boycott to exclude the Potamkins.

BMW NA contended that its decision to deny the Potamkins’ application was made unilaterally, and was made for reasons unrelated to the complaints of existing area dealerships. BMW NA reasoned “that the Potamkin image as high volume price-discounters was incompatible with the desired BMW image; the Potamkins’ customer service record was inadequate; the proposed Philadelphia location was inadequate for a number of reasons; the Potamkins were uncooperative; and Robert [Potamkin] objected to an annual allocation of 94 cars.” The district court found BMW NA’s reasons to be compelling, and granted summary judgment in favor of BMW NA.

The Third Circuit reversed, finding that the Potamkins raised issues of fact excluding the possibility of independent action. The Potamkins’ presented “19 bits” of circumstantial evidence showing an inconsistency between BMW NA’s original interest in the Potamkins and the subsequent “plethora of complaints” about the Potamkins to the franchisor representative who made licensing decisions from area dealers. Particularly when compared to BMW NA’s “concomitant treatment of [existing] BMW dealers,” the evidence raised factual issues regarding whether there was an unlawful conspiracy between BMW NA and certain of its dealers.

The Potamkins were experienced and successful owner/operators of high volume, deep discount automobile dealerships in the eastern United States. Tom Cronin, the Eastern Regional Manager for BMW NA, was “favorably impressed” with the Potamkins after Mr. Cronin was approached by the Potamkins about purchasing a BMW dealership. Nevertheless, after months of negotiations in which it appeared that they had reached an oral agreement to open a dealership in Great Neck, New York, BMW NA’s agent informed the Potamkins that BMW NA had decided not to open a new dealership there. BMW NA asserted that it rejected the Potamkins because they had allegedly attempted to bribe Tom Cronin.

The Potamkins denied that they attempted to bribe Mr. Cronin, pointing out that the denial letter sent by BMW NA did not refer to an alleged bribe. Moreover, the parties had

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100 Big Apple BMW, 974 F.2d at 1380. The court applied the “mere scintilla” standard for summary judgment, which merely requires an opponent to raise issues of fact by a “mere scintilla” threshold to preclude summary judgment.
101 Big Apple BMW, 974 F.2d at 1376.
102 Big Apple BMW, 974 F.2d at 1360.
103 Big Apple BMW, 974 F.2d at 1375. BMW NA claimed that the Potamkins’ “blow out sale[s]” and “sellathon[s]” were inconsistent with BMW’s high quality image and price insensitive target market. Id. at 1376.
104 Big Apple BMW, 974 F.2d at 1374. For example, although BMW NA argued that the Potamkins did not portray the proper image because of its price advertisement strategy, the record indicated that some BMW dealers engaged in price advertising. Id. at 1378.
105 Id. at 1366.
106 Big Apple BMW, 974 F.2d at 1366.
continued to negotiate after date of the alleged bribe. The Third Circuit found that there was evidence showing that Cronin had decision-making authority for BMW NA, that dealers complained to him and that Cronin’s denial merely raised issues of fact. Further, the Third Circuit found that the Potamkins had presented circumstantial evidence that tended to refute the allegation of an attempt to bribe Cronin. From this evidence, the Court found that a “jury could infer that BMW NA would have welcomed a high volume dealer such as [Potamkin], and after succumbing to pressure from its New York area dealers, entertained the prospect of installing a Potamkin dealership in an alternative location.”

The Potamkins presented circumstantial evidence of a similar nature to show that BMW NA rejected the Potamkins’ application for a dealership at two other locations, as well. In addition to the circumstantial evidence, the Third Circuit addressed each of BMW NA’s proffered reasons for denying the Potamkins request for a dealership, rejecting each one. It determined that, while there was no direct evidence presented, the circumstantial evidence presented by the Potamkins to show that the reasons were pretextual tended to negate each reason.

The Third Circuit stated that “there is sufficient indication that the alleged concerted action between BMW NA and its dealers may have diminished retail competition without a corresponding benefit to consumers.” Further, the court stated that if area dealers “were familiar with the Potamkins’ success as high volume price discounters and feared that kind of competition,” it would explain why BMW NA rejected the Potamkins after its original favorable impression and months of good faith negotiations for the Great Neck location. Although the Third Circuit noted that BMW NA did not have to even consider the Potamkins’ application, provided it acted independently, it found that the Potamkins raised issues of fact sufficient to question whether BMW NA had acted unilaterally. Accordingly, the Court reversed the grant of summary judgment in favor of defendants.

