VENDOR REBATES: CONSIDERATIONS IN DRAFTING AND LITIGATING

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I. INTRODUCTION

To varying degrees, and with a variety of contractual approaches, franchisors control the sources of goods, services, and supplies from which franchisees may purchase. Benefits arising from franchisor control over and involvement in the source of products and services include: (a) maintaining product quality, standardization and uniformity that are important to the image and integrity of the franchise system, (b) assuring regular sources of supply at relatively stable and predictable prices; (c) enabling the franchisor to reduce the cost of delivering supplies to franchisees because of the leverage created by the franchisees’ collective purchases, allowing the franchisor to negotiate lower prices; and (d) increasing accountability for the safety of the products distributed.¹

An “approved supplier program” involves setting standards and specifications for products or services necessary to the operation of the franchised outlet, then approving and thereafter monitoring the suppliers (manufacturers and distributors of these products and services). In such a program, the franchisor may be prepared to approve any supplier meeting its standards and specifications. In many instances, however, franchisors adopt a more restrictive and less “open” approach, by designating an exclusive supplier or suppliers from whom franchisees must purchase, or even appointing themselves as the sole supplier. Franchisors may point to the enhanced efficiencies flowing from the more exclusive types of arrangements, including better coordination and integration in the system’s supply chain.

Franchisees may recognize the advantages of some degree of franchisor control over sources of supply for certain products, but may quarrel with respect to the products subject to controls and the appropriate extent of franchisor strictures, especially when franchisors limit sources of supply. The franchisor’s control over the source of the products and services may well cause friction in its relationships with franchisees if they believe that the prices charged are too high when compared to offerings from non-designated vendors. This tension can be particularly acute when the franchisor receives remuneration from sourcing products to the system — either because the franchisor (or an affiliate) is the exclusive source, or because the franchisor receives financial benefits from independent designated/exclusive sources of supply.

In this regard, many franchisors receive consideration from suppliers based on the purchase of goods and services by their franchisees. Payments may take various forms, including: (1) lump-sum payments such as “signing bonuses,” “access fees,” or “exclusivity fees”; (2) continuing rebates or similar payments, typically related to the level of purchases by members of the franchise system; (3) purchases by franchisors that operate company-owned units at lower prices than those available to franchisees; and (4) purchases by franchisors (acting as wholesalers) that receive special wholesale pricing based on purchases by the

¹The authors gratefully acknowledge Christopher Comstock of Mayer Brown LLP, who made very significant contributions to this paper.

¹ For an excellent review of these and other benefits relating to sourcing products and services, see Chesley K. Culp & Rochelle B. Spandorf, Sourcing Products And Services For The System: Efficiencies And Traps In Supply Chain Management, American Bar Association 32nd Annual Forum on Franchising (2009), 22-25.
system. These benefits for the franchisor have the common feature of being based, in whole or in part, directly or indirectly, on purchases by franchisees.  

Franchisees disgruntled with what they believe are non-competitive high prices may believe that franchisors have engaged in “opportunism” by subjecting them to captive suppliers through restrictive sourcing obligations. They may contend that the franchisors receive additional revenues (from vendors, or from their own sales to the system) at the expense of their franchisees, whose viability and competitive strength are sapped by higher operating costs. On their part, franchisors argue that rebates and other forms of consideration from vendors to customers are hardly unusual in modern distribution, and that they have no interest in arrangements that erode the strength of their systems -- from which they derive revenues based on sales, and for which they solicit new franchisees. They also may point to the ways in which the system benefits from restrictions on sources of supply.

Franchisors also may contend that in this area (as in others) the best approach is reasonable disclosure by the franchisor, so that prospective franchisees can make informed pre-contractual decisions about whether to invest in a particular franchise opportunity. And, indeed, because restrictions on sources of supply can be “critical” ones relating to “a vitally important aspect of the franchise relationship,” sourcing disclosures are required by Item 8 of the Franchising Disclosure Documents required by the Federal Trade Commission Rule (and its Compliance Guidelines) and by various states with registration/disclosure statutes which follow NASAA’s Amended and Restated Guidelines.

The required disclosures include: (a) whether the franchisor or its affiliates are among the suppliers that the franchisor will approve for a particular good/service, or if they are the only approved supplier of a particular good/service; (b) any supplier in which the franchisor’s officers own an interest; (c) the fees payable and process involved in franchisees’ getting approval of “alternative suppliers”; (d) how specifications for goods or services are provided to franchisees; (e) the “precise basis” (defined by Item 8 and guidelines) by which the franchisor or its affiliates will, or may, derive revenue or other material benefits from “required” purchases or leases of goods/services; (f) the magnitude of sourcing restrictions on a franchisee’s operating expenses, by estimating the percentage of “required” purchases and leases to the franchisee’s overall cost associated with establishing the franchise business and with monthly operating expense; and (g) payments made by designated suppliers to the franchisor, either as a percentage of a franchisee’s purchase or as a flat amount, or the cash equivalent benefit (such as the discount that the franchisor receives from suppliers on its own purchases of similar goods/services).

The FTC explained its approach to these and related disclosures (and its rationale for rejecting proposals for additional disclosures) in the Statement of Basis and Purpose for its 2007 Amended Rule:

The Commission agrees that full disclosure of source restrictions and purchasing obligations is warranted. To that end, the final

2 Steven B. Fierman, Another Look at Rebates, 24 Franchise L.J. 169 (2005); Culp & Spandorf, supra note 1, at 29-30.


4 For Item 8 of the Amended FTC Rule, see Bus. Franchise Guide (CCH) ¶ 6015. For NASAA’s version of Item 8, see Bus. Franchise Guide (CCH) ¶ 5705.
amended Rule adopts the broader UFOC Guidelines' Item 8 disclosures. Item 8 strikes the right balance between pre-sale disclosure and compliance costs and burdens. It is sufficient to warn prospective franchisees about source restrictions, purchase obligations, and approval of alternative suppliers, without requiring franchisors to disclose their past practices regarding approving alternative suppliers (which may be irrelevant to their current practices) or their future intentions (which may be proprietary information or misleading if the franchisor abandons the intended direction). Moreover, prospective franchisees can always ask existing franchisees or trademark-specific franchisee associations about a franchisor's history of approving alternative suppliers, if this issue is important in their decision-making process.\(^5\)

Although Item 8 disclosure obligations and other presale disclosures have resulted in franchisees being furnished with material information relating to sourcing requirements, and in numerous instances have thwarted franchisee claims, they have not eliminated controversy or litigation involving sourcing restrictions. This paper focuses on a particular aspect of sourcing restrictions: vendor/supplier rebates and payments.

The paper will examine theories that have been pursued in challenging vendor rebates, including the following:

- **Antitrust Theories:**
  - The vendor rebates are part of a program whereby the franchisor ties the purchase of supplies, goods and services to the sale of the franchise, in violation of Section 1 of the Sherman Act, Section 3 of the Clayton Act, and similar state statutes.
  - The vendor payments are commercial bribery prohibited by Section 2(c) of the Robinson-Patman Act.

- **Fraud/Misrepresentation**

  Statements of fact or omissions concerning vendor rebates constitute one or more forms of deceit that form the basis for the following claims:
  - Common law fraud or negligent misrepresentation
  - Deceptive and deficient disclosures in violation of state franchise law anti-fraud provisions
  - Violation of state Little FTC Acts (prohibiting unfair or deceptive practices)
  - RICO
  - Breach of fiduciary duty

\(^5\) SBP, *supra* note 3, at 15487.
• Breach of Contract

The franchisor’s use and disposition of vendor rebates violates contracts between the franchisor and the franchisees.

The paper also will analyze, in light of the case law, what types of presale and other disclosures raise strong defenses to these and related claims.

II. ANTITRUST LITIGATION

Plaintiffs often have premised their rebate-related claims on state and federal antitrust laws. Plaintiffs relying on the antitrust laws have attempted to demonstrate that vendor rebates are somehow anticompetitive, or that they represent improper exploitation of a franchisor’s market power. The prospect of treble damages under the federal antitrust laws undoubtedly motivates plaintiffs to fashion their rebate claims to fit within those laws. This prospect also makes antitrust claims potentially very costly for franchisors.

A. Tying Claims

Vendor rebates may implicate the antitrust laws in numerous ways. One of the most commonly asserted antitrust theories is the theory that the franchisor has improperly “tied” the purchase of a product in a market in which it has market power (e.g., the market for the sale of the particular franchise itself or the market for certain intellectual property associated with the franchise) with the purchase of another product sold by a preferred supplier. In this way, plaintiffs claim, the franchisor exploits its power in the “tying” market to force franchisees to buy “tied” products from designated vendors at inflated prices. Then, the plaintiffs allege, the franchisor reaps the reward in the form of rebates or “kickbacks” from the vendors.

1. Tying Arrangements Generally In Antitrust Law

A tying arrangement involves the sale of “one product but only on the condition that the buyer also purchases a different (or tied) product.”6 The essence of illegality in tying agreements is “the wielding of monopolistic leverage; a seller exploits his dominant position in one market to expand his empire into the next.”7 It violates antitrust law if the seller, by virtue of its market power, exploits its control of the “tying” product “to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.”8 A plaintiff in a tying case must generally show that:

a. The seller’s possession of “market power” over the tying product is sufficient to enable it to “force” the buyer to purchase the tied product.

b. The tying product and the tied product are separate and distinct items, for which separate demand exists.

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7 Times-Picayune Publ’g Co. v. United States, 345 U.S. 594, 611 (1953).
c. The defendant conditioned the sale or lease of the tying product on the purchase of the tied product. That is, there must be a tying relationship.

d. The arrangement has an effect on a "not insubstantial" amount of interstate commerce.⁹

Under the federal antitrust laws, certain tying arrangements are per se illegal, that is to say they are illegal without regard to their actual effect on competition in the relevant market. Generally, when faced with an alleged per se violation of the antitrust laws, a court need not examine the relevant market in exhaustive detail. But courts have found that a tying arrangement may be held lawful if implemented for a legitimate business reason where no less restrictive alternative is available. In order to determine the legitimacy and necessity of the tie, a court must undertake an inquiry into the economic effects of the arrangement. Therefore, tying claims, even per se claims, necessarily involve some measure of analysis into the relevant markets. This fact has resulted in proposals to abandon the per se label in the tying context. For example, Justice O'Connor once famously stated, "[t]he time has therefore come to abandon the 'per se label' and refocus the inquiry on the adverse economic effects, and the potential economic benefits, that the tie may have."¹⁰ Whatever the label applied to the claims, it is clear that courts must define and examine the relevant product markets when adjudicating tying claims brought against franchisors.

2. Standing

Often, the first question in an antitrust case is whether or not the plaintiff has standing to bring his or her claim. This question frequently will turn on whether or not the alleged harm falls within the legal definition of "antitrust injury." Antitrust injury is defined as "injury of the type the antitrust laws were intended to prevent and that flows from that which makes the defendants' acts unlawful."¹¹ Standing issues often arise in vendor rebate litigation when excluded suppliers challenge arrangements that favor other, competing suppliers. Excluded vendors generally must establish that the challenged rebate practice injures not only the excluded vendor, but also competition in the relevant market. To maintain its tying claims, a competing supplier must at least allege that it actually lost income as a result of the alleged tie. Vendors that cannot satisfy this threshold test often face dismissal of their claims at the pleading stage.

a. Hospitality Franchise Systems Hotels

In Valley Products Co., Inc. v. Landmark,¹² Hospitality Franchise Systems ("HFS"), a franchisor that owned the franchising and trademark rights to Days Inn, Ramada, Howard Johnson, Super 8, and Park Inns, was sued by several suppliers of hotel amenity products (such as soaps and shampoos). HFS licensed two manufacturers to produce amenity products bearing the HFS logos. The HFS franchise agreements required franchisees to purchase amenities only from "approved suppliers" and required many of the amenities to be logoed. In

⁹ Id. at 12-13.
¹⁰ Id. at 35 (O'Connor, J., concurring).
return for granting “Preferred Vendor” status to the two licensed manufacturers, HFS required the vendors to pay “up front” fees as well as commissions on sales to franchisees.

The plaintiffs, Valley Products and Savannah Soaps, manufactured and distributed soap and other hotel amenities. They sued HFS and the “preferred vendors,” alleging that the franchise agreement constituted an illegal tying arrangement under two different theories. First, they contended that HFS tied the purchase of logoed amenities to continued access to the right to operate the franchise. Under that theory, the district court found that the plaintiffs’ alleged injury was not caused by the tying arrangement. Rather, the claimed injuries were a result of HFS’s decision to license only a limited number of manufacturers and not to license the plaintiffs. Thus, the plaintiffs’ injury did not flow from any anticompetitive activity. The court noted that the “plaintiffs would have suffered the identical loss if their contracts with HFS had simply been terminated, even if no preferred vendor agreement . . . existed.” Moreover, even if there were no tie, the plaintiffs still would have been unable to manufacture and sell the logoed amenity items, because those items were branded with HFS’s intellectual property. Therefore, HFS’s decision to withhold its license from the plaintiffs, not the rebate practice, was the actual cause of the plaintiffs’ alleged injury.

