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FRANCHISING AND THE ANTITRUST LAWS: PANACEA OR PROBLEM?

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I. Introduction

A recent article in *Fortune* characterized one aspect of the American antitrust laws as follows:

> Instead of relying upon the market to protect consumers and encourage progress, it [the antitrust law] substitutes the preferences of public administrators and judges as to how production and distribution should be organized. By trying to shield specific competitors against the effects of competitive innovation, it tends to reverse — or at least to inhibit — that long line of social evolution which has been described as the movement "from status to contract."[1]

The article then refers to the "significant innovations in merchandising" that have been developing since about 1950 and are now developing to such a degree that we can predict little of the business specifics of 1987 or 1997.

The thesis of the *Fortune* article is that national policy should not prefer any particular size, shape, or number of firms or way of doing business to any other.[2] Although usually concerned with the antitrust policy towards mergers,[3] such comments are equally applicable to the antitrust laws' response to another "significant innovation in merchandising" that has lately come into prominence — franchising.

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1 Ways, *Antitrust in an Era of Radical Change,* Fortune, March 1966, p. 128, also reprinted as a supplement to Fortune, March 1967.

2 *Id.* at 129.

3 *E.g.,* Handler, *Some Misadventures in Antitrust Policymaking — Nineteenth Annual Review,* 76 YALE L.J. 92, 101-09 (1966).

Some uses of franchising, such as trademark licensing and auto and gasoline dealers, have long been a familiar fixture on the American business scene. It is only since World War II, however, that franchising has really come into its own. Household business names, such as Howard Johnson, Sheraton Motor Inns, McDonald Hamburgers, Kelly Girl, Dairy Queen, Chicken Delight, Mary Carter Paints, and to a limited extent, Hertz, Avis, and the like, are eloquent testimony to the pervasiveness of franchising today. The growth and success of franchising prompted *Business Week* to title a recent article that reported sixty-five-billion-dollar-a-year gross sales in franchised outlets "Franchising Finds It's an Industry."[4] This particular article points out that franchising's big problem is the antitrust laws; perhaps in modern America this is a sign of an industry's coming of age, its initiation into adult business society. In its Master Index to Franchising Organizations, *The 1966 Franchise Annual* lists 657 organizations with franchises in areas of operation ranging from "accounting/tax services" to "wigs/hairpieces."[5] An examination of even this list shows that it is far from complete.

What exactly is "franchising"? *Business Week* describes the operation as follows:

> In general, a franchiser is a manufacturer or service company that sets up an individual in business, requires that he put up from $1,000 to $100,000 of his own money, and allows him to sell a product or service under one brand name [owned by the franchiser]. Usually, the franchisee pays a royalty on his sales once the business is operating.[6]

A more formal description of franchising is found in a 1963 study prepared for the Small Business Administration:

> When a market supplier [any business which supplies goods and/or services to the market place] uses franchises in the distribution of his goods and/or services — it means that the supplier is granting a particular distribution right to a limited number of *selected* businesses. The franchise may be granted for only one product, a line of products, or for an entire institution. Hence, it may be said that there are two distinct types of franchise methods used in the distribution of consumer goods and services. One is the franchising of products; the other is the franchising of entire business enterprises.[7] (Emphasis in the original.)

This study concludes that there are "hundreds of thousands of franchised businesses in the United States, and they account for a substantial volume of this nation's retail sales."[8]

The types of franchising can be classified in many ways, but the method adopted by Chadwell seems most useful.[9] According to his analysis, there are three types of franchising:

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4 *Franchising Finds It's an Industry,* Business Week, June 19, 1965, p. 72.
5 *National Franchise Reports,* THE 1966 FRANCHISE ANNUAL, 12-46, 48-53.
6 *Franchising Finds It's an Industry, supra* note 4, at 72. See also Hall, *Franchising — New Scope for an Old Technique,* Harv. Bus. Rev., Jan.-Feb. 1964, p. 60.
7 LEWIS & HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION 4 (1963).
8 *Id.* at 87.
9 Chadwell, *Antitrust Aspects of Dealer Licensing and Franchising,* PROCEEDINGS OF THE FIFTH ANNUAL CORPORATE COUNSEL INSTITUTE 58, 63-64 (1966).

1. Those that establish an efficient method of distribution for the franchisor's products, such as those for cars, trucks, gas, bicycles, food products, electrical appliances, etc.

2. Those that establish retail outlets where the franchisor is principally selling a name and method or format of doing business, such as those for restaurants, motels, laundry and dry cleaning shops, servicing organizations, etc.

3. Those that establish manufacturing or processing plants, such as those for soft drink bottlers, bakeries, mattress manufacturers, etc.