As Big Apple BMW indicates, when a franchisor initially responds favorably towards a prospective franchisee applicant, and then takes a 180 degree turn only after receiving a “plethora of complaints” from existing franchisees, issues of fact as to the existence of a conspiracy to boycott a competitor may be raised by circumstantial evidence.

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107 Id.
108 Id. at 1369.
109 Id. at 1375.
110 Id.
111 Id. at 1378. BMW NA also contended that the Potamkins did not raise genuine issues of material fact that BMW NA and its dealers agreed to set resale price levels as required under Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717 (1988). Id. at 1375. However, the Third Circuit disagreed, stating that the “record [was] replete with evidence that BMW NA representatives and dealers share and discuss retail price statistics.” Id. See Part IV.B.4. for a discussion of Business Electronics.
112 Id. at 1378. But see McAlpine v. AAMCO Automatic Transmissions, Inc., 461 F. Supp. 1232 (E.D. Mich. 1978) for a case in which the collective conduct of franchisees to influence the negotiation of terms of an agreement did not violate Section 1 of the Sherman Act.
3. **Horizontal Allocation of Customers or Territories**

It is a *per se* violation of Section 1 of the Sherman Act for competitors at the same level of distribution to agree to allocate territories or customers in order to minimize competition.\(^{114}\) The Supreme Court “has reiterated time and time again that ‘[h]orizontal territorial limitations . . . are naked restraints of trade with no purpose except stifling of competition.’”\(^{115}\)

In *United States v. Topco Associates, Inc.*, the Supreme Court held that a cooperative purchasing association’s practices in admitting new members constituted a *per se* illegal horizontal territorial market allocation.\(^{116}\) Topco was a member-owned purchasing cooperative that acted as the purchasing agent for small and medium-sized regional supermarket chains operating in thirty-three states.\(^{117}\) Topco owned the brand names under which members distributed a variety of grocery products.\(^{118}\) The members exercised complete control over the operation of the association through existing restrictions on stock transfers and procedures which required that the board of directors and executive officers be chosen from within the association’s membership.\(^{119}\)

Board of director and membership approval was required in order to obtain a license from the association, which permitted members to sell Topco-brand products only in specific geographical territories.\(^{120}\) In order for a new member to obtain a license, both board of director approval and an affirmative vote of 75% of the members were required. The member located closest to the potential new member effectively had veto power; if it voted against approval, the applicant needed an affirmative vote of 85% of the members to obtain approval.\(^{121}\) The extensive cooperation among the co-op members served to block any new applicants when the geographically closest members opposed the applicant.\(^{122}\)

The United States challenged this scheme as an unreasonable restraint on competition in Topco-brand products among retail supermarkets in violation of Section 1 of the Sherman Act.\(^{123}\) Topco defended its practice, arguing that, without territorial divisions, the association could not exist, and that the market allocations were necessary in order to permit members to compete successfully with larger regional and national supermarket chains.\(^{124}\) The district court upheld the legality of the market division under a rule of reason analysis, finding it to be an unreasonable restraint with procompetitive effects, because the intrabrand restrictions on


\(^{116}\) 405 U.S. 596 (1972).

\(^{117}\) *Id.* at 597.

\(^{118}\) *Id.*

\(^{119}\) *Id.* at 598.

\(^{120}\) *Id.* at 601-02. Although some licenses were labeled “non-exclusive,” all licenses effectively operated as either actual or de facto exclusive territories.

\(^{121}\) *Id.* at 602.

\(^{122}\) *Id.*

\(^{123}\) *Id.* at 603.

