



DISTRIBUTION

THE NEWSLETTER OF THE
DISTRIBUTION AND
FRANCHISING COMMITTEE

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MESSAGE FROM THE CHAIR

Welcome to another issue of *Distribution*! This issue considers topics relevant to both parts of the Committee's mandate, and we hope that you find them interesting. Your Committee has been active since the publication of the last issue, including sponsorship of multiple programs during the 2010 Spring Meeting and the conclusion of our *Distribution* in the North American Triangle teleseminar series (co-sponsored with the Unilateral Conduct and International Committees). This year, we have been fortunate to draw upon the assistance of a volunteer Advisory Board composed of active members of the Committee in helping with programming suggestions and other activities. Our members include Ted Banks, Kyriakos Fountoukakos, Thomas Funke, Joy Fuyuno, Stephen Wu and Quentin Wittrock, and I thank them for their participation. For the upcoming year, I am also pleased to announce two new additions to our Committee's leadership: Michelle Burtis and Lisa Carter. I'm sure you will be hearing from them over the next few months, and it is great to have them on board.

As always, if you are interested in participating actively in the Committee, please don't hesitate to contact any member of the Committee's leadership, and I look forward to meeting more of you over the next year.

Subrata Bhattacharjee
Chair, Distribution & Franchising Committee

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DISTRIBUTION welcomes submissions of articles, and case summaries involving significant or interesting decisions, trials, or developments in antitrust law affecting all types of distribution arrangements. Please send all submissions to:

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Can *American Needle* Be Applied to Poke Holes in Franchise and Distribution Practices?

by

Quentin R. Wittrock and Jeremy L. Johnson, Gray Plant Mooty

For most of the history of modern franchising and product distribution, it has been unclear whether the combined activities of a franchisor or supplier and its franchisees or dealers could be attacked under Section 1 of the Sherman Act. Was a franchise system akin to a corporation and its subsidiaries (thus not subject to Section 1), or was it more like a group of totally independent actors (who would be barred from collusion)? The National Football League and its 32 teams now have faced that question in the context of professional sports franchises. And the United States Supreme Court's *American Needle*¹ decision against the NFL on May 24, 2010, appears to open the door to Section 1 attacks against not just members of sports leagues. In addition to the obvious analogies between and similar terminologies used by sports leagues and dealership or franchise systems, the Court's language and rationale offer some comfort to both sides—but mostly to prospective claimants—in future franchise and product distribution cases.

This article will begin by examining the result and reasoning of the Supreme Court's decision, followed by a brief look at the history of Section 1 application in the context of franchising and distribution. We then conclude with thoughts on the impact *American Needle*

could have on future cases involving franchising or distribution practices.

I. *American Needle v. The National Football League*

The Supreme Court in *American Needle, Inc. v. National Football League et al.* held that the NFL and its teams are subject to Section 1 of the Sherman Act. The antitrust Rule of Reason will be applied on remand to determine if the joint licensing activities of the league and its members constitute an unreasonable restraint of trade. The challenged activities involve the exclusive licensing of intellectual property rights to a single manufacturer of headwear (Reebok International Ltd.), an arrangement that replaced a prior nonexclusive license with hatmaker *American Needle*, the plaintiff.

It is most interesting to read the opinion in *American Needle* with an eye out for signs of the breadth or narrowness of future Section 1 application to other types of group activities. Much of the opinion's language can be read as being limited to joint licensing of separate intellectual property rights, which is a context that would not implicate many other types of joint arrangements, including business format franchising and most dealership networks.² Notably, at the outset of its analysis, the Supreme Court states: "Directly relevant to this case, the

¹ *American Needle, Inc. v. National Football League et al.*, No. 08-661, 560 U.S. ___, 2010 LEXIS 4166 (2010).

² Business format franchising and most other networks of dealerships or franchises involve only the intellectual property—most notably trademarks—owned by the franchisor or manufacturer. The licensing of separately-owned trademarks like sports team logos is a distinct and atypical practice.

teams compete in the market for intellectual property.”³ The Court also reiterates that the licensing of “separately owned trademarks collectively” restricts competition.⁴

Throughout its opinion, the Court makes reference to the separateness of the teams, particularly as to their intellectual property ownership. While all of the teams jointly have interests in the NFL brand, their interest in their own trademarks and the licensing of those potentially-competing, team-specific trademarks is strong, the Court points out.⁵ Similarly, the teams’ joint interest and mutual dependency in scheduling games with agreed upon rules does not negate their separateness as competitors both on and off the field.⁶ The Court notes once again near the end of the opinion that the acknowledged joint interests of the teams “does not justify treating them as a single entity for §1 purposes when it comes to marketing the teams’ individually owned intellectual property.”⁷

All of the Court’s emphasis on separately-owned intellectual property may lead one to conclude that *American Needle* could never apply to franchising and distribution systems, because the branded business being franchised or the branded product being distributed uses intellectual property owned by a single party. But there is language in the opinion, too, that holds open concern for franchising and distribution systems.

