ANTITRUST CHALLENGES

The Queen Reigns – and Chops Off the Head of Franchise Tying Claims in the United States

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In a remarkable string of decisions from March to July 2008, six different U.S. federal courts rejected allegations of illegal "tying" arrangements in franchise systems. Just as striking as the unanimity of these opinions was the geographic diversity of the courts rendering them – the U.S. Federal Courts of Appeals for the Fifth Circuit (in the South), the Seventh Circuit (in the Midwest), and the Ninth Circuit (in the far West), and the Federal District Courts for the District of Connecticut, the Northern District of Ohio, and the District of New Jersey.

All but one of these decisions explicitly cited *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*[1] in dismissing the tying claim. This common thread is a notable development for franchisors who are faced with defending purchasing requirements and restrictions.

Background: Tying Claims in the Franchise Context

A tying arrangement is one in which the seller agrees to sell one product (the "tying" product) only on the condition that the buyer also agrees to purchase a different product (the "tied" product) from the seller or from a source in which the seller has a financial interest (or at least agrees not to purchase the tied product from any other supplier). A tying arrangement can violate U.S. federal antitrust law if the seller has "appreciable economic power" in the market for the tying product and if the arrangement affects a substantial volume of commerce in the market for the tied product.[2]

Challenging franchise system purchasing rules as illegal tying arrangements is one of the oldest legal traditions in franchising in the United States. Typically, the challenger is a franchisee who is subject to franchisor-imposed purchasing restrictions. Occasionally, the challenger is a supplier who has been foreclosed from selling to franchisee customers by such restrictions.

Two decades ago, tying claims seemed to have lost their vitality in franchising. Most foundered on the plaintiff's inability to show that the franchisor had "market power" with respect to the tying product sufficient to force the franchisee to purchase the tied product. The "tying" product was usually alleged to be the franchise itself, and few if any franchisors have a significant enough share of the market for the sale of franchises, or even for the sale of franchises within a particular industry, to present a plausible claim of market power. Even a market share of 30% was found insufficient by the U.S. Supreme Court in *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*,[3] (a non-franchise case).

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[1] 124 F.3d 430 (3d Cir. 1997), cert. denied, 1998 U.S. LEXIS 2317.

[2] See *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451, 461-462 (1992). This formulation refers to tying arrangements under the "*per se*" rule of antitrust analysis, which is the focus of this article. In theory, a tying arrangement that does not meet the elements of a *per se* tying claim could still be deemed unlawful under a "rule of reason" analysis, even without proof of market power with respect to the tying product. However, it is very unlikely that a tying arrangement which passes muster under the *per se* rule would be deemed an unreasonable restraint of trade under the less rigorous rule of reason test. In practice, such claims are rarely brought and almost never successful. See, e.g., *Western Power Sports, Inc. v. Polaris Industries Partners L.P.*, 744 F. Supp. 226 (D. Idaho 1990) (noting that no tying claim had ever been sustained based upon a rule of reason analysis), rev'd mem. on other grounds without published opinion, 951 F.2d 365 (9th Cir. 1991), cert. denied, 506 U.S. 821 (1992). A full discussion of the differences between the *per se* rule and the rule of reason is beyond the scope of this article.

[3] 466 U.S. 2 (1984).

Franchise tying claims revived after the Supreme Court's 1992 decision in *Eastman Kodak Co. v. Image Technical Services, Inc.* The *Kodak* decision appeared to offer a new way for aggrieved franchisees to prove the essential "market power" element of their claims. Specifically, plaintiffs alleged that *Kodak* supported a "lock-in" theory of market power – that franchisees become "locked in" to the franchise system once they purchase the franchise, and that the coerced sale of products and services to the group of locked-in franchisees operating in a particular system thus constitutes a "relevant market" for antitrust purposes.