\(^{124}\) *Id.* at 605.
competition between Topco members fostered interbrand competition between Topco members and larger supermarket chains.125

The Supreme Court reversed, finding that the challenged conduct constituted a per se illegal horizontal restriction.126 The Court stated that “Topco has no authority under the Sherman Act to determine the respective values of competition in various sectors of the economy”127 and held that Topco’s practices constituted per se unlawful horizontal market allocations in violation of Section 1 of the Sherman Act.128

Citing Topco, the Third Circuit Court of Appeals concluded in American Motor Inns, Inc. v. Holiday Inns, Inc., that the refusal of Holiday Inn, Inc. ("HI") to grant a Holiday Inn franchise to the plaintiff was the result of a per se illegal horizontal conspiracy to allocate territories.129 The Third Circuit determined that a provision in the Holiday Inn franchise agreement and certain policies endorsed by HI had the effect of permitting existing franchisees unlawfully to veto the grant of a new license.

The challenged contract provision prohibited a franchisee from owning or operating any hotel not franchised by HI (the “non-Holiday Inn clause”). In addition, HI engaged in two noncontractual practices concerning its issuance of licenses: (1) it refused to grant licenses in cities in which HI itself owned and operated hotels (the “company-towns” policy); (2) prior to granting a new license, HI sent notices (“radius letters”) to the three franchisees geographically closest to the proposed new licensee’s location, to allow them to comment on the application.130 Although HI had no contractual obligation to respond to the franchisees’ comments, an objection by a nearby franchisee effectively served as a veto of the application for a new license.131

The plaintiff in American Motor Inns was the owner and operator of 48 Holiday Inn hotels. It purchased property for the purpose of constructing a new Holiday Inn hotel thereon.132 However, a nearby franchisee objected to the grant of the new license after receiving a radius letter. HI then denied the license request and suggested that the plaintiff “try to ‘work something out’ with [the nearby franchisee],” and attempt to “make a deal.”133 HI also rejected the applicant’s request for a waiver of the non-Holiday Inns clause to enable it to operate a Sheraton Inn hotel on the property instead.134 The applicant sued HI, alleging that HI’s practices constituted per se unlawful horizontal allocations of markets in violation of Section 1 of the Sherman Act.

125 Id. at 610.
126 Id. at 606, 608. At the time, the Expediting Act permitted the United States to appeal the district court decision directly to the Supreme Court. Id. at 597.
127 Id. at 610-11.
128 Id. at 612.
130 American Motors Inns, 521 F.2d at 1236.
131 Id.
132 Id. at 1235.
133 Id. at 1237.
134 Id.
The district court sitting without a jury held that the non-Holiday Inn clause combined with the radius letter and company-towns policies resulted in a *per se* illegal horizontal allocation of markets. The court held that the denial of plaintiff's license application resulted from an unlawful conspiracy in restraint of trade.\textsuperscript{135} The court found that (1) the company-town policy and the radius letter policy prevented intrabrand competition among owners of Holiday Inns by eliminating new competition within the franchise system and (2) the non-Holiday Inn clause prevented interbrand competition by preventing franchisees from competing with units in the franchise system.\textsuperscript{136}

On appeal, HI asserted that it acted unilaterally when it denied the plaintiff's license application.\textsuperscript{137} HI argued that even if its decision was influenced, in part, by the comments of the nearby franchisee, it was no more than a decision to grant the nearby franchisee an exclusive territory. Therefore, HI argued, it was not an unlawful conspiracy with franchisees.\textsuperscript{138}

HI also contended that the district court incorrectly concluded that the non-Holiday Inn clause was an unreasonable restraint of trade because it had no anticompetitive impact on competitors of HI or its franchisees.\textsuperscript{139} HI also argued that the combined effect of the radius letter policy, the non-Holiday Inn clause and the company-town policy was not an illegal horizontal allocation of territories.\textsuperscript{140}

The Third Circuit Court of Appeals affirmed in part, reversed in part, and vacated in part. First, it agreed with the district court's conclusion that HI's refusal to grant the plaintiff a license was a *per se* unlawful horizontal allocation of markets. Citing *Topco*, the Third Circuit found that the nearby franchisees' objections to the plaintiff's license application operated as a veto, thus enabling the franchisees to unlawfully allocate the market among themselves and bar intrabrand competition.\textsuperscript{141}

The Third Circuit vacated and remanded for further determination the trial court's conclusion that the non-Holiday Inn clause, by itself, constituted an unreasonable restraint of trade.\textsuperscript{142} The district court had determined that the non-Holiday Inn clause was illegal because it was intended to reduce intrabrand competition among franchisees and to reduce interbrand competition between franchisees and company-owned hotels.\textsuperscript{143} However, the district court had reached that conclusion without exploring whether there was an anticompetitive impact on the relevant market, a necessary determination in any rule of reason analysis.\textsuperscript{144} It failed to identify, test and measure the impact of the contract provision on competition in the hotel-motel industry. Thus, the Court of Appeals remanded for such a determination.