In a sense, the essence of all franchising is the marketing of goods or services through quasi-independent businesses[10] that are subject to various controls respecting their business operations.[11] These controls are imposed either to create a standard image for the public whereby both the franchisor and the franchisee can exploit to the utmost the franchisor's trademark and good will[12] or to provide a stable distribution system, guaranteeing the franchisor protection against interbrand competition by his own franchisees and guaranteeing the franchisee protection against intrabrand competition in a limited geographic area or as regards a limited class of customers.[13]

What has accounted for this great growth of franchising? The SBA study (which did not concern itself with the impact of antitrust laws) cited four factors in explanation:

> 1. Other distribution systems, and particularly manufacturer- (or supplier-) owned outlets, could not be achieved with the same capital requirements, the same personnel training requirements, and within the same time span, as could a franchise system of distribution.
>
> 2. The corporate chains in the food, drug, variety, and hardware lines had their major growth during the 1920s. As a defensive measure, wholesalers in these lines formed the so-called "voluntary chains" which are based on franchise agreements between wholesale institutions and the affiliated dealers.
>
> 3. Some products and services must stand alone in the market place to be effectively marketed rather than mingled with a large variety of other commodity classes. As a result, the most feasible method appears to be franchised dealers.
>
> 4. There is a strong psychological drive harbored by most men to accomplish something of significance during their lifetime. Both franchiser and franchisee may be satisfying this natural drive by "having a business of his own."[14]

A review of these factors shows that all but the third (which is neutral) are

10 Although subject to some control by his franchisor, the franchisee is considered "independent" (and hence not an affiliate) under the Small Business Administration Regulations if he has both the right to profit and the risk of loss in his venture. 31 Fed. Reg. 11973 (1966), amending 13 C.F.R. § 121.3-2(a) (1966).

11 See the FTC memorandum to the SBA's 1966 hearings, which resulted in the amendment to the SBA regulations referred to in note 10, as reported in International Franchise Association's Quarterly Legal Bulletin 25 (1966).

12 See Chadwell, *supra* note 9, at 59.

13 Averill, *Antitrust Considerations of the Principal Distribution Restrictions in Franchise Agreements*, 15 AM. U.L. REV. 28, 30, 51 (1965).

14 LEWIS & HANCOCK, *op. cit. supra* note 7, at 14.

clearly procompetitive factors and, hence, attitudes that the antitrust laws should encourage. The first factor is a description of the process whereby a small manufacturer can market his products (particularly if they are new to the market and must secure customer acceptance), and this means that he can compete with existing larger and often fully integrated companies without the heavy investment and delay involved in setting up a distribution system. The second factor promotes competition as small retailers have a better chance to compete with the larger chains and integrated manufacturer-sellers by means of franchises. The fourth factor is a classic statement of a justification of the antitrust laws' attempt to preserve the small competitor.

It is interesting, with the apparent reasons for the success of franchising being its essentially procompetitive factors, that *Business Week* would state that the antitrust laws were franchising's big problem.[15] Here, as the *Fortune* article indicated, perhaps the antitrust laws are "trying to shield specific competitors against the effects of competitive innovation,"[16] and trying to maintain the size, shape, or type of distribution system against changes resulting from the free choice of manufacturers and retailers, driven by reasons that are basically procompetitive.

Whatever the procompetitive motivations or reasons for it, franchising by its very nature involves certain restrictive, and perhaps anticompetitive, factors. These include the limited control by the franchisor over the franchisee referred to earlier. Admittedly, some control is necessary or there would be no product standardization and, hence, no selling point. But how much control should there be? Can the franchisor require the franchisee to buy all or part of his supplies from a certain source? Can this control extend to pricing, classes of customers, or areas where the franchisee can sell? When does cooperation end and conspiracy begin?

II. Problems in Franchising

A review of some of the currently used franchise agreements suggests a number of areas where antitrust problems can arise. In his statement before the Small Business Administration on March 11, 1966, Professor Handler listed five areas of restrictions and, hence, restraints of trade that "are fairly illustrative of the legal and business problems involved"[17] in franchise distribution. They are:

A. Exclusive Selling;
B. Exclusive Buying;
C. Territorial Restrictions;
D. Customer Restrictions; and
E. Quality Control of Trademarked Products.[18]

15 *Franchising Finds It's an Industry, supra* note 4, at 75. See *Is the Franchise System Legal?* Business Week, April 3, 1965, p. 66.
16 Ways, *supra* note 1, at 128.
17 Handler, Statement Before the Small Business Administration, reprinted in 11 ANTITRUST BULL. 417, 420 (1966).
18 *Id.* at 421.

To this list, one more can be added:

F. Termination Problems.

A. Exclusive Selling

Many franchise agreements contain a restriction preventing the franchisor from selling the franchised product or service to anyone else in the franchisee's defined territory. These restrictions are often called "exclusive franchises" or "exclusive agencies."[19] This is a restriction on the seller or franchisor and is often necessary to protect a dealer in a given area, especially where the distribution of a new product requires a substantial investment by the dealer either in initial selling expense or for a showroom, service facilities, and the like. Under these circumstances, the dealer often would not undertake such an investment without assurances that he would not be faced with direct competition, in close geographic proximity, either from the manufacturer himself or from other dealers franchised for the same territory.[20] The franchisor also benefits, at least in theory, from such a restriction in that he reduces his selling costs, credit risks, and the like by keeping the number of middlemen to a minimum. Typical franchise provisions regarding exclusive selling are:

> Distributor is hereby granted the exclusive right, except as hereinafter provided, to sell during the life of this agreement, in the territory described below, White and Autocar trucks purchased from Company hereunder.[21]

> The first party hereto grants to the second party the exclusive right to use the name of MUGS UP root beer for use in that area generally referred to as .... with boundaries of its present city limits, at such places as may be approved by the party of the first part.[22]

B. Exclusive Buying

The converse provision to an exclusive-selling provision is the exclusive-buying or exclusive-dealing provision found in many franchise agreements. Frequently, this provision and an exclusive-selling provision appear as complementary provisions in the same franchise. An exclusive-buying provision requires the franchisee to purchase only the franchisor's brand or brands designated by him to the exclusion of rival brands. This restriction on buyers or franchisees is intended to create a more effective franchisee by focusing his sales attention on the seller's brands and also by encouraging better stocking. Occasionally it reduces selling and production expenses by making the market more predictable.[23] The franchisee also benefits from such an arrangement by

19 See Robinson, *Restraints on Trade and the Orderly Marketing of Goods*, 45 CORNELL L.Q. 254, 255 (1960); Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795, 802 n.30 (1962).
20 Handler, *supra* note 17, at 422.
21 White Motor Company franchise involved in White Motor Co. v. United States, 372 U.S. 253, 255 (1963). See text accompanying notes 44-51 *infra* for a discussion of this case.
22 A provision from the MUGS UP Root Beer Company franchise quoted at LEWIS & HANCOCK, *op. cit. supra* note 7, at 23.
23 See Robinson, *supra* note 19, at 276; Handler, *supra* note 17, at 424-25.

being assured a supply and providing certain protection against cost increases. Typical franchise provisions regarding exclusive buying are:

> OWNER agrees to purchase, sell and use such products and such brands as may be designated by FRANCHISOR, to order the same from suppliers approved by FRANCHISOR for guaranteed sales and volume purchase benefits, and to at all times maintain a balanced variety of stock of merchandise having a wholesale cost value of not less than ....[24]

> So long as this agreement shall remain in force and effect, the Operator will purchase from the Company any and all products manufactured or sold by the Company which the Operator may need for use or sale at or from the place of business described above and the Operator shall pay therefor at standard prices from time to time fixed by the Company, in full, upon delivery at said place of business. The Operator will diligently promote and make every reasonable effort steadily to increase the sale of said products.[25]

C. Territorial Restrictions

Although an exclusive-selling provision may be satisfactory to the franchisee of a roadside stand, cleaning village, or other stationary franchise, when the franchised goods or services are sold over a wide area by salesmen, or through bidding on jobs for delivery to a project, such a restriction is close to meaningless. The comparable provision to an exclusive-selling provision in such a franchise is a territorial restriction. Such a provision limits the geographic territory in which the franchisee may resell the product.[26] Territorial restrictions can be divided into two basic types, although the means of enforcement may vary. They are: (1) closed territories — the dealer can sell to anyone who comes into his place of business, but cannot solicit sales in another dealer's territory; and (2) geographic customer allocation — the dealer can sell to only those customers who reside or have a place of business in his territory.[27] The same economic factors that motivate exclusive-selling agreements, *i.e.*, the necessity of offering the seller protection against intrabrand competition, motivate territorial restrictions. Typical franchise provisions regarding territorial restrictions are:

> Contractor shall not advertise or actively solicit sales of (franchisor's) swimming pool equipment outside of the exclusive territory and shall make sales of such equipment for use outside of said territory only upon notice to and approval by (franchisor). Repeated or regular sales by contractor outside of said territory shall be deemed conclusive evidence of solicitation outside of said territory and a material breach of this article.[28]

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24 White Hen Pantry Franchise, art. 4.2.

25 Howard D. Johnson Company Operator's Agreement for Restaurant and/or Dairy Bar, ¶ 2.

26 Handler, *supra* note 17, 427-28.

27 Day, *Exclusive Territorial Arrangements Under the Antitrust Laws — A Reappraisal,* 40 N.C.L. REV. 223, 227 (1962).

28 A provision from a swimming pool equipment company franchise, reported in LEWIS & HANCOCK, *op. cit. supra* note 7, at 23.

> The Company hereby assigns to the Dealer not as an agent, a non-exclusive franchise for the sale of its products only within the territory described below and under the conditions hereinafter outlined . . . .[29]

D. Customer Restrictions

From time to time a franchisor will want to restrict the class or type of customer with whom a franchisee may deal or to whom he may sell. A manufacturer may want to reserve to himself government sales, fleet sales, or other sales, often ones involving large volumes of business done on the basis of competitive bidding and, hence, with a lower profit margin. This may be an attempt by the manufacturer to "skim the cream" for himself; more often, it is motivated by a realistic knowledge that a dealer's mark-up or inability to make delivery or render service may result in the loss of a very attractive sale.[30]

On other occasions the manufacturer may reserve no sales to himself, but may restrict his dealers' sales to various categories of customer, *e.g.*, retailers, jobbers, or wholesalers.[31] The economic motivation behind such restrictions is similar to that behind geographic restrictions, *i.e.*, to provide dealers who will concentrate their efforts on the class of trade they are best equipped to serve and thereby increase overall sales. Typical franchise provisions restricting customers are:

> [E]ffective January 1, 1956 Middle Atlantic Cycle and Supply Company will distribute Schwinn products to *franchised Schwinn dealers* within the territory outlined in the map attached hereto.[32] (Emphasis added.)

