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Antitrust -- Division of Territory by Competitors in a Franchise System

Henry C. McFadyen

NOTES

Antitrust—Division of Territory by Competitors in a Franchise System

The defendant in *United States v. Sealy, Incorporated*[1] was a corporation that owned the Sealy tradename and licensed small manufacturers around the country to make Sealy bedding products. Sealy was not an ordinary trademark licensor, however, because almost all of its stock was owned by the manufacturers,[2] who completely controlled its day-to-day activities. Nevertheless, Sealy provided a number of services which were designed to allow the small manufacturers to compete more effectively against larger bedding producers: it advertised and promoted the Sealy name on a national basis, rendered technical and management assistance, and conducted research. It also worked with the manufacturers to fix retail prices. Finally, it served as a device whereby each manufacturer could maintain an exclusive territory in which to sell its product. Sealy licensed only one manufacturer to make and sell under the Sealy name in a particular area. In return each manufacturer promised not to make or sell outside its area.

In the district court the case was tried on the theory that Sealy and the manufacturers had conspired to fix retail prices and allocate territory in violation of Section 1 of the Sherman Act.[3] The district court held that there was a conspiracy to fix prices and enjoined further efforts to regulate retail prices except for the use of suggested retail price lists. The district court also found that there had been no conspiracy to allocate territory. It found that there were agreements to allocate territory, but that they were ancillary to a lawful plan of trademark licensing and therefore reasonable.[4]

On appeal to the United States Supreme Court the Government argued that Sealy was a joint venture of the manufacturers and that

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[1] 388 U.S. 350 (1966).

[2] Stock in Sealy, Inc. was owned disproportionately by all of the manufacturers, and the corporation was usually under the control of several of the largest shareholders. Rudnick, *The Sealy Case: The Supreme Court Applies the Per Se Doctrine to a Hybrid Distribution System for Trademarked Bedding Products*, 57 TRADEMARK REP. 479 (1967).

[3] United States v. Sealy, 1964 Trade Cas. ¶ 71258 (N.D. Ill.).

[4] *Id.*

the agreements to divide territory should be viewed as horizontal agreements among competitors. The United States Supreme Court agreed. Drawing on the lower court holding that there had been price fixing, the Court further held that where manufacturers combine to fix prices and use territorial restraints as part of such a plan, the territorial restraints must be considered per se unreasonable and unlawful.[5]

Although the use of a central agency in the form of a corporation to advertise and market a trademarked product seems to have been found mostly in the bedding industry, the technique is of general interest because it offers a possible way for small manufacturers to enter a national market. The basic elements of the Sealy organization are not affected by the opinion. Sealy may still advertise nationally, suggest retail prices and in general promote the efficiency of its licensees. But it has been suggested that territorial limitations are an important part of such an organization.[6] It will therefore be of interest to see to what extent agreements to divide territory are affected by *Sealy*.

The Government argued that the agreements to divide territory were horizontal in nature because it desired to take advantage of the rule that horizontal divisions of territory by competitors is per se unreasonable. This rule was recently expressed in *White Motor Company v. United States*[7] where the issue was whether vertical territorial restrictions imposed by a manufacturer on its dealers were per se unlawful. In *White Motor*, the United States Supreme Court held it would not determine the vertical issue until extensive market evidence should be presented at a trial. Only then did the Court feel a proper decision could be made whether to use a per se or rule of reason approach to the solution of vertical territorialization.[8] The rationale of the decision in *White Motor* is important here because of the comparison made by the Court between vertical and horizontal territorial restrictions. It was felt that vertical restrictions might deserve rule of reason treatment because a manufacturer could have strong procompetitive reasons for imposing territorial restrictions. By contrast, horizontal agreements to divide territory were considered per se unreasonable because of the high probability of anti-

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[5] 388 U.S. at 357.
[6] Rudnick, *supra* note 2.
[7] 372 U.S. 253 (1963).
[8] *Id.* at 261.

competitive effects and the low incidence, if any, of good effects.[9] In *Sealy* the Supreme Court said it "would violate reality to treat [the territorial agreements] . . . as equivalent to territorial limitations imposed by a manufacturer upon independent dealers as incident to the sale of a trademark product. Sealy, Inc. is an instrumentality of the licensees for purposes of the horizontal territorial allocation."[10]