The Queen City Case

Franchisees tested this theory in several post-*Kodak* cases, one of which was *Queen City Pizza.* In that case, franchisees of the Domino's Pizza chain alleged that the franchisor had unlawfully monopolized the sale of ingredients and supplies and unlawfully tied the purchase of ingredients and supplies to the supply of fresh pizza dough or, alternatively, to the "continued enjoyment" of the franchisees' rights under the franchise agreement. On its face, the franchise agreement only required franchisees to purchase from "approved suppliers," but in practice the franchisor had made itself the only approved supplier for 90% of the ingredients and supplies used in the system. The plaintiffs alleged that Domino's had foiled their attempts to make their own pizza dough on site and had blocked their efforts to buy less expensive ingredients from other sources. The district court dismissed the franchisees' antitrust claims, and the Third Circuit Court of Appeals affirmed, based on the franchisees' failure to plead a relevant market in which Domino's exercised economic power.

To fully understand the Third Circuit's analysis, one must review the Court's treatment of the franchisees' monopolization claim as well as their tying claim. "Monopolization," which is prohibited by section 2 of the *Sherman Act*,[4] has two elements: the possession of monopoly power in a relevant market, and the willful acquisition or maintenance of that power by improper means.[5] Thus, monopolization claims and tying claims both require the plaintiff to define a "relevant market" in which the defendant has economic power.

The Monopolization Claim

The Domino's franchisees suggested that the relevant market for antitrust analysis could be limited to the ingredients and supplies used in the operation of Domino's Pizza stores. The Court, however, held that a relevant market is defined by all reasonably interchangeable products:

> Here, the dough, tomato sauce, and paper cups that meet Domino's Pizza, Inc. standards and are used by Domino's stores are interchangeable with dough, sauce and cups available from other suppliers and used by other pizza companies. Indeed, it is the availability of interchangeable ingredients of comparable quality from other suppliers, at lower cost, that motivates this lawsuit. Thus, the relevant market, which is defined to include all reasonably interchangeable products, cannot be restricted solely to those products currently approved by Domino's Pizza, Inc. for use by Domino's franchisees .... [T]he relevant inquiry here is not whether a Domino's franchisee may reasonably use both approved or non-approved products interchangeably without triggering liability for breach of contract, but whether pizza makers in general might use such products interchangeably. Clearly, they could. Were we to adopt the plaintiffs' position that contractual restraints render otherwise identical products non-interchangeable for purposes of relevant market definition, any exclusive dealing arrangement, output or requirement contract, or franchise tying agreement would support a claim for violation of antitrust laws.[6]

The franchisees cited *Kodak* in an effort to salvage their monopolization claim, arguing that it was economically impracticable for them to abandon the Domino's system and enter a different line of business, and that because they were "locked in," the Court should recognize an "aftermarket" for Domino's-approved supplies as a relevant market for antitrust purposes. But the Court held that this was a misapplication of the "lock in" concept discussed in *Kodak*, where it had come up, not as a means to define the relevant

[4] 15 U.S.C. §2.

[5] Supra note 1 at 437 (citations omitted).

[6] Ibid. at 438.

market in the first place, but rather as a means to rebut a defence raised by the supplier (i.e., the defence that competition in the primary market for sale of copiers precluded market power in the secondary market for parts and repairs).[7]

Moreover, the Court found that the facts in *Queen City* were distinguishable from the facts in *Kodak* in several important ways. Most important, in *Kodak*, a single-brand aftermarket (of repair parts and services for Kodak photocopiers) was held to be a valid relevant market – not because copier purchasers were "locked in," but because repair parts and services for Kodak machines were not interchangeable with the service and parts used to fix other copiers. By contrast, the ingredients and supplies sold by Domino's were clearly interchangeable with supplies available from and used by others in the pizza business.