> Distributor further agrees not to sell nor to authorize his dealers to sell such trucks to any Federal or State government or any department or political subdivision thereof, unless the right to do so is specifically granted by Company in writing.[33]

E. Quality Control of Trademarked Products

Generally speaking, what makes a franchise desirable to a franchisee is the franchisor's trademark or trade name and good will. Whether it be a prestige line that comes into the dealer's store or a trademark or trade name that is applied to the entire franchise operation, whether a coin-op dry cleaning establishment or a line of power tools, the central element of the franchise is the right of the franchisee to use the trademark or trade name.

Under the trademark laws, a trademark owner who allows another (whether a licensee or an affiliated company) to use his trademark without maintaining the required quality control over the use of that trademark stands

29 Snap-On Tools Corporation franchise involved in Snap-On Tools Corp. v. FTC, 321 F.2d 825, 830 (7th Cir. 1963).

30 See Handler, *supra* note 17, at 432.

31 See Note, *supra* note 19, at 796.

32 From one of the Arnold, Schwinn & Co. franchises involved in United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 341 (N.D. Ill. 1965). See text accompanying notes 67-69 *infra* for a discussion of this case.

33 White Motor Co. franchise involved in White Motor Co. v. United States, 372 U.S. 253, 256 (1963). See text accompanying notes 44-51 *infra* for a discussion of this case.

a serious risk of loss of the trademark itself.[34] In addition, whether the franchisor has a licensed trademark or not, to a large degree he is selling the franchisee the right to use and capitalize upon his good will. Thus, when a customer goes to a franchise operation, he goes most often not because of a knowledge of and faith in the franchisee, but because of his knowledge of, faith in, and prior experience with the franchisor. For this very practical reason, as well as for the legal reason of preventing the loss of his trademark, the franchisor must maintain a high degree of quality control over his franchisee. This quality control can be achieved through a variety of devices, including the requirement that the franchisee purchase all his component or end products from the franchisor or suppliers approved by him; the establishment of standards for service, production, and advertising; or by the mere education and supervision of the franchisee. Typical franchise provisions regarding quality control are:

> [T]he Company shall determine and approve standards of quality for all commodities bought, used or sold on the above-described premises, standards of service in connection with their sale, and standards of quality and utility for all furnishings and equipment used on said premises in connection with such sale, and the Operator shall conform to said standards, and the Company may supervise the operation of the Operator's business at the above-described premises.[35]

> To assure uniformity of the nature and quality of Spring Air products manufactured and sold by Manufacturer and other related companies licensed under Spring Air trademarks, Licensor may designate a supplier or suppliers for any or all materials specified in the specifications for Spring Air products, and Manufacturer shall purchase all materials so specified by Licensor required by Manufacturer in the manufacture of Spring Air products from the supplier, or from among the suppliers, so designated by Licensor. In lieu of designating other suppliers, Licensor may procure materials and direct that Manufacturer purchase such materials from Licensor.[36]

F. Termination Problems

Actually, termination problems are not peculiar to the franchise method of distribution; they can arise under any method of sales or distribution. What distinguishes the problems of termination in a franchise situation is that the franchisee has often made a substantial contribution to the value of the franchisor's trademark in a given trade area. For example, when a franchisor grants his first franchise in a given area, his trademark may have little good will or value among the local inhabitants. If, after a local franchisee has built this trademark into a valuable piece of commercial property, the franchisor terminates

34 E. I. du Pont de Nemours & Co. v. Celanese Corp., 35 C.C.P.A. (Patents) 1061, 167 F.2d 484 (1948). See § 5 of the Lanham Act, 60 Stat. 429 (1946), 15 U.S.C. § 1055 (1964).

35 Howard D. Johnson Company, Operator's Agreement for Restaurant and/or Dairy Bar, ¶ 1. Paragraph 2 of the Operator's Agreement also contains a partial exclusive buying agreement. See text accompanying note 25 *supra*.

36 Spring-Air Company franchise involved in Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 406 n.2 (5th Cir. 1962).

that dealer's franchise, the franchisor now has a piece of property that is more valuable to him in that area than it was when he started the arrangement with the franchise. Accordingly, the peculiar problems of franchise termination should also be reviewed.[37] The typical franchise provisions allowing virtually unrestrained termination are found in the auto-dealer franchises. The following is illustrative: "Either party may terminate this agreement upon not less than ninety (90) days' written notice."[38]

G. *Summary*

Each of these restrictions explored above is, by its very nature, a control on the free competitive activities of the franchisor or franchisee, in short, a "restraint of trade." An exclusive-selling provision prevents the franchisor from creating other franchises in the dealer's protected territory. An exclusive-buying agreement prevents the franchisee from selling brands or items competing with the franchisor's brands. A territorial restriction or customer restriction prevents the seller from competing with other sellers of the franchisor's items in certain fields. Quality control tends to keep prices up by reducing price competition (as opposed to quality or brand competition). Thus, each of these controls is potentially within the ambit of the antitrust laws. It should be noted, however, that these restrictions do not result in reducing all competition, but only intrabrand competition. Interbrand competition remains unabated and may even be increased.