Under their second tying theory, the plaintiffs contended that HFS tied the purchase of the amenity product to the use of HFS’s logo. Again, the district court found that the plaintiffs’ alleged injuries did not flow from the rebate arrangement. Instead, their inability to sell to franchisees was a result of HFS’s decision to exclude them from the preferred vendor list. Moreover, the franchise agreements required franchisees to purchase amenities only from approved vendors. Therefore, even if the sale of the amenity were not tied to the logo, the plaintiffs still would have been precluded from selling to HFS franchisees unless and until they received approval from HFS. The district court thus found that the plaintiffs had failed to establish that their injury was “of the sort the antitrust laws were designed to prevent.” The court therefore dismissed their antitrust claims.

On appeal, the Sixth Circuit affirmed the dismissal, finding that “a violation of the antitrust laws was not a ‘necessary predicate’ to the plaintiffs’ loss of business.” Rather, the “loss of logoed amenity sales suffered by Valley upon cancellation of its vendor agreement flowed directly from the cancellation, as we see it; the sales losses would have been suffered as a result of the cancellation whether or not HFS had entered into the alleged tying arrangements with the franchisees.” Valley Products thus demonstrates the difficulty that excluded suppliers face when challenging a rebate relationship. The excluded supplier’s claims may be dismissed unless it can causally connect its injury to the existence of the challenged rebate program.

b. Bandag Tire Retreading

However, when alternative suppliers plausibly allege that the franchisor’s rebate program shut them out of the supply business and caused them economic injury, a court may allow them to proceed with their antitrust claims. For example, in the recent case of Shamrock Marketing, Inc. v. Bridgestone Bandag, LLC, the franchisor, Bandag Tire Retreading Franchises, was sued by an excluded supplier. Bandag owned and franchised the “Bandag

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13 Valley Products Co., Inc. v. Landmark, 128 F.3d 398, 404 (6th Cir. 1997).

Process” for retreading tires. It entered into franchise agreements that enabled franchisees to use the process, sell retreaded tires, and provide maintenance and support to customers.

In 2007, Bandag instituted a program called the “Q-Fund,” whereby every franchisee was given a “Q-Fund” account that was automatically credited with $0.05 for every pound of procured tread rubber that the franchisee purchased from Bandag. The credited funds could only be spent for purchases of designated Bandag and Bandag sponsored-accessories, including curing envelopes. On the same day that it instituted the Q-Fund, Bandag raised the price of procured tread rubber by $0.12/lb., or 5 percent.

The plaintiff in the case was a family-owned business that supplied curing envelopes and other accessories to tire retreading shops, including Bandag franchisees. The plaintiff contended that the credits provided to franchisees pursuant to the Q-Fund totally or nearly totally offset the price difference between plaintiff’s curing envelopes and Bandag’s more expensive curing envelopes. As a consequence, the plaintiff alleged that it experienced a 90% decrease in sales of curing envelopes to Bandag franchisees from the implementation of the Q-Fund to the beginning of the lawsuit. The plaintiff alleged that the Q-Fund created an unlawful tying arrangement between the sale of procured tread rubber and the sale of Bandag curing envelopes and other Bandag accessories.

In the Sixth Circuit, the test for standing requires a plaintiff to show (1) that the alleged violation tends to reduce competition in the market and (2) that the plaintiff’s injury would result from a decrease in that competition rather than from some other consequence of the defendant’s actions. As for the first part, the court found that it was plausible that all other competitors suffered a reduction in sales of curing envelopes similar to the 90% reduction suffered by the plaintiff. As for the second factor, the court found that the plaintiff had adequately alleged that its sales fell after the implementation of the Q-Fund. These claims were therefore sufficient to allege a temporal and causal relation between the injury and the implementation of the Q-Fund. Thus, the court found that the plaintiff had alleged sufficient antitrust standing to survive the pleading stage.

3. Market Power In An Appropriately Defined Market

In order to establish a tying claim, an antitrust plaintiff must show that the defendant has “appreciable economic power in the tying product market.”15 Therefore, the plaintiff generally must show that the defendant has the power to “appreciably restrain free competition in the market for” the tying product16 and 2) has a “direct economic interest in the sale” of the tied product.17 Courts once presumed that a franchisor’s patents or other intellectual property rights

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17 See, e.g., Keener v. Sizzler Family Steak Houses, 597 F.2d 453, 456 (5th Cir. 1979) (finding no illegal tie where defendant seller of franchise trademark (tying product) required franchisee to use particular contractor to construct building because defendant "had no stake in that contractor's business, it derived no income from his sales, and it would receive no rental income from the building"); Trane U.S. Inc. v. Meehan, 563 F. Supp. 2d 743 (N.D. Ohio 2008) (granting franchisor's motion to dismiss where the franchisee failed to allege that the franchisor had any economic interest in the purchase of the tied product); but see Gonzalez v. St. Margaret's House Dev. Fund Corp., 880 F.2d 1514, 1517 (2d Cir. 1989) (declining to require an "economic interest" in the tied product).
created appreciable economic power in markets for those patented products, but that presumption no longer exists.\(^{18}\)

Thus, in the tying context, as in the antitrust context generally, a plaintiff must define the relevant product market in order to bring rebate-related claims against a franchisor. The outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it.\(^{19}\)

Contractual restraints may practically foreclose the substitution of other “available” products. In the franchising context, exclusive or approved supplier requirements foreclose other suppliers from the relevant market, but courts generally hold that such contractual restrictions are irrelevant to determining market definition if the contractual restrictions were entered into freely. But if the terms of the contract are not fully disclosed or if the franchisor changes the rules after the franchisee makes an initial investment, the court may consider the franchisee to be “locked into” a limited market for suppliers that it could not have foreseen when it entered into the relevant contract. Therefore, where the supply restrictions are not fully disclosed in the FDD or the franchise agreement, courts are more likely to define a relevant market narrowly, find that the franchisor has market power, and allow a plaintiff to proceed with its tying claims.

Plaintiffs bringing rebate claims often allege that the franchisor has market power in the market for the right to operate the franchise itself; for example, only Dairy Queen has the ability to license a Dairy Queen franchise. Franchisors, however, often respond by arguing that potential franchisees are free to choose between numerous franchises and may shop around to find a franchise relationship with favorable supply requirements. Thus, a franchisor facing antitrust claims often argues that its franchise is essentially interchangeable with any other franchise, at least from the perspective of potential franchisees. Plaintiffs, however, stress the unique characteristics of each franchise in an attempt to define the market as narrowly as the court will allow.

**a. Dairy Queen**

A prototypical example of a case in which a franchisee successfully argued that its franchisor had power in the market for the operation of the relevant franchise involved the Dairy Queen system.\(^{20}\) In that case, the franchisees argued that Dairy Queen had tied the right to buy a franchise to the purchase of food products and supplies from approved suppliers who sold the products to authorized warehouses for distribution. The warehouses, in turn, paid Dairy Queen a fee on every sale to a franchisee.

Dairy Queen argued that no anticompetitive tying arrangement could exist because it did not have the requisite power in the relevant market. The franchisees alleged that the relevant market was soft-serve ice cream franchises. According to the plaintiffs, the “primary product line” that identified and differentiated the Dairy Queen brand was soft-serve ice cream. Dairy


\(^{20}\) *Collins v. International Dairy Queen, Inc.*, 939 F. Supp. 875 (M.D. Ga. 1996). One of the authors of this paper, Lee Abrams, represented the plaintiffs in this case.
Queen disagreed, arguing that the franchisees' proposed market was far too narrow and that all fast food franchisors competed for the same potential franchisees.

To support their position, the plaintiffs presented evidence demonstrating that most Dairy Queen restaurants sold more ice cream items than other food items and that most Dairy Queen restaurants realized a higher profit margin on ice cream than on other food options. Plaintiffs further argued that potential franchisees demonstrated little cross-elasticity of demand when choosing among all fast-food franchises. For example, according to the franchisees, an increase in the cost of a McDonald's franchise did not affect the cost of a Burger King franchise.

Finally, the franchisees argued, even if the relevant market included all fast food franchises, there was a possible 'submarket' limited to soft-serve ice cream franchises that was defined by practical indicia such as industry or public recognition, peculiar product characteristics, unique production facilities, distinct customers, distinct prices, sensitivity to price changes and specialized vendors.

The court ultimately ruled in favor of the franchisees on this point, finding sufficient evidence to support their claim that the relevant market was limited to soft-serve ice cream franchises or that soft-serve ice cream restaurants were at least a submarket of the larger market for fast-food franchises. The court also found evidence in favor of Dairy Queen's claim that the relevant market consists of all fast-food franchises. Given this contradictory evidence, the court denied Dairy Queen's motion for summary judgment on the tying claims.

b. Domino's Pizza

As demonstrated by the Dairy Queen decision, plaintiffs bringing antitrust tying claims often attempt to define the relevant product markets as narrowly as possible. However, courts have generally been unreceptive to plaintiffs' attempts to define the market in terms of the contract between the franchisor and the franchisees. For example, the Third Circuit rejected an attempt by Domino's franchisees to define a product market as the limited market for ingredients and supplies that were available to Domino's franchisees.21

The franchisees in that case alleged that Domino's restricted their ability to purchase competitively priced dough by increasing processing fees and altering quality standards and inspection practices for franchisees who produced their own dough instead of buying it directly from Domino's. They claimed Domino's prohibited stores that produced dough from selling their dough to other franchisees, even though the dough-producing stores were willing to sell at prices 25% to 40% below Domino's price. Additionally, according to plaintiffs, Domino's ingredient and supply specifications were so vague that potential suppliers could not provide Domino's purchasing agent with meaningful price quotations for the relevant supplies. Finally, plaintiffs alleged that Domino's entered into exclusive supply agreements with several suppliers and tied sales of dough to sales of other ingredients and supplies.

The plaintiffs argued that the relevant product market was limited to those ingredients and supplies that were approved by Domino's because only those products could be used by franchisees without violating the terms of the franchise agreement. The district court disagreed, dismissing the plaintiffs' antitrust claims with prejudice. According to the district court, the fact

21 Queen City Pizza, Inc. v. Domino's Pizza, Inc., 124 F.3d 430 (3d Cir. 1997).
that the franchisees were “locked in” to purchasing franchisor-approved supplies stemmed from their contractual relationship and thus was “not the concern of the antitrust laws.”

Foregoing an opportunity to replead their state law claims against Domino’s, the plaintiffs instead decided to appeal the dismissal of their antitrust claim to the Third Circuit. They again argued that the relevant product market was limited to ingredients and supplies that were approved by Domino’s. But the Third Circuit agreed with the district court and found that the relevant product market was not so limited.

The Third Circuit began its analysis by finding that the dough, tomato sauce, and paper cups that met Domino’s standards were “interchangeable” with dough, sauce and cups available from other suppliers and used by other pizza companies. The court held that the test for a relevant market is not whether the commodities are reasonably interchangeable by a particular plaintiff, but whether the “commodities [are] reasonably interchangeable by consumers for the same purposes.” Therefore, the court found that the relevant inquiry was not whether a Domino’s franchisee might reasonably use both approved and non-approved products interchangeably without triggering liability for breach of contract, but whether pizza makers in general might use such products interchangeably.

Plaintiffs contended that they had been “locked in” to the market for approved supplies by virtue of their contractual relationship with Domino’s. They alleged that franchisees faced information and switching costs that locked them in to their position as Domino’s franchisees, making it economically impracticable for them to abandon the Domino’s system and enter a different line of business. The Third Circuit rejected this position, finding that the existence of information and switching costs alone did not render an otherwise invalid market definition valid.

In addition, the plaintiffs knew that Domino’s retained significant power over their ability to purchase cheaper supplies from alternative sources at the time they became franchisees because that was spelled out in detail in the standard franchise agreement and the disclosure documents. There had been no change in Domino’s policy after the franchisees entered into the agreement. Therefore, the court found that the relationship between Domino’s and franchisees was subject to competition at the pre-contract stage.

In rejecting the plaintiffs’ arguments, the Third Circuit, through Judge Scirica, offered a defense of supplier restrictions and tying requirements in the franchise context generally. The court stated that franchise tying contracts are an essential and important aspect of the franchise form of business because they reduce agency costs and prevent franchisees from free riding by 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. Further, Judge Scirica said that franchising is a bedrock of the American economy and took note of the fact that more than one third of all dollars spent in retail transactions in the United States are paid to franchise outlets. Given the importance of the franchise model and the centrality of supplier restrictions to that model, the court could not believe that the antitrust laws were designed to erect a serious barrier to the implementation of such restrictions. For these reasons, the court rejected the plaintiffs’ proposed product market and affirmed the district court’s dismissal of their tying claim.