\textsuperscript{135} *Id.* at 1237, 1239.

\textsuperscript{136} *Id.* at 1240.

\textsuperscript{137} *Id.*

\textsuperscript{138} *Id.*

\textsuperscript{139} See *id.* at 1240.

\textsuperscript{140} *Id.* at 1241.

\textsuperscript{141} *Id.* at 1242.

\textsuperscript{142} *Id.* at 1248.

\textsuperscript{143} *Id.* at 1247.

\textsuperscript{144} *Id.*
Finally, the Third Circuit held that the company-town policy and the non-Holiday Inn clause, together, constituted an unlawful horizontal restraint on competition.\textsuperscript{145} While it noted that the company-town policy, standing alone, was not unlawful because it was the result of unilateral decision of HI not to grant licenses in certain cities,\textsuperscript{146} HI also operated in some capacities the same as a franchisee because it had company owned hotels. Thus, as an arrangement among operators on the same level of distribution, the non-Holiday Inn clause (which eliminated interbrand competition), when combined with the company-town policy (which eliminated intrabrand competition), constituted a horizontal allocation of markets among competitors.\textsuperscript{147}

As the foregoing discussion makes clear, antitrust issues are raised when franchisees influence the licensing decisions of its franchisors and provides a basis for \textit{per se} claims under Section 1 of the Sherman Act. Thus, when a franchisor invites franchisee input, either individually or through a franchisee association, on licensing issues, termination or discipline of existing franchisees, there is a risk that the injured franchisee will claim that the participants have engaged in a horizontal allocation of territory, or other violation of Section 1 of the Sherman Act.

4. \textbf{Vertical Restraints}

The Supreme Court has recognized “that the scope of \textit{per se} illegality should be narrow in the context of vertical restraints.”\textsuperscript{148} Consistent with this view, the Court has held that “a vertical restraint is not illegal \textit{per se} unless it includes some agreement on price or price levels.”\textsuperscript{149}

In \textit{Continental T.V., Inc. v. GTE Sylvania, Inc.}, the Supreme Court held that nonprice vertical restraints are to be reviewed under a rule of reason analysis.\textsuperscript{150} The Court emphasized that the impact of such restraints is often complex; although such restraints may reduce intrabrand competition, by reducing the number of competitors selling the same brand in the same area, they often stimulate interbrand competition, by permitting manufacturers to distribute products more efficiently.\textsuperscript{151} The Court noted that “[i]nterbrand competition . . . is the primary concern of antitrust law.”\textsuperscript{152} In emerging markets, for example, vertical restrictions enable a manufacturer to provide incentives for retailers to invest in new products and aggressively promote them.\textsuperscript{153} In established markets, vertical restrictions encourage retailers to implement promotions or provide added service.\textsuperscript{154} Because of these “redeeming virtues,” the Court held that nonprice vertical restrictions should be reviewed under a rule of reason analysis.

\textsuperscript{145} \textit{Id.} at 1254.
\textsuperscript{146} \textit{Id.} at 1253.
\textsuperscript{147} \textit{Id.}
\textsuperscript{149} \textit{Id.} at 736.
\textsuperscript{150} 433 U.S. 36, 59 (1977).
\textsuperscript{151} \textit{Id.} at 51, 54.
\textsuperscript{152} \textit{Id.} at 52, n.19.
\textsuperscript{153} \textit{Id.} at 55.
\textsuperscript{154} \textit{Id.}
In contrast to nonprice vertical restrictions, vertical restraints containing an agreement to set resale prices or price levels constitute *per se* violations of Section 1 of the Sherman Act. In *Dr. Miles Medical Co. v. Park & Son, Inc.*, the Supreme Court held that a manufacturer was not entitled to control the resale price of its product. The Court stated that the manufacturer “having sold its product at prices satisfactory to itself, the public is entitled to whatever advantage may be derived from competition in the subsequent traffic.” Thus, agreements between manufacturers and dealers (or franchisors and franchisees) to fix resale prices are *per se* unlawful.