In the light of these problems, it is clear why *Business Week* described the antitrust laws as franchising's big problem. The question thus becomes will the courts and enforcement agencies treat these restraints as per se violations of the antitrust laws and thus outlaw them, or will they treat them as within the "rule of reason"[39] — liberally construed — and sanction them whenever they are not motivated by predatory intent and do not significantly reduce overall competition?

III. Antitrust Impact of Franchising Controls

A. *Supreme Court Teaching: Past, Present, and To Come*

Although the various controls or restrictions commonly found in franchise agreements can be separated for academic consideration, they are rarely found singly in actual practice. Territorial restrictions are often coupled with customer restrictions.[40] Exclusive-buying and exclusive-selling provisions often appear as the consideration for each other.[41] Quality-control provisions often encompass

37 See, *e.g.*, Potvin, *Choosing and Dropping Distributors*, 26 ABA ANTITRUST SECTION 99, 102-07 (1964).

38 Chrysler Direct Dealer Sales Agreement, ¶ 8. This provision also contains Chrysler's buy-back obligations upon termination. *But see* Automobile Dealers' Day in Court Act, 70 Stat. 1125 (1956), 15 U.S.C. §§ 1221-25 (1964).

39 Standard Oil Co. v. United States, 221 U.S. 1, 60 (1911).

40 See, *e.g.*, White Motor Co. v. United States, 372 U.S. 253 (1963); United States v. Arnold, Schwinn & Co., 237 F. Supp. 323 (N.D. Ill. 1965).

41 See Handler, *supra* note 17, at 425.

at least a limited exclusive-buying provision.[42] As a result of this intermingling of restrictions, the few franchising antitrust cases that have reached the courts have seldom been limited to a single restriction, and even the consideration of these restrictions may be obscured by other issues involved in the cases, particularly in the earlier ones.

Moreover, the uncertainty surrounding the validity of these franchise provisions is increased by the fact that only three cases involving such franchising controls have reached the decisional stage in the United States Supreme Court.[43] In the first of these, *White Motor Co. v. United States*,[44] the Court held in 1963 that the district court should not have granted summary judgment for the Government on its contention that the territorial and customer restrictions of White Motor Co.'s franchises were per se violations of section 1 of the Sherman Act[45] and section 3 of the Clayton Act.[46] The Court noted that this was the first vertical, as opposed to horizontal, territorial restriction that had come before it[47] and admitted that it knew too little of the "economic and business stuff out of which these arrangements emerge to be certain" of their purpose and effect.[48] The case was remanded to the district court for further hearing with the warning that the Court did "not intimate any view on the merits" and "that the legality of the territorial and customer limitations should be determined only after a trial."[49] The further trial, and the Supreme Court's subsequent review, never occurred as White Motor Company signed a consent decree requiring the elimination of the territorial and customer restrictions from its franchises.[50] In discussing the territorial restrictions, the Court set forth possible results flowing from their use:

> They may be too dangerous to sanction or they may be allowable pro-

42 *E.g.*, Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *petition for cert. dimissed*, 381 U.S. 125 (1965). See text accompanying note 25 *supra*.

43 In a fourth case, Susser v. Carvel Corp., *supra* note 42, the Supreme Court originally granted certiorari, 379 U.S. 885 (1964), but then dismissed the writ as having been improvidently granted, 381 U.S. 125 (1965). There have been other cases before the Court involving franchising, but none of them involved the franchising controls discussed. See, *e.g.*, Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911).

44 372 U.S. 253 (1963).

45 Section 1 of the Sherman Act, 50 Stat. 693 (1937), as amended, 15 U.S.C. § 1 (1964), provides in part:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.

46 Section 3 of the Clayton Act, 38 Stat. 731 (1914), 15 U.S.C. § 14 (1964), provides:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

47 See, *e.g.*, Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951).

48 White Motor Co. v. United States, 372 U.S. 253, 261, 263 (1963).

49 *Id.* at 264.

50 United States v. White Motor Co., 1964 Trade Cas. ¶ 71195 (N.D. Ohio 1964).

> tections against aggressive competitors or the only practicable means a small company has for breaking into or staying in business . . . and within the "rule of reason." We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a "pernicious effect on competition and lack . . . any redeeming virtue" . . . and therefore should be classified as *per se* violations of the Sherman Act.[51]

White Motor, then, expressly left the status of these restrictions unresolved.