Following this ruling, the plaintiffs submitted a petition asking the Third Circuit for a rehearing en banc, which the court denied by a vote of 7-6.22 Chief Judge Becker wrote a

22 Queen City Pizza, Inc. v. Domino’s Pizza, Inc., 129 F.3d 724 (3d Cir. 1997).
strong dissent, criticizing both the panel’s specific decision and its general defense of franchise tying arrangements. Chief Judge Becker characterized the panel’s decision as limiting the “lock in” theory to situations in which franchisors tied their franchises to “unique” products or services. This interpretation, he argued, would render the franchisor/franchisee relationship “virtually immune from antitrust scrutiny.” Further, Chief Judge Becker criticized the panel’s recitation of “the oft-heard paean for franchising,” specifically Judge Scirica’s endorsement of franchising as a “bedrock of the American economy” and his description of the franchise tying arrangement as an “essential and important aspect of the franchise form of business organization.” He argued that “food franchisors are leviathans” who should not “be permitted with impunity to perpetuate the type of arrangements” at issue. He further described the “average franchisee” as a “relatively small business person whose sunk costs [i]n the franchise represent all or most of his or her assets and who lacks the considerable resources necessary to switch or defranchise.” Finally, he argued that the amount of commerce foreclosed in the market for supplies such as pizza sauce and flour was “enormous.”

c. **Little Caesars Pizza**

Following the Third Circuit’s opinion in *Domino’s*, courts generally have been unreceptive to arguments from franchisees that they were “locked in” to an aftermarket of the franchisor’s approved supplies, at least where there was no change in the franchisor’s supply policy and the policy was fully disclosed to the franchisees in the FDD or the franchise agreement. However, if the disclosures in the FDD and franchise agreement are too vague, confusing, or inadequate, a court may allow the franchisees to proceed on a theory of tying in a product market limited to approved supplies. For example, shortly after the *Domino’s* case was decided, Little Caesars lost a summary judgment motion because the court found that the disclosures regarding vendor restrictions were inadequate to apprise potential franchisees of the effect of such restrictions.

In that case, a group of Little Caesars franchisees brought suit alleging that the franchisor had illegally tied the right to continue the franchise relationship to the purchase of supplies directly from Little Caesars. Little Caesars franchisees needed both logoed products and non-logoed products in order to operate their businesses. The franchisees alleged that Little Caesars had tied sales of its logoed paper products to its franchises and then extended that tie to the entire market basket of goods needed to operate a franchise. The only allegation by the franchisees was that the cost of the *entire market basket of goods* was supracompetitive. The claim was that the tie of logoed products to franchises dissuaded alternative distributors from entering the market for providing the basket of goods needed to run the franchise.

The court first found that the continued operation of the franchise was itself an economic commodity that *could* constitute a tying product for purposes of the plaintiffs’ claims. However, the court found that there was no evidence that any alternative supplier: (1) had to leave the market, (2) was unable to enter the market, or (3) was dissuaded from applying to be an alternative distributor. Thus, the court found that the plaintiffs had not been “locked in” to an aftermarket featuring only one supplier. Rather, the court found that the relevant product market was pizza franchising opportunities available to prospective franchisees before they contracted with Little Caesars.

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Thus, the question was whether any potential franchisee considering signing a franchise agreement could have anticipated the lack of access to logood products that would preclude alternative distributors from entering the general product market to compete with Little Caesars’ distributor. The court found that a disputed issue of material fact existed as to whether any potential franchisee could have anticipated the lack of alternative suppliers. In fact, each franchisee had a contractual right to seek approval of a second source of supplies for any and all items other than logood products. Thus, on the record before the court, there was an unresolved factual question concerning whether a potential franchisee could have anticipated that its contractual right (under the franchise agreement) to obtain a second supplier would be effectively undermined by the lack of an alternative in the market for logood products. The court therefore denied Little Caesars’ motion for summary judgment.

d. Quizno’s Toasted Sandwich Restaurants

One of the most recent examples of a franchise tying claim premised on vendor rebates involves the multiple lawsuits filed against Quizno’s. Over the past five years, Quizno’s has faced lawsuits challenging its franchise policies, including its vendor rebate policies, in courts across the country. 24

The plaintiffs generally alleged that after Quizno’s became privately owned in 2001, it adopted a strategy of rapid growth and at the same time adopted methods of increasing revenues. The plaintiffs brought a variety of non-rebate related claims, alleging that Quizno’s misrepresented its store closure rates and the company’s general inability to sustain its franchise system. Plaintiffs alleged that these misrepresentations induced potential franchisees into signing unconscionable and one-sided franchise agreements.

Plaintiffs further challenged a system of vendor rebates that figured prominently into Quizno’s alleged strategy to increase franchisor revenues. According to the plaintiffs, Quizno’s tied the franchisees’ use of the Quizno’s trademark and right to participate in the franchise system to the supply of food products, supplies, services, and other essential goods necessary for the operation of the franchised restaurants. The franchise agreement allegedly required the franchisees to “purchase all equipment, products, services, supplies and materials required for the operation of the Restaurant from manufacturers, suppliers or distributors designated by Franchisor or its affiliates.” These products included fungible staple food items such as meat, cheese, and condiments, as well as services such as in-store “Muzak” and cash register system leases.

The franchisees further alleged that Quizno’s disclosure documents were inadequate with regard to the vendor restrictions. According to the franchisees, the agreements contained a provision allowing the use of undesignated suppliers with Quizno’s approval, but this provision was meaningless and misleading because such approval was rarely, if ever, granted. Moreover, plaintiffs alleged, the process for alternative-supplier approval was deliberately vague and complex, with no timelines provided.

With respect to the supplier restrictions at issue, the plaintiffs argued that Quizno’s exploited the franchisees in two ways. First, Quizno’s and its affiliated supplier entities allegedly

sold products to the plaintiffs at inflated prices, which resulted in Quizno’s and/or its affiliated companies reaping revenues and profits that significantly exceeded what they would have been if franchisees were not required to buy from those sources. Second, Quizno’s allegedly required independent suppliers to pay rebates or kickbacks as a condition of becoming an approved source of products, services or materials to franchisees. The plaintiffs alleged that Quizno’s required approved vendors to pass along the cost of the kickbacks to its franchisees, thereby requiring the franchisees to pay prices for products, services and materials that were higher than the franchisees could have obtained from independent third parties in a competitive market.

The plaintiffs alleged that Quizno’s and the Quizno’s-owned suppliers received a large amount of revenue from allegedly inflated prices and kickbacks. For example, they alleged that American Food Distributors LLC, a company owned by the same management group that operated the franchisor, had $33,353,377 in kickbacks from approved food vendors in 2005. Another supplier owned by the same group, Source One Distribution LLC, which sold equipment to Quizno’s franchisees, was alleged to have received kickbacks from approved equipment vendors of $4,809,233 in 2005.

To support their tying claim, the plaintiffs alleged that Quizno’s had market power in the market for “Quick Service Toasted Sandwich Restaurant Franchises.” Quizno’s argued that this market was far too narrow and failed to account for substitutes, including other franchises that the plaintiffs could have contracted with before they signed franchise agreements with Quizno’s. The courts that considered the issue sided with Quizno’s, finding that the plaintiffs had proposed a market that was impermissibly narrow. For example, in one of the cases, the court noted that the proposed market “would appear to include Quizno’s and only Quizno’s.” Another federal district court noted that “the artificially-narrow definition of the relevant market, not as, e.g., the fast-food franchise market or even the fast-food sandwich franchise market, but as the ‘Quick Service Toasted Sandwich Restaurant’ franchise market, fails to consider, ‘reasonable interchangeability and cross-elasticity of demand’ and ‘does not encompass all interchangeable substitute products.’ Yet another court described the plaintiffs’ proposed product market as “patently absurd.” This was because “[t]he mere fact that a particular franchise is known for a unique product and way of doing business does not show market power over investors.”

The courts thus rejected the plaintiffs’ proposed market definitions in favor of broader definitions, which encompassed a greater array of relevant considerations. For example, the Wisconsin District Court held that, in order to determine whether Quizno’s had the relevant “market power,” it was necessary to determine whether “Quiznos was in a position to coerce investors not otherwise determined to do so to purchase its franchise.” The courts found that Quizno’s lacked this “market power,” and broadly suggested that franchisees would generally have a difficult time showing that the franchisor had the power to coerce them to join the organization because “[t]here are literally thousands of franchise opportunities available to prospective investors, and federal law operates to ensure that prospective investors are given

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26 Martrano, 2009 WL 1704469, at *11-12.
27 Westerfield, 527 F. Supp. 2d at 857.
28 Id.
29 Id.
information about the likely costs and revenues of a particular franchise opportunity in order to help them make an informed choice.\footnote{\textit{id.} (quoting George A. Hay, \textit{Is the Glass Half-Empty or Half-Full?: Reflections on the Kodak Case}, 62 Antitrust L.J. 177, 188 (1983)).} Despite the victories on the rebate-related claims, Quizno’s ended up settling the state law and non-rebate-related claims in 2010 by promising to provide more than $206 million to franchisees and to the system as a whole.\footnote{See, e.g., \textit{Siemer v. Quizno’s Franchise Co. LLC}, No. 07 C 2170, 2010 WL 3238840 (N.D. Ill. Aug. 13, 2010) (approving settlement).}

e. Wendy's

Although the Quizno's franchisees were unable to make a serious case that they had been "locked in" to the market for approved supplies and equipment, a recent decision in favor of a Wendy’s franchisee suggests that the "lock in" theory is still viable in the franchise context.\footnote{\textit{Burda v. Wendy's International}, Inc., 659 F. Supp. 2d 928 (S.D. Ohio 2009).} In that case, Wendy’s required franchisees to buy only from approved suppliers, but it had previously approved multiple suppliers in the plaintiff’s geographic area. The plaintiff alleged that Wendy’s changed its policies after several years and granted one vendor the exclusive right to supply franchises in plaintiff’s region. According to the plaintiff, Wendy's received a percentage of the revenues generated by the vendor’s status as the exclusive supplier of foods to Wendy's franchises. Moreover, Wendy’s allegedly imposed a 4-cent-per-case surcharge on any purchases of food supplies that the plaintiff made from any approved, out-of-region suppliers.

The plaintiff alleged that it had been “locked in” to a product market consisting of Wendy’s-approved food supplies. Specifically, the plaintiff owned the real estate on which his stores were located, and he was bound by an agreement with Wendy’s that the locations could only be used for Wendy's stores. He argued that if he no longer was a Wendy’s franchisee, the stores could not be converted to another use. Instead, the plaintiff would have to sell the properties to a Wendy’s approved operator or to one of Wendy’s corporate entities.

Moreover, the franchisee alleged that it had been locked into a market that it could not have anticipated when it signed the franchise agreement, because Wendy’s changed its policies by granting a supplier exclusive rights over the relevant territory. Wendy’s disagreed and noted that the franchise agreement disclosed the possibility of such an exclusive supplier relationship. The franchise agreement required franchisees to purchase food items only from suppliers who could demonstrate the ability to meet Wendy’s “standards and specifications for such items." The court found that this language did not adequately disclose that Wendy’s retained the ability to create an exclusive supply relationship. Rather, the court found that the language suggested that supplier competition was welcome so long as prospective suppliers met Wendy’s “standards and specifications." Therefore, the court held that the franchisee had successfully pled that he had been "locked in" to the Wendy's-approved food supply market, and denied Wendy's motion to dismiss the tying claim.

f. Summary

For antitrust tying claims, the importance of an adequate market definition cannot be overstated. The plaintiff’s entire claim often will rise or fall on the basis of the market definition.
Although the plaintiff generally wishes to define a market narrowly so that the franchisor will have the power to appreciably restrain competition in that market, the definition must be sufficiently broad to capture reasonably interchangeable substitute products. As the *Quizno's* cases demonstrate, a plaintiff cannot propose a market limited to the unique qualities of the franchisor. However, as the *Wendy's* case shows, a franchisee that has been "locked in" because of a change in the franchisor's supply and rebate policies may have a viable antitrust claim based on an aftermarket limited to supplies from approved or exclusive sources.

4. **The Requirement of Two Separate and Distinct Products**

In any antitrust tying case, the plaintiff must show that the "tying" product and the "tied" product are two separate and distinct products. The test for whether the products are distinct is whether there is "sufficient demand for the purchase of [the tied product] separate from [the tying product] to identify a distinct product market."  

The two-product issue often arises in the franchising area, where a franchisee alleges that the tying product consists of the franchise itself or the franchise trademark and that the franchisee is required to purchase some products as a condition of operating the franchise. Franchises, almost by definition, necessarily consist of "bundled" and related products or services.  

Historically, many courts classified franchises differently depending upon the nature of the relationship between the franchisor and the franchisees. These courts traditionally divided franchises into "business format franchises" and "distribution system franchises." In a business format franchise, the franchisor licenses a method of operating a business. Tying allegations arise in business format franchises when the franchisor forces its franchisee to purchase items that are not related to the trademark license (e.g., a fast food franchisor requires its franchisees to purchase generic paper cups from it). In a distribution system franchise, in contrast, the primary purpose of the franchise is the sale of the franchisor's specific trademarked products. Tying disputes typically arise in distribution system franchises when the franchisor prohibits the sale of products other than its own.  

Courts thus traditionally have examined the nature of the franchise in order to determine whether two alleged products actually were separate and distinct. Some courts applied a slightly different test, however, and considered whether the allegedly tied products were integral components of the business method being franchised. Where the alleged product was an essential part of the franchise, these courts found that payment for the product was more akin to an additional franchise fee than a separate purchase, and held that the two "products" could not form the basis of an antitrust tying claim.