First and most tellingly for franchising and distribution, the Supreme Court also focuses on the separate

decisionmaking of the NFL teams and the league itself, with separate decisionmaking being regarded as precisely what antitrust law seeks to preserve. Quoting from and citing previous court rulings, Justice Stevens in *American Needle* writes that “the key” to determining whether a “contract, combination . . . , or conspiracy” exists under Section 1 is if it “joins together separate decisionmakers.”⁸ In the end, if “the agreement joins together ‘independent centers of decisionmaking,’” then “the entities are capable of conspiring under §1, and the Court must decide whether the restraint of trade is an unreasonable and therefore illegal one.”⁹ The Court notes later that the NFL teams, despite their “common interests,” remain “separate, profit-maximizing entities.”¹⁰ The obvious analogy to franchising and distribution systems, in which the franchisees, distributors, and dealers generally are independently-owned entities operating under contracts with the franchisor or supplier, is more than enough to leave open the possibility that Section 1 will apply broadly to franchising and product distribution after *American Needle*.

The Court also includes other language that increases the likelihood that the holding of *American Needle* will be cited broadly. Just as “a nut and bolt can only operate together,” the Court writes, for example, “an agreement between nut and bolt manufacturers is still subject to §1 analysis.”¹¹ While jointly-acting parties may dispute which is the “nut,” most will likely have to concede that they are part of an “agreement” that is “subject to §1.” The

³ *American Needle*, Slip Opinion at 12.

⁴ *Id.*

⁵ *Id.* at 13.

⁶ *Id.* at 5 n. 7.

⁷ *Id.* at 19.

⁸ *Id.* at 10.

⁹ *Id.* at 11 (quoting *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 769 (1984)).

¹⁰ *Id.* at 13.

¹¹ *Id.* at 14-15.

applicability of Section 1 will not be the end of the analysis, as discussed in part III below, but the ability to argue that Section 1 simply does not apply will be severely impaired. This is likely to be the case outside the context of sports franchises and leagues, including business format franchising and product distribution systems.

II. Prior Application of Section 1 to Franchising

Before *American Needle*, the closest the Supreme Court had come to the topic at hand was in *Copperweld Corp. v. Independence Tube Corp.*, the Court's 1984 decision that had held that, as a matter of law, a corporation and its wholly-owned subsidiary cannot conspire with each other in violation of Section 1 of the Sherman Act.¹² Although *Copperweld* was not a franchise case, franchisors have cited it successfully for the proposition that a franchise system is a single economic unit for antitrust purposes and, therefore, franchisors and franchisees are incapable, as a matter of law, of conspiring in violation of Section 1.¹³ Whether this is a proper application of *Copperweld* has been unclear because the Supreme Court has not revisited its holding in *Copperweld* to give more meaningful guidance on the long list of difficult issues that arise outside the narrow situation raised in that case. Moreover, as discussed below, such an application may conflict with pre-*Copperweld* Supreme Court authority. In light of the Supreme Court's *American Needle* decision, in which the Court reiterates the principles laid down in *Copperweld* and arguably opens the door to the application of Section

1 to a broader range of joint activities, including franchising, now is a good time to revisit the extent to which the *Copperweld* doctrine insulates franchisors and franchisees from Section 1 liability. Specifically, the question is whether the handful of post-*Copperweld* district court cases that have relied on *Copperweld* in refusing to subject a franchise system to Section 1 liability are consistent with the principles of *Copperweld* after *American Needle*.

Prior to *Copperweld*, the Supreme Court had seemed to accept that franchisors and franchisees, just like any other related corporate entities, were capable of conspiring in violation of Section 1 of the Sherman Act. For example, in *United States v. General Motors Corp.*,¹⁴ the Court found an unlawful conspiracy between General Motors and certain of its dealers and dealer associations to refuse to sell General Motors vehicles to independent discount dealers and to police adherence to this agreement. Without any mention of the intra-enterprise conspiracy doctrine and without even questioning whether the franchise relationship could be subject to Section 1 liability, the Court held:

We have here a classic conspiracy in restraint of trade: joint, collaborative action by dealers, the appellee associations, and General Motors to eliminate a class of competitors by terminating business dealings between them and a minority of Chevrolet dealers and to deprive franchised dealers of their freedom to deal through discounters if they so choose.¹⁵

¹² Under the intraenterprise conspiracy doctrine, enunciated in earlier Supreme Court decisions, common ownership of separately incorporated entities did not exempt the actions of those entities from Section 1 scrutiny.

