A PRACTICAL GUIDE TO FRANCHISING AND ANTITRUST

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I. INTRODUCTION

Franchise relationships can vary so greatly that it is often difficult to generalize about them. Business models range from relatively simple distribution systems, in which a manufacturer uses a network of franchisees to distribute its branded products, to business format franchises in which the franchisor prescribes the “look and feel” of the franchise, the equipment required to be used in each franchised outlet, methods of keeping track of customer transactions and inventory, and systems of cost control, promotion and advertising. But in many – if not most – cases, while the factual setting may vary, antitrust issues in franchise relationships are analyzed no differently than those that arise between and among manufacturers, distributors, suppliers and end-users in traditional, non-franchised arrangements.

The primary federal antitrust statutes regulating franchisors and franchisees are the Sherman and Clayton Acts,¹ which prohibit certain agreements in “restraint of trade,” and the Robinson-Patman Act,² which prohibits price discrimination among competing purchasers that may substantially lessen competition.³ Agreements evaluated under the Sherman Act may be “horizontal,” meaning that they are between or among competitors, or “vertical,” meaning that they are between or among a manufacturer and its distributors (franchisees) or suppliers. This paper addresses the application of these statutes to a variety of questions that frequently arise in franchising.⁴

II. PRICING ISSUES FOR FRANCHISORS AND FRANCHISEES

A. Can a Franchisor Specify Product Pricing by Franchisees, in Advertising Or Otherwise?

Suppose a franchisor decides that to build the system’s brand image, preserve adequate profits and protect dedicated franchisees against others’ free-riding, it would like to curtail discounting and set a consistent price or price range at which franchisees will resell the product. Aside from simply raising its own prices to the franchisees, what can and can’t the franchisor do to achieve this objective? Since the franchisor will be attempting to influence pricing decisions by entities on a different distribution level, its activities will be governed by rules relating to vertical price-fixing under Section 1 of the Sherman Act.⁵ As a general matter, as spelled out

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³ While it is conceivable that a franchisor may be deemed a monopolist, either in a traditional product market or under the narrow standards articulated by the Supreme Court in Eastman Kodak Co. v. Image Technical Services., Inc., 504 U.S. 451 (1992), for defining a single-product market, we do not address here the application of Section 2 of the Sherman Act to pricing decisions by a monopolist.
⁴ In addition, most states have their own antitrust laws that may or may not coincide with the federal standards. See, e.g., Robert M. Langer, Suzanne E. Wachsstock and Erika L. Amarante, So You Think You’re Safe Under the Antitrust Laws? A Word of Advice to Those Who Would Ignore the States, ANTITRUST REP. (2002). Although this paper notes a few potential differences between state and federal law, where applicable, a full discussion of state antitrust law is beyond the scope of this paper.
⁵ A few courts have held that franchise systems should be considered single economic entities incapable of liability under Section 1, applying the reasoning of the Supreme Court in Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984). For a critical analysis of these cases, see Suzanne E. Wachsstock and Erika L. Amarante, Antitrust and Franchising: Conspiracies Between Franchisors and Franchisees under Section 1, 23 FRANCHISE L.J. 7 (Summer 2003) (arguing that the logic applied in these rare decisions is faulty, but that courts should pay heed to the realities of the particular franchise relationship and the type of conspiracy alleged to determine if the alleged conduct is a vice about which the antitrust laws should be concerned). Because the cases holding that franchise systems are
below, franchisors may set price ceilings but not floors; they may suggest, but not coerce compliance with, retail prices; they may, within the constraints of state franchise and distribution statutes, establish truly unilateral pricing policies; they may establish genuine consignment relationships; and they may advertise prices directly to consumers and, possibly, require compliance with certain promotional pricing programs. But each of these actions must be undertaken with great care, so as not to overstep the Sherman Act’s boundaries.

1. Resale Price Maintenance

Agreements between a supplier and its distributors establishing a floor or fixed price, or dictating a permissible range of prices, for distributors’ resale of products and services, also known as minimum resale price maintenance ("RPM") agreements, have long been deemed per se unlawful as conspiracies in restraint of trade. Although all agreements relating to resale price were once considered per se unlawful, the current law excludes agreements setting only a ceiling for resale prices, known as “maximum” resale price maintenance, from this category. Maximum RPM arrangements are instead subject to the fact-intensive “rule of reason” analysis, and courts have recognized that such agreements are often procompetitive. In State Oil Co. v. Khan, the Supreme Court noted that, where there is vigorous competition, a per se rule against vertical maximum price fixing could actually be harmful to competition and consumers’ welfare. Notably, there have been no federal court decisions since Khan in which a vertical maximum price fixing arrangement has been found unlawful under the rule of reason. Courts and the state and federal antitrust agencies have not hesitated, however, to condemn what they view as minimum price fixing arrangements.

Strictly speaking, RPM is not per se unlawful unless there is an actual agreement committing the distributor to adhere to specific prices. As we shall see, however, any requirement to abide by a floor price, other than a truly unilateral, take-it-or-leave-it policy, will, as a practical matter, be viewed by courts as a tacit agreement between suppliers and distributors to fix prices, and will be considered per se unlawful.

These rules apply to any franchise system in which the franchisees resell products sold to them by the franchisor. In such a system, it is clear that a franchisor may not fix the price at which its franchisees must resell the product. But this does not mean that a franchisor’s hands

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9 Id. at 18.
10 See ANTITRUST ADVISOR § 2.16, at 2-30 (4th Ed. 2001). It is important to note, however, that some states may not follow Khan under their comparable antitrust statutes. See, e.g., Langer, supra note 5 (noting that California may continue to apply the per se rule to maximum resale price maintenance). Because Khan is a relatively recent decision and its application under state law remains to be seen, franchisors and suppliers should be aware of the potential for liability under state law as well.
13 Infra notes 23-29 and accompanying text.
are tied when it comes to franchisee pricing. To the contrary, franchisors still may influence franchisee pricing in a number of important ways.

a. Setting a Price Ceiling, Not a Floor

Under the federal law since Khan, a franchisor can generally require its franchisees to participate in a marketing promotion that sets the price of a product at no higher than a pre-determined price nationwide (e.g., a “99 cent-or-under” menu) or requires a particular discount off each sandwich (e.g., retail minus $1.00). In both cases, the promotion sets the price ceiling and not the floor; franchisees are free to sell the sandwiches at an even lower price (or a steeper discount) if they choose. So long as franchisees are free to sell the product at a lower price, the arrangement would be analyzed under the rule of reason and generally will not run afoul of Section 1.

b. “Suggested” Resale Prices

Franchisors can provide their franchisees with suggested resale prices, whether in the form of price lists, menu boards, pre-ticketed items or otherwise. Such suggestions are not unlawful, even if the franchisees ultimately adhere to the recommended pricing, so long as each franchisee “independently decides to observe specified resale prices.”

A much-litigated issue is whether a seller, by unduly aggressive tactics, can be said to have coerced a buyer’s adherence to a certain pricing policy, thereby engaging in collective action. Such tactics as penalizing non-cooperating dealers in product allocation and delivery, requiring approval of deviations from suggested pricing, and threats and imposition of sanctions for noncompliance, have been deemed evidence of coercion.

At the same time, some courts have upheld actions that come quite close to actual coercion. In Curry v. Steve’s Franchise Co., for example, an ice cream shop franchisor provided its franchisees with a menu board that stated the prices for the various ice cream products sold at the store. After the franchisee raised prices by 10% (this case was pre-Khan), a representative of the franchisor visited the franchisee’s stores and physically altered the prices on the stores’ menu boards and cash registers. On the franchisor’s motion to dismiss franchisee’s resale price maintenance claims, the district court concluded that, notwithstanding the representative’s actions, the franchisees were not coerced or harassed into maintaining resale prices, in part because the franchisee did not allege that the franchisor threatened “adverse consequences of noncompliance.”

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14 Khan, 522 U.S. 3. But again, care must be taken to ensure that state law principles do not differ. See supra note 11.
16 E.g., Acquaire v. Canada Dry Bottling Co. of N.Y., Inc., 24 F.3d 401, 410 (2d Cir. 1994); Gray v. Shell Oil Co., 469 F.2d 742, 748 (9th Cir. 1972).
20 Id. at *4.
are distinct from coercion. . . . The [franchisee’s] affidavit does not indicate that [his] independent discretion as to pricing was not maintained.”

Of course, a different court might have viewed the facts differently and concluded that the franchisor’s conduct crossed the line.

c. Unilateral Pricing Policy and Refusal to Deal With Violators

Because Section 1 of the Sherman Act only prohibits agreements or conspiracies in restraint of trade, a franchisor, like any supplier, can (at least in theory) simply announce its resale prices in advance and unilaterally refuse to deal with those who refuse to comply. Such unilateral pricing policies are known as “Colgate” policies, after the Supreme Court decision that announced this principle. As the Supreme Court later explained in Monsanto Co. v. Spray-Rite Service Corp., “under Colgate, a manufacturer can announce its resale prices in advance and refuse to deal with those who fail to comply. And a distributor is free to acquiesce in the manufacturer’s demand in order to avoid termination.” While manufacturers in numerous industries have successfully adopted such Colgate pricing policies, embarking on a unilateral pricing program is a complicated enterprise that should not be considered lightly.

First, all Colgate programs must be carefully defined and strictly enforced to ensure that they are truly “unilateral” and that there is no concerted action with the resellers. Thus, the franchisor cannot negotiate with non-compliant franchisees, but must terminate them (or at least their right to sell the products at issue) upon any violation of the policy. For these reasons, while it is relatively easy to draft a Colgate unilateral-price policy, it is often quite difficult to enforce one— as it flies in the face of the common instinct to try to persuade recalcitrant distributor/franchisees to cooperate rather than terminate them on the spot.

Note that termination of a discounting franchisee following complaints by other franchisees does not necessarily imply an agreement on resale price, and challenges to such conduct are frequently rejected. However, a franchisor may not terminate a price-cutting franchisee as part of an agreement (express or implied) with other, remaining franchisees to charge a set price. In addition, if a franchisor imposes a price restriction as a direct result of pressure from other franchisees (and not because it is in the franchisor’s independent interest to

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21 Id. at *3.
24 E.g., United States v. Parke, Davis & Co., 362 U.S. 29 (1960) (ruling that supplier may not seek promise from distributor to stop discounting); see JALA v. W. Auto Supply Co., 1995-2 Trade Cas. (CCH) ¶ 71,173, 1995 WL 463683 (D. Me. July 26, 1995) (“Acquiescence because of a fear of termination does not create an agreement.”) (quoting PHILLIP AREEDA, ANTITRUST LAW ¶ 1451d, e at 127, 128 (1986)).
25 E.g., Euromodas, Inc. v. Zanella, Ltd., 368 F.3d 11, 26 (1st Cir. 2004) (no evidence of an agreement on price or price levels with the remaining distributor, as needed to establish per se violation); Ezzo’s Invs., Inc. v. Royal Beauty Supply, Inc., 243 F.3d 980 (6th Cir. 2001) (application of the rule of reason proper where plaintiff failed to present evidence of a price agreement within the challenged vertical restraint); Rossi v. Standard Roofing, Inc., 156 F.3d 452 (3d Cir. 1998) (“were this simply a vertical conspiracy . . . we would analyze it under the rule of reason unless there was some evidence of price fixing”); Bailey’s, Inc. v. Windsor Am., Inc., 948 F.2d 1018 (6th Cir. 1991) (summary judgment affirmed; termination after complaints of price discounting upheld in absence of agreement to set resale prices); Jeanery, Inc. v. James Jeans, Inc., 849 F.2d 1148, 1160 (9th Cir. 1988) (JNOV upheld where no evidence that, in response to manufacturer’s coercive tactics, terminated dealer or other dealers communicated acquiescence to suggested price).
do so) a court could find that such a “nominally vertical arrangement [was] in fact . . . a horizontal one in disguise,” and deem the conduct per se unlawful on those terms.27

Second, many state franchise and distribution statutes prohibit unilateral termination of resellers except in certain narrow circumstances.28 Thus, while a unilateral pricing program calling for termination of recalcitrant distributors/franchisees might be permissible under the Sherman Act, it might nevertheless violate state law. Careful review of all applicable state laws is therefore critical before embarking on any Colgate pricing program.

d. Consignment and Agency Arrangements

Where there is no “sale” of product to a franchisee for resale, franchisors and suppliers cannot be liable for price fixing. Thus, if a franchisor supplies products to end users via its franchisees under a genuine consignment arrangement, without transferring control, title and risk of loss in that product to the franchisees, then the franchisor generally can set the resale price unilaterally.29 Similarly, franchisors do not engage in unlawful resale price maintenance when they set the price at which their commissioned sales agent or employee must sell products.30 The question in many cases is whether a true agency relationship exists between the manufacturer and its resellers.31 As with Colgate programs, trying to fit a franchisee pricing program under this “agency” rubric can raise numerous other complications and should not be considered lightly.32

e. Advertising Prices

Franchisors generally can advertise their “suggested” prices directly to the consumer – for example, a nationally-advertised “99¢ Menu.” Although franchisees might feel pressure to comply with the pricing once consumers are aware of it, courts have held that such direct-to-consumer advertising does not constitute “coercion” sufficient for a finding of antitrust conspiracy.33 Thus, a franchisor might make a suggested pricing program “voluntary” for franchisees, while advertising the prices directly to consumers to obtain compliance without an “agreement.”34 In fact, in Jack Walters & Sons Corp. v. Morton Building, Inc., Judge Posner,

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27 E.g., Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215, 1231 (8th Cir. 1987); Bus. Elecs., 485 U.S. at 720 n.4 (“[A] facially vertical restraint imposed by a manufacturer only because it has been coerced by a ‘horizontal cartel’ agreement among its distributors is in reality a horizontal restraint.”).

28 See, e.g., Wisconsin Fair Dealership Law, Wis. Stat. § 135 (prohibiting termination or substantial change in competitive circumstances of franchisee, distributor or dealers without cause and opportunity to cure).


30 See, e.g., Day v. Taylor, 400 F.3d 1272 (11th Cir. 2005) (examining indicia of agency to conclude that U-Haul’s relationship with its independent dealers was genuine agency).

31 E.g., Simpson, 377 U.S. at 13 (finding that the alleged consignment/agency relationship between supplier and distributor was a sham used to establish resale price maintenance).

32 For example, a true agency relationship with franchisees can give rise to liability and other issues that franchisors often strive to avoid.

33 E.g., Acquaire v. Canada Dry Bottling Co., 24 F.3d 401 (2d Cir. 1994); Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698 (7th Cir. 1984).