Having found the arrangement in *Sealy* to be horizontal, it is striking that the Court *did not use* the rule that horizontal divisions of territory by competitors are per se unreasonable.[11] The theory actually used by the Court was that the territorial division should be found per se unreasonable because it was part of a per se unreasonable plan of price-fixing. It was, as stated by the Court, "part of 'an aggregation of trade restraints' including unlawful price fixing and policing . . . unlawful under § 1 of the Sherman Act without the necessity for an inquiry in each particular case as to their business or economic justification, their impact in the market place, or their reasonableness."[12] The fact that the Court used this approach rather than apply the easily available per se rule against horizontal division of territory expressed in *White Motor* may indicate that the Court did not consider *Sealy* an appropriate case for that rule. This leads therefore to the question whether, absent price fixing, the rule of reason might have been applied to the issue of territorialization alone.

A strong argument can be made that where competitors of little market power have franchised and advertised a brand name (and no price-fixing is practiced), the Court should then treat territorial restrictions under the rule of reason. At least one writer has noted that the per se rule expressed in *White Motor* is derived from a line of cases in which the competitors were possessed of large shares of the market and great market power.[13] It was also suggested in an amicus curiae brief filed with the *White Motor* case that the per se rule should not be applied in the horizontal franchise situation where

[9] *Id.* at 263.

[10] 388 U.S. at 354.

[11] Zeidman, *The Growth and Importance of Franchising—Its Impact on Small Business*, 12 ANTITRUST BULL. 1191, 1200 (1967); Williams, *Distribution and the Sherman Act—The Effects of General Motors, Schwinn and Sealy*, 1967 DUKE L.J. 732, 737.

[12] 388 U.S. at 357.

[13] Rudnick, *supra* note 2, at 465.

no price fixing is involved.[14] The Court paid little heed to this brief in *White Motor,* but it may, by way of an interesting dictum in *Sealy,* be hinting that it overstated the rule in *White Motor*:

> It is argued . . . that a number of small grocers might allocate territory among themselves on an exclusive basis as incident to use of a common name and common advertisements, and that this sort of venture should be welcomed in the interests of competition, and should not be condemned as per se unlawful. But condemnation of appellee's territorial arrangements certainly does not require us to go so far as to condemn that quite different situation, whatever might be the result if it were presented to us for decision.[15]

The case for application of the rule of reason is also buttressed by the dissent in *Sealy.* The dissent argued that the rule of reason ought to be applied, but hung this conclusion on its view that the restrictions were vertical in nature.[16] It would seem, however, that the facts of the case make it more desirable to view the arrangement as horizontal, because Sealy, Inc. was completely dominated by the manufacturers and had little life of its own. Thus it could be argued that the real point of the dissent is that in an appropriate case of territorial division by competitors of little market power and with a small share of the market, the rule of reason should be applied.

If it is still possible for firms with little aggregate market power to use territorial division in a franchise system under the rule of reason, the next question is what factors would be considered in applying the rule of reason? As to anticompetitive effects, it is clear that any division of territory will cause some reduction in competition. Indeed, it has been argued that division of territory is even more damaging to competition than price fixing, because it eliminates all *intrabrand* competition in the sale of the product.[17] As to pro-

[14] Brief as Amicus Curiae, White Motor Co. v. United States, 372 U.S. 235 (1963). This brief was filed by Serta Associates, a bedding licensor, to correct a false impression it felt that White Motor Company was making on the Court. White Motor Company, in an attempt to distinguish between vertical and horizontal arrangements, had assumed that horizontal territorial agreements were per se unlawful. Serta attempted to show in the brief that the rule of reason should be applied. *See* Bureau of National Affairs, Inc., Antitrust and Trade Regulation Today: 1967, at 71.

[15] 388 U.S. at 357.

[16] *Id.* at 378.