Second, in *Kodak*, the seller changed its original policy of allowing copier owners to obtain service from independent organizations – a change which the buyers had no ability to foresee at the time they purchased the copiers. By contrast, the Domino's franchisees "knew that Domino's Pizza retained significant power over their ability to purchase cheaper supplies from alternative sources because that authority was spelled out in detail in section 12.2 of the standard franchise agreement. Unlike the plaintiffs in *Kodak*, the Domino's franchisees could assess the potential costs and economic risks at the time they signed the franchise agreement."[8]

Third, the franchise transaction between Domino's Pizza, Inc. and the franchisee plaintiffs had been subjected to competition at the pre-contract stage. The same could not be said of the conduct challenged in *Kodak* because that conduct "was not authorized by contract terms disclosed at the time of the original transaction. Kodak's sale of its product involved no contractual framework for continuing relations with the purchaser. But a franchise agreement regulating supplies, inspections, and quality standards structures an ongoing relationship between franchisor and franchisee designed to maintain good will. These differences between the *Kodak* transaction and franchise transactions are compelling."

The Tying Claim

The Third Circuit affirmed dismissal of the franchisees' tying claims against Domino's for the same reason it dismissed their monopolization claim – failure to plead a relevant market in which Domino's exercised market power:

> This claim fails because the proposed tying [product] market – the market in Domino's-approved dough – is not a relevant market for antitrust purposes. Domino's dough is reasonably interchangeable with other brands of pizza dough, and does not therefore constitute a relevant market of its own. All that distinguishes this dough from other brands is that a Domino's franchisee must use it or face a suit for breach of contract. As we have noted above, the particular contractual restraints assumed by a plaintiff are not sufficient by themselves to render interchangeable commodities non-interchangeable for purposes of relevant market definition. If Domino's had market power in the overall market for pizza dough and forced plaintiffs to purchase other unwanted ingredients to obtain dough, plaintiffs might possess a valid tying claim. But where the defendant's "power" to "force" plaintiffs to purchase the alleged tying product stems not from the market, but from plaintiffs' contractual agreement to purchase the tying product, no claim will lie.[9]

The claim based on an alleged tie of ingredients and supplies to the franchise rights fared no better. The Court held that "Domino's Pizza's control over plaintiffs' 'continued enjoyment of rights and services under their Standard Franchise Agreement' is not a 'market.' Rather, it is a function of Domino's contractual powers under the franchise agreement to terminate the participation of franchisees in the franchise system if they violate the agreement."

In other words, the *Queen City* Court concluded that the franchisor's power to force franchisees to purchase ingredients and supplies derived from the contract, not from the

[7] Ibid. at 439.
[8] Ibid. at 440.
[9] Ibid. at 443.

franchisor's position in a market for pizza dough or franchise rights (the alleged tying items).[10] Accordingly, the franchisees' remedy for any abuse of the franchisor's power arose under contract law, not antitrust law.

The 2008 Decisions

Other decisions from the same era did not fully align with *Queen City*,[11] but the string of 2008 cases discussed below decisively demonstrates that the *Queen City* rationale now reigns. Moreover, it is encouraging to potential franchisor defendants not only that the franchisors won in each of these cases, but that they generally won at the motion to dismiss stage. The traditional reluctance to dismiss complex, fact-driven antitrust claims at such an early stage clearly is waning. The federal courts have been empowered by the U.S. Supreme Court's decision in *Bell Atlantic Corp. v. Twombly*,[12] in which the Court sent into "retirement," at least in antitrust matters, the rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim.[13] Under *Twombly*, in antitrust matters, factual allegations must be sufficient to cross a plausibility threshold.

The 2008 decisions are summarized below in the order in which they were rendered:

1. *Schlotzsky's Ltd. v. Sterling Purchasing and Nat'l Distrib. Co., Inc.*[14] The franchisor of a deli restaurant system sued Sterling for falsely representing to suppliers that it was the exclusive purchasing representative for the Schlotzsky's system. Sterling filed an antitrust counterclaim, alleging that Schlotzsky's tied the right to use its trade mark to the purchase of specific products, forcing franchisees to purchase both proprietary and non-proprietary products on terms they would not otherwise have accepted. Sterling alleged that the franchisees were "locked in," relying on *Kodak*. The Court understood Sterling to be arguing that "the relevant [tying product] market [was] the narrow universe of Schlotzsky's franchises," but it found that "to the contrary, the Schlotzsky's universe was created by contract and not by dominance of a market."[15] Finding the *Queen City* analysis to be "instructive," the Court held that Schlotzsky's contractual purchasing restriction "was not an antitrust 'tying arrangement' because it was not an exercise of market power but of contract power."[16]