34 Note, however, that to avoid liability for false advertising, direct-to-consumer advertising of this sort generally must carry an “at participating stores only” caveat. E.g., Murphy v. White Hen Pantry, Bus. Franchise Guide (CCH) ¶ 7716, No. 79-C-460, 1981 WL 2215, *3-4 (E.D. Wis. Aug. 6, 1981), aff’d, 691 F.2d 350 (7th Cir. 1982).
writing for the court, found no conspiracy to fix prices where the manufacturer exerted some pressure on dealers to comply with nationally advertised prices, concluding that:

[If it is lawful to advertise a retail price, it should be lawful to take at least the minimum steps necessary to make that advertising beneficial. It would be pretty embarrassing for a manufacturer who had advertised a special retail price to be bombarded by complaints from consumers that dealers were refusing to sell to them at that price. Such refusals would make the advertising misleading and might even expose the manufacturer to legal sanctions under the Federal Trade Commission Act or counterpart state regulations. . . . [Thus, the defendant] had to pressure its dealers to lower price in order to maintain the credibility of its price advertising.\textsuperscript{35}

Cooperative advertising programs that contain price restrictions – i.e., where advertising co-op funds are only available for advertisements that comply with the manufacturer’s suggested pricing – were once considered close enough to actual coercive price maintenance to warrant treatment as \textit{per se} unlawful.\textsuperscript{36} However, the Federal Trade Commission now analyzes cooperative advertising arrangements under the rule of reason, so long as the arrangements do not limit the dealer’s right: (1) to discount below the advertised price, and (2) to advertise at any price when the dealer itself pays for the advertisement.\textsuperscript{37} Cooperative advertising programs that deny co-op payments to retailer advertisements that include prices below a “minimum advertised price” ("MAP") are generally upheld under the rule of reason, so long as the retailers are allowed to advertise below the MAP at their own expense, and to sell below MAP.\textsuperscript{38}

Note, however, that a prohibition on advertising below MAP regardless of whether or not the manufacturer is contributing to the costs of the advertising, and particularly where the restrictions effectively prevent sales at discount prices, is far more problematic. In a recent series of cases, the FTC entered into consent orders restricting the major music companies from making their retailers’ receipt of cooperative advertising or other promotional funds contingent on MAP that included prohibitions on all discount advertising, including ads funded by the retailer and those in the store itself. Such restrictive rules were deemed to effectively prevent any discounting, and were therefore \textit{per se} illegal.\textsuperscript{39}

The CD-MAP cases illustrate that a franchisor cannot prohibit its franchisees from advertising prices below the franchisor’s suggested resale prices if the effect of the prohibition would be to prevent franchisees from \textit{selling} at prices lower than the suggested resale price. The prevalence of internet retailing illustrates how fine this line may be to walk in practice. In brick-and-mortar franchises – where there is actually a “store” for consumers to visit – a MAP restriction that is properly limited to off-premises advertising would generally not limit the

\textsuperscript{35} Jack Walters, 737 F.2d at 708 (note, however, that because \textit{Jack Walters} involved manufacturer pressure to lower prices, rather than raise them, the rule of reason would likely apply today under \textit{Khan} in any event).


\textsuperscript{37} E.g., \textit{In re Am. Cyanamid Co.}, 123 F.T.C. 1257, 1265 (1997).

\textsuperscript{38} E.g., \textit{In re Advertising Checking Bureau}, 109 F.T.C. 146, 147 (1987).

franchisee’s ability to sell at lower prices. If a franchisee exists solely on the internet, however, any franchisor-imposed restriction on advertising prices below MAP might also be deemed to restrict the franchisee’s ability to sell its product at lower prices through its website.40

f. Promotional Pricing and Requiring Pass-on to Downstream Retailers or Consumers

Following from the general rule that setting maximum prices, rather than minimum, is generally viewed as procompetitive and beneficial to consumers, manufacturers may require that their distributors pass on discounts to downstream retailers or consumers, where the arrangement does not prohibit the distributor from offering greater discounts than the manufacturer provides.41 They may also adjust their pricing to distributors based on competitive changes in the resale market, again so long as they do not actually mandate resale prices.42

Franchisors may also be granted more leeway in requiring franchisees to adhere to special pricing in a limited-time promotional setting, especially where the franchisor bears the burden of the discount, either by reducing its wholesale prices or by providing money back to the franchisees as a credit, rebate, or contribution of advertising dollars. For example, in Jack Walters, the Seventh Circuit upheld a manufacturer’s efforts to ensure that its dealers complied with special promotional pricing where the manufacturer gave the dealers a discount from the wholesale price to make it easier for them to offer consumers the special retail price, and the manufacturer wanted that discount to inure to the benefit of the consumers, not the dealers.43 Thus, the manufacturer’s actions in advertising the special price directly to consumers and monitoring its dealers to ensure that they sold product at no more than the advertised price were lawful.44

B. Do the Rules Change When a Franchisor Also Competes With Its Franchisees Through Company Stores, or Where the Franchisor Uses Franchisees to Service a National Accounts Program?

1. Dual Distribution Systems

Where a franchisor licenses franchisees to sell products but also operates its own corporate stores, there is some risk that courts will view any restrictions between the franchisor and the franchisees as horizontal (that is, between competitors), rather than as vertical, downstream arrangements. Because horizontal agreements are subject to heightened scrutiny under the antitrust laws (i.e., even maximum price fixing remains per se unlawful among competitors), classification of such arrangements often will be outcome determinative – per se unlawful if characterized as a horizontal restraint, but reasonable under the rule of reason if viewed as vertical (and falling outside the narrow contours of minimum RPM).

40 E.g., David Balto, Emerging Antitrust Issues In Electronic Commerce, 1999 ANTITRUST INSTITUTE DISTRIBUTION PRACTICES: ANTITRUST COUNSELING IN THE NEW MILLENNIUM (November 12, 1999), available at 1999 WL 1065039, at *15 (“If the website is not simply an advertisement, but takes purchase orders as well – the business is true electronic commerce, in other words – the prices listed are both part of the advertising and the equivalent of in-store price stickers, suggesting that the MAP restrictions would be the exact functional equivalent of resale price maintenance.”).

41 See AAA Liquors, Inc. v. Joseph E. Seagram & Sons, 705 F.2d 1203 (10th Cir. 1982) (a manufacturer who grants a discount from its own pocket through a distributor to its retailer has a legitimate interest in making sure that the distributor is not pocketing the price support instead of passing it on; it is not thereby coercing compliance with resale price).

42 E.g., Sun Oil Co. v. FTC, 294 F.2d 465 (5th Cir. 1961), rev’d on other grounds, 371 U.S. 505 (1963).

43 Jack Walters, 737 F.2d at 709.

44 Id.
Most courts generally treat non-price vertical restraints imposed by such “dual distributing” manufacturers as vertical restraints subject to the rule of reason. A manufacturer’s decision to make certain downstream sales on its own rather than through independent distributors or franchisees is an internal decision that, these cases conclude, should not turn an innocuous vertical restriction into a per se illegal horizontal agreement.

In Krehl v. Baskin-Robbins Ice Cream Co., franchisor Baskin-Robbins Ice Cream Co. (“BRICO”) operated on two levels: (1) as a licensor of independent area franchisors who established franchised stores, and (2) as an area franchisor itself, directly competing with its own licensees. Plaintiff franchisees alleged that this dual distribution arrangement constituted horizontal (and therefore per se illegal) market allocation. The Ninth Circuit disagreed. According to the court, “our inquiry focuses not on whether the vertical or horizontal aspects of the system predominate, but rather, on the actual competitive impact of the dual distribution system employed by Baskin-Robbins.” On the facts, the court concluded that “[w]e do not believe that BRICO’s decision to retain these [area franchisor] responsibilities in certain areas has any significant effect on competition. . . . Franchisees have failed to establish here any significant, adverse impact upon either interbrand or intrabrand competition.”

A similar analysis should apply to agreements on price in a dual distribution franchise arrangement. Generally speaking, suggested pricing programs that would otherwise pass muster under RPM principles (for example, because they only involve maximum resale pricing) should not violate Section 1 simply because the franchisor also operates company stores. Collective pressure from company stores and franchisee-owned stores on competing franchisees to stop discounting, however, may lead courts to find a horizontal price agreement.

2. National Account Programs

“National account” programs raise related issues. These programs typically involve agreements between manufacturers/franchisors and large customers, such as national retail chains or governmental units, pursuant to which the manufacturer either services these customers directly (to the exclusion of distributors/franchisees) or arranges to have these accounts serviced by distributors, on centrally-negotiated terms. National accounts may raise concern as a form of RPM where distributors are required (either by contract or in practical effect) to participate and sell product at prices set by the supplier.

However, where distributors’ participation in such programs is truly voluntary and they are not prohibited from competing with the manufacturer for the account outside of the program, courts have held that they do not run afoul of Section 1. As noted above, national account

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45 E.g., Elecs. Commc’ns Corp. v. Toshiba Am. Consumer Prods., Inc., 129 F.3d 240, 243 (2d Cir. 1997); Glacier Optical, Inc. v. Optique Du Monde, 46 F.3d 1141 (Table), 1995-1 Trade Cas. (CCH) ¶ 70,878, 1995 WL 21565 (9th Cir. Jan. 19, 1995); Smalley & Co. v. Emerson & Cuming, Inc., 13 F.3d 366 (10th Cir. 1993); White Motor Co. v. United States, 372 U.S. 253, 261 (1963) (where a truck manufacturer sold both to dealers and directly to certain customers, while prohibiting the dealers from selling to those customers, the court treated the relationship as vertical).

46 664 F.2d 1348 (9th Cir. 1982).

47 Id. at 1356.

48 Id.

49 E.g., Bostick Oil Co. v. Michelin Tire Corp., 702 F.2d 1207 (4th Cir. 1983) (holding that the formal voluntariness of a national account program was not a proper basis for the granting of a directed verdict for defendant when plaintiff had introduced sufficient evidence of defendant's efforts to pressure it into joining the program unwillingly).

50 E.g., Mularkey v. Holsum Bakery, Inc., 146 F.2d 1064, 1065 (9th Cir. 1998) (per curiam) (no RPM where bakery negotiated national pricing arrangement with 7-11 chain stores, since agreement provided that “chain-wide price list”.
programs can also be structured as a true consignment or agency relationship, such that the supplier enlists the assistance of its dealers to service the end user but the supplier itself retains title, makes the sale and bears the risk of loss. Because there is no independent "resale," this structure should avoid a claim of RPM even where dealer participation is mandatory.\footnote{51}

C. Can Franchisees Band Together to Agree on the Prices They Will Charge Consumers or the Prices They Will Pay for Products (i.e., Through a Buying Coop)?

Collective activities among franchisees themselves can raise a host of antitrust issues. For example, can franchisees jointly agree on a local promotional program, or share information about their pricing plans? Franchisees may also want to form an association and/or buying cooperative to pool their bargaining power when dealing with suppliers and the franchisor itself. How far can such an association go in negotiating with a supplier for lower prices for the franchisees collectively? And what rules apply, if any, to limiting the membership of and/or administering such a cooperative?

1. Are They Competitors?

Because horizontal agreements among competitors are often deemed \textit{per se} illegal, the first step in this analysis is determining whether the franchisees involved in the collaboration actually compete with each other. Where franchisees have exclusive territories or operate in geographically distinct markets, or sell to different categories of customer, agreements among such franchisees will be less suspect. However, even in a formally divided system, it is important to consider whether franchisees with seemingly "exclusive" territories are actually permitted to sell outside those territories – for example, if any sales occur across territorial boundaries, over the internet, or if consumers can cross territory lines to purchase from another franchisee.\footnote{52} All of these factors will affect whether franchisees, in reality, should be treated as horizontal competitors.

2. Franchisee Agreements to Sell at Common Price

An agreement between or among competing independent franchisees (either through an association or otherwise) to sell their product at a fixed price would likely be \textit{per se} unlawful under Section 1.\footnote{53} A \textit{per se} unlawful price fixing agreement need not involve an actual agreement as to the ultimate price: agreements to standardize credit terms, use uniform trade-in allowances or cash down payments, limit or establish discounts, restrict price or feature


\footnote{53}See Arizona v. Maricopa County Med. Soc’y, 457 U.S. 332, 348-55 (1982) (maximum price fixing); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 221-23 (1940) (setting of price floor); United States v. Trenton Potteries Co., 273 U.S. 392, 397-98 (1927) (“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.”).
advertising, discontinue free service and rig bids have all been summarily condemned as unlawful price fixing.\textsuperscript{54}

The \textit{per se} rule has also been applied to strike down agreements among competitors to limit production or quantity of product sold, on the theory that agreements to limit output will have a direct effect on price based upon the laws of supply and demand.\textsuperscript{55}

Notably, franchisee collaborations that result in agreements to fix price or divide markets are also not without risk to the franchisor. Where distributors band together to convince a manufacturer to boycott or harm a competing distributor (for example, a known discounter), the distributors and the manufacturer all may be liable under the \textit{per se} prohibition against horizontal agreements.\textsuperscript{56}

3. \textbf{Exchanges of Price-Related Information}

Unlike actual agreements relating to price, exchanges of price information among franchisees, or agreements to share pricing information – for benchmarking purposes, for example – are not necessarily illegal \textit{per se}.\textsuperscript{57} Under the rule of reason, such agreements are prohibited where they have, or are likely to have, an anticompetitive effect on the industry.\textsuperscript{58} The FTC and Department of Justice have promulgated safe harbors for exchanges of price-related information as well as general guidelines for exchanges that fall outside of these safe harbors.\textsuperscript{59} For example, under Statement 6 of the FTC and DOJ's \textit{Statements of Antitrust Enforcement Policy in Health Care}, which has been applied to exchanges outside of the health care realm, written surveys of price and cost information will not be challenged if the following conditions are satisfied:

1) the survey is managed by a third party (e.g., a purchaser, government agency, . . . consultant, academic institution, trade association);

2) the information provided by survey participants is based on data more than 3 months old; and

\textsuperscript{54} E.g., Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 692-93 (1978) (holding \textit{per se} unlawful a provision in an engineering society's canon of ethics that prohibited engineers from discussing prices with potential customers until after negotiations resulted in initial selection of an engineer – although the court analyzed the challenged canon at a level of detail resembling a rule of reason analysis).

\textsuperscript{55} E.g., Hartford-Empire Co. v. United States, 323 U.S. 386, 406-07, clarified, 324 U.S. 570 (1945); see also Nat'l Macaroni Mfrs. Ass'n v. FTC, 345 F.2d 421, 424 (7th Cir. 1965) (resolution by trade association of macaroni producers to produce macaroni with a reduced durum content in response to a shortage of durum wheat constituted \textit{per se} illegal horizontal agreement).