¹³ See *Alaska Rent-A-Car, Inc. v. Cendant Corp.*, No. 3:03-cv-00029, 2007 U.S. Dist. LEXIS 55474 (D. Ak. July 27, 2007); *Search International v. Snelling & Snelling*, 168 F. Supp. 2d 621 (N.D. Tex. 2001), *aff'd without opinion*, 31 Fed. Appx. 151 (5th Cir. 2001); *Hall v. Burger King Corp.*, 912 F. Supp. 1509 (S.D. Fla. 1995); *Williams v. Fischer*, 794 F. Supp. 1026 (D. Nev. 1992).

¹⁴ 384 U.S. 127 (1966); see also *Abboud's McDonald's, LLC v. McDonald's Corp.*, No. CV04-1895P, 2005 U.S. Dist. LEXIS 30053 (W.D. Wash. Oct. 14, 2005).

¹⁵ 384 U.S. at 140.

Similarly, two years later, in *Perma Life Mufflers, Inc. v. International Parts Corp.*,¹⁶ the Supreme Court had reversed the dismissal of a Sherman Act Section 1 claim brought by franchisee dealers who had operated Midas Muffler Shops, against the franchisor, Midas, Inc., and its parent company. The franchisee plaintiffs had alleged, among other things, that restrictions in the sales agreements—namely, terms prohibiting the franchisees from purchasing product from non-Midas suppliers, allocating franchisee sales territories, tying the sale of mufflers to other products in the Midas line, and fixing retail prices—violated Section 1. In granting summary judgment for the defendants, the district court held that the franchisees’ Section 1 claim was barred under the doctrine of *in pari delicto*.¹⁷ On appeal, the Seventh Circuit affirmed the lower court’s ruling on the *in pari delicto* defense and further held that the franchisees’ Section 1 claim was barred because Midas, Inc. and its parent, International Parts Corp., “while functioning as separate corporations, had a common ownership and therefore, could cooperate without creating an illegal conspiracy.”¹⁸ The Supreme Court reversed the Seventh Circuit’s ruling on the *in pari delicto* defense, stating that it was “not to be recognized as a defense in an antitrust action.”¹⁹ The Court also reversed the Seventh Circuit’s alternative holding on the grounds that “since respondents Midas and International availed themselves of the privilege of doing business through separate corporations, the fact of common ownership could not

save them from any of the obligations that the law imposes on separate entities.”²⁰ The Supreme Court then took one step further:

In any event each petitioner can clearly charge a combination between Midas and himself, as of the day he unwillingly complied with the restrictive franchisee agreements . . . or between Midas and other franchise dealers, whose acquiescence in Midas’ firmly enforced restraints was induced by ‘the communicated danger of termination.’²¹

The Court’s statement is arguably dicta, but no subsequent Supreme Court decision, including *Copperweld*, has ever confronted and overturned this “alternative holding” in *Perma Life* that a franchisor is capable of conspiring with its franchisees in violation of Section 1. In fact, the Court was careful in *Copperweld* to distinguish *Perma Life* on that decision’s primary holding and not on the statement that each franchisee could “clearly charge a combination” between the franchisor and itself.²² Moreover, while *Perma Life* has since been cited primarily for the proposition that the doctrine of *in pari delicto* is not a proper defense to an antitrust action, a handful of courts have cited *Perma Life* after *Copperweld* for the proposition that a franchisee and franchisor can conspire in violation of Section 1.

For instance, in *Will v. Comprehensive Accounting Corp.*,²³ the Seventh Circuit Court of Appeals, in

¹⁶ 392 U.S. 134 (1968).

¹⁷ “Although the doctrine of *in pari delicto* literally means ‘of equal fault,’ the doctrine has been applied, correctly or incorrectly, in a wide variety of situations in which a plaintiff seeking damages or equitable relief is himself involved in some of the same sort of wrongdoing.” *Id.* at 138.

¹⁸ *Perma Life v. International Parts Corp.*, 376 F.2d 692 (7th Cir. 1967).

¹⁹ 392 U.S. at 140.

²⁰ *Id.* at 141.

²¹ *Id.* at 142.

²² See *Copperweld*, 467 U.S. at 766 (“Thus, . . . the [intra-enterprise conspiracy] doctrine was at most only an alternative holding in *Perma Life Mufflers*.”)