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35 *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 46-48 (9th Cir. 1971).

36 *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348, 1352-54 (9th Cir. 1982).

37 Compare *Principe v. McDonald's Corp.*, 631 F.2d 303, 309 (4th Cir. 1980) (McDonald's franchise and property leased from McDonald's constitute a single product); with *Midwestern Waffles, Inc. v. Waffle House, Inc.*, 734 F.2d 705 (11th Cir. 1984) (Waffle House franchise is a product separate from the equipment and vending services that franchisees were required to purchase.).
In the leading Supreme Court case, *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, the Court held that two separate and distinct products exist when there is "a sufficient demand for the purchase of [the tying product] to identify a distinct product market in which it is efficient to offer [the tied product] separately from [the tying product]." In that case, a hospital had contracted with a firm of anesthesiologists, and the contract required all anesthesiology services at the hospital to be performed by that firm. The hospital argued that no "tie" could exist because it was only offering "a functionally integrated package of services" to patients. The majority, however, found that there was ample support in the record for a conclusion that patients actually differentiated between hospital services generally and anesthesiology services specifically. In fact, patients actually arranged for and paid for anesthesiology services separately from general hospital services.

Following *Jefferson Parish*, some courts have suggested that the older franchise classifications and definitions are not helpful in applying the Supreme Court's consumer demand test. Other courts have found that the classifications aid in applying the relevant test and continue to refer to "business format franchises" and "distribution system franchises." Post-*Jefferson Parish*, however, most courts facing tying claims have decided whether two separate products exist by examining the "direct and indirect evidence of consumer demand for the tied product separate from the tying product." Where there is "sufficient demand" for the tied product separate from the tying product, courts generally have found this prong of the test to have been satisfied.

a. **Little Caesars Pizza**

In the *Little Caesars* case, discussed above, the franchisees brought a tying claim alleging that the franchisor had tied its logoed products to its pizza franchises. The court found that the market for logoed Little Caesars' products (including cups, paper goods and condiments) was a separate market from the market for pizza franchises themselves. The court applied the consumer demand test.

In that case, different suppliers covered different regions throughout the country and each distributed exclusively in one region. Eventually, one supplier expanded to cover the entire nation. Between the time the suit was commenced and the time of the court's opinion, Little Caesars had approved three additional alternative suppliers. The court found that the past history as well as the current approvals of new distributors demonstrated that there was sufficient consumer demand both for logoed goods and the other goods to provide those goods separately from the sale and marketing of the franchise itself.

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39 *Casey v. Diet Ctr., Inc.*, 590 F. Supp. 1561, 1555-66 (N.D. Cal. 1984) ("Characterizing a particular franchise as business format or distributional does not aid in weighing the economic benefits that society is acknowledged to derive from franchises against any potential harm from the tie of component products.").

40 *Smith v. Mobil Oil Corp.*, 667 F. Supp. 1314, 1327 (W.D. Mo. 1987) ("The court finds it difficult to accept the conclusion that [Jefferson Parish] overruled the whole flock of cases using various franchise-type tests without mentioning even one of them.").


42 *Little Caesar Enterprises, Inc.*, 34 F. Supp. 2d at 467-70.
b. **Shell & Texaco Gasoline Stations**

In *Rick-Mik Enterprises Inc. v. Equilon Enterprises, Inc.*, the Ninth Circuit held that a gas station’s credit card processing services were not separate from the gas station franchise system itself.\(^{43}\) The plaintiffs were franchisees who alleged that the franchisor processed all of the franchisees’ daily credit and debit card sales and charged each franchisee a processing fee. The plaintiffs further alleged that the franchisor had conspired with numerous banks, banking associations, and financial institutions throughout the United States to fix, peg, and stabilize the price of credit and debit card processing fees charged to the franchisees. According to the plaintiffs, in consideration for its part in this alleged conspiracy, the franchisor received kickbacks or commissions from the banks. The plaintiffs alleged that this scheme forced them to pay higher credit and debit card processing fees than they would have paid in a “free and competitive market.”

Among other problems with the plaintiff’s claims, the court found that the gas station franchises were not a separate and distinct product from the credit-card processing services. Noting that franchises, almost by definition, necessarily consist of “bundled” and related products or services, the court first considered whether the processing services were “integral components of the business method being franchised.” According to the court, the credit card services were an essential part of its franchise. The court found that the arrangement gave the franchisor the ability to ensure the quality and reliability of credit card processing and helped guard against franchise default and unauthorized transactions.

The court also considered the *Jefferson Parish* test of whether there was sufficient demand for the processing services independent of the franchise itself. The court found that the plaintiffs’ complaint failed to plead facts necessary to assess whether the credit-card services were distinct from the franchise agreements. According to the court, the relevant “purchaser” was the franchisee, not the general consumer of credit card processing services. But the complaint did not set forth any allegations about the franchisees’ demand for credit card services. Although the court could assume that there was a billion dollar market for credit card processing in the general economy, under *Jefferson Parish* the relevant market was the market for separate credit card processing services among franchisees in general (or gasoline franchisees in particular). There were no facts pled indicating the existence of a separate market for credit-card processing services among franchisees. Therefore, the court found that the plaintiffs had failed to allege two separate and distinct product markets, and affirmed the dismissal of the complaint.

5. **The Existence of a Tying Arrangement**

A traditional tying arrangement is “an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier.”\(^{44}\) In order to prevail on its tying claims, a plaintiff must generally show that the defendant has actually “tied” or conditioned the sale of one product to the sale of another product.\(^{45}\) In the context of vendor rebate litigation

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\(^{43}\) 532 F.3d 963, 974 (9th Cir. 2008).

\(^{44}\) *Northern Pac. Ry. Co.*, 356 U.S. at 5-6.

against franchisors, the purchase requirements traditionally are set forth in the franchise agreement or in another contract between the franchisor and the franchisees.\textsuperscript{46}

a. Bandag Tire Retreading

Where the franchise agreement does not explicitly require the franchisee to purchase from an approved or exclusive supplier, courts nevertheless may find that the franchisee was "coerced" into purchasing the tied item through economic incentives. For example, in \textit{Shamrock Marketing, Inc. v. Bridgestone Bandag, LLC}, discussed above, the court found that the requisite tying could exist even though the franchisor had merely instituted a "Q-Fund," whereby franchisees who purchased supplies from the franchisor received credits that could be used to purchase accessories such as curing envelopes.\textsuperscript{47}

The court found that a tying arrangement could exist whenever a franchisor's deal "induces all rational buyers" of the tying product to accept the tied product. According to the court, the plaintiffs had alleged such a relationship, because the plaintiffs alleged that they lost 90\% of their business from franchisees following the institution of the "Q-Fund." The court found that it was reasonable to assume that 90\% of all buyers were rational. Therefore, the court found that it was plausible to conclude that many, if not all, rational buyers had been incentivized to buy tied curing envelopes in connection with their rubber purchases.

b. Other Purchase Requirements

In addition to the type of purchase incentive described above in the \textit{Shamrock Marketing, Inc. v. Bridgestone Bandag, LLC} case, franchisors also institute more direct purchase requirements through contractual clauses in franchise agreements. These clauses often require franchisees to purchase from approved suppliers or to purchase supplies directly from the franchisor itself. In such a case, there is rarely a question as to whether a "tying arrangement" exists, because the ability to operate the franchise is clearly conditioned on the franchisees' use of approved supplies and products.

Franchisors may also require franchisees to use branded or logoed supplies or products. By granting an exclusive or limited license to certain suppliers to produce branded or logoed products, the franchisors can restrict the franchisees' purchase options. This type of requirement may give rise to special considerations, which are discussed below.

6. Special Considerations When a Franchisor Licenses Intellectual Property in Exchange for Royalty Fees

Traditionally, franchisors have been accused of receiving inappropriate rebates and fees from vendors and suppliers who benefit from contractual restrictions between the franchisor and the franchisee, including exclusive and approved supplier restrictions. As a slight variant on the traditional claim, however, instead of directly granting exclusive or approved rights of supply to certain vendors, franchisors occasionally license their logos and trademarks to particular vendors. These franchisors may then require the franchisees to use logoed or trademarked

\textsuperscript{46} See, e.g., \textit{Collins}, 939 F. Supp. at 883 (noting that Dairy Queen could terminate or refuse to renew a franchise agreement if a franchisee failed to carry the full authorized menu of food products or did not meet quality standards).

\textsuperscript{47} \textit{Shamrock Marketing, Inc}, 2011 WL 864955, at *5.
products in their day-to-day operations. The franchisor may then extract a royalty or license fee from the suppliers based on each logoed or trademarked product sold to the franchisees.

Plaintiffs have argued that the requirement that the franchisees use logoed or trademarked goods or products constitutes an anticompetitive tying arrangement. Under this theory, plaintiffs characterize the royalty fee as a kickback, analogous to a traditional vendor rebate. Courts thus have analyzed tying claims involving intellectual property in much the same manner as they have analyzed traditional supplier tying claims.

a. Dairy Queen

In the Dairy Queen case referenced above, the franchisees were required to use certain logoed Dairy Queen goods in the day-to-day operations of their franchises. The plaintiffs alleged that the requirement prohibited the franchisees from using cheaper generic or non-logoed products which could have been purchased from suppliers not affiliated with Dairy Queen. Further, the plaintiffs argued that prospective suppliers were discouraged from entering the market because it was not feasible for them to invest the time and money to produce the logos while risking the possibility that Dairy Queen could change its logos, graphics, or configuration of products at any time. The plaintiffs pointed to an actual example of such a situation, in which Dairy Queen had approved an alternative supplier only to change the structures and graphics of certain products shortly after granting this approval.

Because Dairy Queen charged a fee to approved warehouses based on the sale of every logoed product from the warehouse to the franchisees, the court found that it was “clearly in the financial interest of [Dairy Queen] that the franchisees purchase their products directly from the company or from company-authorized warehouses rather than from alternative sources.” The court further noted that “power gained through some natural and legal advantage such as a patent, copyright, or business acumen can give rise to liability if a seller exploits his dominant position in one market to expand his empire into the next.” Given these facts, the court found that the plaintiffs had produced sufficient evidence of economic loss, overpriced products, and refusal to consider alternative sources of comparable products to warrant denial of Dairy Queen’s motion for partial summary judgment.

b. Hospitality Franchise Systems Hotels

In the Valley Products Co. case referenced above, the franchisor, Hospitality Franchise Systems (“HFS”), licensed two manufacturers to produce logoed hotel amenities for use in franchised hotels. The plaintiffs alleged that HFS received commissions on the sales of logoed amenities from these preferred vendors. The court, however, found that the plaintiffs, excluded suppliers, lacked standing to challenge these commissions. The court also found that HFS had not committed “trademark abuse.” Rather, HFS’s license agreements gave it the right to terminate the plaintiffs’ license at any time, and it was not a violation of the antitrust laws for the franchisor to refuse to continue to license the excluded suppliers.

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49 Id. at 883 (quoting Eastman Kodak, 504 U.S. at 479 n.29).
50 Valley Products Co., Inc., 877 F. Supp. at 1089.
51 Valley Products Co., Inc., 128 F.3d at 404.
In so holding, the court distinguished the case from *Siegel v. Chicken Delight.* In *Siegel,* certain franchisees brought suit against a fast food franchisor that required them to buy cooking equipment, dry-mix food items, and trademarked paper packaging from the franchisor itself. Analogizing the Chicken Delight trademark to a patent or copyright, the Ninth Circuit concluded that the license to use the trademark in the operation of a fast food store was a tying product with sufficient "market power" to bring the case within the Sherman Act. The Ninth Circuit observed that "[o]ne cannot immunize a tie-in from the antitrust laws by simply stamping a trade-mark symbol on the tied product—at least where the tied product is not itself the product represented by the mark."

The *Valley Products* Court noted that the continuing viability of *Siegel* had been questioned in the intervening years, and stated that that case ignored "the obvious differences between patents and trademarks—a patented product is necessarily unique, for one thing, while a trademarked product is not." Therefore, the *Valley Products* court found that the franchisor had not "abused" its trademark by refusing to license the excluded suppliers and extracting a commission from the sale of logoed goods to franchisees.53

7. **Using Intellectual Property to Price Discriminate Amongst Franchisees**

The use of intellectual property arrangements in which franchisors charge a fee for the use of their trademarks or logos may allow the franchisor to engage in price discrimination among franchisees. For example, where the franchisor's royalty is computed as a percentage of total sales or as a fee for each item sold, the franchisor may extract a larger payment from higher volume franchisees. Hovenkamp, Janis, Lemley and Leslie, however, have argued that such price discrimination is unlikely to meet the "substantially injure competition" standard of Section 3 of the Clayton Act or the "restraint of trade" standard of Section 1 of the Sherman Act, even when the price discrimination imposed by tying is inefficient.54 The authors note that the result of such arrangements is that the franchisor's profits are not generated by a fixed, up-front entry fee, but are generated by a volume charge that varies with each franchisee's use of logoed or trademarked products. As a result, more franchisees may be able to afford entry into the franchise arrangement.