While an agreement between a manufacturer and dealer (or franchisor and franchisee) on resale price is *per se* unlawful, the Supreme Court has long held that a manufacturer may decide with whom it will deal, absent an intent to monopolize:

> In the absence of any purpose to create or maintain a monopoly, the act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal; and, of course, he may announce in advance the circumstances under which he will refuse to sell.

Thus the manufacturer may lawfully refuse to sell to anyone who does not resell at indicated prices. Accordingly, the deciding issue in many price-fixing cases has been whether the manufacturer’s refusal to deal with a distributor was made unilaterally or as a result of a conspiracy between the manufacturer and one or more of its distributors.

In *Monsanto Co. v. Spray-Rite Service Corp.*, the Supreme Court established the evidentiary standard to be applied in determining the existence of a vertical conspiracy to maintain retail prices. There, Monsanto terminated the plaintiff, which had been reselling Monsanto herbicides at low margins. Plaintiff ranked in the top ten percent of distributors in terms of sales at the time it was terminated and it had been a Monsanto distributor for eleven years. After its termination, the plaintiff purchased Monsanto herbicide from other distributors, but it was unable to purchase as much or as early in the season as it required.

The plaintiff sued, alleging that it was terminated as a result of a conspiracy between Monsanto and some of its remaining distributors to fix resale prices. Monsanto provided independent business reasons for terminating the plaintiff, namely that plaintiff failed to hire trained salesmen and to adequately promote sales to dealers. However, the jury agreed with

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155 *Dr. Miles Medical Co. v. Park & Son, Inc.*, 220 U.S. 373, 408-09 (1911).
156 *Id.* at 409.
157 *Id.* at 408-09.
159 *Id.* Accordingly, a franchisor can suggest retail prices and engage in price advertising, provided franchisees are in fact free to set their own prices, and any price advertisement makes clear that prices may vary among franchisees.
162 *Id.*
163 *Id.*
the plaintiff, and the Seventh Circuit affirmed. The Seventh Circuit held that “proof of termination following competitor complaints is sufficient to support an inference of concerted action to survive a directed verdict.”\(^\text{164}\)

Although the Supreme Court affirmed the lower court’s judgment, it held that the Seventh Circuit had applied an incorrect standard. The Supreme Court held that termination of a price-cutter following complaints from other distributors is not enough to survive a motion for a directed verdict. Rather, the correct standard is that the evidence must exclude the possibility of independent unilateral action by the manufacturer.\(^\text{165}\)

The Supreme Court made clear that a manufacturer may terminate a distributor without raising antitrust concerns, provided that it does so independently.\(^\text{166}\) The Court stated that to allow an inference of concerted conduct on the basis of distributor complaints alone could penalize legitimate business conduct.\(^\text{167}\) The Court recognized that “distributor feedback” is a valuable source of information for manufacturers, and does not, by itself, raise antitrust concerns.\(^\text{168}\) Thus “something more than evidence of complaints is needed.”\(^\text{169}\) The Court held that a plaintiff must present evidence to show that the manufacturer and its distributors engaged in a scheme intended to achieve an unlawful purpose.\(^\text{170}\)

The Court found that the plaintiff had provided substantial direct evidence of “something more” than mere complaints, and thereby enabled the jury to conclude that there was an agreement between Monsanto and the complaining distributors to fix resale prices. Monsanto had warned price-cutting distributors that they would not be able to purchase adequate supplies of Monsanto products if they did not conform to its retail pricing policies.\(^\text{171}\) There was evidence that when one distributor complained, Monsanto notified its parent company, which advised the distributor to comply with Monsanto’s pricing policies, and the distributor thereafter complied. Further, Monsanto implicitly warned distributors in a newsletter that they must comply with its pricing policies by stating that noncompliance “could discolor the outlook for continuity as one of the approved distributors during the future upcoming seasons” and that those who complied would not “risk being deleted from this customer service opportunity.”\(^\text{172}\) From this evidence, the Court concluded that the jury could properly infer the existence of an agreement to maintain prices.\(^\text{173}\)

The Supreme Court subsequently elaborated on the evidentiary standard in resale price fixing cases, holding that in order to constitute a per se violation of Section 1, a vertical restraint

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\(^{164}\) Id. at 758 (quoting Monsanto, 684 F.2d 1226, 1238 (7th Cir. 1982)).