   The Court also took guidance from the U.S. Supreme Court's 2006 decision in *Illinois Tool Works, Inc. v. Independent Ink, Inc.*,[17] which was not a franchise case but declared in no uncertain terms that "in all cases involving a tying arrangement, the plaintiff must prove that the defendant has market power in the tying product."[18] *Illinois Tool Works* was a watershed decision in which the Court overruled prior cases which had held that market power could be presumed from the existence of a patent (or, by implication, a trade mark) on the tying product.

   Another echo of *Queen City* in the *Schlotzsky's* decision was its emphasis on the pro-competitive benefits of the franchisor's purchasing restrictions. In *Queen City*, the Court observed that Domino's purchasing requirements benefitted franchisees by supporting product uniformity and consistency, "the essence of a successful nationwide fast-food chain." The assurance of uniformity and consistency for customers "means that individual franchisees need not build up their own good will."[19] In *Schlotzsky's*, the Court found that the franchisor's purchasing restrictions helped the system return to profitability and exit from bankruptcy

[10] On appeal, the franchisees advanced a different monopolization theory – that Domino's had a monopoly in a relevant market comprised of pizza franchise opportunities of the type offered by Domino's. However, the Third Circuit refused to consider this claim because it had not been properly raised and preserved at the district court level. Supra note 1 at 443-444.

[11] E.g., *Little Caesar Enters., Inc. v. Smith*, 34 F. Supp. 2d 513 (E.D. Mich. 1998); *Wilson v. Mobil Oil Corp.*, 940 F. Supp. 944 (E.D. La. 1996).

[12] 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007).

[13] Ibid. at 945.

[14] 520 F.3d 393 (5th Cir. 2008).

[15] Ibid. at 407.

[16] Ibid. at 408.

[17] 547 U.S. 28 (2006).

[18] Ibid. at 46.

[19] Supra note 1 at 433.

proceedings, thereby preserving a competitor. In short, "competition in the market was improved by the exercise of Schlotzsky's contract power in its small part of the relevant market."[20]

2. *Bansavich d/b/a Lori's Mobil v. McLane Company, Inc.*[21] An On the Run convenience store franchisee sued McLane Co., a distributor appointed by Mobil which was the only approved supplier available to the franchisee for certain exclusive items. McLane had informed the franchisee that it would not sell any products to the franchisee unless the franchisee also agreed to purchase tobacco products from McLane. The franchisee alleged an illegal tie of the tobacco products to the other, unidentified franchise-related products. However, the Court ruled that the plaintiff failed to satisfy the pleading requirements of Federal Rule of Civil Procedure 8. Specifically, her allegation that the tying products were "not otherwise available to consumers anywhere except OTR franchises" failed to plead a relevant tying product market.

   The Court cited *Queen City* for the proposition that "market power must flow from the market rather than from private knowing contractual relations," but held that an antitrust claim based on contractually created market power could still be viable under *NewCal Industries, Inc. v. Ikon Office Solution*.[22] The Court granted McLane's motion to dismiss, but allowed the franchisee an opportunity to replead in order to identify the specific tying products.

   In a subsequent ruling a few months later, again citing *Queen City*, the Court found the amended complaint "facially unsustainable" because the franchisee had "impermissibly limited the product market to exclude potential substitutes, such as non-Mobil-branded coffee, soda, pastries and promotional glassware or figurines that would be reasonably interchangeable by consumers."[23] The Court observed that in *NewCal Industries*, cited in its previous opinion, the Ninth Circuit – expressly distinguishing *Queen City* – had limited the *NewCal Industries* rationale to situations in which "the defendant is exploiting a contractual relationship to gain monopoly power in an aftermarket that is 'wholly derivative from and dependent on'" a primary market.[24] Because the market for any of the products identified in the complaint – like the pizza ingredients and supplies in *Queen City* – would exist whether or not there were gasoline franchises, the market was not "wholly derivative," *NewCal Industries* did not apply, and the complaint was dismissed again.