\textsuperscript{56} E.g., United States v. Gen. Motors Corp., 393 U.S. 333, 337-38 (1969) (holding unlawful under the rule of reason an exchange of information concerning the most recent price charged or quoted among sellers of corrugated shipping containers).

\textsuperscript{57} See DOJ/FTC Statements of Antitrust Enforcement Policy in Health Care ("Health Care Guidelines"), Statement 6 (August 1996) (while promulgated in connection with health care antitrust enforcement, these guidelines and safe harbors have been widely applied in diverse industries), available at http://www.ftc.gov/reports/hlth3s.htm.
3) there are at least five [franchisees] reporting data upon which each
    disseminated statistic is based, no individual [franchisee]'s data
    represents more than 25 percent on a weighted basis of that statistic, and
    any information disseminated is sufficiently aggregated such that it would
    not allow recipients to identify the prices charged . . . by any particular
    [franchisee].

Any joint franchisee information exchanges that comply with these standards will
withstand antitrust scrutiny. However, competitor exchanges of price and cost information
outside these boundaries run the risk of close scrutiny, and should be carefully evaluated by
counsel before they are initiated.

4. Purchasing Cooperatives

Not all agreements among competitors – even those involving price – are per se illegal.
Certain horizontal arrangements involving price may be evaluated under the rule of reason,
rather than summarily condemned, where they are designed to increase efficiency, create a
new product, or otherwise promote competition.

Joint purchasing as well as joint marketing and promotional arrangements may be tested
under the rule of reason where their potentially anticompetitive effects are “ancillary” to (that is,
reasonably necessary to achieve) otherwise procompetitive purposes. The Competitor
Collaboration Guidelines issued by the FTC and the Department of Justice recognize that many
collaborations can be procompetitive. In particular, with respect to buying cooperatives, the
Collaborations Guidelines provide:

Buying Collaborations. Competitor collaborations may involve agreements jointly
to purchase necessary inputs. Many such agreements do not raise antitrust
concerns and indeed may be procompetitive. Purchasing collaboration, for
example, may enable participants to centralize ordering, to combine warehousing
or distribution functions more efficiently, or to achieve other efficiencies.
However, such agreements can create or increase market power (which, in the
case of buyers, is called “monopsony power”) or facilitate its exercise by
increasing the ability or incentive to drive the price of the purchased product, and
thereby depress output, below what would likely prevail in the absence of the

60 Id.
61 E.g., Broad. Music, Inc. v. CBS, 441 U.S. 1, 18-21 (1979) (upholding, under rule of reason, an agreement by
    holders of copyrights to musical compositions to set a fee for a blanket license to their compositions, on the ground
    that the agreement was necessary for the license to be available at all); see also NCAA v. Bd. of Regents, 468 U.S.
    85, 98-104 (1984) (rule of reason applied to restraints on output of televised broadcasts of NCAA football games); but
    see Ind. Fed’n of Dentists v. FTC, 476 U.S. 447, 459-64 (1986) (striking, under the rule of reason, policy of dentists’
    association requiring members to withhold X-rays from insurers in connection with evaluating patient claims for
    benefits).
    the rule of reason, a purchasing cooperative among competing stationery retailers on the ground that such
    purchasing co-ops are “designed to increase economic efficiency and render markets more, rather than less,
    competitive,” and where the co-op did not control access to an input non-members needed to compete); Broad.
    Music, 441 U.S. at 18-21 (upholding, under rule of reason, an agreement by holders of copyrights to musical
    compositions to set a fee for a blanket license to their compositions, on the ground that the agreement was necessary
    for the license to be available at all).
63 Collaboration Guidelines, supra note 58.
relevant agreement. Buying collaborations also may facilitate collusion by standardizing participants’ costs or by enhancing the ability to project or monitor a participant’s output level through knowledge of its input purchases.64

To encourage buying cooperatives while combating the potential for a cooperative to exercise monopsony power in a relevant market, the Collaboration Guidelines establish a “safety zone” for purchasing collaborations that do not pose a significant threat to competition. The safety zone provides that the agencies will generally not challenge such a collaboration if the market share of the collaboration and the participants collectively account for no more than 20% of each relevant market in which competition may be affected.65 Collaborations with market shares exceeding the safety zones will not necessarily be challenged, but the agencies may take a closer look at the collaborations’ effect on the market and any procompetitive justifications.66

Applying these rules in the context of a particular franchisee association depends heavily on the definition of the relevant market affected by the collaboration. As discussed in more detail below in connection with franchise tying claims,67 defining the market can be tricky. In most cases, the relevant market will be the larger market for the types of products the franchisees purchase and resell (fast food, for example), and the franchisee association will easily fall under the safety zone’s market share caps. But in certain, rare instances, it is possible that the relevant market will be limited to the particular franchise system, thereby greatly increasing the likelihood that a franchisee co-op will exceed the safety zone.68

In any case, in light of the risk that they may be found to have market or monopsony power, or to control access to a product or input necessary for non-members to compete, it is prudent for all franchisee associations to comply with some basic standards.

In particular, franchisee cooperatives should ensure that “any limitations on membership [are] narrowly drawn, objective, nondiscriminatory, applied on a uniform basis, and related to some procompetitive process.”69 particularly where the effect of exclusion from the group is tantamount to a denial of access to necessary products, ingredients, supplies or other goods.70 Further, purchasing cooperatives are well-advised to have a neutral party, not affiliated with any participant, confidentially gather information about the franchisees’ purchasing needs and

64 Id., at § 3.31(a).
65 Id., § 4.2. See also Health Care Guidelines, supra note 60, Statement 7 (Policy on Joint Purchasing Arrangements) (often applicable in non-health care situations by analogy, these guidelines apply two different caps: the combined volume of the jointly-purchased products must not exceed 35% of the total purchases in the relevant market(s); and the cost of the jointly purchased products and services may not exceed 20% of the total revenues from all products and services sold by the competing participants).
66 Id.
67 See infra notes 186-215 and accompanying text.
68 See Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451 (1992) (denying summary judgment on claim that relevant market can never be limited to a single product, where evidence that purchasers of copiers were “locked-in” and faced substantial “information costs” when they made their initial purchase); see also discussion of Kodak infra notes 179-85 and accompanying text. The authors are unaware of any cases applying Kodak’s single-brand market analysis to franchisee buying cooperatives.
70 E.g., Nw. Wholesale Stationers, 472 U.S. at 296 ("[W]holesale purchasing cooperatives must establish and enforce reasonable rules in order to function effectively.").
negotiate pricing with suppliers.\textsuperscript{71} Finally, to further limit the antitrust risk, franchisees should not be required to buy through the coop, but should be permitted to negotiate separate pricing with suppliers if they choose.

D. **Can a Franchisor Charge Franchisees Different Prices for Products it Sells into the System for Resale?**

Suppose that a franchisor sells products to its franchisees for resale to end users. Suppose, further, that the franchisor determines that certain of its distributor franchisees are more efficient or profitable than others, and it wishes to offer them products at advantageous prices to reward and encourage their success (with the hope of increasing its own royalties and overall profits in the long run). Are there any limitations on its ability to do so? The answer is a resounding “yes.” The limits of such efforts are defined by the nuanced (and often-criticized) Robinson-Patman Act (“RPA”), whose key provisions are outlined below.

1. **Price Discrimination under the RPA**

Section 2(a) of the RPA prohibits sellers from discriminating in the price of goods of “like grade and quality” sold contemporaneously to more than one customer, where “the effect of such discrimination may be substantially (a) to lessen competition or . . . (b) to injure, destroy, or prevent competition with any person who either (i) grants or (ii) knowingly receives the benefit of such discrimination. . . .”\textsuperscript{72} The alleged injury to competition may be “primary line”, “secondary line”, or beyond.

**Primary Line Injury** is harm to the seller’s own competitors, and generally is limited to predatory pricing, or below-cost pricing with a reasonable prospect of recoupment – a very difficult standard to satisfy.\textsuperscript{73}

**Secondary Line Injury** is harm to the competitors of the “favored” purchaser. The majority of RPA cases involve secondary line injury, and thus the following discussion focuses on this type of claim. Under *FTC v. Morton Salt Co.*, secondary line injury is presumed where there is substantial price discrimination over time in the sale of a product that is resold in the same form in an industry in which competition is “keen.”\textsuperscript{74}

**Tertiary and Fourth Line Injury** is harm to the competitors of the customers of the “favored” purchaser, or to the competitors of the customers of the customers of the “favored” purchaser. The RPA does not limit the levels of injury for which complaints can be made, but evidentiary problems generally restrict claims beyond the tertiary level. In both tertiary and fourth-level cases, the plaintiff must prove that the “favored” purchaser actually passed on part of the discount, causing harm to competition on the next level.\textsuperscript{75}

\textsuperscript{71} *E.g.*, Funeral Home Joint Purchasing Caskets, 1999 WL 14657 (July 23, 1998) (DOJ letter approving a proposed joint purchasing arrangement in which the group would employ a full-time, independent buying agent to negotiate volume discounts with casket suppliers).


\textsuperscript{74} *FTC v. Morton Salt Co.*, 334 U.S. 37 (1948); *see also Falls City Indus.*, Inc. v. Vanco Beverage, Inc., 460 U.S. 428, 435 (1983).

\textsuperscript{75} *E.g.*, Minneapolis-Honeywell Regulator Co. v. FTC, 191 F.2d 786 (7th Cir. 1951).
The RPA’s restrictions apply to all franchise systems in which the franchisor sells commodities to franchisees for resale to end-users or otherwise. However, franchisors that require their franchisees to purchase products from independent suppliers and distributors would generally not be considered “sellers” under the RPA. Moreover, the RPA applies only to the sale of goods, not services or other intangible items. The Act also does not apply to non-sale transactions such as leases, bona fide agency or consignment arrangements, licenses, and loans.

2. The Elements of a Price Discrimination Claim

To make out a traditional discrimination claim under the RPA, an injured reselling customer must demonstrate a number of elements comprising its prima facie case:

1. The plaintiff must show “price discrimination,” which means nothing more than a difference in price. The “price” of a commodity includes all discounts, rebates and other allowances. Thus, charging two buyers the same list price, but providing a special rebate or incentive to one buyer and not the other, constitutes an actionable difference in price.

2. The commodities at issue must be of like grade and quality. Generally, if the products are materially distinguishable or customers prefer one product over another for performance reasons (not just because of a brand name), then the products generally are not of like grade and quality.

Under FTC v. Borden Co., brand differences alone do not cause otherwise physically identical products to be of unlike grade and quality. Thus, if a franchisor sells the identical product to different franchisee distributors under different brand names and for different prices – i.e., a “premium” branded product and a “standard” product – the products likely will be deemed of like grade and quality for purposes of the RPA. However, such a price difference may not actually violate the RPA, where consumer preferences indicate that the differences do not substantially lessen competition (the final element of the prima facie case, addressed below). In other words, if consumers value “premium” and “standard” branded products differently such that they do not consider them to be competitive (or interchangeable) products, there likely will be no harm to competition from the franchisor/supplier’s decision to price the brands differently, and the price difference should not violate the RPA.

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76 While Section 2(a) of the RPA technically applies to price discrimination among any customers, whether or not they are resellers, its requirement that the price discrimination “may substantially . . . lessen competition” effectively eliminates sales to end-users or, for example, to OEM customers who merely use the product as a minor component in a finished product. But see Corn Prods. Ref. Co. v. FTC, 324 U.S. 726, 739 (1945) (holding that RPA applied to discrimination in price of glucose to candy manufacturers, in light of findings that glucose is a “principal ingredient” of low priced candy and that differences of small fractions of a cent in the sales price of such candy are enough to divert business from one manufacturer to another).

77 E.g., Yellow Page Solutions, Inc. v. Bell Atl. Yellow Pages Co., 2002-1 Trade Cas. (CCH) ¶ 73,556, 2001 WL 1468168, at *10 (S.D.N.Y. Nov. 19, 2001) (Act does not apply because newspaper advertising is a service, not a good).


79 E.g., Rose Confections, Inc. v. Ambrosia Chocolate Co., 816 F.2d 381 (8th Cir. 1987).

80 E.g., Utah Foam Prods. Co. v. Upjohn Co., 154 F.3d 1212, 1217-18 (10th Cir. 1998); see also Dyno Nobel, Inc. v. Amotech Corp., 63 F. Supp. 2d 140 (D.P.R. 1999) (blasting caps sold to two distributors at different prices were not of like kind and quality where the caps sold to one distributor were “old, obsolete or approaching the end of their shelf lives”).

3. There must be two (completed) sales – one to each of two different purchasers. Thus, as noted above, licenses, consignments, product swaps, and uncompleted offers to sell are not covered by the Act. Furthermore, if a buyer declines to buy a product from a seller because of the discriminatingly high price being offered, the buyer cannot bring a claim under the RPA. A buyer only has a claim if it actually bought the product at the higher price.

The U.S. Supreme Court in Reeder-Simco GMC v. Volvo GM Heavy Truck Corp., considered a challenge by Reeder-Simco, a Volvo heavy-duty truck dealer, to Volvo’s practice of offering job-specific discounted quotes to dealers bidding on end-user jobs. In this industry, customers typically put out a bid for a certain number of trucks with particular specifications, and the trucks are built to order following a lengthy bidding process; dealers do not carry significant ready-built inventory. In most cases, moreover, the customer selects only one dealer for each manufacturer to bid on the job. The Court held, under these facts, that differences in price quotes offered to customers who were bidding on different end-user jobs – i.e., who did not use these quotes to compete for resale to the same downstream customers – did not violate the RPA. However, as relates to the “two sales” element of an RPA claim, the Court declined to go as far as Volvo sought (and as a few circuit courts have suggested), to find that differences in bid quotes could never constitute “sales” under the Act, even if the dealers are bidding on the same job, because only one of the competing bidders could actually win the bid and therefore make a purchase at the quoted price for resale.

Transfers within the same organization (such as from a manufacturer to its wholly-owned subsidiary) or to agents are also typically not considered “sales” under the RPA. Many courts have similarly held that a transfer between affiliated corporations does not constitute a “sale” under the RPA. In Kuligowska v. GNC Franchising, Inc., for example, the district court dismissed a price discrimination claim alleging that supplier General Nutrition Distribution, L.P. (“GND”) sold products to General Nutrition Corporation (“GNC”) for corporate-owned stores at prices lower than those at which it sold the same product to franchisees. Because GND was a wholly-owned subsidiary of GNC, the court held that the intra-corporate transfers between GND and GNC were not “sales” within the RPA. Under this reasoning, a franchisor that provides a better price on products to its corporate-owned stores than to its franchisees would not be subject to liability for price discrimination under the RPA.