8. **Defenses to Tying Claims in the Franchise Context**

Because of the unique nature of the franchise relationship, several courts have recognized a limited defense to tying claims brought against franchisors. Specifically, franchisors have occasionally been able to defend against tying claims by arguing that the tie constitutes a necessary device for controlling the quality of the end product sold to the consuming public.55 This defense has rarely been invoked successfully, however, because courts often hold that a "less restrictive alternative" to the tying restriction exists -- namely, the

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52 448 F.2d 43 (9th Cir.1971), cert. denied, 405 U.S. 955, 92 S.Ct. 1172, 1173, 31 L.Ed.2d 232 (1972).

53 Following the *Valley Products* decision, the Supreme Court expressly disavowed any presumption of market power based merely on a defendant's trademark or other intellectual property. *Illinois Tool Works Inc.* , 547 U.S. at 42.


55 See, e.g., *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.* , 549 F.2d 368, 376 (5th Cir. 1977).
franchisor is free to prescribe specific quality standards for the products and services sold to the consumer.

a. Kentucky Fried Chicken

In a case demonstrating the unique franchisor defense to tying claims, the Fifth Circuit affirmed the entry of judgment in favor of KFC when it was able to show that the alleged “tie” was necessary to “control the quality of the franchisee’s product.” In that case, KFC brought suit against a vendor of boxes and other supplies, alleging that the vendor was infringing on KFC’s trademarks and engaging in unfair competition by selling supplies to KFC franchisees without authorization. The vendor counterclaimed, alleging that KFC’s authorized supplier policy constituted an anticompetitive tying arrangement.

The Fifth Circuit affirmed the judgment in KFC’s favor on the vendor’s tying claim, in part because KFC’s authorized supplier arrangement enabled KFC to control the quality of products sold by franchisees. The court noted that, although “[p]roduct protection through tying can have a legal legitimacy,” in order to rely on the defense “the franchisor must establish that the tie constitutes the method of maintaining quality that imposes the least burden on commerce.” “If there are less burdensome alternatives,” the court noted, “a franchisor is obligated to employ them rather than the tie.” The court stated that the burden of proof rested with the franchisor and that burden was high because “specification of the type and quality of the product to be used in connection with the tying device is protection enough” and the only situation where specification would be inadequate would be where “specifications for a substitute would be so detailed that they could not practicably be supplied.”

However, the Fifth Circuit noted that the case before it presented a unique situation in which the vendor had brought its tying claim under the rule of reason. Given this posture, the court held that the vendor bore the burden of proving that the quality control rationale was a sham. In this context, the court noted, the presence of less restrictive alternatives to the tying arrangement was “a factor to be considered in the reasonableness analysis, but it [was] not necessarily the decisive factor.” The Fifth Circuit thus affirmed the district court’s finding that the vendor had failed to show that KFC’s supply arrangement was not a reasonable method for achieving quality control.

b. Bandag Tire Retreading

As suggested by the Kentucky Fried Chicken court, a franchisor arguing that a tying arrangement is necessary to protect the quality of its products will generally face an uphill battle. Such a defense was implicitly rejected in the recent case of Shamrock Marketing, Inc. v. Bridgestone Bandag, described above. The court there noted that although the franchisor had not explicitly raised an affirmative defense based on the necessity of the tying arrangement, it had stated that the primary reason for its “Q-Fund” program was to standardize the products used in the franchised tire retreading process, and that the “Q” in Q-Fund stood for “quality.”

The court noted that a less burdensome alternative to a tying arrangement existed. Namely, the franchisor could have established “clear quality specifications.” The court also quoted the Jefferson Parish decision and noted that the Supreme Court had previously “rejected

56 Id. at 380.

similar ‘goodwill’ defenses for tying arrangements, finding that the use of contractual quality specifications [we]re generally sufficient to protect quality without the use of a tying arrangement.” The court acknowledged that “the nuance of a franchise arrangement complicates the antitrust analysis,” but stated that it would not “suggest that franchises are somehow outside of the scope of antitrust laws.” Therefore, the court denied the defendant’s motion to dismiss.

The differing outcomes of Kentucky Fried Chicken and Shamrock Marketing demonstrate the balancing undertaken by courts to avoid imposing harsh burdens on franchisors that would undercut the efficiencies of franchise distribution while still applying the antitrust laws in an evenhanded manner.

B. Vendor Rebates and Commercial Bribery Under Section 2(c) of the Robinson-Patman Act

Some plaintiffs have relied upon Section 2(c) of the Robinson-Patman Act in order to support rebate-related claims. That statute generally prohibits “commercial bribery.” Nonetheless, the Third Circuit case of 2660 Woodley Road Joint Venture v. ITT Sheraton Corp. suggested that vendor rebates may not result in “antitrust injury” or injury to the competitive process sufficient to support such commercial bribery claims. Thus, the viability of these claims is questionable at this time.

Section 2(c) of the Robinson-Patman Act prohibits any person from paying or granting anything of value as a commission, brokerage, or other compensation except for services rendered in connection with the sale or purchase of goods, wares, or merchandise. That statute was enacted primarily to curb the use of “dummy” brokerage fees as a means of securing price rebates. This concern arose from large retailers using their economic dominance to force sellers to pay a fee for doing business with them. Recently, some plaintiffs have premised vendor rebate claims on this statute, arguing that such rebates effectively represent commercial bribery of the franchisor by the exclusive or approved vendor or supplier.

1. Sheraton Hotels

a. District Court Opinion

Sheraton Hotels, which acts as a management agent for certain hotel owners, was sued under Section 2(c) by one of the hotel owners in federal district court. The owner challenged the “Sheraton Purchasing Resource” program (the “SPR”) that was initiated pursuant to the terms of a Management Agreement. Pursuant to the terms of the SPR program, Sheraton negotiated large-volume discounts with vendors seeking to supply Sheraton-managed hotels. Sheraton then required the vendors to add a surcharge to the price billed to the individual hotels for each purchase. However, the surcharge was not itemized, or even disclosed, on any bills or invoices that vendors sent to individual hotels. Rather, the surcharge was remitted directly to Sheraton in the form of a “rebate.” The Management Agreement provided that Sheraton was entitled to be reimbursed for the costs of providing these services.

58 369 F.3d 732 (3d Cir. 2004).


Sheraton contended that the rebates served as reimbursements for the centralized purchasing services that Sheraton provided under the SPR program, as well as associated overhead costs. The owner, however, suggested that it suffered a competitive injury because owners of managed hotels "fooled the bill" for Sheraton's rebate scheme and incurred higher purchasing costs than Sheraton-owned hotels. The owner's suit proceeded to trial, and the jury found for the owner on its Robinson-Patman Act claim. The jury awarded damages of $750,000 on the Robinson-Patman Act claim (subsequently trebled by the court).

Sheraton then moved for judgment as a matter of law, contending that the owner had failed to present evidence showing that it had suffered antitrust injury. The court held that under the Robinson-Patman Act, the owner was required to prove, by a preponderance of the evidence, that (1) Sheraton received payments from vendors that constituted, or were given in lieu of, commissions, brokerage or other compensation and not for services rendered in connection with a sale or purchase from a vendor; (2) such payment injured the owner by virtue of the fact that Sheraton was in the same business as, or was in competition with, the owner; and (3) Sheraton was acting as an agent for the owner. Sheraton argued that the owner had not shown that it was injured by virtue of the fact that Sheraton competed with the owner.

The district court disagreed with Sheraton, noting that the owner had presented expert testimony suggesting that owners of managed hotels were treated differently than Sheraton-owned hotels with which they competed. Therefore, according to the court, the owner had presented sufficient evidence from which a reasonable jury could find that that the owner was in the same business as, or in competition with, Sheraton. Accordingly, the court denied Sheraton's motion for judgment as a matter of law.

b. **Third Circuit Opinion**

On appeal, the Third Circuit reversed, finding that the owner lacked standing to sue under the Robinson-Patman Act. The owner argued that it had suffered antitrust injury as a result of what it characterized as Sheraton's commercial bribery scheme, i.e., the SPR program. According to the owner, it suffered antitrust injury because it could only purchase goods from vendors participating in Sheraton's SPR program and it had to pay artificially inflated prices for goods purchased through that program. The owner also argued that the increased cost put it at a competitive disadvantage with regard to hotels owned by Sheraton.

The Third Circuit was not persuaded by the owner's argument. It held that paying inflated purchasing prices to vendors, without more, was not "an injury of the type the antitrust laws were intended to prevent." Rather, the court found, the owner's injury was caused by a breach of contract and the corruption of the principal-agent relationship. The Third Circuit agreed that, in an appropriate case, a breach of contract or a breach of fiduciary duty could result in the kind of injury that "the antitrust laws were intended to prevent." However, the court did not believe that the owner had established such an injury.

The Third Circuit noted that although Section 2(c) of the Robinson-Patman Act defines certain conduct as illegal, it does not create a private right of action to sue for damages. Rather, the private right of action for a Section 2(c) Robinson-Patman Act claim, as for all private plaintiff antitrust rights of action, is provided by Section 4 of the Clayton Act. Nevertheless, the court stated, a Section 2(c) plaintiff does not have to prove competitive injury to establish a violation.

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61 2660 Woodley Road Joint Venture v. ITT Sheraton Corp., 369 F.3d 732 (3d Cir. 2004).
Rather, the proscriptions of Section 2(c) are absolute, and that section does not require, as proof of a *prima facie* violation, a showing that the illicit practice has had an injurious or destructive effect on competition. Instead, the court found, a Section 2(c) plaintiff must demonstrate that it has “antitrust standing,” under a multi-factor test. The relevant factors include (1) the causal connection between the antitrust violation and the harm to the plaintiff and the defendant's intent to cause that harm, with neither factor alone conferring standing; (2) whether the plaintiff's alleged injury is of the type for which the antitrust laws were intended to provide redress; (3) the directness of the injury, which addressed the concerns that liberal application of standing principles might produce speculative claims; (4) the existence of more direct victims of the alleged antitrust violations; and (5) the potential for duplicative recovery or complex apportionment of damages.

The court found that factors (1), (3), (4), and (5) all weighed against the plaintiff. Sheraton contended that the rebates were simple reimbursements for the expenses that it incurred in administering the group buying program. Further, there were clearly “more direct victims” of the alleged violation -- the vendors who were prevented from selling goods because they refused to participate in the rebate program. Moreover, an award of damages to the owner would be inextricably intertwined with the awards on its breach of contract and breach of fiduciary duty claims. According to the court, allowing a separate recovery under Section 2(c) would create insurmountable problems in apportioning damages, plus the real possibility of cumulative damages. Accordingly, the Third Circuit held that the owner lacked standing to sue under Section 2(c) and reversed the district court's judgment on that claim.

2. Marriott Hotels

Following the district court's opinion in *Sheraton*, but prior to the Third Circuit's reversal, a district court in West Virginia allowed a plaintiff to go forward on its Section 2(c) claims against the Marriott hotel management company.\(^{62}\) In that case, the plaintiffs were hotel owners who had contracted with Marriott to manage their hotel. Under the terms of the contract, Marriott was granted unfettered authority to manage and control the hotel. The contract provided that Marriott's compensation for its services would consist solely of management fees as set forth in the agreement. The plaintiffs also brought suit against one of Marriott's affiliates, Avendra LLC, a company that operated as Marriott's procurement agent.

For purposes of their antitrust claim, the plaintiffs alleged that Marriott, acting in conjunction with Avendra, entered into exclusive or preferred contracts with vendors to provide goods to the hotel. Marriott and Avendra solicited and received “sponsorship funds,” which were payments and rebates by vendors made in the course of selling, or in exchange for the opportunity to sell, goods to the hotel. Marriott and Avendra retained these payments and rebates for themselves and did not disclose them to the plaintiffs. As a consequence, the plaintiffs alleged, the hotel was restricted in its choice of vendors, paid a higher price for goods than it otherwise would have paid, and suffered vis-à-vis rival hotels (some of which were owned or managed by Marriott) that were not paying these higher prices.

According to the plaintiffs, the payments and rebates received by Marriott and Avendra were not related to services rendered, but were essentially commercial bribes of Marriott, which was supposed to be acting solely in the interest of the hotel owners, not in its own conflicting self-interest. In response, Marriott argued that even if the plaintiffs had adequately stated a

Section 2(c) claim, they lacked standing to pursue that claim because they had not alleged an antitrust injury. Marriott contended that antitrust injury required proof that the plaintiffs’ injury resulted from “a competition-reducing aspect or effect of the defendant’s behavior.” In contrast, the plaintiffs contended that antitrust injury was simply “injury of the type the antitrust laws were intended to prevent.” In some cases, the plaintiffs acknowledged, the type of injury the antitrust laws were intended to prevent is a reduction in competition. This was true, for example, in claims brought under Section 1 of the Sherman Act. Section 2(c), the plaintiffs argued, is different: unlike most provisions of the federal antitrust laws, Section 2(c) is intended to protect an individual firm against losses caused by commercial bribery (among other things), not to protect the competitive process as a whole. Accordingly, the plaintiffs said, in the context of Section 2(c), an “injury of the type the antitrust laws were intended to prevent” is a firm’s loss resulting from commercial bribery, not a loss resulting from a competition-reducing aspect of that bribery.