   It should be noted that, after *NewCal Industries* (which came out in January 2008) and in between the two *Bansavich* rulings, the Ninth Circuit issued its opinion in *Rick-Mik Enterprises*, the last case in the string discussed in this article. The second *Bansavich* opinion did not cite *Rick-Mik Enterprises*.

3. *Trane U.S. Inc. v. Meehan.*[25] Trane, a manufacturer of heating, ventilating, and air conditioning equipment, terminated Meehan's franchise and sued for monies owed. Meehan filed several counterclaims, including a tying claim alleging that Trane used its control over the franchise rights and branded equipment to force Meehan to purchase non-Trane products from other suppliers on terms dictated by Trane. Relying on *Kodak*, the franchisee asserted that the Trane brand was both a product and a relevant market. Trane moved to dismiss for, among other things, failure to plead a cognizable market in which Trane had market power.

   The Court concluded that the Sixth Circuit had not followed *Queen City* in refusing to recognize the "lock in" effect of contractual arrangements, rejecting Trane's contention that the Sixth Circuit had done so in *Valley Products Co., Inc. v. Landmark*.[26] The Court acknowledged "some distinctions between parties

[20] Supra note 14 at 408.
[21] 2008 U.S. Dist. LEXIS 25817, 2008-1 Trade Cas. (CCH) ¶ 76,109 (D. Conn. April 1, 2008).
[22] 513 F. 3d 1038 (9th Cir. 2008).
[23] 2008 U.S. Dist. LEXIS 89071, *8 (October 31, 2008).
[24] Ibid. at *9-10.
[25] 2008 U.S. Dist. LEXIS 42748, 2008-1 Trade Cas. ¶ 76,185 (N.D. Ohio May 29, 2008).
[26] 128 F.3d 398 (6th Cir. 1997).

'locked-in' by purchase of a product and parties 'locked-in' by ratification of a franchise agreement."[27] However, the Court was "not convinced" that they warranted different treatment under the antitrust laws. The issue was left undecided, however, because the Court found other grounds to dismiss the claim – namely, that the franchisee failed to allege that Trane had an economic interest in the franchisee's purchase of the tied products.

4. *Sheridan v. Marathon Petroleum Company, LLC.*[28] Sheridan filed suit against Marathon, charging it with unlawfully tying the processing of credit card sales to the Marathon franchise. The opinion by the redoubtable Judge Richard Posner makes short work of the claim. He gave the plaintiffs grudging credit for being "at least dimly aware that they would have to plead and prove that Marathon had significant unilateral power over the market price of gasoline."[29] The facts alleged in the complaint, however, consisted only of Marathon's rank among refiners, its number of retail outlets, and its annual sales of gasoline. Judge Posner computed Marathon's share of gasoline sales by dividing its alleged sales volume into total U.S. gasoline sales (a figure which he retrieved from the public website of official U.S. Government energy statistics). The result was 4.3%, which he concluded was "no one's idea of market power."[30]

   The *Sheridan* opinion does not cite *Queen City* (perhaps because the plaintiffs do not appear to have relied on a "lock in" theory), but it does briefly address the single-brand market argument made in that case and other cases: "Marathon does of course have a 'monopoly' of Marathon franchises. But 'Marathon' is not a market; it is a trade mark; and a trade mark does not confer a monopoly; all it does is prevent a competitor from attaching the same name to his product. 'Not even the most zealous antitrust hawk has ever argued that Amoco gasoline, Mobil gasoline, and Shell gasoline' – or, we interject, Marathon gasoline – 'are three [with Marathon, four] separate product markets.'"