4. The two sales must be made contemporaneously, which means within a reasonable time period and under similar market conditions, to be comparable for RPA

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82 E.g., Crossroads Cogeneration Corp. v. Orange & Rockland Utils., Inc., 159 F.3d 129, 142 (3d Cir. 1998).
84 See, e.g., Terry’s Floor Fashions, Inc. v. Burlington Indus., Inc., 763 F.2d 604, 615 (4th Cir. 1985) (no violation of RPA where supplier offered different quotes in competitive bidding, because no two “purchasers”); M.C. Mfg. Co. v. Texas Foundries, Inc., 517 F.2d 1059, 1067 n.17 (5th Cir. 1975), cert. denied, 424 U.S. 968 (1976) (similar); but see Am. Can Co. v. Bruce’s Juices, Inc., 187 F.2d 919 (5th Cir. 1951) (plaintiff could still be considered competing “purchaser” even if did not make particular purchase, if its failure to do so was “directly attributable to defendant’s own discriminatory practice”).
purposes. Depending on the nature of competition and pricing within the industry, a delay of five months or only one month could render the two purchases insufficiently contemporaneous for the RPA to apply.

5. To show the requisite harm to competition from the price discrimination in a secondary line discrimination case, the two sales generally must be made to two competing buyers – that is, to buyers who compete for the same customers and the same resale dollar. The reason for this requirement is the recognition that there can be no harm to competition if the favored purchaser and the non-favored purchaser do not actually compete for business.

A common issue arises in assessing whether resellers that operate in different territories are “in competition.” Franchisees with iron-clad exclusive and non-overlapping territories would likely not be deemed to be in competition, and a franchisor/supplier could charge them different prices for product without running afoul of the RPA. However, again, the availability of wide-ranging internet sales and the possibility of transshipping make it easier for geographically-distinct purchasers to be “in competition.” Overlapping territories, and the ability of customers to buy across territory lines, also make it more likely that distributors will be deemed to be in competition with each other. However, the Supreme Court in Reeder-Simco held that sales to resellers that do not compete for the same ultimate end-user customer, in a made-to-order, bid-based industry, are not covered by the RPA, even where the resellers operate in the same general geographic area.

Generally, price differences to different distributive classes (i.e., wholesalers vs. retailers) are permitted, if the differentials correspond to the particular customer’s rung in the distributive ladder. Buyers who generally sell at different distributive levels may be “in competition” if they compete for the same accounts. However, the Hasbrouck Court recognized the validity of true “functional discounts,” addressed below.

Until the Supreme Court’s decision in Reeder-Simco, most courts applying the RPA to secondary-line claims had held that harm to an individual competitor, rather than to interbrand competition more broadly, was sufficient to state a claim under the RPA. However, the Court in Reeder-Simco took a different view, stating (arguably in dicta) that “[t]he Robinson-Patman Act signals no large departure from” the primary focus of antitrust on interbrand, rather than intrabrand, competition. Moreover, the Court continued, “we would resist interpretation [of the Act] geared more to the protection of existing competitors than to the stimulation of competition,” and “continue to construe the Act ‘consistently with broader policies of the antitrust laws.’” In so holding, the Court arguably aligned the application of the Act to secondary line claims with

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89 E.g., Coastal Fuels of Puerto Rico, Inc. v. Caribbean Petroleum Corp., 990 F.2d 25, 27 (1st Cir. 1993); Motive Parts Warehouse v. Facet Enters., 774 F.2d 380, 389-90 (10th Cir. 1985).
90 E.g., Godfrey v. Pulitzer Pub’g Co., 276 F.3d 405, 409 (8th Cir. 2002); Best Brands Beverage, Inc. v. Falstaff Brewing Co., 842 F.2d 578, 584-85 (2d Cir. 1987).
91 E.g., Com Prods. Ref. Co. v. FTC, 324 U.S. 726 (1945).
92 E.g., Nat’l Ass’n of College Bookstores, Inc. v. Cambridge Univ. Press, 990 F. Supp. 245, 253 (S.D.N.Y. 1997) (noting that Amazon.com competes in every retail book market in which there are customers with internet access).
93 Reeder-Simco GMC, --- U.S. ---, 126 S. Ct. 860.
95 E.g., Chroma Lighting v. GTE Prods. Corp., 111 F.3d 653, 656-57 (9th Cir. 1997); J.F. Feerer, Inc. v. Serv-a-Portion, Inc., 909 F.2d 1524, 1535 (9d Cir. 1990); Alan’s of Atlanta, Inc. v. Minolta Corp., 903 F.2d 1414, 1418 n.6 (11th Cir. 1990). But see, e.g., Richard Short Oil Co. v. Texaco, Inc., 799 F.2d 415, 420 (8th Cir. 1986) (need to show harm to competition); Motive Parts Warehouse v. Facet Enters., 774 F.2d 380, 395 (10th Cir.1985) (same).
96 Reeder-Simco GMC, --- U.S. at ---, 126 S. Ct. at 872.
97 Id. at 873.
the approach already taken in connection with allegations of primary line injury – requiring a showing of harm to competition generally, and not merely harm to an individual competitor.98

3. **Defenses to and Justifications for Price Discrimination**

Assuming the complaining franchisee can demonstrate each of the elements of the *prima facie* case, the RPA statute offers the selling franchisor three potential defenses to liability for price discrimination:

1. **Cost Justification:** Section 2(a) of the RPA specifically states that “nothing herein contained shall prevent differentials which only make due allowance for differences in the cost of manufacture, sale or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered.”99 Under this defense, for example, manufacturers may be able to offer a discount to large customers who purchase by the truckload as compared to other customers who purchase by the boxload, so long as the discount equates to the different marginal cost of sales to these types of customers. The cost justification defense has been called “largely illusory in practice” because it is so difficult to establish.100 However, the defense may be available to a company that closely tracks the cost of production, marketing, and delivery of its goods such that it has contemporaneous cost studies that may be used to justify differential pricing to different customers or classes of customers.

2. **Meeting Competition:** Section 2(b) of the RPA provides that “nothing herein contained shall prevent a seller from rebutting a prima-facie case by showing that its lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor.”101 The Supreme Court has stated that the test for determining whether a seller has a valid “meeting competition” defense is whether the seller can “show the existence of facts which would lead a reasonable and prudent person to believe that the granting of a lower price would in fact meet the equally low price of a competitor.”102

To establish the required “good faith,” it is important for a seller to have documentation or other proof that the lower price was a *bona fide* attempt to meet competition.103 Thus, a seller must evaluate a buyer’s claim of a lower competitive offer by such means as written verification from the buyer; corroborating reports from other customers; previous experience with the buyer and the market; available documentary evidence and market data; and otherwise assessing the credibility of a threat not to purchase from the seller if the discount is not met. Note that it is not sufficient for the seller to establish that there was general competition in the marketplace and the threat of reduced sales as a result of that competition.104 Instead, the seller must demonstrate that it was trying to meet an equally low price from a competitor. Because of the risk of collusive action (prohibited under the Sherman Act), however, the seller may not communicate directly with the competitor in an attempt to verify a competing price.105

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Meeting competition may be used as a defensive measure (e.g., to keep from losing existing customers) or on the offensive (e.g., in an attempt to attract new customers).\textsuperscript{106} A seller may rely on the defense to lower its prices to an individual customer who alerts the seller to a competitive offering, or on an area-wide basis.\textsuperscript{107} Finally, although a seller is required to “meet, not beat” the competitor’s price, where a seller makes a good faith effort but is unable to verify the amount of a competing offer, the seller retains the meeting competition defense even if it unknowingly beats it.\textsuperscript{108}

Walker v. Hallmark Cards, Inc.\textsuperscript{109} offers an example of the meeting competition defense in a franchise context. There, Walker, \textit{dba} Great’s Hallmark Shop, alleged that the defendant was selling product to a local Walgreens store on more favorable terms than it was selling to plaintiff. Defendant successfully used the meeting competition defense to defend the differential pricing by showing that its primary competitor (American) made sales to Walgreens that were on more favorable terms than Hallmark’s sales, and that Hallmark’s relationship with Walgreens could be in jeopardy if Hallmark did not attempt to meet American’s terms.

3. Changing Conditions: Section 2(a) of the RPA provides that “nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to: actual or imminent deterioration of perishable goods; obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned.”\textsuperscript{110} Thus, price discrimination between customers of seasonal or perishable goods, such as eggs and dairy products, is permissible.\textsuperscript{111} Some courts have applied this defense where the rapid development of technology renders a product obsolete.\textsuperscript{112}

In addition to the statutory defenses, there are two court-created “justifications” for price discrimination that can be used to negate a plaintiff’s claim that competition was harmed by a price difference. Both of these justifications have taken on substantial importance for manufacturers fighting claims of discrimination.

1. Functional Availability: A price discount that is equally available to all purchasers is not price discrimination, even if certain customers choose not to partake of the available discount program. “Availability” requires that all competing purchasers know about the lower price or discount program, although it is not entirely clear whether this requires sellers to affirmatively communicate price discounts to all customers.\textsuperscript{113} In addition, and importantly, the lower price or discount program must be “functionally” available — that is, within the practical reach of most customers. In other words, a manufacturer cannot announce a discount program with bronze, silver, gold and platinum volume levels, where the higher discount levels are well

\textsuperscript{106} E.g., Falls City Indus., 460 U.S. at 446.
\textsuperscript{107} See id. at 448-449.
\textsuperscript{108} Great Atl. & Pac. Tea Co., Inc. v. FTC, 440 U.S. 69, 82-83 (1979); Hillside Dairy Co. v. Fairmont Foods Co., 667 F.2d 1026 (Table), 1981-2 Trade Cas. (CCH) ¶ 64,375 (6th Cir. 1981).
\textsuperscript{109} 992 F. Supp. 1335 (M.D. Fla. 1997).
\textsuperscript{112} Comcoa, Inc. v. NEC Tels., Inc., 931 F.2d 655 (10th Cir. 1991).
\textsuperscript{113} Compare Caribe BMW, Inc. v. Bayerische Motoren Werke Aktiengesellschaft, 19 F.3d 745, 752 (1st Cir. 1994), with Klamath-Lake Pharm. Ass’n v. Klamath Med. Serv. Bureau, 701 F.2d 1276, 1283 (9th Cir. 1983). Note that it is clear that affirmative communication to all customers is required for promotional allowances under § 2(d) and § 2(e) of the Act. See infra note 125 and accompanying text.
beyond the total annual purchases of most of the manufacturer's customers, and then defend the program as functionally available.\(^{114}\)

Where the qualifications for earning discounts are, in fact, equally available to all competing customers, however, this justification can be used to support a wide variety of discount programs – including, for example, loyalty programs (i.e., discounts for committing 75% of the distributor’s capacity to the manufacturer) and rebates based upon hitting set percentage growth targets. Of course, such programs must also pass muster under the Sherman Act, as discussed in the second half of this paper.\(^ {115}\)

2. Functional Discounts: Based on the Supreme Court’s decision in *Texaco, Inc. v. Hasbrouk*, sellers may also provide a “functional” or trade discount that is “given to a purchaser based upon its role in the supplier’s distributive system, reflecting, at least in a generalized sense, the services performed by the purchaser for the supplier.”\(^{116}\) The discount is intended to compensate customers, typically on a different functional level from other resellers, for undertaking valuable marketing or distribution services – such as warehousing, shipping, offering a showroom and trained sales staff, etc. – that would have otherwise fallen on the seller. Such a discount must bear a reasonable relationship to the value of the services to the supplier or the cost to the distributor/wholesaler of the wholesaler’s actual marketing functions.\(^ {117}\) The functional discount should be given to any customer providing equivalent services. Note also that where a distributor serves a dual role – i.e., as both a wholesaler and a retailer – and only provides distribution-related services in connection with one of those roles, any functional discount must be limited to those goods with respect to which it provides the services.\(^ {118}\)

This “defense” is generally explained as either a variant of the cost justification defense (although the relationship between the discount and the cost/value of the service provided may be less precise in the case of the functional discount than in the stringent cost justification analysis), or as negating a finding of competitive injury because the discount is deemed to be absorbed in the cost of the service, so that no price difference is passed on to consumers. Under the latter logic, where the discount actually results in a loss of sales to favored distributors, courts are likely to reject the defense. Thus, in *Schwartz v. Sun Co., Inc. (R&M)*, the Sixth Circuit affirmed the district court’s ruling rejecting the defendant’s functional discount defense where defendant sold gasoline to “jobbers” at lower prices than to non-jobber distributors.\(^ {119}\) The court found injury to competition in the fact that the volume of gasoline sold at plaintiff’s stations decreased when the jobbers opened stations nearby, selling the same gas at a lower retail price.\(^ {120}\) According to the court, “it is sensible to acknowledge that whenever

\(^{114}\) E.g., *Morton Salt*, 334 U.S. at 42-43 (volume discount program not functionally available as no single independent grocery store or distributor could purchase enough salt to receive the maximum discount, and some customers could not purchase enough salt to receive any discount at all).

\(^{115}\) See infra Section III.


\(^{117}\) *Id.* (holding a functional discount unreasonable because it was “untethered to supplier’s savings or the wholesaler’s costs”). See also George Haug Co., Inc. v. Rolls Royce Motor Cars Inc., 146 F.3d 136, 142 (2d Cir. 1998) (whether “functional discounts” offered to one purchaser were in fact legitimate functional discounts or subterfuges to avoid section 2(a)’s restrictions presented question of fact precluding summary judgment).

\(^{118}\) See *Hasbrouk*, 496 U.S. at 561 (a dual distributor is only “eligible for a discount corresponding to any part of the function he actually performs on the part of the goods for which he performs it”).

\(^{119}\) *Schwartz v. Sun Co., Inc. (R&M)*, 276 F.3d 900 (6th Cir. 2002).

\(^{120}\) *Id.* at 905.
there is price discrimination of the sort involved here, the overall financial health of the
disfavored purchaser will usually be affected for the worse."121

E. Can a Franchisor Provide its Franchisees with Differential Promotional Services and Advertising Allowances?

Suppose a franchisor wants to provide an advertising co-op program that offers large franchisees a co-op payment of 5% of their prior year’s sales, and competing smaller franchisees a payment of 3% of their prior year’s sales. Will this pass muster under the RPA? The short answer, spelled out in more detail below, is no.