The court found that it was unclear whether an antitrust injury under Section 2(c) required allegations of an injury that flowed from an injury to competition. Indeed, the court noted a number of cases coming down on both sides of that issue. After considering the legislative history and the purposes of Section 2(c), the court found that one of the purposes of Section 2(c) was to protect against “the corruption of an agency relationship” and held that “the antitrust injury standing requirement is met when a plaintiff alleges an injury flowing from ‘the corruption of an agency relationship.’” The plaintiffs had alleged that Marriott served as the agent for the hotel owners in procuring and purchasing goods and supplies for the hotel. In its capacity as the agent of the owners, Marriott received undisclosed payments and rebates from vendors for the opportunity to sell goods to the owners. According to the court, these allegations fit the terms of Section 2(c). The plaintiffs alleged that the were injured by these actions in two ways: (1) they were deprived of the rebates and payments to which they were entitled, and (2) they lost business vis-a-vis their competitors, because they paid higher prices for their hotel supplies. The court found that those injuries were typical harms caused by commercial bribery in the form of corruption of the agency relationship, and thus were injuries of the type that Section 2(c) was intended to prevent. Therefore, the court denied Marriott’s motion to dismiss the Robinson-Patman Act claims.

3. D’Angelo Sandwich Shops

As demonstrated by the Sheraton and Marriott cases, courts are split regarding the allegations that a plaintiff must plead in order to show antitrust standing under Section 2(c). However, courts have been more uniform in holding that the plaintiff must plausibly allege that the payments involved were made to a party to the franchise relationship or to someone connected with that party in an agency, representative, or intermediary relationship. In other words, the payments must cross the seller-buyer line. In the franchise context, this effectively means that the franchisor must compel the franchisee to purchase from the entity that allegedly provides the commercial bribes.

For example, the D’Angelo Sandwich Shop franchisor was unsuccessful in moving to dismiss a Section 2(c) claim by franchisees when D’Angelo had “effectively compelled” the franchisees to purchase food products from an entity that allegedly provided commercial bribes to D’Angelo. In that case, the franchise agreements required that all perishables, meats, dairy, poultry, seafood, and janitorial and paper products be purchased from suppliers

designated by D'Angelo. One of these designated suppliers was U.S. Foodservice, Inc., together with its wholly owned subsidiary JP Foodservice Distributors, Inc. Every week from April 1999 through March 2001, U.S. Foods charged the plaintiffs a flat delivery fee of $284 plus state sales tax, and from April 2001 until mid-January 2002, the delivery fee was 10% of the supplies purchased, plus tax. The plaintiffs alleged that U.S. Foods was secretly kicking back a substantial portion of the delivery fees to the franchisor--$157 of the $284 flat fee and 4% of the percentage fee.

The court began by holding that commercial bribery is generally actionable under Section 2(c), following the five circuit courts that had previously decided the issue. D'Angelo argued that any commercial bribery claims were improper because there was no fiduciary relationship between itself and the plaintiffs. But the court found that under First Circuit precedent, the lack of fiduciary relationship was immaterial because the payments crossed the seller-buyer line when D'Angelo “effectively compelled” franchisees to purchase supplies from U.S. Foods. In addition, D'Angelo itself purchased supplies directly from U.S. Foods for use in its franchisor-owned sandwich shops. Thus, the court found, the seller-buyer line had been crossed, and the defendants' contention that there was no fiduciary relationship between franchisor and franchisee was immaterial.

Next, D'Angelo argued that the franchisees had failed to adequately allege antitrust standing. The plaintiffs alleged, however, that the payment scheme forced them to operate their sandwich shops at a competitive disadvantage to the franchisor-owned shops and other competitors, estimating lost profits in excess of $1.5 million. The court found that this alleged injury was of “the type of harm the antitrust laws were intended to prevent,” and flowed “from that which makes the defendants' acts unlawful.”

In addition to their federal antitrust claim, the plaintiffs also alleged a claim under the Massachusetts Antitrust Act, which does not contain any specific analog to the Robinson-Patman Act or any other specific reference to price discrimination. D'Angelo moved to dismiss the state antitrust claim, arguing that price discrimination without an adverse impact on competition, rather than simply an impact on competitors, is not an unfair method of competition or an unfair trade practice. However, the court found that general statement to be true only in the case of price discrimination at the "primary line," or price discrimination by competing sellers. The court found price discrimination at the "secondary line," or discrimination that injures competitors of a seller's favored customers, to be materially different. Because the case involved competing buyers and was therefore a "secondary line" case, the court found that the plaintiff had stated a claim for a "restraint of trade or commerce" under Massachusetts law.

As these cases demonstrate, there remains considerable uncertainty about the viability of a franchisee's vendor rebate claims under Section 2(c) of the Robinson-Patman Act. The Third Circuit's holding in Sheraton demonstrates the challenges that face franchisees who claim to have standing to challenge vendor rebates under a commercial bribery theory. As the D'Angelo opinion illustrates, however, commercial bribery claims remain at least theoretically available in the vendor rebate context.

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64 Mass. Gen. Laws ch. 93, Sections 1-14A.
III. FRAUD/MISREPRESENTATION

Outside the antitrust context, vendor rebate litigation generally proceeds under a variety of state statutes and common law actions. Such state laws have been designed with a number of purposes in mind—to protect the contractual process, to prevent unfair dealing, or to promote some aspect of a state’s public policy.

Fraud and misrepresentation laws generally are designed to prevent deceitful misrepresentations of fact and to protect parties against such misrepresentations. This category is broad and encompasses a wide variety of legal theories, including common law fraud, negligent misrepresentation, deceptive and deficient disclosures in violation of state franchise law anti-fraud provisions, violation of state Little FTC Acts (prohibiting unfair or deceptive practices), RICO, and breach of fiduciary duty. This wide and varied theoretical underpinning is further complicated by the different jurisdictional variations in each theory. Therefore, a franchisor facing a fraud complaint or a franchisee attempting to bring a fraud claim should thoroughly study not only vendor rebate litigation, but should also be generally familiar with the relevant state fraud laws. A study of representative cases reveals some common themes that may be applied by both franchisors and franchisees with respect to fraud claims and vendor rebates.

A. Tubby’s Sub Shops

In a case involving a variety of state fraud claims, Tubby’s was sued by a group of its franchisees who alleged a wide ranging kickback scheme. The plaintiffs also sued several Tubby’s affiliates, including SDS, the purchaser of all of the products sold to and used by franchisees, and Tubby’s Advertising, which collected advertising money from franchisees and oversaw the expenditures of those funds for the benefit of Tubby’s and its franchisees. Tubby’s had formed SDS to enter into agreements with food manufacturers and other distributors of products used by Tubby’s franchisees. After entering into agreements with product manufacturers, SDS administered the warehousing and distribution of the products, took orders from and delivered such products to franchisees, and then invoiced the franchisees for the products. Franchisees were required to purchase their products from SDS.

The plaintiffs alleged that Tubby’s owners set up a scheme whereby the owners negotiated product purchase contracts with manufacturers who paid substantial kickbacks to Tubby’s. The plaintiffs further alleged that SDS then added a mark up to the manufacturers’ invoices when it resold the goods to the franchisees. When SDS paid the manufacturers’ invoices, the manufacturers paid Tubby’s a kickback. According to plaintiffs, the kickback scheme consisted of Tubby’s asking the manufacturers to increase prices by 30-90%, and then to bill SDS at the inflated amounts. When billing the franchisees, SDS added its overhead and profit to the amount submitted by the manufacturers. Upon receiving the bill, the franchisees paid the SDS invoices, SDS then paid the manufacturers the entire invoice amount, and in return, the manufacturers paid SDS the kickback. The plaintiffs, disgruntled over the rebate scheme, sued under a number of different state law theories.

The plaintiffs brought a claim under the Michigan Franchise Investment Law (“MFIL”), alleging that Tubby’s had not sufficiently disclosed the vendor payments in Item 8 of the UFOCs. Specifically, the franchisees argued that the UFOCs failed to disclose: (i) that Tubby’s

had negotiated the payment of kickbacks from product manufacturers, (ii) that Tubby's had promised a 20% reduction in product costs to franchisees because of the volume purchasing power of SDS, (iii) that the SDS kickback scheme violated the limitation in the franchise agreements relating to limiting rebates to 2%, and (iv) that substantially all of Tubby's profits were derived from revenues received as a result of the SDS kickback scheme.

Section 5 of the MFIL provides that "][(a) person shall not, in connection with the filing, offer, sale, or purchase of any franchise, directly or indirectly: (a) Employ any device scheme, or artifice to defraud; (b) Make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; (c) Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." However, Section 5 only imposes liability on a person who offers or sells a franchise and does not apply to the renewal or extension of an existing franchise where there is no interruption in the franchisee's operation of the franchised business.

The defendants initially argued that because the MFIL only imposed liability in connection with an offer or sale of a franchise, the statute did not apply to any conduct or transaction after the initial franchise sale. The defendants contended that there were only seven franchise agreements signed after 1999, the year in which SDS was created, and only two or three of the plaintiffs who signed those agreements had potential claims.

The defendants also argued that one of the franchisee owners with potential claims had previously purchased another franchise, so that he would not have relied on any misrepresentations or omissions in the UFOC. The court rejected this argument, finding that a franchisee's past relationship with the franchisor was irrelevant to the question of whether the franchisee relied on any misrepresentations or omissions in the UFOC when purchasing the franchise. Further, the court found that a genuine issue of material fact existed as to whether the defendants had made the proper disclosures. The UFOC at issue contained language referencing a two percent limitation on rebates and omitted the defendant's revenues from product sales and rebates. The court further rejected the defendants' argument that they had provided financial statements with the UFOC, from which the actual markup of the products could be deduced. The court did not find this argument persuasive in view of the two percent language in the UFOC.

The defendants next argued that Tubby's was not obligated to disclose the existence of SDS in the UFOC because SDS was an affiliate of Tubby's. According to the defendants, the rule only required disclosure about revenue that the franchisor itself received from third party suppliers. The plaintiffs argued that the defendants did not comply with Item 8 because they failed to disclose revenues derived from franchisee purchases from SDS. The court also cited to the requirements of the FTC Rule. Given the guidelines and the FTC Rule, the court denied Tubby's motion for summary judgment because it found a genuine issue of material fact as to whether Tubby's was required to report (1) the revenue generated from SDS, and (2) the amount of the rebate/kickback that Tubby's received from SDS.

The plaintiffs also alleged that the defendants had committed fraud by failing to make the required disclosures under Item 8 and the FTC Rule. Because the FTC Act does not provide a

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65 M.C.L. § 445.1505.

67 16 C.F.R. § 436.1.
private cause of action, the plaintiffs brought this claim as a state common law fraud claim. For the same reasons given for rejecting Tubby’s motion for summary judgment as to the MFIL claim, the court found that the defendants were not entitled to summary judgment on the fraud claim premised on Tubby’s alleged failure to comply with the FTC Act.

The plaintiffs further argued that the defendants had committed fraud by claiming that the exclusive supply agreement with SDS would lower franchisees’ costs by twenty percent. The defendants allegedly had made these statements at a meeting with the franchisees. The defendants argued that the plaintiffs had actual knowledge that their costs were not decreasing, so the fraud claim was deficient. The court disagreed, finding that there was a genuine issue of fact as to whether the defendants had concealed the fact that SDS was never going to reduce the franchisees’ costs. According to the plaintiffs, the owners of Tubby’s had continued to represent that the cost decreases were forthcoming. The plaintiffs further testified that the defendants had changed the price and quantities of supplies, which made it difficult to track the actual changes in costs. Therefore, the court denied the defendants’ motion for summary judgment on the fraud claim.

B. Lady of America Fitness Centers

The Tubby’s case demonstrates the availability of state law causes of action to franchisees who feel misled by vendor rebates. However, disgruntled franchisees must be able to make a sufficient showing that they were misled about the rebates through lies or omissions. And, at the most basic level, franchisees must be able to allege the existence of the rebates or kickbacks at issue. Innuendo and hearsay will not suffice to establish a concrete allegation of vendor rebates. Failure to make these basic showings will result in judgment for the franchisor.

For example, in Randall v. Lady of America Franchise Corporation, franchisees of women’s fitness centers brought suit against the franchisor, alleging that the franchisor failed to disclose the fact that it received rebates from vendors. The court found that the plaintiffs had raised only one concrete allegation about the alleged rebates. One of the franchisees alleged that her landlord had told her that he had paid a $10,000 kickback to the franchisor after the franchisee had signed the lease. Nonetheless, the court granted summary judgment for the franchisor, noting that the one concrete allegation regarding vendor rebates was hearsay and thus was not sufficient to defeat the franchisor’s summary judgment motion. In an interesting footnote, however, the court stated that it doubted that the franchisor could succeed on its argument that it had “fully disclosed vendor rebates” in its UFOC. Indeed, the UFOC contained only a blanket assertion that the franchisor might get unspecified rebates from unspecified vendors. The court noted that such a “blanket statement” was "almost surely insufficient under federal and state franchise laws, which require detailed disclosures by franchisors about vendor rebates.”