The next franchising-control cases did not reach decision in the Supreme Court until 1966. The first was *United States v. General Motors Corp.*,[52] in which General Motors was charged with conspiring with three associations of Chevrolet dealers in the Los Angeles area to eliminate sales of new Chevrolets through "discount houses" and "referral services." The district court had found no conspiracy, but the Supreme Court reversed, holding that the facts of the case showed a "classic conspiracy in restraint of trade."[53] General Motors argued that the location clause in its dealer franchises, which prohibited a franchised dealer from moving to or establishing "a new or different location, branch sales office, branch service station, or place of business . . . without the prior written approval of Chevrolet,"[54] was lawful and justified its action in stopping sales of new Chevrolets by its franchised dealers through discount houses and referral services. The Government, in turn, argued that this provision violated the Sherman Act. Because of its decision on the conspiracy issue, the Court did not reach the question of the validity of the location clause in the franchise agreements. *General Motors*, as did *White Motor*, left the status of franchising restrictions, absent conspiracy,[55] unresolved.

The first case to consider the restrictions inherent in franchising specifically, *FTC v. Brown Shoe Co.*,[56] was decided less than two months after the *General Motors* case. *Brown Shoe* was an appeal from the eighth circuit's reversal of an FTC cease-and-desist order directed at Brown Shoe's franchising program. The FTC had charged that Brown Shoe, the country's second largest shoe manufacturer, had committed an unfair trade practice under section 5 of the Federal Trade Commission Act[57] by the use of its "Franchise Store Program." As part of that program, the 659 Brown Shoe franchisees agreed not to buy lines

51 White Motor Co. v. United States, 372 U.S. 253, 263 (1963).

52 384 U.S. 127 (1966). The district court also granted General Motors' motion for acquittal at the end of the Government's evidence in the companion criminal case on the ground that General Motors was acting unilaterally in enforcing the location clause in its dealers' franchises. United States v. General Motors Corp., 1963 Trade Cas. ¶ 70704 (S.D. Calif. 1963).

53 United States v. General Motors Corp., 384 U.S. 127, 140 (1966). See also Ford Motor Co. v. Webster's Auto Sales, Inc., 361 F.2d 874 (1st Cir. 1966), where the court of appeals rested its decision on *General Motors*, but cast some doubting glances at the "vertical" vs. "vertical-horizontal" distinction. The franchise provision involved was more akin to a group boycott. "The agreements here, however, go beyond the attempt to keep dealers geographically in their place and have as their objective the total elimination of one class of Ford competitor." *Id.* at 882.

54 United States v. General Motors Corp., 384 U.S. 127, 130 (1966).

55 See Klor's, Inc., v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

56 384 U.S. 316 (1966).

57 Section 5 of the Federal Trade Commission Act, 66 Stat. 632 (1952), 15 U.S.C. § 45(a)(1) (1964) provides: "Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful."

in competition with the Brown Shoe lines it carried (in effect, an exclusive-buying agreement).[58] The Supreme Court stated the issue as follows:

> Thus the question we have for decision is whether the Federal Trade Commission can declare it to be an unfair practice for Brown, the second largest manufacturer of shoes in the Nation, to pay a valuable consideration to hundreds of retail shoe purchasers in order to secure a contractual promise from them that they will deal primarily with Brown and will not purchase conflicting lines of shoes from Brown's competitors. We hold that the Commission has power to find, on the record here, such an anticompetitive practice unfair, subject of course to judicial review. See *Atlantic Rfg. Co. v. FTC,* 381 U.S. 357, 367 [1965].[59]

The *Atlantic Refining* case cited by the Court is the decision that sustained the FTC's cease-and-desist order against Atlantic's TBA (tires, batteries, and accessories) arrangement with Goodyear. There, Atlantic was charged with using its economic power over its dealers to coerce them to sign a contract to carry and sell Goodyear's products. The Court thus analogized Atlantic's "stick" (the power over its existing dealers) with Brown Shoe's "carrot" (the extra benefits that went to an independent dealer who joined the franchise program). The Supreme Court concentrated its attention in reviewing the franchise system on the effective foreclosure of Brown Shoe's competitors from "a substantial number of retail shoe dealers," which the Court felt "obviously conflicts with the central policy of both §1 of the Sherman Act and §3 of the Clayton Act against contracts which take freedom of purchasers to buy in an open market."[60] It went on to state that proof of a substantial lessening of competition or tendency to create a monopoly (essential elements of a section 3 violation) was not necessary to the FTC's case since: "[T]he Commission has power under §5 to arrest trade restraints in their incipiency without proof that they amount to an outright violation of §3 of the Clayton Act or other provisions of the antitrust laws."[61] This is the so-called incipient incipiency test. The Supreme Court reversed the court of appeals decision and affirmed the FTC's order.

As of this writing, these cases represent the Supreme Court's entire teaching on the antitrust status of franchising. There are, however, two cases now pending in the Supreme Court, not yet argued or scheduled for argument, that will probably provide answers to some of these questions. These cases, *United States v. Sealy, Inc.*,[62] and *United States v. Arnold, Schwinn & Co.*,[63] involve the problems

58 The franchise provision was:
In return I will:
1. Concentrate my business within the grades and price lines of shoes representing Brown Shoe Company Franchises of the Brown Division and will have no lines conflicting with Brown Division Brands of the Brown Shoe Company. FTC v. Brown Shoe Co., 384 U.S. 316, 318 (1966).

59 *Id.* at 320.