1. Promotional Allowances Under the RPA

Because they are seen as enabling “hidden” discrimination more easily than direct favoritism in distributors’ purchase prices, advertising and promotional allowances are treated more stringently than pure price discrimination. Sections 2(d) and 2(e) of the Act prohibit sellers from furnishing promotional or advertising services to buyers related to the buyer’s resale of the product (or compensating buyers for those advertising or promotional services) unless the payments or services are made available to all competing customers on proportionally equal terms. These sections are implicated when the seller either provides such services or pays the buyer for promotional services rendered by the buyer.122

The distinction between discrimination covered by sections 2(d) and (e) and that under section 2(a) can sometimes be elusive. Simply put, sections 2(d) and (e) cover “resale”-related allowances and services, while section 2(a) regulates discrimination in the initial sale from the manufacturer to the reseller. Thus, sections 2(d) and (e) cover such promotional services and products as: cooperative advertising; handbills; demonstrators and demonstrations; catalogues; display cabinets; displays; prizes or merchandise for conducting promotional contests; and special packaging, or package sizes. By contrast, section 2(a) of the Act would apply to discriminatory discounts or rebates applied to a distributor’s purchase price. It is important to remember that there can be a violation of sections 2(d) and (e) of the RPA even when there is no price discrimination under section 2(a).123

To comply with both sections 2(d) and 2(e), a seller must take affirmative action to inform customers of any available promotions.124 Proportionally equal terms means that the terms must be fair and reasonable to all customers; “fairness” and “reasonableness” can be determined based on the quantity of goods purchased from the seller during a specified period of time, by the dollar volume of each buyer’s purchases, or by other methods. For example, offering an equivalent percentage of the prior years’ sales to all customers would satisfy the proportionality requirement (even though the larger customer would obviously earn a higher absolute total of co-op dollars), but providing a greater percentage return to a larger customer would not.

121 Id.
123 E.g., Maddaloni Jewelers v. Rolex Watch USA, Inc., 2003-2 Trade Cas. (CCH) ¶ 74,086, 2003 WL 21507529 (S.D.N.Y. June 30, 2003) (dismissing section 2(a) claims but holding that “the allegations concerning preferential treatment given to certain dealers fall under sections 2(d) and 2(e)”).
124 E.g., Vanity Fair Paper Mills, Inc. v. FTC, 311 F.2d 480 (2d Cir. 1962).
These sections of the Act are often described as essentially *per se*, as most of the defenses available under section 2(a) are not available, and a plaintiff need not prove injury to competition. Only the meeting competition defense applies to sections 2(d) and (e).  

2. **Guidance for Promotional Programs**

Recognizing that the rules relating to promotional allowances and services can be complicated and difficult to implement, the FTC in 1969 issued a set of *Guides for Advertising Allowances and Other Merchandising Payments and Services* (“Fred Meyer Guides”). The Fred Meyer Guides provide useful guidance for complying with these sections of the Act, including practical examples clarifying the meaning of the critical proportionality requirement. In addition, the Guides recommend that a seller that grants promotional payments or services should do so under a plan, although it need not be written or formal.

3. **Vendor Rebate Programs**

Even if the franchisor does not actually supply franchisees with products for resale, franchisors may wish to receive payments from otherwise independent vendors that supply the franchise system. Such arrangements can take myriad forms, but are generally characterized by payments calculated – either directly or indirectly – as a function of purchases by franchisees. For convenience, such arrangements will be referred to as “vendor rebates.”

Franchisees and competing vendors have mounted various challenges to the legality of such arrangements. Most recently, plaintiffs have asserted that such payments constitute commercial bribery in violation of Section 2(c) of the Robinson-Patman Act, which prohibits payment or receipt of:

> commissions, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction, or to any agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.


While the nuances of challenges under this section are beyond the scope of this article, it is important to be aware that some courts have allowed such claims to survive at least early procedural challenges, while others have rejected them on various grounds. Based on the existing caselaw, it may help to deter commercial bribery and other Section 2(c)...

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125 E.g., *Simplicity Pattern*, 360 U.S. at 58-59 (“neither absence of competitive injury nor the presence of ‘cost justification’ defeats enforcement of the provisions [of § 2(d) and § 2(e)].”).


allegations if the payments: are fully disclosed;\textsuperscript{130} are up-front rather than calculated as a percentage of franchisee sales;\textsuperscript{131} are expressly made for valuable services rendered;\textsuperscript{132} do not “cross the buyer-seller line” (that is, the franchisor is not an agent or fiduciary of the franchisees and does not mandate their purchase of the product from the vendor from whom it receives the payments) and do not reflect the breach of a fiduciary duty.\textsuperscript{133} However, the district court in \textit{Substantial Investments, Inc. v. D’Angelo Franchising Corp.}\textsuperscript{134} rejected each of these defenses in denying defendants’ motion to dismiss. Because of the uncertainty of current law in this area, franchisors would do well to examine any vendor rebate programs carefully and keep a close eye on developments in this area as they establish their supply and distribution programs.

\section*{III. PRODUCT DISTRIBUTION}

\subsection*{A. Can a Franchisor Control the Products Its Franchisees Buy and From Whom They Buy Them? What Steps Can a Franchisor Take to Maximize Its Ability To Do This?}

The supply of products and services from a franchisor or franchisor-designated supplier to franchisees is generally permissible but can raise issues under federal and state antitrust laws. Such supply arrangements can and have been challenged as illegal tying arrangements. This portion of the paper will survey the principal antitrust issues which can arise in, and should be considered in planning, any such franchisor-franchisee relationship.

\subsubsection*{1. Basics of Tying}

An illegal tying arrangement involves an agreement by a party to sell one product (the desired or “tying product”) only on the condition that the buyer also purchase a second, distinct product (the “tied product”), where (a) the seller has sufficient economic power to restrain

\begin{itemize}
  \item \textsuperscript{131} August News Co. \textit{v. Hudson News Co.,} 269 F.3d 41 (1st Cir. 2001) (holding that 2(c) does not apply to up-front “access fees” or “signing bonuses” but only to payments connected to specific sales).
  \item \textsuperscript{132} E.g., Labrador, Inc. \textit{v. Iams Co.}, 1995-2 \textit{Trade Cas. (CCH)} ¶ 71,161, at 75,601, 1995 WL 714454 (C.D. Cal. Sept. 18, 1995) (payments made by manufacturer to retailers to defray promotional costs were within exception), \textit{aff’d}, 105 F.3d 665, 1997-1 \textit{Trade Cas. (CCH)} ¶ 71,740 (9th Cir. 1997) (unpublished); Thurman Indus., Inc. \textit{v. Pay ‘N Pak Stores, Inc.}, 709 F. Supp. 985, 997 (W.D. Wash. 1987) (“statute permits the buyer to perform some brokerage services for the seller and to receive compensation”), \textit{aff’d}, 875 F.2d 1369 (9th Cir. 1989); Kem-Tech, Inc. \textit{v. Mobil Corp.}, 1986-1 \textit{Trade Cas. (CCH)} ¶ 66,947, 1985 WL 3011 (E.D. Pa. Oct. 8, 1985) (complaint dismissed where no allegation that discount was not for services rendered); \textit{Stephen Jay Photography}, 713 F. Supp. at 937 (holding that the photographer’s payments were not proportionate to the services rendered, but that the level of services was irrelevant so long as they were more than \textit{de minimis}); Burge \textit{v. Bryant Pub. Schl. Dist.}, 658 F.2d 611, 612 (8th Cir. 1981) (similar).
  \item \textsuperscript{133} E.g., \textit{Stephen Jay Photography}, 903 F.2d at 993 (while the “schools arranged to have yearbook photographs taken by [the photographers] and encouraged the students to purchase portraits from them. . . . letters encouraging the students to purchase these photographs either expressly or implicitly indicated that their decision to purchase portraits was optional. . . . [As a result,] the schools did not assume a position resembling that of a portrait purchasing agent for the student. . . . Without such a relationship to connect the students’ purchasing decisions to the schools, the payment from the [photographers] to the schools does not cross the seller-buyer line”); Range, Inc. \textit{v. Sterling Nelson \& Sons,} 351 F.2d 851, 858 (9th Cir. 1965) (holding that payment constituted commercial bribery and violated section 2(c) where “the bribery not only undermined a fiduciary relationship which Congress sought to protect, but gave one seller a grossly unfair advantage over a competing seller”), \textit{cert. denied}, 383 U.S. 936 (1966); cf. \textit{Blue Tree Hotels Inv. (Canada), Ltd. v. Starwood Hotels \& Resorts Worldwide, Inc.}, 369 F.3d 212, 224 n. 9 (2d Cir. 2004) (“the proscriptions of § 2(c) apply regardless of whether the improper payment is made to the purchaser or its agent.”).
\end{itemize}
competition in the tied product and (b) a “not insubstantial” amount of interstate commerce is affected.135 The Supreme Court’s definition of “not insubstantial” is substantial enough in terms of dollar amount so as not to be merely de minimis.136 The principal concern with tying arrangements is that the tie-in allows the seller to extend its market power with respect to one product to a second and different product.137 Thus, the seller exploits its control over the tying product to force the buyer to purchase a product “that the buyer either did not want at all, or would have preferred to purchase elsewhere on different terms.”138

A required purchase of products from a third party can also amount to a tying arrangement if the seller of the tying product derives some economic benefit or has some economic interest in the third party’s sale of the tied product.139 Tying arrangements may be challenged under Section 1 of the Sherman Act, 15 U.S.C. § 1; Section 3 of the Clayton Act, 15 U.S.C. § 14,140 Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45; and various state antitrust laws.

2. Quality Control Mechanisms

In a franchise relationship, the franchisor may wish to have a high degree of control over the products and services sold throughout the franchise system as a method of maintaining the quality, uniformity and regularity of supply for such products and services. The quality of such items as perceived by the public will be associated with the franchisor and the franchise system, hence the image and integrity of the individual franchise is essential to the larger franchise system. In addition, under trademark law, the franchisor is under an obligation to control the use of the franchised mark.141

The franchisor has several options for effecting control over the quality of products sold in the franchise system, all of which create potential risks of an illegal tying claim. These options (listed in descending order of tying claim risk but in ascending order of monitoring costs for quality enforcement) include the franchisor: acting as the exclusive seller to the franchisee; acting as one of two or more sellers to the franchisee; designating sources of supply from which the franchisor receives a commission or other form of compensation; approving suppliers and receiving no commission; or setting product standards and specifications.

140 Section 3 of the Clayton Act applies only when both the tying and tied products are goods or other tangible commodities rather than services or other intangibles. Section 3 thus cannot apply to an alleged tying arrangement involving a franchise as the tying product. See, e.g., In re 7-Eleven Franchise Antitrust Litig., 1974-2 Trade Cas. (CCH) ¶ 75,429, 1974 WL 989 (N.D. Cal. Dec. 23, 1974); Crossland v. Canteen Corp., 711 F.2d 714 (5th Cir. 1983).
3. **Essential Tying Principles**

Tying arrangements may be found to be illegal *per se* if certain elements (discussed below) are proven.\(^{142}\) They may also be unlawful under a rule of reason analysis even if all of these elements are not present, although the authors are unaware of any case in which a court has so held. In *Jefferson Parish Hospital District Number 2 v. Hyde*,\(^{143}\) the court commented that "certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable *per se*.\(^{144}\) This however, does not mean the courts will not consider the pro-competitive effects of or possible justifications for tying arrangements, including those in franchisor-franchisee relationships.\(^{145}\)

Certain elements must be proven before a supposed tying arrangement will be condemned. At the core of unlawful tying arrangements is the forced purchase of a second product with the desired purchase of the “tying” product, resulting in economic harm to competition in the “tied” market.\(^{146}\)

In general, a tying arrangement will be *per se* unlawful if (1) the tying and tied products are separate and distinct, (2) the sale of one product is conditioned on the purchase of another, (3) the seller possesses economic power in the market for the tying products sufficient to enable it to force a buyer to purchase the tied product, and (4) there is an effect on a "not insubstantial" amount of interstate commerce.\(^{147}\) Most cases also require that the tie-in violator itself competes, or has another economic interest, in the tied product market.\(^{148}\)

4. **The Two Product Issue**

One of the principal tying issues found in franchising cases is whether the alleged tie involves two separate and distinct products. The franchisee or a supplier may assert that the franchise system’s trademark constitutes the tying “product” and that, as a condition of operating the franchise under the trademark, the franchisee is required to purchase various products, the tied products, from the franchisor.\(^{149}\)

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\(^{142}\) *See Fortner I*, 394 U.S. at 503 (tying arrangements “generally served no legitimate business purpose that cannot be achieved in some less restrictive way”).

\(^{143}\) 466 U.S. 2 (1986).

\(^{144}\) *Id.* at 9. Despite use of the *per se* label, imposition of the economic analysis requirements discussed below may suggest that the rule of the reason is really the operative approach. *See id.* at 34 (concurring opinion).

\(^{145}\) *See NCAA v. Bd. of Regents*, 468 U.S. 85, 104 n.26 (1984) ("[W]hile the Court has spoken of a ‘*per se*’ rule against tying arrangements, it has also recognized that tying may have procompetitive justifications that make it inappropriate to condemn without considerable market analysis."); *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, 922 F. Supp. 1055 (E.D. Pa. 1996), aff’d, 124 F.3d 430, 440-41 (3d Cir. 1997) (observing that courts and legal commentators have long recognized that franchise tying contracts prevent “free riding - offering products of sub-standard quality insufficient to maintain the reputational value of the franchise product while benefiting from the quality control efforts of other actors in the franchise system.").

\(^{146}\) *Times-Picayune Publ'g Co.*, 345 U.S. at 614.


\(^{148}\) *See* e.g., *Robert’s Waikiki U-Drive.*, Inc. v. *Budget Rent-A-Car Sys.*, 732 F.2d 1403, 1407-08 (9th Cir. 1984); *Beard v. Parkview Hosp.*, 912 F.2d 138, 139, 142-44 (6th Cir. 1990); *Keener v. Sizzler Family Steak Houses*, 597 F.2d 453, 456 (5th Cir. 1979); *Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc.*, 585 F.2d 821, 835 (7th Cir. 1978); *cert. denied*, 440 U.S. 930; *CTUnify, Inc. v. Nortel Networks, Inc.*, 115 Fed. Appx. 831 (6th Cir. 2004); *contra Gonzalez*, 880 F.2d at 1517.

\(^{149}\) *See* e.g., *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972) (cooking equipment, dry-mix food items and packaging were separate and distinct products from the trademark); *Midwestern...*
By contrast, franchisors typically assert that only one product, namely the complete franchise, is involved in the transaction between franchisor and franchisee. This assertion is often accepted when raised by a product distribution franchisor, and has met with some success in connection with business format franchises.