C. Raving Brands Holdings, Inc.

Another example of vendor rebate litigation implicating state fraud and misrepresentation laws involves Raving Brands Holdings, Inc., the parent corporation of numerous franchisors, including Moe’s Southwest Grill, Mama Fu’s and Doc Green’s. Investors and franchisees brought three separate lawsuits in the Northern District of Georgia against Raving and the

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individual franchisors. In each case, the plaintiffs alleged that Raving was not disclosed in the “affiliates” section of the respective UFOCs and that the franchisor-defendants did not maintain separate identities and thus were subject to piercing of the corporate veil.

The three complaints asserted similar claims against the three franchisors, including identical claims under the Georgia civil RICO statute, the Florida Deceptive and Unfair Trade Practices Act, and the Robinson-Patman Act. In each case, the complaint centered around allegations that the defendants had set up a “dummy brokerage” company in order to collect kickbacks under a secretive agreement with the franchisors’ independent distribution management company, Chain Reaction Marketing (“CRM”). CRM was engaged by the franchisor-defendants to negotiate vendor agreements on behalf of the franchise system. The franchisees were required to purchase their supplies from the “authorized” vendors/suppliers whose agreements were negotiated by CRM.

According to the plaintiffs, the defendants collected an unearned commission, brokerage fee, or “kickback,” which was calculated based upon the authorized suppliers’ sales volumes. These “kickbacks” allegedly were paid to the defendants in addition to the commissions that were actually earned by CRM when it negotiated the vendor agreements on the franchisees’ behalf. As a result of the kickbacks, the plaintiffs claimed to have overpaid for food, supplies, equipment, and other goods and services used in their franchise operations. This kickback scheme allegedly conferred improper benefits on the defendants and hindered the franchisees’ ability to compete in the market.

The plaintiffs alleged that the defendants had made numerous misrepresentations in their UFOCs. Specifically, the defendants supposedly failed to disclose the alleged supplier kickbacks as required by the FTC Franchise Rule. The franchisees also pointed to a section of the UROC in which the franchisor stated that it did not “negotiate purchase arrangements with suppliers for the benefit of franchisees.” The defendants moved to dismiss, or for judgment on the pleadings, in all three cases.

At the pleading stage, the court refused to dismiss the majority of the plaintiffs’ claims. Specifically, although the court dismissed the Robinson-Patman Act claims, it denied the defendants’ motion to dismiss the RICO and fraud claims. The court found that the allegations of wrongful concealment of the rebates were sufficient to survive a motion to dismiss.

The case against the Mama Fu’s franchisor then went to a bench trial in which the district court entered judgment in the franchisor’s favor on all of the claims. With regard to the specific misrepresentations alleged by the plaintiffs, the court found that either the

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70 The plaintiffs in Moe Dreams, LLC v. Sprock additionally brought claims for intentional infliction of emotional distress and conspiracy, addressed infra. See Moe Dreams, 2008 WL 4787493, at *8-9.

71 The court also dismissed the plaintiffs’ intentional infliction of emotional distress claim in the Moe Dreams case, finding that none of the alleged behavior rose to the level of “extreme and outrageous” as required to support a claim for intentional infliction of emotional distress. However, the court denied the defendants’ motion to dismiss the civil conspiracy and negligent misrepresentation claims. See Moe Dreams, 2008 WL 4787493, at *8-9.

representations were not false, the plaintiffs did not justifiably rely on the representations, or the representations did not result in any demonstrated damage to the plaintiffs. With regard to the alleged failure to disclose commissions or rebates, the court held that such failure did not result in any harm to the plaintiffs. The court found that the rebate practice did not constitute fraud and therefore found that the defendants had not engaged in “a pattern of fraudulent activity,” as required under the Georgia civil RICO act, or “a deceptive or unfair practice,” as required under the Florida Deceptive and Unfair Trade Practices Act. Accordingly, the court granted the franchisor’s motion for judgment as to each of the plaintiffs’ claims. The Eleventh Circuit later affirmed the district court’s holding without a written opinion.73

The Mama Fu’s case ably demonstrates the fact-intensive nature of most rebate or “kickback” litigation, especially litigation brought under state law fraud or misrepresentation theories. Although the plaintiffs in these cases may allege facts sufficient to support their claims, they still must produce proof that the franchisor made the alleged misrepresentations in order to survive a motion for summary judgment and to prevail at trial. Moreover, they will need to produce tangible proof that they relied upon franchisor misstatements and that they were damaged by such reliance. Failure to produce evidence to back up their rebate claims doomed the plaintiffs in the Mama Fu’s case.

D. The Cleaning Authority

Finally, to support a fraud claim, a plaintiff generally must show that a franchisor misrepresented the existence or nature of payments from vendors, suppliers, or other third parties. Generally, payments from an affiliate of the franchisor to the franchisor need not be disclosed, and failure to disclose such payments generally will not support a fraud claim. For example, The Cleaning Authority (“TCA”), a franchisor of residential cleaning businesses, sued several franchisees for improper termination of their franchise agreement.74 The franchisees counterclaimed against TCA and another company, S&T Management (“S&T”), alleging fraud in the inducement, violation of the South Carolina Unfair Trade Practices Act, breach of contract, tortious interference with contract, and RICO. The franchisees alleged that when they signed the franchise agreement with TCA, they also signed a “Mailer Services Agreement” with S&T, which agreed to send a minimum number of mailers to customers each week. The franchisees alleged they paid a $2,000 mailer setup fee as well as more than $500,000 in royalties and advertising funds to S&T. The franchisees also alleged that S&T paid rebates, kickbacks and other payments to TCA and that TCA failed to disclose those payments. They further alleged that TCA represented to potential franchisees that it would consider alternate suppliers of promotional brochures, but in fact refused to do so because of the undisclosed kickbacks.

The court found that the UFOC disclosed the $2,000 mailer setup fee, disclosed the fact that TCA and S&T were affiliated, and disclosed the requirement that franchisees use S&T’s direct mail advertising services. The court also noted that TCA claimed that it did not currently receive rebates from any of its approved suppliers named in the UFOC. TCA also stated that franchisees were required to request approval before using suppliers that were not previously approved by TCA. The court found that TCA never claimed that it would consider alternate suppliers and also clearly required its franchisees to purchase advertising services through S&T. Therefore, any reasonable reader of the UFOC would have understood that he had no other options when it came to sourcing advertising materials. The court also found that the

73 Peterson v. Sprock, 372 F. App’x. 50 (11th Cir. April 5, 2010).

franchisees had not pled sufficient facts to show that the representations in the UFOC led to their decision to purchase a TCA franchisee.

The court also found that the plaintiffs’ RICO claim lacked plausibility. The court found that the plaintiffs had not adequately alleged facts to support a finding of wire fraud or mail fraud as “predicate acts” by TCA. To support a finding of wire fraud or mail fraud, the plaintiffs would have to show that the misrepresentations were material. The court again found that the plaintiffs had failed to properly support their claim with particular allegations. Rather, the plaintiffs’ conclusory allegations were insufficient under Rule 9(b). The court also cited to the FTC Rule. In the 1978 version of that document, the FTC had stated:

“The Commission has determined on the basis of comments on the public record that “rebate” information is “material” to a prospective franchisee since it permits the prospective franchisee to determine how much of what he or she is paying for goods or services which the franchisor requires or advises him or her to buy actually goes toward the purchase of such goods, and what portion of the purchase price is being rebated to the franchisor or affiliated person.”

“[T]he disclosure requirements of section 436.1(a)(11) of the rule provide for a description of the basis for calculating, and, if such information is readily available, the actual amount of any revenue or other consideration to be received by the franchisor, or persons affiliated with the franchisor, from suppliers to the prospective franchisee in consideration for goods or services which the franchisor requires or suggests that the franchisee obtain from such suppliers.”

[Most important, the disclosure as to “rebate” information is required of a franchisor only where (a) the supplier or suppliers in question are “required” or “advised” sources of franchisee purchases, and (b) the rebate in question is received by the franchisor or affiliated person in consideration for such “required” or “advised” franchisee purchases.]

Based on the FTC statement, the court found that the FTC had distinguished between “affiliated persons” and “suppliers.” Because S&T was “affiliated” with TCA and TCA had disclosed that fact in the UFOC, the court found that the “kickback” to TCA was immaterial. Once S&T had the money, it was free to move it to an affiliated entity (TCA). The court therefore dismissed the plaintiffs’ fraud and RICO claims.

IV. BREACH OF CONTRACT

As mentioned above, the franchisor-franchisee relationship is governed by a multitude of state and federal regulations. However, it is fundamentally a contractual relationship and arguments that vendor rebates violate the terms of the franchise agreement are among the most fundamental of all vendor rebate claims. As with any contract term, courts will attempt to

75 43 Fed Reg. 59657-58 (emphasis added).
discern the parties' intentions with respect to vendor rebates by examining the language of the relevant documents. For this reason, the franchisor must ensure that its desired vendor rebate policy is clearly and accurately reflected in the relevant contracts. The franchisee, meanwhile, should be familiar with the language in these documents in order to understand the permissibility, scope, and acceptable terms of any rebate program. Litigation about the meaning and effect of vendor rebate clauses can be protracted and costly, so it is preferable for both sides to understand clearly their present and future rights and obligations under the franchise agreement before signing the contract or changing the relevant rebate practices.

A. **Little Caesars**

In the *Little Caesars* case, *supra*, the franchisees alleged that Little Caesars failed to credit them with rebates, discounts, and bonuses that vendors paid to the franchisor’s exclusive distributor.76 The franchisees alleged that either the franchise agreements or the covenant of good faith and fair dealing required Little Caesars to credit its franchisees for these rebates. Little Caesars moved for summary judgment on the breach of contract claim, arguing that the agreements did not require it to credit the franchisees and that the covenant of good faith and fair dealing was inapplicable.

The relevant franchise agreements made no provision for crediting the accounts of franchisees with vendor rebates or discounts. Little Caesars argued that the covenant of good faith and fair dealing likewise did not require the franchisor to make the credits because, under Michigan law, "courts will recognize an action for breach of an implied covenant of good faith and fair dealing where a party to a contract makes the manner of its performance a matter of its own discretion." According to Little Caesars, nothing in the franchise agreements provided it discretion regarding whether or not to credit franchisee accounts. Adopting Little Caesars’ reasoning, the court found that the franchisor had breached neither the franchise agreement nor the covenant of good faith and fair dealing. Thus, the court entered summary judgment in favor of Little Caesars on the franchisees’ breach of contract claim.

B. **Marriott Hotels**

In *In Town Hotels Ltd. Partnership v. Marriott Intern., Inc.*, *supra*, Avendra, an affiliate of Marriott that operated as the hotel chain’s procurement agent, was sued by franchisees who alleged that Avendra had profited from rebates on purchases of hotel supplies.77 Avendra moved to dismiss the claims against it, arguing that the contract between the franchisees and Marriott specifically permitted Marriott to (1) purchase inventories and supplies from affiliates such as Avendra, and (2) make a reasonable profit on such transactions. Therefore, Avendra argued, the profits realized on the rebates could not be the basis of a breach of contract claim.

Specifically, Avendra cited Section 1.02 of the Management Agreement between Marriott and the franchisees. That section provided that Marriott "shall have discretion and control...in all matters relating to the management and operation of the Hotel, including...procurement of inventories, supplies and services (purchases from [Marriott] and its affiliates shall be at competitive prices)...." This provision, Avendra argued, clearly contemplated that Marriott and Avendra could profit from purchases of hotel supplies.


77 *In Town Hotels Ltd. Partnership*, 246 F. Supp. 2d at 483-84.
In response, the plaintiffs pointed to Section 5.01.A of the Agreement, which provided that Marriott "will retain, as a management fee for services performed hereunder, an amount . . . equal to twenty percent (20%) of Operating Profit." The plaintiffs also pointed to Section 5.01.D, which provided that "[n]o charges or fees are to be paid by [the franchisees] to [Marriott] except as provided in the Agreement."

Given this contractual language, the court could not conclusively determine whether the Agreement expressly permitted the rebate payments at issue. Specifically, the court noted that the language of Section 5.01.D appeared to restrict Marriott's compensation to the management fee set out in Section 5.01.A. This suggested to the court that Marriott's and Avendra's receipt of the rebate payments might not have been permitted under the contract. However, Section 1.02 gave Marriott discretion as to procurement and only limited Marriott and Avendra to purchasing "at competitive prices." Ultimately, the court found that, without some factual development regarding the specific details of the relationship between Marriott and the franchisees, the context and nature of the alleged rebates and payments, the course of dealing of the parties, and the standard practice in the industry, the court could not resolve the tension between the two parts of the Agreement. Because the contract did not unambiguously authorize the allegedly wrongful rebates and payments to Marriott and Avendra, the court denied Avendra's motion to dismiss the breach of contract claim.