60 *Id.* at 319, 321.

61 *Id.* at 322.

62 United States v. Sealy, Inc., 1964 Trade Cas. ¶ 71258 (N.D. Ill. 1964), *prob. juris. noted,* 382 U.S. 806 (1965) (No. 238, 1965 Term, renumbered No. 9, 1966 Term). See 5 CCH TRADE REG. REP. ¶ 67100 for current Supreme Court status. See also 2361 State Corp. v. Sealy, Inc., 263 F. Supp. 845 (N.D. Ill. 1967), whose opinion was written by the same judge that decided United States v. Sealy, Inc., *supra.* In *2361 State Corp.* a former supplier of private-label bedding to Montgomery Ward sued Ward, Sealy, and others for treble

of territorial division, customer restriction, quality control, and exclusive buying and selling. In both, the lower federal courts have sustained the franchising controls as reasonable restraints of trade and, hence, not violative of the antitrust laws. These cases, although still subject to review by the Supreme Court, the earlier lower court decisions on franchising, and the Supreme Court decision in *Brown Shoe* provides guidelines for evaluating the antitrust exposure in each of the franchising restrictions considered earlier.

The *Sealy* case involved a civil injunction suit against Sealy, Inc., a franchisor owned to a large extent by some thirty bedding manufacturers. The suit sought to restrain the territorial restrictions and resale-price-maintenance provision of the Sealy franchises. Insofar as is relevant here, Sealy granted licenses to use the Sealy trade name and trademarks in limited geographic areas. The Government attacked this provision of the franchises on the ground that it violated section 1 of the Sherman Act.[64] The district court held that these territorial restrictions had a legitimate business purpose and were directed toward obtaining additional licenses and more intensive market coverage. The district court's treatment of the Sealy franchise was similar to that accorded the comparable Spring Air bedding franchises by the Court of Appeals for the Fifth Circuit in *Denison Mattress Factory v. Spring-Air Co.*[65] Dealing with the complementary exclusive-selling limitation on Sealy and the territorial restriction on the licensees, the district court noted that these applied only to mattresses sold under the Sealy label and not the licensees' private-label products and stated:

> [T]he Sealy licensing arrangements were developed in the early 1920's for entirely legitimate business purposes, including royalty income to Sugar Land Industries, which owned the Sealy name, trademarks and patents, and the benefits to licensees of joint purchasing, research, engineering, advertising and merchandising. These objectives were carried out by successor companies, including defendant, whose activities have been di-

damages resulting from Ward's 1961 switch from the plaintiff and others as bedding suppliers for Ward to Sealy, which operates as a national sales agent for its franchisees in the sale of bedding not bearing the Sealy trademark but complying with Ward's quality-control standards. The court granted summary judgment for defendants on the charge of violating § 2 of the Sherman Act, but denied summary judgment on the exclusive-dealing charge (§ 3 of the Clayton Act and, inferentially, § 1 of the Sherman Act).

63 United States v. Arnold, Schwinn & Co., 237 F. Supp. 323 (N.D. Ill. 1965), *prob. juris. noted,* 382 U.S. 936 (1965) (No. 611, 1965 Term, renumbered No. 25, 1966 Term). See 5 CCH TRADE REG. REP. ¶ 67100 for current Supreme Court status.

64 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1964).

65 308 F.2d 403 (5th Cir. 1962). Noting the aid such franchising arrangements, through national advertising and the like, gave small companies in competing with the large national bedding manufacturers, the court in *Spring-Air* stated:

> The purpose of the antitrust laws is to prevent a select few in a particular field from achieving such monopolistic power as to stifle competition. An agreement which strengthens and promotes competition is not a violation of the law. *Id.* at

413.

Complaints similar to that in *Sealy* were filed against other franchisors in the mattress industry. Two cases were disposed of by consent decrees prohibiting, *inter alia,* the assignment of exclusive territories to franchisees. United States v. Spring-Air Corp., 1962 Trade Cas. ¶ 70402 (N.D. Ill. 1962); United States v. Restonic Corp., 1960 Trade Cas. ¶ 69739 (N.D. Ill. 1960). A third case, United States v. Serta Associates, Inc., Civ. No. 60C843, N.D. Ill., is still pending. See 5 CCH TRADE REG. REP. (1967 Trade Cas.) ¶ 45003.

rected not toward market division among licensees but toward obtaining additional licensees and more intensive sales coverage.[66]

The district court held as a conclusion of law that the assignment of exclusive territories by Sealy did not violate the antitrust laws. The case, like *Spring-Air*, is particularly interesting because of the overtones of horizontal action in the formation of Sealy by the former licensees of Sugar Land and the current partial ownership of the franchisor by the franchisees.