In Jefferson Parish, the Supreme Court held that anesthesiology services were a product separate from other hospital facilities and services. In doing so, the Court rejected the hospital’s claim that it was only providing a “functionally integrated package of services,” and stated rather that two products should be found where there is “a sufficient demand for the purchase of [the tied product] separate from [the tying product] to identify a distinct product market in which it is efficient to offer [the tied product] separately from [the tying product].”

The underlying Jefferson Parish test was further refined in Eastman Kodak Co. v. Image Technical Services, Inc., where the Court stated that two products will be found when there is “sufficient consumer demand so that it is efficient for a firm to provide [two products] separately.” In that case, the Court noted that the two items in dispute, copier replacement parts and service, were being sold separately both by the defendant and by others, and that some customers preferred the separate supply of such items. Therefore, the Court ruled that there was a triable issue of fact as to whether two products or only one existed.

A number of district court decisions have analyzed Jefferson Parish and Kodak’s consumer demand principles in the franchise context. In Little Caesar Enterprises v. Smith, a class of franchisees accused the franchisor of unlawfully tying to the franchise the sale of logoed napkins and condiments from a subsidiary. The court rejected the franchisor’s argument that the franchise and products were not in separate markets because the logoed items “could not be sold anywhere or used anywhere separate from a [Little Caesar’s franchise].” Instead, the court found that the proper test was whether it would be “efficient for a firm to provide [these items] separate from the [Little Caesar’s] franchise.” The court found that two distinct markets existed because, in the past, “other private distributors, unrelated to Little Caesar, sold all the goods and services necessary to run Little Caesars” franchises.

Using a similar analysis but holding in favor of the franchisor on the separate product issue, the court in Subsolutions, Inc. v. Doctor’s Associates, Inc. held that a corporation’s policy of requiring its Subway franchisees to replace cash registers with computer-based point

Waffles, Inc. v. Waffle House, Inc., 734 F.2d 705 (11th Cir. 1984) (Waffle House franchise constituted a product separate from equipment and vending services franchisees were required to purchase); Little Caesar Enters. v. Smith, 34 F. Supp. 2d 459 (E.D. Mich. 1998) (market for pizza franchise was separate from market for goods and services used in operating the franchise).

See, e.g., Krehl v. Baskin-Robbins Ice Cream Co., 664 F.2d 1348 (9th Cir. 1982) (trademark and franchise, which served no function other than to identify and distribute the branded products, constitute a single product).


Id. at 462.

34 F. Supp. 2d at 459.

Id. at 464.

Id. at 468.

Id. at 469.

Id.

2006 WL 1778817.
of sale systems (“POS systems”) was not an illegal tying arrangement. The court found that POS systems were not a separate product from the franchise because the devices were specifically designed for Subway franchises for quality control purposes. Because the devices could not be used interchangeably in other retail operations, there could be no separate market for the tied POS system. The court found that in contrast to the fungible napkins and condiments in *Little Caesar*, the POS system played a “central role in the functioning of the franchise.”

5. Conditioned Sale

The requirement that purchase of the tying product be conditioned upon purchase of the tied product requires some showing of coercion or forcing of the purchaser, or some explicit agreement between purchaser and seller. Of course, not every sale of two products is illegal. For example, if the purchaser voluntarily purchases two products together, by definition, there should be no tie-in. Similarly, if the purchaser were permitted to acquire the allegedly tied product from a third party, refused to purchase the tied product or found that a tying policy was not actually enforced, there would be no actionable tie.

On the other hand, a tie-in may be expressly required by the parties’ agreement. A tie may also be the product of the seller’s policy or practice that, as a practical matter, requires purchase of the tied product. If the purchaser’s decision to purchase the second product results solely from sales pressure, persuasion or even threats that are not carried out, however, there would be no coercion.

Applying these principles, courts continue to be skeptical of tying claims where there is insufficient evidence of coercion. For example, in *Little Caesar Enterprises, Inc. v. Smith*, the court rejected the argument that an approved supplier program constituted a tying arrangement because “each of the franchise agreements at issue specifically allows the plaintiffs the ability to seek approval of independent distributors to provide them with supply.” Similarly, in *Carsten v. United Parcel Service, Inc.*, the court concluded there was no evidence that the franchisor Mail Boxes Etc. had imposed a tying arrangement by providing certain benefits to its franchisees and requiring the franchisees to use carriers other than Federal Express unless requested otherwise. The court concluded, “Plaintiff’s purported tying claim is deficient for the additional reason that the [complaint] fails to allege that anyone was actually coerced into

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161 *Id.* at *7.
162 *Id.* at *6-7.
163 *Id.* at *6.
169 895 F. Supp. 884.
170 *Id.* at 895.
purchasing an MBE franchise or into agreeing not to use Federal Express unless requested by customers.”

6. Market Power

In *U.S. Steel Corp. v. Fortner Enterprises*, the Court confronted the question of what evidence would be necessary to prove economic power over the tying product sufficient to force the purchase of the tied product. The Court stated that “the question [is] whether the seller has the power, within the market for the tying product, to raise prices or to require purchasers to accept burdensome terms that could not be exacted in a completely competitive market” or “whether the seller has some advantage not shared by his competitors in the market for the tying product.”

The Court in *Jefferson Parish* focused on market power as the key factor in determining if there has been a tying violation. The majority found that the only evidence of market power was the preference of persons residing in Jefferson Parish to go to East Jefferson Hospital and that such a preference was not necessarily probative of market power. The majority further found that the hospital’s market share of only 30% was insufficient to infer market power.

Whether market share is the only means of showing market power is open to question, but the Court in *Kodak* cited *Jefferson Parish* with approval for the proposition that market power “ordinarily is inferred from the seller’s possession of a predominant share of the market.” Lower courts have treated a 30% market share as the minimum necessary to establish the requisite market power.

Not even the largest franchisor has 30% of the market for the sale of franchises, which is the broadest market in which a tying product defined as a franchise might be sold. However, the Court’s decision in *Kodak* takes a very different view, holding that the sales of a single brand of product, surely the narrowest possible market, could in some circumstances be the relevant market.

*Kodak* competed with independent service organizations (“ISOs”) for the servicing of Kodak machines, but Kodak refused to sell replacement parts to owners of its business machines unless the owners agreed not to use the ISOs’ repair services. The ISOs charged that Kodak had illegally tied service to parts to drive the ISOs from the Kodak service market. It was acknowledged that, with a 23% market share, Kodak did not have market power in the primary market for Kodak business machines, and Kodak argued that such a lack of power in the primary market prevented a finding of an illegal tie as a matter of law. Kodak argued that if it raised prices for parts or service above competitive levels its customers would stop buying Kodak products.

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172 Id. at *3.
173 429 U.S. 610 (1977) (hereinafter *Fortner II*).
174 Id. at 620.
176 Id. at 26.
177 Id. at 27.
178 *Kodak*, 504 U.S. at 464.
The Court countered this assertion on three grounds. First, it noted that there was no evidence that Kodak lost equipment sales after it raised prices in the service market. Second, higher prices in the service and parts markets would only affect Kodak’s primary market of business machines if consumers could “inform themselves of the total cost of the ‘package’ – equipment, service and parts – at the time of purchase; that is, consumers must engage in accurate lifecycle pricing.” Finally, if the cost of switching to another brand of equipment was higher than the price increases in the aftermarkets, then consumers would be “locked-in,” and would “tolerate some level of service-price increases before changing equipment brands.” These conditions provided for the possibility that Kodak could have market power in the tying product of parts for Kodak copiers even though it lacked market power in the primary copier market.

Many observers accurately predicted that the Kodak decision would alter the market power inquiry in franchising cases. Franchisees and competing suppliers began arguing that either they could not inform themselves of the cost of the package before purchase or that they were “locked-in” to a franchise system by their investment and could not avoid a tie by switching to another system. Further, by rejecting Kodak’s argument “that, as a matter of law, a single brand of product or service can never be a relevant market under the Sherman Act,” the Court raised interesting issues for the franchise world. However, as will be noted, most courts considering franchise tying claims post-Kodak have ultimately rejected these claims.

7. Ramifications of Kodak for Franchise Tying Claims

a. Definition of Relevant Market

Although several older cases viewed trademarks as presumptively creating market power, by the mid-1980s both courts and commentators had rejected this theory and concluded that market power could not be inferred from ownership of one’s own trademark. Instead, most courts held that the proper standard for determining the relevant market was all reasonably interchangeable franchise opportunities or products. Kodak reintroduced the possibility, however, that a single product line, such as a franchise, could constitute a “relevant market” for purposes of analyzing tying arrangements under federal antitrust law. Courts have been divided over the effect of Kodak on the definition of “relevant market” in the franchise context.

In Queen City Pizza, Inc. v. Domino’s Pizza, Inc., the plaintiffs, owners and operators of Domino’s Pizza franchises, alleged that a tying arrangement arose from a condition of the

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181 Kodak, 504 U.S. at 472.
182 Id. at 473.
183 Id. at 476.
185 See, e.g., Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972) (franchisor’s control of trademark creates presumption of market power), cert. denied, 405 U.S. 955 (1972).
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Domino’s franchise sale, namely that the franchisees could be required to purchase ingredients, materials and supplies from either Domino’s or a Domino’s-approved supplier. The plaintiffs alleged that the relevant market for purposes of a tying arrangement determination should be the market for ingredients and supplies among Domino’s franchisees.

On a motion for summary judgment, the Queen City court ruled that this market definition failed as a matter of law. The court distinguished the plaintiffs’ claim from that in Kodak on the ground that in this case, the alleged tie arose by virtue of a valid and binding franchise agreement, as opposed to the unique nature of the tying product, as in Kodak. Furthermore, the relevant market inquiry in Kodak primarily considered the choices available to the ultimate consumer, not to the franchisee, and the approved flour, sugar and similar products alleged to be the “tied” products in Queen City were indistinguishable from any other flour and sugar from the perspective of anyone other than a Domino’s franchisee. The Third Circuit affirmed, holding that “[a] court making a relevant market determination looks not to the contractual restraints assumed by a particular plaintiff when determining whether a product is interchangeable, but to the uses to which the product is put by consumers in general.”

In Wilson v. Mobil Oil, the court declined to adopt an across-the-board rule as in Queen City that Kodak’s “relevant market” definition does not apply to franchise relationships, citing Kodak for the proposition that courts should avoid making economic assumptions on a blank factual record in tying cases. The court also noted that it was “not convinced that a principled distinction can be drawn as a matter of law between the franchise context and the durable equipment market involved in Kodak.”

The plaintiffs in Wilson I were a group of SpeeDee Oil Change franchisees who alleged that they were required to purchase motor oil lubricant products, equipment and financial services from Mobil to become and remain SpeeDee franchises. The Wilson I court appeared to accept the franchisees’ definition of “relevant market” as the market for SpeeDee franchises, at least for purposes of a motion to dismiss:

Under Fifth Circuit authority, plaintiffs may establish that a tying arrangement is illegal per se under the antitrust laws by demonstrating that SpeeDee had sufficient control over the tying market, here allegedly the SpeeDee trademarked franchise for fast lube businesses, to have a likely anticompetitive effect on the tied product market, the sale of lubricant products and related equipment and services to the SpeeDee franchise network.

In Wilson II, however, the court reconsidered this ruling following discovery and adopted the approach articulated by the Queen City appellate court.

In Collins v. International Dairy Queen, the plaintiffs were a group of Dairy Queen franchisees who alleged that the right to buy a Dairy Queen franchise was conditioned upon the requirement that franchisees also purchase products in which the defendants had a financial interest. The court declined to follow the view of the district court in Queen City that

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189 Queen City Pizza, 124 F.3d at 438.
191 Id. at 949.
192 Id. at 947.
Plaintiffs argued that the tying market was the market for soft-serve ice cream franchises and that the tied market consisted of food products and supplies which are sold to Dairy Queen franchisees. In response to the defendants’ counter argument that it was unrealistic to define the relevant market as narrowly as the plaintiffs urged “because all fast-food franchisors are in competition with Dairy Queen for the same customers,” the court observed: “Defining a relevant product involves the identification of products which have actual or potential ability to take significant amounts of business from each other.”196 In that regard, the court noted approvingly plaintiffs’ argument that “even though consumers may consider fast-food units to be interchangeable, prospective franchisees do not,” and plaintiffs’ alternative theory that “soft-serve ice cream franchised units constitute a submarket existing within the broader market of all fast-food franchised outlets.”197

Citing *U.S. Anchor Manufacturing, Inc. v. Rule Industries, Inc.*,198 for the proposition that practical indicia must be examined to determine the boundaries of a relevant submarket, the *Collins* court summarized the practical indicia of the alleged submarket as follows: “(1) unique product mix, with more than 50% of sales coming from soft-serve ice cream; (2) the use of proprietary formula; (3) the generation of significantly higher profit margins for soft-serve ice cream than for sandwiches; (4) attraction of a distinct group of customers; and (5) operation of a highly seasonal business, with sales generally being higher during spring and summer months.”199

After analyzing these factors and others offered by the plaintiffs, the court concluded that there was evidence to support the plaintiffs’ definition of the relevant tying market as limited to soft-serve ice cream franchises, or at least that there was a soft-serve submarket of the larger fast-food franchise market. Thus, *Collins* suggests that courts can sometimes be reluctant to make a determination of the relevant market that would have the effect of dismissing a claim, particularly in light of *Kodak’s* emphasis on market realities.200 Other courts, however, have rejected this analysis.201

### b. Pre-Contract Versus Post-Contract Analysis

An important aspect of the “relevant market” analysis which may explain in part the differences in the cases discussed above is the time frame chosen for the analysis of the relevant market, *i.e.*, pre-contract or post-contract. In the franchise context, the market for franchises is much larger prior to signing the franchise agreement (when the market is all reasonably interchangeable franchises) than after signing the franchise agreement (when the market is arguably limited to the type of franchise contemplated by the franchise agreement). In *Queen City*, *Wilson II*, and recently in *Subsolutions*, for example, the courts performed a pre-contract analysis; in *Wilson I*, the court performed a post-contract analysis.