\(^{165}\) Id. at 767.

\(^{166}\) Id. at 761. Further, it noted that concerted action to terminate a price-cutting distributor in order to fix prices is per se illegal, whereas such action taken to maintain nonprice restrictions is scrutinized under a rule of reason analysis. Id.

\(^{167}\) Id. at 767.

\(^{168}\) Id. at 763-64.

\(^{169}\) Id. at 764.

\(^{170}\) Id.

\(^{171}\) Id. at 765.

\(^{172}\) Id. at 765-66.

\(^{173}\) Id. at 767.
must include an express or implied agreement on price or price levels.\textsuperscript{174} In \textit{Business Electronics Corp. v. Sharp Electronics Corp.}, a manufacturer terminated a price-cutting retail electronics dealership after a competing retail dealer complained about the plaintiff's low prices, and threatened to stop buying from the manufacturer if it failed to terminate the plaintiff within 30 days.\textsuperscript{175} The dealership agreement contained suggested retail prices, but dealers purportedly did not have to charge those prices. In fact, the evidence showed that the complaining retail dealer often charged prices below the manufacturer's suggested retail prices.\textsuperscript{176}

Based on those facts, the Fifth Circuit reversed a jury verdict in favor of the plaintiff, and the Supreme Court affirmed. The Supreme Court cautioned that in the context of vertical restraints, the scope of \textit{per se} illegality should be narrowly construed.\textsuperscript{177} The Court noted that there was no evidence that an agreement between a manufacturer and a dealer to terminate a price-cutting dealer restrains trade or reduces output, absent an agreement on the prices that the remaining dealer will charge.\textsuperscript{178} Because there was no evidence that the manufacturer and the complaining dealer in \textit{Business Electronics} had agreed on price — indeed, the evidence showed that the complaining dealer set its own retail price levels, often at levels below those suggested by the manufacturer—the Court held that the plaintiff failed to establish a \textit{per se} unlawful vertical price restraint.\textsuperscript{179}

Applying the principles in \textit{Business Electronics}, the Seventh Circuit affirmed the entry of summary judgment for the defendant in \textit{Center Video Industrial Company, Inc. v. United Media, Inc.}, finding that there had been no agreement to set resale price levels.\textsuperscript{180} There the evidence showed that the complaining distributor raised its prices to levels that were higher than those it had maintained while in competition with the price-cutting plaintiff.\textsuperscript{181} The plaintiff admitted that it had no evidence of an actual agreement between the manufacturer and the complaining distributor on resale price levels.\textsuperscript{182} Further, the Seventh Circuit noted that the complaining dealer's decision to raise its prices after the plaintiff's termination to even higher levels indicated that there was no agreement to maintain the complaining distributor's prices at a certain level during the period in which it was competing with the plaintiff.\textsuperscript{183} Therefore, the Seventh Circuit affirmed the entry of summary judgment in the defendant's favor.\textsuperscript{184}