[17] Brief for Appellee, United States v. Sealy Inc., 388 U.S. 350 (1966). In White Motor Co. v. United States, 372 U.S. 253, 263 (1963), it was said that "[h]orizontal territorial limitations, like '[g]roup boycotts, or con-

competitive effects, the main argument in justification is that, notwithstanding a reduction in intrabrand competition, division of territory can lead to an increase in *interbrand* competition.[18] This is said to result from the fact that each manufacturer will concentrate his efforts on the maximum penetration of his area, rather than waste effort trying to sell in the areas assigned to his counterparts. This concentration is said to insure keener competition between rival brands than would be the case if the franchisees were in competition with each other.[19] The rebuttal to this justification is that if interbrand competition were healthy, prices would be so low that franchisees would not need protection from their counterparts. If this is so, it would appear that the attempt to limit intrabrand competition is only a ruse to eliminate at least some degree of competition from the market as a whole.[20]

Perhaps a stronger argument for territorial division can be made when firms adopt franchising in order to enter a new market or to prevent the failure of their businesses due to changing market conditions. In such event a temporary restraint on territory might be acceptable because of the promise of an additional product in the market. This argument draws support from the dicta in *Sealy* which seems to contemplate the situation where firms may wish to franchise in order to meet the competition of giant merchandisers.[21] As the new brand became established, and as interbrand competition were im-

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certed refusals by traders to deal' . . . are naked restraints of trade with no purpose except stifling of competition."

[18] Brief for Appellee, United States v. Sealy, Inc., 388 U.S. 350 (1966).

[19] This argument is more often made on behalf of a manufacturer who is attempting to justify territorial limitations placed on the retail sale of franchised goods. See generally, Handler, *Recent Antitrust Developments,* 112 U. PA. L. REV. 159, 166 (1963); Note, *Restricted Channels of Distribution under the Sherman Act,* 75 HARV. L. REV. 795, 827 (1962).

[20] In Brief for Appellant, United States v. Sealy, Inc., 388 U.S. 350 (1966) at 15, the Government argued:

> Protection from the competitive inroads of the relatively few manufacturers who compose the Sealy system and who in the aggregate compose but a small segment to the bedding industry would be futile if the competition from other brands were as effective as competition within the Sealy family. The principal justification suggested by appellee for the territorial restriction—that Sealy cannot attract licensees without offering them protection against competition from existing licensees—presupposes that the restriction is an effective method for reducing the competitive pressures upon the manufacturers who are party to the scheme.

[21] 388 U.S. at 358.

proved, it would seem that intrabrand restrictions would become less important to the franchisees and eventually could be lifted.

Sealy adds a new dimension to the law of antitrust because it is the first case in which the agreements of firms with little market power to divide territory have been found unlawful.[22] Yet because the Court used the presence of price fixing to find the agreements per se unlawful, it is possible to argue that not *all* horizontal agreements to divide territory need be per se unlawful. It would seem that it might be possible to convince the Court to apply the rule of reason favorably, especially where the success of a new entry or a group of failing firms was at stake.

HENRY C. MCFADYEN

Civil Rights—Racially Discriminatory Employment Practices Under Title VII

In *Quarles v. Phillip Morris, Incorporated,*[1] the United States District Court for the Eastern District of Virginia held that present differences in departmental seniority of Negroes and whites that resulted from the company's past and intentional racially discriminatory hiring policy were unlawful employment practices in violation of Title VII of the Civil Rights Act of 1964.[2] *Quarles* was the first such case to be litigated under Title VII.[3]

Prior to 1966, Phillip Morris employed Negroes only in one of three departments covered by a collective bargaining agreement with Local 203 of the Tobacco Workers International Union, the prefabrication department.[4] The jobs available in prefabrication were generally lower paying and less desirable than those in either

[22] Cases behind the rule in *White Motor,* all involving firms with large market power, are Timkin Roller Bearing Co. v. United States, 341 U.S. 593 (1951); United States v. National Lead Company, 332 U.S. 319 (1947); Addyston Pipe and Steel Co. v. United States, 175 U.S. 211 (1899).

[1] 279 F. Supp. 505 (E.D. Va. 1968).

[2] Pub. L. No. 88-352, 78 Stat. 241. There were also allegations of racial discrimination in the employer's hiring practices, employment and promotion of supervisory personnel, and the payment of wages. The court summarily dismissed the first two issues, and found racial discrimination in the payment of wages only as to two Negro employees.

[3] 42 U.S.C. §§ 2000e to 2000e-15 (1964).

[4] Negroes were also employed for seasonal work in another department, but this was covered by a different collective bargaining agreement.