²³ 776 F.2d 665 (7th Cir. 1985).

affirming a jury verdict in favor of the franchisor defendant on the franchisee plaintiffs' Section 1 tying claim, held that the lower court had properly instructed the jury on the "agreement" element of the plaintiffs' claim:

[*Perma Life*] provides plaintiffs with an escape hatch. The Court stated that a franchisee 'can clearly charge a combination between [the franchisor] and himself, as of the day he unwillingly complied with the restrictive franchise agreements, . . . or between [the franchisor] and other franchise dealers, whose acquiescence in [the] firmly enforced restraints was induced by "the communicated danger of termination". . . This portion of *Perma Life* survived *Copperweld*. . .²⁴

Similarly, in *Western Duplicating, Inc. v. Riso Kagaku Corp.*,²⁵ the district court for the Eastern District of California noted that *Copperweld* overruled *Perma Life* on "other grounds," and the court went on to apply the *Perma Life* principle that a franchisor can conspire with its franchisees, to hold that the plaintiff, a competing dealer, had stated a Section 1 claim against the defendant and its franchisee dealers. In *Arno Park, Inc. v. Yogurt Ventures U.S.A., Inc.*,²⁶ the court, citing *Perma Life* for the proposition that a franchisor can conspire with a franchisee, denied the defendant franchisor's motion to dismiss the plaintiff franchisee's Section 1 tying claim.

There also are a few post-*Copperweld* cases, however, in which district courts have held that the franchisor was incapable, as a matter of law, of conspiring with its

franchisees in violation of Section 1. In their 2003 *Franchise Law Journal* article, "Antitrust and Franchising: Conspiracies Between Franchisors and Franchisees Under Section 1," Suzanne E. Wachsstock and Erika L. Amarante, provided an excellent and thorough treatment of these cases and concluded that while the analyses in these cases "leave much to be desired, they may have been headed in the right general direction."²⁷ In the first of these cases, *Williams v. Fischer*,²⁸ the plaintiff, a manager of a Las Vegas Jack-in-the-Box restaurant, sued the franchisee and the franchisor alleging that a "no-switching" clause in the franchise agreement that prohibited a franchisee from offering employment to any person that had been the manager of another Jack-in-the-Box restaurant, violated Section 1. In granting the franchisor's motion for summary judgment, the district court held that the franchisee and the franchisor were "incapable of conspiring."²⁹ While the court acknowledged that "the nature of an entity and its ability to combine and conspire in violation of Section 1 is a fact question,"³⁰ it failed to address the specifics of the franchise relationship in that case and instead reached its decision based on sweeping factual conclusions regarding fast-food franchises generally:

In a fast-food franchise the franchisor does everything to promote a uniform, non-competitive environment between the franchises: Each franchise serves substantially the same products; the products are served to the public in the same manner; the franchisor develops products and services for all franchises; the employees dress alike;

²⁴ *Id.* at 669-70.

²⁵ 2001-1 Trade Cas. (CCH) ¶ 73,135 (E.D. Cal. 2000).

²⁶ 1994-2 Trade Cas. (CCH) ¶ 70,825 (W.D. Mo. 1994).

²⁷ *Franchise Law Journal*, Summer 2003, at 12.

²⁸ 794 F. Supp. 1026 (D. Nev. 1992).

²⁹ *Id.* at 1032.

³⁰ *Id.* at 1030.

the décor of each franchise is similar; the franchises are advertised as a single enterprise for exclusivity within a certain geographic area to minimize competition between franchises.

Additionally, their economic unity of interest continues beyond the payment by the franchisee of the licensing fee. The franchisor continues to receive both a royalty fee and marketing fee based upon a percentage of the restaurant's gross sales.³¹

The Ninth Circuit affirmed the decision in a per curiam opinion, holding that the franchisee and franchisor were "incapable of conspiring" because they were a "common enterprise."³²

Likewise, in *Hall v. Burger King Corp.*³³ and *Search International v. Snelling & Snelling*,³⁴ the district courts in those cases held that franchisors and franchisees were incapable of conspiring. In *Hall*, the district court, citing *Williams v. Fischer*, granted the defendant franchisor's motion for summary judgment holding that "[e]ven if there were a scintilla of evidence which supported [plaintiff's] conspiracy claim it still would fail because BKC and its franchisees are incapable of conspiring with each other."³⁵ In *Search International*, the district court granted the franchisor defendant's motion to dismiss on the ground that the franchisee plaintiff had failed to state a Section 1 claim, holding that "Snelling and its franchisees constitute a 'single economic unit' incapable

of conspiring under Section 1."³⁶ Like the court in *Fischer*, the court in *Search International* reached its decision based on factual conclusions common in almost every franchisor-franchisee relationship:

For example, Snelling owns all of the improvements, enhancements, advertising, public relations programs, or inventions developed by its franchisees as well as all goodwill associated with Snelling's proprietary marks. In addition, all clients of a Snelling franchise are automatically clients of Snelling, and franchise clients pay Snelling directly for all services rendered by the franchise. Lastly, Snelling controls where its franchises are located and who its franchisees can compete with.³⁷

Most recently, in *Alaska Rent-A-Car, Inc. v. Cendant Corp.*, the United States District Court for the District of Alaska granted summary judgment for the defendants, car rental franchisors and their parent corporations, on a plaintiff franchisee's Section 1 claim. Citing *Fischer* for the proposition that a "franchiser and franchisee constitute[] a common enterprise incapable of conspiring to violate § 1 of the Sherman Act," the court rejected the plaintiff's argument that *Fischer* should be disregarded as being contrary to *Copperweld* and *Perma Life* holding that "Not only is *Fischer Nevada* consistent with *Perma Life* and *Copperweld*, but *Copperweld* tends to reinforce *Fischer Nevada*."³⁹

³¹ *Id.* at 1031-32.