C. Dunkin' Donuts

A franchisor should generally be careful when announcing policy or procedure, because franchisees may interpret the announcement as a guarantee. Nonetheless, in order to enforce any contractual promises from the franchisee, the franchisor must prove the existence of a contract. For example, Dunkin' Donuts was sued by a franchisee who claimed that a policy document required the franchisor to allocate any rebates to an advertising fund, but the franchisee was unsuccessful in its claim because it could not show the existence of a valid contract.78

In that case, Dunkin' Donuts sued the franchisee for fraud, breach of contract, and trademark infringement. The franchisee then countersued, alleging, among other claims, breach of contract. Specifically, the franchisee alleged that Dunkin' Donuts' sister brand, Togo's, had received a $1 million rebate from a marketing agreement with Pepsico. The franchisee pointed to a "Marketing Operating Philosophy" document that addressed supplier rebates. According to the document, if any of the sister brands entered into a contract providing for a vendor rebate, the income from the rebate was to be split proportionately among all of the brands and applied to each brand's respective Advertising Fund "based on the conditions of the rebate." The franchisee alleged that the franchisor breached the Operating Philosophy document by failing to apply Dunkin' Donuts' share of the Pepsico rebate to its Advertising Fund.

Dunkin' Donuts moved for summary judgment on the franchisee's breach of contract claim and the court granted that motion. The court held that the franchisees had never reached an agreement with Dunkin' Donuts to share in the supplier's rebate because the Operating Philosophy document was not a contract. The document specifically stated that it was not intended to supersede or take the place of any terms contained in the franchise agreement or any other agreements between the franchisees and the franchisor. Further, the franchise

agreement did not make any reference to the Operating Philosophy. Instead, the agreement contained an explicit integration clause stating that the document represented the “full and complete agreement” between the franchisee and franchisor.

Moreover, the court found that even if the Operating Philosophy document was a contract, it did not require Dunkin’ Donuts to contribute its share of the rebate to the Advertising Fund. Rather, the document explicitly stated it was “based on the conditions of the rebate.” The agreement between Pepsico and Togo’s, in turn, required the rebate to be used “on the promotion of the Togo’s brand.” Therefore, the Operating Philosophy document did not require Dunkin’ Donuts to contribute the rebate money to its Advertising Fund. The court therefore granted Dunkin’ Donuts’ motion for summary judgment with respect to the franchisee’s breach of contract claim.

D. Wendy’s

In a 2008 lawsuit, a group of franchisees sued Wendy’s and Wendy’s National Advertising Program, Inc. (“WNAP”), alleging breach of contract based on rebates allegedly paid by a soft drink vendor. The plaintiffs alleged that the Wendy’s franchise agreements provided for open bidding with regard to the purchase of fountain beverage syrup from a variety of companies. However, in 1998, Wendy’s mandated the sale of Coca-Cola products by franchisees who did not have an existing contractual relationship with Pepsi. The plaintiffs argued that this restriction constituted a breach of the franchise agreement. Further, the plaintiffs alleged that Wendy’s had entered into a secret agreement with Coca-Cola whereby Coca-Cola agreed to contribute funds to WNAP based on each gallon of fountain beverage syrup purchased by the franchisees. The plaintiffs alleged that the cost of beverage syrup was artificially increased by the amount of the Coca-Cola contributions to the WNAP.

Under the franchise agreement, the franchisees had agreed to sell only products that “have been expressly approved for sale in writing by Franchisor[,]” Further, they agreed “to discontinue selling and offering for sale any menu items, products or services which Franchisor may, in its discretion, disapprove in writing at any time.” The court held that the franchise agreement thus gave Wendy’s full discretion to mandate the exclusive use of Coca-Cola products. Moreover, nothing in the agreement required Wendy’s to inspect Coca-Cola products or apply any particular criteria in approving Coca-Cola as an exclusive supplier.

In a letter to franchisees, Wendy’s had announced that Coca-Cola agreed to contribute $42 million to WNAP as a one-time contribution and also agreed to contribute 32¢ per gallon sold to WNAP. Wendy’s also stated that it intended to use a portion of those payments to decrease WNAP payments owed by franchisees for a two year period, after which the WNAP payments would return to their normal levels. The plaintiffs alleged that Wendy’s failure to continue reducing the franchisees’ WNAP payments was a breach of contract, but the court noted that no language in the franchise agreement required Wendy’s to reduce WNAP payments based on any third party contributions. Further, the franchise agreement gave Wendy’s the right to determine what percentage of gross sales, up to four percent, had to be paid to WNAP. The court thus found that the plaintiffs failed to state a claim for breach of contract. The court also dismissed the plaintiffs’ unjust enrichment claim. The court noted that

Wendy's did not benefit from the WNAP contributions, because such contributions were only used for advertising purposes and were maintained in a separate account.

The court further rejected the argument that "the duty of good faith and fair dealing" required Wendy's to apply any particular criteria in making its decision regarding which soft drink vendor to approve. Under Ohio law, the implied covenant of good faith and fair dealing does not apply where a party to a contract has the absolute and exclusive authority to make the decision at issue. In this case, Wendy's had absolute unilateral authority under the agreement to approve or disapprove suppliers. Therefore, the court found no basis for applying the covenant of good faith and fair dealing.

The breach of contract cases cited above demonstrate the importance of drafting clear contractual provisions and disclosures. The Wendy's court granted the franchisor's motion to dismiss because it found that the franchise agreement unambiguously gave Wendy's discretion to choose a supplier, regardless of the criteria applied. In contrast, the Marriott court denied the procurement agent's motion to dismiss, because it found that the franchise agreement was unclear and seemed to restrict the franchisor to receiving only the fees set forth explicitly in the agreement. The contrast between the results in these two cases highlights the crucial importance of drafting clear contractual provisions that address vendor rebates.

V. DRAFTING CONSIDERATIONS WITH RESPECT TO VENDOR REBATES

As demonstrated by the cases discussed above, vendor rebates are a controversial and volatile aspect of franchising law. These rebates, whether disclosed or not, can present a major source of tension between franchisees and franchisors. Disgruntled franchisees often claim unfairness when a franchisor reaps rewards from the purchase of goods, supplies, and equipment used in the day-to-day operation of the franchise. Meanwhile, suppliers who find themselves excluded from selling to franchisees may take offense at the preferential or exclusive relationships conferred upon vendors who provide these rebates.

Moreover, plaintiffs have had some success under a number of legal theories. Some have alleged that rebates harm competition in the relevant industry insofar as they allow franchisors to extend any market power that they have over the rights to the franchise into the market for goods and supplies used by the franchisees. Others have argued that rebates constitute commercial bribery, of the type outlawed by the Robinson-Patman Act. Still other plaintiffs have eschewed arguments broadly based on harm to competition and have instead focused on the specific relationships between individual franchisees and franchisors. Some have argued that franchisors defrauded franchisees or misrepresented the existence or extent of the rebates. Others have argued that the franchisor's rebate practice violated the terms of the franchise agreement and breached the contract between the franchisor and franchisee.

Because rebate claims can be brought under any number of legal theories, and by a number of different plaintiffs, preventing and defending litigation in this area can be unusually complicated, time-consuming, and costly. Therefore, a franchisor should take preemptive steps to avoid rebate-related litigation and to proactively minimize the harm from any such legal action. A franchisor can take significant steps to protect itself in the event of rebate-related litigation by drafting clear, straightforward FDDs and franchise agreement provisions dealing with supply sourcing and rebates.

Comprehensive disclosure documents and transparent franchise agreements can prevent or mitigate the potential harm from legal action brought under any of the multitude of
potential legal theories available to plaintiffs. For example, by disclosing rebates, the franchisor can show that the franchisees freely chose to enter the relationship, despite knowledge of the rebates. The franchisor can then defend its practices against antitrust claims by arguing that it participates in a competitive market when selling franchise services and that this competition limits its ability to profit from vendor sales to franchisees. If a franchisor can show that its rebate actions are constrained by competitive forces, it has a much better chance of preventing and defending against antitrust actions. Additionally, the ability to point to clear disclosures is invaluable for franchisors defending against claims of fraud or misrepresentation. Plaintiffs will have a difficult time arguing that they reasonably relied on any misstatements about rebates if accurate disclosures were provided to the franchisees. Finally, plaintiffs relying on a breach of contract theory must necessarily argue that the disclosures or contractual terms given to them were unclear or insufficient to support the franchisor’s practices. Franchisors who explain their rebate practices accurately and completely will be better prepared to prevent or defend against any of the rebate-related legal claims described in this paper.

Beyond the practical value of transparent disclosure, franchisors, of course, must make certain mandatory disclosures by law. The FTC Rule specifically requires franchisors to disclose “[a] description of the basis for calculating, and, if such information is readily available, the actual amount of, any revenue or other consideration to be received by the franchisor or persons affiliated with the franchisor from suppliers to the prospective franchisee in consideration for goods or services which the franchisor requires or advises the franchisee to obtain from such suppliers.”\(^{80}\) Item 8 of the NASAA Guidelines, meanwhile, requires franchisors to disclose “[w]hether, and if so, the precise basis by which the franchisor or its affiliates will or may derive revenue or other material consideration as a result of required purchases or leases.”\(^{81}\) Therefore, disclosure of the specifics of any vendor rebate agreement between a franchisor and a supplier is required under relevant law.

Complete and accurate disclosure of a franchisor’s right to collect rebates both conforms to legal requirements and decreases future litigation risk. However, a franchisor drafting disclosure documents or contractual provisions must walk a fine line with regard to vendor rebates. Specifically, the disclosures and contractual terms should be specific enough to put the potential franchisee on notice of the franchisor’s right to collect rebates, but general enough to allow the franchisor the flexibility to make necessary changes in its rebate policy if the franchisor’s needs and desires change over time. If a franchisor changes its rebate policy without contractual authorization and without warning to the franchisee, the franchisee could allege that it has been “locked in” to a relationship that it could not have anticipated. This could lead the franchisee to bring suit under any number of legal theories. Therefore, the franchisor must balance the need to provide thorough, adequate, and transparent disclosures with the desire to maintain flexibility to meet the changing needs of the business.

For example, in the rebate-related cases brought against Quizno’s, the franchisor used FDDs with specific language to put franchisees on notice of the possibility of rebates while simultaneously reserving its right to control the sources of supplies. Specifically, in its FDD, Quizno’s warned franchisees that the “willingness to pay us and/or our affiliates may be a condition of our approval of a supplier.”\(^{82}\) Therefore, Quizno’s was able to defeat certain rebate-

\(^{80}\) 16 C.F.R. § 436.1(a)(11).

\(^{81}\) NASAA Guidelines, Item 8(6).

\(^{82}\) See Martrano, 2009 WL 1704469, at *11-12.
related legal claims by demonstrating that the franchisees were aware of the possibility of supplier restrictions and the potential for Quizno's to collect rebates from those suppliers.

In contrast, where the FDD is silent as to the franchisor's ability to grant exclusivity and the franchisor changes its policies, the franchisee may contend that it was "locked-in" to an agreement that it could not have anticipated. For example, when a Wendy's franchisor eliminated alternative suppliers available to a particular franchisee, the franchisee claimed that it could not have anticipated the change in policy. Unlike the Quizno's FDD, the Wendy's Unit Franchise Agreement ("UFA") stated only that franchisees were required to purchase their supplies from vendors that met Wendy's standards and specifications, possessed adequate quality controls, and were approved in writing. The UFA also allowed franchisees to submit unapproved suppliers for Wendy's approval. The court found that the UFA language did not put the plaintiff on notice that Wendy's could eliminate all competition in the supply market by naming an exclusive supplier and then receiving rebates from that supplier. Therefore, Wendy's lost its motion to dismiss the rebate-related claims.

The contrasting results in the Quizno's and Wendy's cases demonstrate the careful balance that must be struck by drafting specific, yet flexible, contractual language regarding vendor rebates. As shown by the cases discussed in this paper, transparency often is the best defense against rebate-related litigation, no matter what legal theory the plaintiffs are relying on. Therefore, an attorney who drafts a franchise agreement or a disclosure document must understand the specific needs and desires of the franchisor with respect to vendor rebates. The attorney should strive to disclose accurately any rebates received by the franchisor and to allow the flexibility for the franchisor to adopt new supply policies to meet the changing needs and requirements of the franchise.

VI. CONCLUSION

Because of the increase in vendor rebate-related litigation over the past 15 years, franchisors that receive rebates or payments from suppliers must remain aware of the possibility of litigation in this area. Given the risk that a franchisor's rebate system will be challenged, it is important for franchisors to remain informed about relevant case law developments. In recent cases, plaintiffs have argued that vendor rebates are anticompetitive, constitute fraud, and/or breach the franchise agreement or other relevant contract between the parties. However, accurate, comprehensive, and flexible contract terms and disclosure provisions can provide a strong defense against these rebate-related claims, no matter what legal theories underlie the claims. Therefore, drafting the Item 8 disclosures and the contractual terms governing rebates is an increasingly important aspect of the formation of the franchise relationship.

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83 See Burda, 659 F. Supp. 2d at 928.
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