5. *Beuff Enters. Florida, Inc. v. Villa Pizza, LLC*[31] is nearly a clone of *Queen City* – a claim by a pizza restaurant franchisee that the franchisor illegally tied supplies, furniture, and signs from designated sources to the sale of the franchise. The case even arose in the same federal circuit as *Queen City*. The plaintiffs attempted to distinguish the precedent by arguing that the proposed market in *Queen City* was "ingredients, supplies, materials, and distribution services," whereas their proposed market was "determined by the franchising aspects of [Villa Pizza's] franchise system." The complaint alleged that no other franchisor in the proposed geographic market of Florida offered a similar bundle of "unique services."[32]

   The Court would have none of this. It noted that the Villa Pizza franchise system was nothing more than a conglomeration of specific ingredients, supplies, materials, and services – "exactly the items that the *Queen City* Court found to be inadequate for a proposed relevant market in an antitrust case."[33] Adding the elements of trade names, trade marks and service marks did nothing, because trade marks do not establish a relevant submarket. Because the franchise system did not offer unique products or services, because potential franchisees had reasonably equivalent alternatives for franchise investments, and because the plaintiffs were bound by contract – not uniqueness – to purchase certain supplies, the claim was dismissed.

6. *Rick-Mik Enters., Inc. v. Equilon Enters., LLC.*[34] The claim in *Rick-Mik* was a mirror image of the claim against Marathon in the *Sheridan* case: Shell and Texaco dealers alleged that Equilon (franchisor of Shell and Texaco gasoline

[27] Supra note 25 at *32 (citation omitted).
[28] 530 F.3d 590 (7th Cir. 2008).
[29] Ibid. at 594.
[30] Ibid. at 595.
[31] 2008 U.S. Dist. LEXIS 50591, 2008-1 Trade Cas. (CCH) ¶ 76,216 (D.N.J. 2008) (designated not for publication).
[32] Ibid. at *17-19.
[33] Ibid. at *20.
[34] 532 F.3d 963 (9th Cir. 2008).

stations) illegally tied credit card processing services to the franchise. The outcome of the case was also a mirror image of *Sheridan* – dismissal of the claim. The Court cited *Queen City* and other cases for the proposition that failure to allege market power in the relevant market is grounds for dismissal.[35] And the Court found that Rick-Mik had not alleged that Equilon had market power with respect to the tying product – gasoline franchises. The complaint lacked information regarding Equilon's percentage of branded franchises, the percentage of gasoline sales from non-franchised outlets, and so forth. Furthermore, the allegation that the Shell and Texaco brands provided Equilon with economic power over the plaintiffs was foreclosed by *Illinois Tool Works*, which eliminated any presumption that intellectual property rights confer market power. Finally, the allegation of a franchise relationship was also insufficient, as the Court – again citing *Queen City* – held that "a tying claim generally requires that the defendant's economic power be derived from the market, not from a contractual relationship that the plaintiff has entered into voluntarily."

Conclusion

Collectively, these decisions seem to bury whatever remaining hopes franchise tying plaintiffs may have gleaned from *Kodak*. The edict of *Queen City* – that a relevant tying product market cannot be defined by contractual restrictions alone – has won the day.

These cases, together with the Supreme Court's decisions in *Twombly* and *Illinois Tool Works*, will make it challenging for franchisees and foreclosed suppliers to plead facts sufficient to avoid a motion to dismiss a tying claim under federal law. The same is likely, though not certain, to be true under state antitrust laws, which generally follow federal interpretations. Even if plaintiffs clear that procedural hurdle, market power and the other elements of a tying claim still must be proven, and the plaintiffs will also have to contend with the courts' explicit recognition of pro-competitive benefits of franchise purchasing restrictions.

Franchisees can, of course, still attack purchasing restrictions under contract law and other doctrines. But the spectre of treble damages under federal antitrust law will be greatly diminished, a result not lamented by franchisors.

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[35] Ibid. at 972-973.