³² *Williams v. I.B. Fischer Nevada*, 999 F.2d 445, 447 (9th Cir. 1997).

³³ 912 F. Supp. 1509 (S.D. Fla. 1995).

³⁴ 168 F. Supp. 2d 621 (N.D. Tex. 2001), *aff'd without opinion*, 31 Fed. Appx. 151 (5th Cir. 2001).

³⁵ 912 F. Supp. at 1548.

³⁶ 168 F. Supp. 2d at 625.

³⁷ *Id.* at 626.

³⁸ No. 3:03-cv-00029, 2007 U.S. Dist. LEXIS 55474 (D. Ak. July 27, 2007).

³⁹ *Id.* at *77 n. 76.

Ms. Wachsstock and Ms. Amarante were correct that it would be and still is difficult to predict how the Supreme Court would treat any particular franchisor/franchisee conspiracy under *Perma Life* and *Copperweld* were it to encounter one. The lower courts' categorical refusals in the above cases to subject a franchise relationship to Section 1 liability seems to be inconsistent with *Perma Life*, *Copperweld* itself, and, as discussed below, *American Needle*, if for no other reason than because those lower courts disregard the Supreme Court's directive to eschew such a formalistic approach "in favor of a functional consideration of how the parties involved in the alleged anticompetitive conduct actually operate."⁴⁰

III. Impact of *American Needle* on Franchising

In the common-law-like world of antitrust, the impact of any single decision always depends on future developments and the permutations followed by other courts. There are a number of indicators, however, that *American Needle* is significant, potentially even for what generally is known as "franchising." As a biggest picture matter, *American Needle*, if nothing else, can be viewed as the start of the pendulum swinging back: the plaintiff was the first to "win"⁴¹ an antitrust case in the Supreme Court in nearly two decades. In ruling for the plaintiff, the Supreme Court cited its long-past decisions in *United*

*States v. Sealy, Inc.*⁴² and *United States v. Topco Associates, Inc.*,⁴³ which could breathe new life into those cases and signal at least a partial return to a more pro-plaintiff era. The *American Needle* decision thus holds the highest potential for use by franchisees, distributors, and dealers in antitrust cases since *Image Technical Services v. Eastman Kodak*⁴⁴ in 1992. While the Court's *American Needle* decision quickly could be relegated the way *Kodak* was by subsequent decisions like *State Oil v. Kahn*,⁴⁵ *Bell Atlantic Corp. v. Twombly*,⁴⁶ and *Leegin Creative Leather Prods. v. PSKS, Inc.*,⁴⁷ as well as lower-court interpretations like *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*,⁴⁸ for now at least the antitrust landscape looks brighter for plaintiffs.

As to franchising and distribution more specifically, certainly the "independent decisionmakers" language and emphasis portends significance for *American Needle*. For franchise and distribution systems generally acknowledge that the franchisees and dealers are "independent contractors"⁴⁹ as it relates to the franchisor or supplier. Franchisees, distributors, and dealers also are commonly viewed as independent from each other. Therefore, after *American Needle*, the applicability of Section 1 to franchising and product distribution systems may be clear.

⁴⁰ *American Needle*, Slip Opinion at 15.

⁴¹ We put the word win in quotation marks because the plaintiff still may face an uphill battle in the district court.

⁴² 388 U.S. 350 (1967).

⁴³ 405 U.S. 596 (1972).

⁴⁴ 504 U.S. 451 (1992).

⁴⁵ 522 U.S. 3 (1997).

⁴⁶ 550 U.S. 544 (2007).

⁴⁷ 551 U.S. 877 (2007).

⁴⁸ 124 F.3d 430 (3rd Cir. 1997).

⁴⁹ A typical franchise agreement clause reads something like this: "The parties to this agreement are independent contractors and no training, assistance or supervision which we may give or offer to you shall be deemed to negate such independence or create a legal duty on our part. ... The parties to this agreement further acknowledge and agree the relationship created by this agreement and the relationship between us is not a fiduciary relationship nor one of principal and agent. ... You acknowledge and agree that you do not have the authority to act for or on our behalf or to contractually bind us or our affiliates to any agreement."