\textsuperscript{174} \textit{Business Electronics}, 485 U.S. at 735-36.
\textsuperscript{175} \textit{Id.} at 721.
\textsuperscript{176} \textit{Id.} at 721.
\textsuperscript{177} \textit{Id.} at 724.
\textsuperscript{178} \textit{Id.} at 726-27. The Court noted that vertical restraints can be used to facilitate the formation of horizontal cartels. \textit{Id.} For example, where dealers threaten to boycott a manufacturer who would otherwise not enforce vertical restrictions, such an arrangement might constitute a \textit{per se} illegal horizontal price-fixing agreement or a \textit{per se} illegal horizontal allocation of markets. \textit{See supra} Parts IV.B.1. and IV.B.3., respectively, for discussions of horizontal price-fixing agreements and horizontal allocations of markets.
\textsuperscript{179} \textit{Id.} at 735-36.
\textsuperscript{180} \textit{Center Video Industrial Company, Inc. v. United Media, Inc.}, 995 F.2d 735, 739 (7th Cir. 1993).
\textsuperscript{181} \textit{Center Video}, 995 F.2d at 736. The complaining distributor was a discount dealer like the plaintiff. However, it sold at prices levels above those maintained by the plaintiff. \textit{Id.}
\textsuperscript{182} \textit{Id.} at 739.
\textsuperscript{183} \textit{Id.}
\textsuperscript{184} \textit{See also Bailey’s, Inc. v. Windsor America, Inc.}, 948 F.2d 1018 (6th Cir. 1991) (holding that a dealer’s termination did not violate the Sherman Act, despite evidence from which the jury could infer that the manufacturer stopped selling to the plaintiff as a \textit{quid pro quo} for offers of two distributor to increase their purchases of the
As the foregoing demonstrates, the standard for proving the existence of a vertical resale price-fixing agreement is rigorous. In termination cases, franchisee “feedback” on suggested retail price levels, without proof of an agreement on specific price levels, will not rise to the level of a per se unlawful vertical restraint. Nevertheless, caution is advised when franchisees participate in discussions, perhaps at franchisee association meeting, about retail price levels. As discussed above, a horizontal conspiracy to fix prices may be inferred if franchisees agree among themselves to boycott a franchisor who refuses to enforce resale price levels by terminating a price-cutting franchisee.

5. Benchmarking—Information Sharing

An important benefit of franchisee associations is the ability to share information in order to permit franchisees to benchmark their individual operations against the operations of others in the franchise system. Benchmarking is the “continuous systematic process for evaluating the products, services and work processes of organizations that are recognized as representing best practices for the purpose of organizational improvement.”185 Through benchmarking, companies seek to improve their own performance by emulating the best practices of other companies.

While benchmarking may provide valuable information that enables a particular franchisee to compete more effectively, as the foregoing discussions illustrate, information sharing among competitors or potential competitors may raise antitrust issues. Thus, information sharing by itself does not rise to the level of a per se violation of the Sherman Act.186 However, the exchange of information may enable competitors to signal a change in price or terms, thereby facilitating a horizontal agreement to fix price. Further, an exchange of information followed by a suggestion on course of action may constitute a solicitation to engage in concerted conduct.187 Therefore, information exchanges that lead to horizontal price fixing are per se illegal. That said, most information exchanges have been evaluated under the rule of reason.188

The U.S. Department of Justice and Federal Trade Commission (“FTC”) statements of Enforcement Policy and Analytical Principles Relating to Health Care and Antitrust (1994) (the “Health Care Guidelines”) address information exchange in the specific context of the health care industry, but the guidance is informative for other industries as well. The FTC and Justice Department have stated that they will not challenge an exchange of price and salary information where the program is administered by a third party, the information provided is more than three months old, there are at least five participants providing information, none of which accounts for manufacturer’s products, because there was no evidence of an agreement between the manufacturer and the two distributors on resale price levels).

187 See In re Coordinated Proceedings in Petroleum Products Antitrust litigation, 906 F.2d 432 (9th Cir. 1990) (denying the defendants’ motion for summary judgment because an inference of an agreement to raise prices was reasonable based on defendants’ public announcements of wholesale price changes with a procompetitive business justification), cert. denied, 111 S.Ct. 2274 (1991); United States v. American Airlines, 743 F.2d 1114 (5th Cir. 1984), cert dismissed, 474 U.S. 1001 (1985).
more than 25 percent of the total, and the information is sufficiently aggregated so that no single participant’s data can be identified. Information exchanges not falling within this “safe harbor” will be evaluated individually, with exchanges involving future information (i.e., future prices and salaries) being considered to be “very likely to be considered anticompetitive;” if there is evidence of any agreement on price and salary, such agreements will be considered to be per se unlawful.