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195 *Id.* at 883.
196 *Id.* at 880 (citation omitted).
197 *Id.*
198 7 F.3d 986 (11th Cir. 1993), cert. denied, 512 U.S. 1221 (1994).
199 *Collins*, 939 F. Supp at 880.
200 In response to a subsequent motion to dismiss, the Court noted that the plaintiffs had failed to allege “net economic loss,” as required, but denied the franchisor’s motion. *Collins v. Int’l Dairy Queen*, 59 F. Supp. 2d 1312 (M.D. Ga. 1999). The case thereafter settled prior to appellate review.
201 See, *e.g.*, Maris Distrib. Co. v. Anheuser-Busch, Inc., 302 F.3d 1207, 1220 (1st Cir. 2002).
The *Queen City* court quoted approvingly from a 1985 economic analysis by Professors Klein and Saft, who articulated the difference between pre-contract and post-contract analysis as follows:

The important economic distinction that must be made is between pre-and postcontract economic power. Precontract, competition among franchisors (such as McDonald’s or Kentucky Fried Chicken) to sign up franchisees prevents [a single franchisor] from exercising any economic power in setting contract terms with potential franchisees. [The franchisor], although it possesses a trademark, does not possess any economic power in the market in which it operates – the fast food franchising (or perhaps, more generally, the franchising) market.

Postcontract, on the other hand, a franchisor can use the threat of termination to “hold up” a franchisee that has made a specific investment in the marketing arrangement. However, this potential economic power has nothing to do with market power, ultimate consumers’ welfare, or antitrust.\(^{202}\)

Applying this reasoning, the *Subsolutions* court rejected the Subway franchisees’ claim that they had been locked into an illegal tying arrangement because of their substantial investment in the development of the franchise. They argued that this investment forced them into purchasing the franchisor’s prescribed POS system.\(^{203}\) The court found their argument unavailing under the lock-in theory because they did not show that the franchisor had engaged in exploitation that a reasonable Subway franchisee could not have foreseen.\(^{204}\) The court found that the franchisor put all prospective franchisees on notice in the franchise agreement, which explicitly stated that it reserved the right to change product requirements. Additionally, the court noted that franchisees could have reasonably anticipated that POS systems would become the dominant technology because, years before the challenged requirement went into effect, the Subway Uniform Franchise Offering Circular stated that the franchisor was considering requiring its franchisees to purchase an electronic cash register or computer system.\(^{205}\)

The court in *Tominaga v. Shepherd*,\(^{206}\) a pre-Kodak decision, also agreed with the Klein/Saft analysis in assessing the relevant market in a tying claim by a former distributor of packaging materials and refrigerated food products to Pizza Man franchisees:

Plaintiff’s implicit argument is that the relevant market is the ‘Pizza Man’ franchising market. This market definition is erroneous as a matter of law. No reasonable argument can be made that Pizza Man possesses the power to coerce potential franchisees to purchase the tied product rather than sell a different brand of fast food (the tying product). The analysis must take place at the “pre-contract” stage. . . . Plaintiff, however, engages in “post-contract” analysis concerning defendant’s power over already existing

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\(^{203}\) *Subsolutions*, 2006 WL 1778817 *7*.

\(^{204}\) *Id.*

\(^{205}\) *Id.* at 8; *See Queen City Pizza*, 124 F.3d. at 440-41.

franchises by virtue of their “sunk costs.” This argument was explicitly rejected in Mozart.\textsuperscript{207}

Thus, while post-contract analysis had apparently been considered and rejected by at least some courts and commentators prior to Kodak, the Kodak decision revived it. The Kodak majority’s analysis of the relevant market by reference to the choices available to equipment owners who might be locked in inherently adopted a post-contract frame of reference. Queen City, Subsolutions and Wilson II, on the one hand, and Wilson I, on the other, came to different conclusions with respect to whether post-contract market power analysis should ever be relevant in the franchise context.

c. Switching and Information Costs

Kodak, as noted above,\textsuperscript{208} elaborates on the Jefferson Parish discussion of market share and is significant for its holding that, while market power is ordinarily inferred from the seller’s possession of a predominant share of the relevant market, lack of a predominant share of the pre-contract market does not necessarily preclude a finding that an illegal tying arrangement has occurred. Two important reasons are information costs and switching costs.

“Information costs” refers to consumers’ or franchisees’ difficulty in informing themselves of the total cost of the ‘package’ – copier, service and parts, or franchise and required products – at the time of purchase. “Switching costs” refers to the costs of switching to another brand of equipment, product or franchise. Those courts that have found an illegal tying arrangement in the franchise context have often relied on the presence of information and switching costs as basis for limiting the relevant market limited to the franchise system itself – a market in which the franchisor is essentially a monopolist. For example, in Wilson I, the court found that a franchisee’s tying claim based upon alleged information and switching costs was enough to survive defendant’s motion to dismiss.\textsuperscript{209} The court held that, while the availability of information about SpeeDee’s policy was “highly relevant” to the existence of information and switching costs, it was unwilling to make a \textit{per se} rule that such disclosures would be adequate to support a franchisor’s motion to dismiss:

[I]t is not self-evident to this Court that before-the-fact disclosure of the tie-in means in all cases that information costs are not so high as to preclude accurate lifecycle pricing, . . . It may well be that disclosure that a tie-in exists does not allow accurate lifecycle pricing of a long-term franchise agreement and the purchase of ten-years’ worth of tied products, equipment and financial services.\textsuperscript{210}

Wilson I also noted that the fact that Mobil was not locked in to the prices it would charge over the life of the agreement would render it more difficult for the franchisee to estimate costs.

Two important lessons concerning information and switching costs emerge from Wilson I: first, the term of the franchise may be a factor in determining whether a franchisee could accurately predict the costs of entering into the franchise agreement; second, if the disclosure of the alleged tie does not provide sufficient detail about the terms of the required purchases, such as price, then a defense based upon pre-contract disclosure may lose some force. Thus, while

\textsuperscript{207} Id. at 1494-95 (citation omitted).
\textsuperscript{208} See supra note 154, et seq., and accompanying text.
\textsuperscript{209} Wilson I, supra note 191, at 954.
\textsuperscript{210} Id. at 953.
Queen City and Subsolutions suggest that broad disclosures may be sufficient to put franchisees on notice, franchisors seeking to rely upon the franchise agreement and Item 8 of the Uniform Franchise Offering Circular to defend against a tying claim need to consider whether the description of required products or services is sufficient to provide a franchisee with enough information to make an informed decision.

Several non-franchise cases illustrate this point. First, in Lee v. Life Insurance Co. of North America,211 University of Rhode Island students challenged on tying grounds the University’s requirement that students pay a mandatory health clinic fee and purchase health insurance. The plaintiffs alleged that the URI education (the tying or “lock-in” product) was tied to the health clinic and insurance plan (the tied products), and that once students were enrolled at the University they were locked into the system and could not freely switch to other universities.

In rejecting the plaintiffs’ argument, the court found that information on healthcare costs at URI was adequately disclosed prior to the student’s matriculation; that the educational value of each semester at URI was discretely priced and transferable to another institution; and that the plaintiffs had failed to show that there were any “switching costs” in transferring to another school.

Similarly, in PSI Repair Services, Inc. v. Honeywell, Inc.,212 the court distinguished Kodak in finding that the relevant market for purposes of a tying claim brought by an independent repair services company was the original equipment market. The court noted that in Kodak, the Supreme Court may have been affected by a change in policy imposed by Kodak on customers who previously purchased equipment without knowledge of the seller’s impending change of policy, whereas Honeywell had a repair and upgrade policy that was well-known in its industry. The court followed the First and Seventh Circuits’ interpretations to the effect that Kodak must be limited to situations in which a seller’s policy was not generally known to customers:

We likewise agree that the change in policy in Kodak was the crucial factor in the Court’s decision. By changing its policy after its customers were ‘locked in,’ Kodak took advantage of the fact that its customers lacked the information to anticipate this change. Therefore, it was Kodak’s own actions that increased its customers’ information costs. In our view, this was the evil condemned by the Court and the reason for the Court’s extensive discussion of information costs.213

Thus, the court went on to hold that “an antitrust plaintiff cannot succeed on a Kodak-type theory when the defendant has not changed its policy after locking-in some of its customers, and the defendant has been otherwise forthcoming about its pricing structure and service policies.”

Thus, the Kodak decision threatened to have a profound impact on the analysis of market power in the franchising context for several reasons. First, it reinstated the possibility that the “relevant market” could encompass a market for a single brand of franchise. Second, it

212 104 F.3d 811 (6th Cir. 1997).
213 Id. at 20.
provided alternative methods of demonstrating a franchisor’s market power, even with a tiny “pre-contract” market share, through a showing of information and switching costs among its franchisees. However, later courts applying these principles have, with rare exceptions, declined plaintiffs’ invitations to ascribe to franchisors market power that would not have been found under a traditional market analysis.

B. Can a Franchisor Define the Territories in Which, and the Customers to Whom, Franchisees May Sell Products?

Generally, yes. As shown above, tying is a form of vertical restraint that a franchisor may impose on franchisees to protect against “free riding” on the brand name by reducing quality. Another form of vertical restraint that a franchisor may impose is a customer or territorial restriction which limits the customers to whom the franchisee may sell its products or the areas in which the franchisee may offer its products or services.

Franchisors generally use vertical restraints to promote intrabrand competition within the franchise system. These non-price restrictions are often justified by the belief that they will foster efficiency and make the franchise more competitive vis-à-vis interbrand competition. There are many variations of such restraints: franchisees may be barred from selling outside a defined area; they may be limited to only certain types of sales (e.g., non-Internet sales); or they may be restricted in terms of the type of customer to whom a sale can be made or directed. All of these vertical restraints may be lawful when measured under the rule of reason, as mandated by the Supreme Court in Continental T.V., Inc. v. GTE Sylvania, Inc.214


In 1977, the U.S. Supreme Court issued a seminal decision in GTE Sylvania, a franchisee termination case involving a territorial restriction in a franchise agreement.215 The decision overruled United States v. Arnold, Schwinn & Co.,216 which had held that vertical territorial restrictions were a per se violation of the Sherman Act, on the ground that it was unreasonable for a manufacturer to restrict and confine areas within which or persons with whom an article may be traded after the manufacturer has parted with it.217

In overruling Schwinn, the Supreme Court halted the extension of the per se rule to vertical restraints, instead limiting its application to situations where the conduct is manifestly anticompetitive.218 The Court recognized that the rule of reason was the preferred approach to antitrust analysis because the primary concern of antitrust law is interbrand competition, not intrabrand competition. The Court found that vertical restraints could promote procompetitive effects by allowing the manufacturer to achieve certain efficiencies in the distribution of its products. The Court concluded that “redeeming virtues,” such as avoiding market imperfections that result from the “free-rider” problem, are implicit in every decision sustaining vertical restrictions under the rule of reason.219

2. Rule of Reason Analysis

215 Id.
217 Id.
218 Continental T.V., 433 U.S. 49.
219 Id. at 53.
When applying the rule of reason, courts undertake a case-by-case analysis to determine:

“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. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable.”

Rule of reason analysis typically requires a comprehensive analysis of relevant market conditions. However, this analysis may be abbreviated in some situations. For example, if it is concluded that a restraint has no likely anticompetitive effects, it may be considered reasonable without an elaborate market analysis. Similarly, if a restraint facially appears to be of a kind that would always or almost always tend to reduce output or increase prices, and the restraint is not reasonably related to procompetitive efficiencies, the restraint may be challenged without an elaborate analysis of particular industry circumstances.

In what has become known as a “quick look” or truncated rule of reason analysis, a court will first assess whether the restraint is “inherently suspect,” whereby it is “likely, absent an efficiency justification, to restrict competition and decrease output.” If the restraint is not “inherently suspect,” the rule of reason is applied.

However, if the restraint is deemed to be “inherently suspect,” the court will then assess whether there is a plausible efficiency justification for the practice. If the practice is incapable of creating or enhancing competition, “the restraint can quickly be condemned.” If the efficiency justification is plausible, further inquiry . . . is needed to determine whether the justification is really valid. If a court finds the justification to be valid, the full rule of reason test applies. If not, the restraint is deemed unlawful without further inquiry or analysis.

Thus, under either the full or truncated rule of reason analysis, courts will generally give deference to a franchisor’s decision to restrict the scope of its franchisees’ sales, so long as the restrictions do not relate to price, are truly “vertical”, are grounded in some legitimate business justification, and the franchisor does not have a dominant market share.

C. Can a Franchisor or Distributor Require Exclusivity and Refuse to Sell to Franchisees or Dealers that Carry Competitive Products?

It depends. “Exclusive dealing” arrangements can be efficiency enhancing or they can be an anticompetitive means to foreclose markets. The primary antitrust concern with exclusive

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220 Bd. of Trade of Chicago v. United States, 246 U.S. 231, 238 (1918).
222 Id.
223 Id.
224 Id.
225 Id.
226 Id.
227 See Cernuto, Inc. v. C & C. Builders Supply Co., 595 F.2d 164, 167 (1979) (“[t]he interest of the manufacturer in controlling the marketing of its own product has been thought to justify restrictions on those who distribute it, or those who would like to do so”); Krehl v. Baskin-Robbins Ice Cream Co., 664 F.2d 1348, 1355 (9th Cir. 1982) (Baskin Robbins Ice Cream company’s justification that franchise territorial restrictions were to better service customers found to be a reasonable vertical restraint).
dealing arrangements is that they may be used in certain circumstances to restrain competition. Because few franchisors control a substantial share of the overall market for the goods or services their franchisees sell, restrictions on franchisees’ ability to sell competing products rarely threaten a material competitive impact, and are therefore rarely challenged. Moreover, exclusive dealing arrangements often result in pro-competitive benefits and raise no antitrust concerns. In any case, a company should use care when implementing an exclusivity provision.

1. Basics of Exclusive Dealing

An exclusive dealing arrangement is an agreement under which a buyer commits to purchase products or services from one seller, to the exclusion of the seller’s competitors, for an extended period of time. Exclusive dealing arrangements may be challenged under Section 1 of the Sherman Act, 15 U.S.C. § 1; Section 3 of the Clayton Act, 15 U.S.C. § 14; and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 15.228 Clayton Section 3 prohibits such arrangements that involve commodities where the effect “may be to substantially lessen competition or tend to create a monopoly in any line of commerce.” (Emphasis added.) While Section 3 may therefore be read as creating an easier standard for challenging such arrangements than Sherman Section 1 provides,229 as a practical matter there is little difference between the two under recent court decisions.230 Section 5 of the FTC Act provides an even more lenient standard for challenging such an arrangement as an unreasonable restraint of trade, thereby permitting the Commission to reach potentially anticompetitive arrangements in their incipiency without proving that they violate the standards of Sherman 1 or Clayton 3.231 The Commission’s current enforcement position permits such arrangements under a rule of reason analysis unless the arrangements result in a substantial reduction of interbrand competition.232

a. Is There Exclusive Dealing?