Do franchisees or dealers within a system or network compete with each other? That question gains significance from the Supreme Court's emphasis on whether the NFL's teams are truly "competitors" in an economic sense as much as they are on the field of play. In *American Needle*, the answer was a definite yes—"the teams still have distinct, potentially competing interests."⁵⁰

The argument that a system's franchisees or dealers do not compete with one another could theoretically be supported by the concept of exclusivity—that the system is arranged such that there is no overlap, thus no competition. Such a theory breaks down, however, either when a system is not in fact set up with exclusive territories, or when customers can still buy from multiple franchisees or dealers despite any territory assignments. In the former situation, the lack of exclusivity ends the argument, as the franchisees or dealers likely do compete for sales to any customers who could buy from more than one outlet. Even when dealers or franchisees do have some exclusivity, they still compete absent the strictest of monitoring and enforcement, with the rise of internet sales increasing the level of intrasystem competition.

If franchisees or dealers within a system are considered economic competitors in the same ways the NFL teams were deemed to be, then their agreements will be subject to the same antitrust scrutiny. And that scrutiny will be under the Rule of Reason. That is the basic message of *American Needle*.

A rule subjecting franchise systems and distribution networks to Section 1 is nothing more than a rule,

however, until it is overlaid against real fact situations that arise in practice. It is not hard to think of "agreements" that are commonly formed; the difficulty will come in determining which agreements, if any, restrain trade unreasonably under the Rule of Reason. For starters, the existence of a franchise agreement, distribution agreement, or dealership agreement, of course, is not inherently anticompetitive. So too are there ample justifications and a lack of harm to competition in the individual provisions contained in most such agreements. These are the types of easy Rule of Reason inquiries that the Supreme Court in *American Needle* predicted could be resolved favorably for the defendant "in the twinkling of an eye."⁵¹ Ultimately, in many situations, the functional consideration of the realities of franchise relationships will dictate the same results reached in prior district court cases—a finding that the franchisor and franchisee, as a matter of law, have a unity of economic interest and are thus incapable of conspiring in violation of Section 1.

American Needle does give some general assistance in determining what types of agreements should be safe under Rule of Reason analysis. First, the Court noted that the NFL and its teams "must cooperate in the production and scheduling of games," which "provides a perfectly sensible justification for making a host of collective decisions."⁵² Second, the Court, quoting from its old decision in *Board of Trade of Chicago v. U.S.*,⁵³ repeated that a restraint that "merely regulates and perhaps thereby promotes competition" should not be found to be illegal.⁵⁴ We will leave for another day any detailed analysis of the types of distribution or

⁵⁰ *American Needle*, Slip Opinion at 13.

⁵¹ *Id.* Slip Opinion at 19 (quoting *National Collegiate Athletic Assn. v. Board of Regents of Uni. of Okla.*, 468 U.S. 85, 109 n. 39 (1985)).

⁵² *Id.* Slip Opinion at 18.

⁵³ 246 U.S. 231, 238 (1918).

⁵⁴ *American Needle*, Slip Opinion at 18, quoting *Chicago Board of Trade*, 246 U.S. at 238.

franchising restraints⁵⁵ that fall outside these safe harbors. We will say now, however, that franchise systems, like football teams and leagues, “*must cooperate*” in most respects, and there are “perfectly sensible justifications” for most joint decisions in franchising and distribution. Most aspects of these relationships “merely regulate” and “promote” interbrand competition, which of course is the main focus of antitrust law.⁵⁶ Just as “[f]ootball teams that need to cooperate are not trapped by antitrust law,”⁵⁷ franchisees (and their franchisors) should not be hindered much by application of Section 1 to their collaborations.

The ironic conclusion is that the defendants’ “loss” in *American Needle* puts them in much the same position as another defendant after its much-ballyhooed “win,” that being in *Leegin*. Both defendants face a trial or further motions in a federal district court. Both plaintiffs have the same opportunity, to prove an unjustifiable, adverse impact on competition. In rejecting the NFL’s hoped-for preemptory victory by refusing to rule that Section 1 does not apply, the Supreme Court simply held that there is no such bright line defense. Substance, not form and not broad immunities, will control.♻

⁵⁵ Examples of typical joint activity in franchising and distribution include: (1) agreed pricing promotions and practices; (2) joint advertising, including through advertising “cooperatives”; (3) systemwide licensing; (4) other multiparty contracts with vendors; (5) group decisions on rules and restrictions; and (6) selection or elimination of approved suppliers.

⁵⁶ *GTE Sylvania v. Continental T.V., Inc.*, 433 U.S. 36,52 n. 19 (1977).

⁵⁷ *American Needle*, Slip Opinion at 18.