The type of information that is being exchanged also influences the degree of antitrust risk. For example, historical information does not raise the same level of antitrust risk as current or future information. Further, the exchange of cost information does not always raise antitrust issues, however it can be problematic if it leads to price stabilization. Other factors that impact the degree to which an information exchange raises antitrust issues include the purpose for the exchange (i.e., to fix price or divide markets, as opposed to establishment of best practices), the frequency of the exchange (the more frequent the exchanges, the greater the antitrust risks), whether the information is otherwise available through public sources and whether participation in the exchange is voluntary as opposed to compulsory. The format in which information is exchanged also impacts the level of antitrust risk. When information is aggregated or averaged and does not match information with the specific entities that provided the information, it lowers the antitrust risk.

Franchisee associations resemble industry trade associations and many of the early decisions of the Supreme Court that have shaped the development of the antitrust laws involved trade associations. That said, the courts have recognized that trade associations perform many legitimate functions. Given the fact that trade associations are, by definition, gatherings of competitors, they often exercise precautions to minimize the risk of antitrust claims and to keep the participants focused on the legitimate business goals of the association. For example, it is

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190 Id. at 20,784-85.

191 See United States v. United States Gypsum Co., 438 U.S. 422, 441 n.16 (“Exchanges of current price information, of course, have the greatest potential for generating anticompetitive effects and although not per se unlawful have consistently been held to violate the Sherman Act.”). FTC Advisory Opinion No. 158, 73 F.T.C. 1289 (1968) (declining to state that the FTC would not challenge a trade association’s proposed preparation and distribution of a standard rate and service pricing manual for use by electronics servicemen; there was “too grave a danger that it will serve as a device through which service rates and fees would stabilize.”). See also In re Coordinated Proceedings in Petroleum Products Antitrust Litig., 906 F.2d 432 (9th Cir. 1990) (denying summary judgment to defendant oil companies because there was evidence to support an inference of a conspiracy where current and future price information was allegedly shared through press releases, price posting, and direct communications between competitors).

192 See United States v. National Malleable & Steel Castings Co., 1957 Trade Cas. (CCH) (68,890 (N.D. Ohio) (the exchange of cost information between competitors did not violate Section 1 of the Sherman Act because the purpose of the exchange was to check costs, not to increase prices), aff’d per curiam, 358 U.S. 38 (1958).

193 See United States v. Watch Case Mfg. Ass’n, 1953 Trade Cas. (CCH) ¶ 67,422 (S.D.N.Y. 1953) (manufacturers of watch cases and trade association were enjoined by a consent decree from participating in a plan which had the effect of circulating information on the costs of watch cases and enjoined them from distributing statistics relating to costs).

advisable for trade association meetings (and franchisee association meetings) to limit their
discussions to the items on a written agenda, which focused the group’s discussion on areas of
legitimate concern. Participants should avoid post-meeting casual discussions with other
competitors in lobbies or restaurants where otherwise innocent discussions about the business
in general may later be viewed as having an anticompetitive purpose.

Many associations maintain written antitrust compliance policies and they distribute
copies of it at association meetings. The association’s counsel often attends association
meetings, and takes steps to prevent the discussion from veering off into sensitive areas.\textsuperscript{195}

V. CONCLUSION

When franchisor purchasing departments fail to meet the expectations of franchise
associations and their members, or where the franchisor is no longer interested in performing
the purchasing function, opportunities for the formation of a purchasing cooperative will be
present. When the franchisor acknowledges that it is not performing this function well, or is
simply not interested in the supply business, the cooperative’s formation is likely to be a positive
and non-controversial process. On the other hand, when the franchisor is opposed to such a
possibility, it will be a long and contentious struggle to create a competitor to the incumbent
purchasing system. Franchise systems do not adjust to many changes rapidly, nor is the
formation of a purchasing cooperative an overnight process. And, always lurking in the
background, will be antitrust considerations which under no circumstance can be ignored.

\textsuperscript{195} For a more complete discussion of the antitrust issues affecting trade associations, see MacArthur, \textit{Associations and the Antitrust Laws} (1984).
APPENDIX

BIBLIOGRAPHY OF RELEVANT LITERATURE

FRANCHISEE ASSOCIATIONS


PURCHASING COOPERATIVES