Before determining whether a challenged arrangement violates any of the applicable statutes, one must first determine whether the arrangement involves exclusive dealing. Traditionally exclusive dealing requires an explicit contract or agreement under which the buyer is restrained from using or dealing in the products or services of a third party. Exclusive dealing may not be involved if the seller merely offers an exclusive dealing option but no contract results from the offer,233 the buyer refuses to purchase on the terms proposed by the seller,234 the

228 Exclusive dealing arrangements may also be used as evidence of the predatory conduct needed to establish an attempt to monopolize under Section 2 of the Sherman Act. Gen. Indus. Corp. v. Hartz Mountain Corp., 810 F.2d 795 (8th Cir. 1987).
229 In Standard Oil Co. v. United States, 337 U.S. 293 (1941), the Supreme Court stated that Section 3 is violated by an arrangement that creates a “potential clog on competition . . . [which], were it to become actual,” could foreclose competition. Id. at 314. The Court had also noted, though, that Section 3 requires proof that “competition has been foreclosed.” Id. (emphasis added). In a subsequent decision, Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961), the Court determined that Section 3 would be violated only where it is “probable that performance of the contract will foreclose competition.” Id. at 327.
230 But see Barnosky Oils, Inc. v. Union Oil Co., 582 F. Supp. 1332 (E.D. Mich. 1984), in which the court resolved a motion for summary judgment under Section 3, rather than Section 1, because of the directive on remand from the court of appeals to the effect that if the challenged contract was legal under Section 3, it would also be legal under the less stringent Section 1. Barnosky Oils, Inc. v. Union Oil Co., 665 F.2d 74, 85 (6th Cir. 1981).
232 See FTC v. Beltone Elecs. Corp., 100 F.T.C. 68 (1982), in which the Commission stated that “proper analysis of exclusive dealing arrangements should take into account market definition, the amount of foreclosure in the relevant markets, the duration of the contracts, the extent to which entry is deterred, and the reasonable justifications, if any, for the exclusivity.”
buyer in fact purchases competitive products, or the contract offers incentives for but no requirement of exclusivity. On the other hand, exclusive dealing not embodied in a contract may be established through some form of coercion by the seller, such as a policy of terminating buyers who do not purchase exclusively, particularly if the policy results in buyers acceding to the exclusivity. Thus, while seller practices that practically prevent the buyer from purchasing from competitive sellers may well constitute exclusive dealing, restrictions on the buyer that merely restrict but do not prevent competitive purchases may not.

**b. Does the Arrangement Impermissibly Lessen Competition?**

Once an exclusive dealing arrangement has been found, the remaining question is whether the arrangement has lessened competition in violation of the applicable statutes. Over the years the courts have applied varying tests to determine the impact of such arrangements. The principal remaining tests are derived from the Supreme Court decisions in *Standard Oil Co. v. United States* and *Tampa Electric Co. v. Nashville Coal Co.*

In *Standard Stations*, the Supreme Court adopted a market share test, which has since been referred to as the “quantitative substantiality” test, in evaluating the requirements contracts in effect between Standard Oil and its independent dealers, who in an eight-state area constituted 16 percent of all independent stations and accounted for 6.7 percent of gasoline sales. The district court had concluded that Standard’s contracts affected “an appreciable segment of interstate commerce … a substantial number of outlets, and a substantial amount of products whether considered comparatively or not.” The Supreme Court agreed, stating that Clayton Act Section 3 is violated whenever an exclusive dealing arrangement forecloses “a substantial share of the line of commerce affected.” The Court was likely swayed by other factors in the case, such as “the widespread adoption of such [exclusive dealing] contracts by Standard’s competitors,” which together with Standard’s restrictions affected 65 percent of the market, and the fact that less than two percent of the independent stations in the area carried more than one brand. Although the Court acknowledged that exclusive dealing arrangements may result in some benefits, such as assuring adequate product supplies and protecting the buyer from price increases and other risks, it rejected Standard’s evidence of such benefits, stating that “serious difficulties would attend” any effort at more complex economic analysis.

The Supreme Court revisited this issue in *Tampa Electric*, in which it adopted a “qualitative substantiality” test requiring a more detailed evaluation of the competitive effects of an exclusive dealing arrangement. The Court assessed a requirements contract that would,
over its 20-year term, result in $128 million in coal purchases. While the dollar amount of the contract was significant, only 0.77 percent of the relevant market was affected. The Court outlined in the following terms the sort of analysis required in order to determine whether a substantial share of the market was foreclosed:

[I]t is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involved a substantial number of dollars is ordinarily of little consequence.246

Applying this standard, the Court found that there were 700 other coal producers in the market, with more than 100 times the volume of coal covered by the subject contract, and that there were no artificial barriers to entry. The Court also concluded that requirements contracts of this nature had some procompetitive benefits, including assured supplies for buyers and consistent demand for sellers.247 Accordingly, the Court found that the contract would not have a significant adverse effect on competition in the market.248

Courts since Tampa Electric have generally followed its qualitative substantiality test, although the quantitative test of Standard Stations has never been overruled. Thus, while the percentage of the market affected (i.e., foreclosed) by an exclusive dealing arrangement is typically the most important factor analyzed,249 courts assess other factors as well. These factors include: the duration of the contract, with short-term contracts viewed as imposing less significant restraints;250 whether the use of exclusivity arrangements is widespread in the industry;251 whether the exclusivity effectively prevents competing sellers from obtaining an outlet in the market;252 whether exclusivity is necessary to protect intellectual property rights;253

246 Tampa Electric, 365 U.S. at 329.
247 Id. at 329-30.
248 While not an exclusive dealing case, Jefferson Parish (discussed infra notes 144-145, 153 and 176-178 and accompanying text) may also be helpful in determining the competitive effect of exclusive dealing arrangements. Indeed, in her concurring opinion, Justice O’Connor treated the Jefferson Parish restraints as exclusive dealing and stated that such arrangements are unreasonable when a “significant fraction” of sellers and buyers are restricted by them, which on the other hand could be “substantially procompetitive by ensuring stable markets and encouraging long-term, mutually advantageous relationships.” Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 45 (1984).
249 Although the general principle is that the larger the market share, the more likely that an exclusive dealing restriction will be found unlawful, there is no fixed market share percentage below which the seller will be safe and above which the restriction will be condemned. Market shares as low as 1% have been found to result in an illegal restriction, FTC v. Brown Shoe Co., 384 U.S. 316 (1966), while a market share as high as 78% has been found not anticompetitive. Concord Boat Corp. v. Brunswick Co., 207 F.3d 1039 (8th Cir. 2000). Many counselors use the Jefferson Parish market share of 30% as a threshold for concern about market foreclosure.
250 Roland Mach. Co. v. Dresser Indus., 749 F.2d 380 (7th Cir. 1984); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983).
252 Twin City Sportservice, Inc. v. Charles O. Finley & Co., Inc., 676 F.2d 1291 (9th Cir. 1982); Am. Motor Inns, Inc. v. Holiday Inns, Inc., 521 F.2d 1230 (3rd Cir. 1975).
and the ease of new entrants’ entry into the market or other indicia of market competitiveness.  

2. Recent Developments

Many of the most recent exclusive dealing decisions have focused on practices that are not classic exclusive dealing arrangements but rather are based upon other exclusionary practices. The following recent decisions (none involving franchisors) apply the principles of the above case history and illustrate some of the remaining questions about exclusive dealing arrangements.


In 1999 the Department of Justice (“DOJ”) filed a lawsuit against Dentsply International, Inc., a manufacturer of artificial teeth, challenging its “Dealer Criterion 6,” which prohibited existing dealers from selling Dentsply’s competitors’ products to dental laboratories and required new dealers to drop some or all competing lines to obtain Dentsply’s products. The government argued that Dentsply’s policy foreclosed competing manufacturers’ ability to develop an adequate dealer network. After the district court dismissed all claims, the DOJ chose not to appeal the rulings under Sherman Act Section 1 and Clayton Act Section 3. Instead, the DOJ appealed successfully on the grounds that Dentsply’s policy violated Sherman Act Section 2 – the antitrust provision prohibiting abuse of monopoly power.

Dentsply asserted that it had a legitimate business justification for its exclusivity policy: to encourage dealers to promote its product more effectively and to deter free-riding. The court rejected these justifications as pretextual. It found that Dentsply had market power in the artificial tooth market because it controlled nearly 80% of total revenues, and was 15 times larger than the next closest competitor, which had only 5% of the market share. The court also considered the “at will” nature of the arrangement meaningless in light of Dentsply’s market power, regardless of whether this factor would have been a defense to a typical exclusive dealing claim under Sherman 1 or Clayton 3, finding that even though dealers theoretically could easily terminate the relationships, “dealers have a strong economic incentive to continue carrying Dentsply’s teeth.” The court concluded that although competitors could sell directly to laboratories, Dentsply’s dealer network possessed a controlling degree of access to the laboratories that made it impracticable for dealers outside the network to compete. Thus, even if it did not violate Sherman 1 or Clayton 3, Dentsply’s policy could violate Sherman 2.

Dentsply is noteworthy for at least two reasons. First, it demonstrates that a company with significant market power in a particular industry should be wary of implementing an exclusive dealing policy that impedes its competitors’ access to that market. Second, it shows

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255 399 F.3d 181 (3d Cir. 2005).

256 Dentsply, 399 F.3d at 185-86.

257 Id. at 184.

258 Id. at 196-97.

259 Id.

260 Id. at 188.


262 Id. at 189.
that a company with market power can be deemed to violate the antitrust laws even if its exclusive dealing arrangement may be easily terminated by the restricted reseller.


In this case, the DOJ challenged a different form of exclusive dealing arrangement under Sherman Act Section 1. The defendants Visa and MasterCard are associations of banks whose bylaws prevented member banks from issuing general purpose payment cards through competitive networks such as American Express and Discover. The court found that the defendants had market power, with shares of 50 and 26 percent, respectively, in the network services market.  Despite this finding, the defendants argued that their policies had no adverse effect on the market inasmuch as both American Express and Discover had successfully distributed their cards to consumers without using Visa or MasterCard member banks. The court rejected these arguments, holding that the restrictions were horizontal, not vertical, in nature and accordingly that the restrictions were more akin to group boycott than exclusive dealing restrictions.  The court also dismissed the defendants’ argument concerning market effects, noting that the Visa and MasterCard restrictions had slowed the rival cards’ dissemination and acceptance by merchants.

c. United States v. Microsoft Corp.  

In this well-publicized case, the DOJ challenged Microsoft’s agreements with most of the internet access providers (“IAPs”) in North America under which Microsoft provided incentives for the IAPs to promote Microsoft’s browser to the exclusion of competing browsers. The district court found no violation of Sherman Act Section 1 because the competing browsers were not completely excluded from alternative distribution channels. However, the court also found, and the D.C. Circuit affirmed, that Sherman Act Section 2 was violated because Microsoft’s contracts with the IAPs foreclosed a substantial portion of the primary channel for browser distribution, this restriction prevented the competitors from effectively competing with Microsoft’s operating system monopoly, and there were no procompetitive justifications for the restriction. The appellate court noted that “a monopolist’s use of exclusive contracts, in certain circumstances, may give rise to a § 2 violation even though the contracts foreclose less than the roughly 40% or 50% share usually required to establish a § 1 violation” under the traditional exclusive dealing rules described above.

The moral of these decisions is that a franchisor or manufacturer with a large market share, or anything close to it, must carefully consider any exclusionary strategies that may adversely affect its competitors’ access to the market. Each company should review the scope of its distribution needs, and whether the exclusivity provisions are reasonably necessary to meet those needs. Companies should also identify at the outset the procompetitive benefits that are likely to result from an exclusivity provision. The franchisor or other manufacturer should then weigh all of these factors to determine whether the exclusivity provision is likely to survive challenge under the rule of reason. For rapidly growing companies, this analysis should be repeated periodically to take into account any changes in the companies’ market power.

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263 344 F.3d 229 (2d Cir. 2003).
264 Id. at 240.
265 Id. at 242.
266 253 F.3d 34 (D.C. Cir. 2001).
267 Id. at 71.
IV. CONCLUSION

Federal antitrust law has dictated much of the structure and operation of franchise and distribution systems in this country. While antitrust claims were practically a staple in franchise/distributor relationship litigation in years past, they have become increasingly rare as case law has developed in a manner generally supporting franchisors, manufacturers and other suppliers. As this paper has demonstrated, though, antitrust issues still abound in this field and regularly produce litigation, occasionally with surprising results. For this reason, the well-counseled franchisor or supplier will carefully consider and periodically reassess the principles set forth in this paper as both the law and market conditions continue to evolve.
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Michael K. Lindsey is a partner in the Los Angeles office of Paul, Hastings, Janofsky & Walker LLP, an international law firm of more than 1,000 attorneys serving clients from 17 worldwide offices. He is a corporate and transactional lawyer, with a practice concentration in the areas of franchise, distribution and intellectual property law. Mr. Lindsey’s practice includes antitrust preventive counseling; merger analysis and structuring; franchise disclosure, registration and relationship matters; and advice concerning the sale, distribution and marketing of products and services through manufacturing, joint venture, distribution, dealership and agency relationships. He has spoken and written extensively in these fields. He is the co-author of Annual Franchise and Distribution Law Developments 2003 (ABA Press 2003) and International Sales Transaction Checklist (IBA 2003), and a chapter author of The Intellectual Property Handbook: A Practical Guide for Franchise, Business and IP Counsel (ABA Press 2005). He also served as co-editor-in-chief of the treatise State Antitrust Law and Statutes (2d ed. 1999) and editor-in-chief of the monograph Franchise Protection: Laws Against Termination and Establishment of Additional Franchises (1990), both published by the ABA Section of Antitrust Law. Mr. Lindsey has been active for a number of years in various Bar organizations, having served as chair of the Franchise Law Committee of the California State Bar Business Law Section and of the Franchise and Dealership Committee of the ABA Antitrust Law Section. He currently serves as Chair of the Computer & Internet Committee of the ABA Antitrust Law Section, a member of the Steering Committee of the International Franchise and Distribution Division of the ABA Forum on Franchising and a member of the Executive Committee of the Antitrust and Trade Regulation Section of the Los Angeles County Bar Association. He is also a member of the ABA’s Standing Committee on Continuing Legal Education. Active in civic affairs as well, Mr. Lindsey currently serves as immediate past president and member of the Alliance Board of the Los Angeles County Museum of Natural History. He received his B.S. degree, summa cum laude, from Texas A&M University and his J.D. degree from Stanford Law School. Mr. Lindsey has been named a Southern California Super Lawyer by Los Angeles Magazine, and is listed in The Best Lawyers in America, Guide to the World’s Leading Competition and Antitrust Lawyers and in Who’s Who Legal, The International Who’s Who of Business Lawyers.
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