Franchisors Beware, Puerto Rico Is Not a “Blue Pencil” Jurisdiction for Non-Compete Clauses

by

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Once again, the Supreme Court of Puerto Rico has made it clear that Puerto Rico is not a “blue pencil” jurisdiction and non-compete clauses will be struck if any component of the non-compete provisions is deemed unreasonable. In *Franquicias Martín’s BBQ, Inc. v. Luis García de Gracia*,¹ the Supreme Court of Puerto Rico considered for the first time the validity of a non-compete provision in the context of a franchise agreement.

Franquicias Martín’s BBQ, Inc. (the “Franchisor”) entered into a franchise agreement (the “Agreement”) with Luis García de Gracia (the “Franchisee”) granting him rights to operate one of Franchisor’s rotisserie-style fast food restaurants over a 5-year period. Among other things, the Agreement included a non-competition clause which required the Franchisee to refrain from promoting or selling foods prepared in the same or similar manner as those of the franchise and from operating a similar business within ten (10) miles of any restaurant of the Franchisor for a period of two (2) years after the termination of the Agreement. Before the expiration of the Agreement, Franchisee informed Franchisor that it would not renew the same. Notwithstanding, once the Agreement expired, Franchisee continued operating a rotisserie-style restaurant in the same location.

The Franchisor moved to obtain a preliminary injunction to force Franchisee to comply with the non-

compete clause. The lower court granted the preliminary injunction restricting the sale of certain products by Franchisee. The Franchisee appealed the decision, stating that the non-compete clause was unreasonable. The Court of Appeals vacated the lower court’s holding stating that it affected Franchisee’s right to work and that the two-year restriction contradicted established law governing non-competes in the employer-employee context.² The Franchisor appealed to the Supreme Court via certiorari, questioning the applicability of the employer-employee contract criteria to a franchise agreement. Although the Supreme Court agreed with Franchisor that the employee-employer test was inapplicable, it affirmed the Court of Appeals’ ruling that the covenant-not-to-compete at issue was unreasonable. In reaching this conclusion, the Supreme Court once again refused to blue-pencil a non-compete to bring it within a reasonable scope.

As part of its analysis, the Supreme Court discussed the evolution, benefits and virtues of the franchise system and the issues that led to its regulation by the states and the Federal Trade Commission. The Supreme Court stated that in Puerto Rico franchise agreements are not expressly regulated by Puerto Rico law nor have they been the subject of detailed analysis by jurisprudence. Guided by the “freedom of contract” doctrine and the

¹ 2010 TSPR 71 (2010).

² Specifically, the Appellate Court relied on *Arthur Young & Co. v. Vega III*, 136 D.P.R. 157 (1994), discussed *infra*.

provisions of Article 1207³ of the Puerto Rico Civil Code, the existence and validity of franchise agreements were acknowledged by the Supreme Court.⁴

The Supreme Court then turned its attention to the analysis of the non-compete clause. Again, based on the “freedom of contract” doctrine, the Supreme Court had previously upheld the validity of non-compete agreements in Puerto Rico.⁵ In its key decision on this topic, *Arthur Young*, the Supreme Court of Puerto Rico was asked to evaluate the validity of a non-competition clause in the context of an employment contract. In doing so, the Supreme Court recognized that the “freedom of contract” doctrine permeates our judicial system. The Supreme Court added, however, that such liberty is limited by Article 1207 of the Puerto Rico Civil Code. *See* note 3, *supra*. The Supreme Court then established the following criteria that non-compete agreements must comply with in order to be enforceable: (i) The employer's legitimate business interests will be substantially affected in the absence of the non-competition agreement; (ii) The non-competition prohibition must be limited to activities similar to those carried on by the employer - it is not necessary that the prohibition be limited to the employee's specific duties; (iii) The non-competition period cannot exceed twelve (12) months; (iv) The geographic area covered under the prohibition must be that strictly necessary to avoid real competition between the employer and the ex-employee; (v) When the covenant not to compete is phrased in terms of prohibited clients, it must refer only to those that the employee personally serviced during a reasonable time prior to the termination of the employment relationship; (vi) The contract must have adequate consideration (continuity of employment does not constitute adequate consideration); (vii) The essential elements for the validity of a contract must be present; and (viii) The contract must be in writing. The Supreme

Court concluded that non-competition clauses that do not meet the above-mentioned reasonability factors, not only “violate contractual good faith but also public policy, by excessively and unjustifiably restricting the employee's freedom of contract and the general public's freedom of choice”. In applying the aforementioned criteria, the Supreme Court invalidated the non-compete clause on the basis that the two year non-competition prohibition was excessive. The Supreme Court emphasized the fact that the legitimate interests of the company did not justify such a lengthy prohibition. The clause would have been enforceable had it limited the prohibition to twelve months, since the Supreme Court held that all other conditions of the non-competition clause were reasonable.

In the case at hand, the Supreme Court was faced with whether the *Arthur Young* factors should apply to a non-compete in a franchise agreement. The Supreme Court recognized that typically non-compete clauses were found in employment, sale of business and franchise agreements. For the first time in Puerto Rico, however, the Supreme Court faced the validity and enforceability of a non-compete clause in the context of a franchise agreement. The Supreme Court looked to other jurisdictions for guidance. The Supreme Court determined that as a general rule, U.S. states and members of the European Union have upheld the validity of reasonable non-compete clauses in franchise agreements. However, the Supreme Court could not identify a pattern in the treatment of such clauses across the various jurisdictions. It did point out that some jurisdictions compared non-compete clauses in franchise agreements with those in employment agreements while other jurisdictions compared them with those in sale of business agreements. The Supreme Court considered the relationship between franchisor and franchisee as one between businessmen, rather than one of employment. The Supreme Court

3 Article 1207 of the Puerto Rico Civil Code provides: “Contracting parties may enter into agreements and establish the clauses and conditions which they may deem advisable, provided they are not in contravention of law, morals, or public order.” 31 L.P.R.A. § 3372.

4 Citing *Tastee Freez de P.R., Inc. v. Negociado de Seguridad de Empleo*, 108 D.P.R. 495 (1979).

5 *Arthur Young & Co., supra*. *See also PACIV, Inc. v. Pérez Rivera*, 159 D.P.R. 523 (2003), and *Aconi Telecommunications, Inc. v. Noa*, 136 D.P.R. 579 (1994).

concluded that non-compete clauses in a franchise agreement are valid so long as the terms are reasonable.

In essence, the Supreme Court determined that the legality of non-compete clauses in franchise agreements depended on the reasonableness of the clause itself. In evaluating the reasonableness of the non-compete clause, the Supreme Court established that it would focus on the following four factors: (i) interests being protected; (ii) term; (iii) area; and (iv) restricted activities.

The franchisor must demonstrate that the interests that require protection are of such importance that they warrant the imposition of restrictions on the franchisee. The reasonableness of the restrictions imposed on the franchisee will be measured against the franchisor's legitimate interests.

The term of the non-compete clause must be reasonable. Alluding to case law decided in various U.S. states, the Supreme Court found that time restrictions permitted by other jurisdictions ranged from six (6) months to three (3) years. With respect to the geographic area of non-competition, the Supreme Court found that some states limited the area of non-competition to the area of exclusivity of the franchise in question while others consider the business locations of other franchisees. The Supreme Court refused to establish specific parameters for these elements. However, with regards to restrictions on geographical area, the Supreme Court did establish that unless a franchisor can demonstrate an interest requiring a larger area of protection—considering as a whole the reasonableness on the restrictions of time, area and activities—or in those cases where no exclusive geographical area is specified for the franchisee, the geographic area subject to the non-compete clause shall not exceed the geographic area of operation of the franchise.

Finally, with regards to the restricted activities, the same must be limited to those that put the franchisor in a competitive disadvantage should the franchisee continue to use the franchisor's methods or information, among other things, thus hurting the franchisor's legitimate interests.

Applying the above-mentioned criteria, the Supreme Court proceeded to evaluate the non-compete clause in the *Martin's BBQ* case.

The Supreme Court concluded that Franchisor demonstrated that it had legitimate interests (namely, the franchise itself, recipes, and business methods) which required protection. The Supreme Court also deemed reasonable the following restrictions: (i) 2-year term, and (ii) the restriction on selling foods prepared in the same or similar manner as those of the franchise. However, the Supreme Court invalidated the entire non-compete clause because it did not consider reasonable the geographic area subject to its restrictions. Even though the area of exclusivity granted to the Franchisee covered a radius of two (2) miles, the non-compete clause required that the Franchisor not compete over an area covered by a radius of ten (10) miles from any restaurant of the Franchisor and the Franchisor did not provide reasons to justify the larger area of protection. The Supreme Court added that, Puerto Rico's territorial extension (estimated at 100 x 35 miles) and public interest considerations, would have led it to the same conclusion that the geographic restriction was unreasonable.

Although the Supreme Court's decision provides some guidance on what may be considered reasonable, it fails to establish clear parameters when drafting a non-compete clause for a franchise agreement. On the facts of the case, it deemed reasonable the 2-year restriction and the restricted activities. It is clear the Supreme Court will be overcautious in enforcing a restriction that exceeds the area of operation of the franchise. Yet, the Supreme Court reiterated its position that it will not modify non-compete agreements to bring them to a standard which it deems reasonable, and thus enforceable, and will continue to strike down those non-compete agreements containing a component it deems unreasonable. Until clearer standards on what will be considered "reasonable" are established by the Puerto Rico Supreme Court, non-compete clauses in a franchise agreement will continue to be the subject of debate. In the meantime, franchisors beware, your non-compete agreement risks being completely invalidated. ■