The *Schwinn* case, on the other hand, involved a clearer vertical arrangement, since the franchisor and franchisees were independently owned. This was also a civil injunction suit. Schwinn, a bicycle manufacturer, distributed its products through franchised wholesalers and franchised retailers. The franchised retailers could deal only with franchised wholesalers and both were, in general, granted exclusive territories determined by Schwinn. In addition, one wholesaler was limited to one class of outlets only, all of which were owned or franchised by that distributor. The Government tried to limit the relevant market to Schwinn products and Schwinn-approved products, claiming the franchise restrictions were illegal per se and that any evidence of interbrand competition was irrelevant. The district court put Schwinn's antitrust problems as follows, colorfully picturing a small distributor competing with integrated or national giants:

> To put it bluntly, if Schwinn were Sears, Roebuck & Co., its largest bicycle competitor, or if it were General Motors Corporation, it would be able to do exactly what it has done in franchising retail dealers with no penalty attached either through its own retail stores and salesmen as Sears, Roebuck & Co. does or through direct franchising on a nation-wide scale as General Motors and other giant corporations do.
>
> And penalized for what? Being a pygmy, compared to its giant bicycle competitors, Sears, Roebuck & Co. and Montgomery Ward & Co.? Yes, if the plaintiff's theory of the law applicable should be adopted by this court. Here, however, we do not even have the case of David and Goliath, where a well-directed stone from a slingshot might equalize the contestants. We do not even have the case of a pygmy pitted against a Cyclops, where a poison arrow might make competition a reality. What we do have is a microscopic Lilliputian whose extension ladders would not be able to mount the little toe of its Brobdingnagian foes.
>
> Now it appears to this court that if General Motors, Sears, Roebuck & Co., Montgomery Ward & Co., Ford Motor Co., and other international corporations can rely upon a sound and long-established principle of common law and safely choose its customers, deal, and refuse to deal, with whomsoever it will, and wherever it will, so can a small business firm such as Schwinn.[67]

The district court found the Schwinn franchises, which did not prevent its dealers from handling competing bicycle lines, resulted in increased rather than decreased competition. It concluded that Schwinn's franchising system, including its allocation of prime responsibility for certain territories to certain distributors, was "reasonable, fair and good business procedure under all the

66 United States v. Sealy, Inc., 1964 Trade Cas. ¶ 71258, at 80083 (N.D. Ill. 1964).
67 United States v. Arnold, Schwinn & Co., 237 F.Supp. 323, 334 (N.D. Ill. 1965).

circumstances existing in the bicycle industry"[68] and that the franchise agreements did not violate the antitrust laws. The court did find, however, that certain agreements between Schwinn, certain cycle distributors, and certain retail franchised dealers that the distributors should confine their sales of purchased Schwinn products to designated separate territories constituted a per se violation of section 1 of the Sherman Act.[69] The *Schwinn* case, rather than applying a looser standard towards the horizontal aspects of franchising arrangements, seems to apply a stricter test than *Sealy.*

B. Lower Court Teaching

Until the Supreme Court resolves some of the outstanding questions on franchise controls either in its decisions in the *Sealy* and *Schwinn* cases or later, the current body of lower court case law gives the franchisor some reason to be optimistic about the antitrust status of his franchise provisions.

1. Exclusive Selling

Exclusive-selling provisions, under that title or the title of exclusive franchises or exclusive agencies, have long been deemed reasonable as long as vertically imposed in the absence of monopoly or market dominance.[70] When market dominance is not present, either by the franchisor or the franchisee, such exclusive-selling provisions have been upheld.[71] There is some reason to believe

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68 *Id.* at 343.

69 In distinguishing these two results, the court stated:

> The Court finds that Schwinn has a right to assign primary responsibility to a distributor in an area or territory. Schwinn has a right, when it receives direct orders from a retail dealer in such territory, to pay its usual commission to the distributor in the territory in which such sale originated. When a distributor takes orders of Schwinn products and has them shipped directly to the Schwinn dealer, there is a fixed price, and then one distributor cannot offer to a dealer any advantage of price, service or reduced freight rates or shipping costs over that offered by another distributor. The distributor is truly an agent of Schwinn in such instances and Schwinn has a right to allocate its agents or salesmen to a particular territory.
>
> However, when a distributor fills orders from warehouse stock that he has purchased, where he can set the price, and where there may be a differential in shipping costs or promptness or quality of service, he is acting as an owner and not as an agent or salesman for Schwinn. Where the ultimate risk and loss is borne by the distributor, as where he has purchased and taken title to the Schwinn products, he is truly an entrepreneur, or just a plain businessman.
>
> It matters not that no actual damage has been shown to any distributor or dealer. Such division of territory by agreement between the distributors is horizontal in nature, and whether agreed upon after being imposed or even merely suggested from above in a vertical manner by the manufacturer does not alter its illegality and violation of Section 1 of the Sherman Act. *Id.* at 342.

70 See, *e.g.,* Whitwell v. Continental Tobacco Co., 125 Fed. 454 (8th Cir. 1903) (a case based on some now-questionable reasoning).

71 Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir.), *cert. denied,* 355 U.S. 822, *rehearing denied,* 355 U.S. 900 (1957), 357 U.S. 923 (1958); Cole Motor Car Co. v. Hurst, 228 Fed. 280 (5th Cir. 1915); Schwing Motor Co. v. Hudson Sales Corp., 138 F. Supp. 899 (D. Md. 1956), *aff'd. per curiam,* 239 F.2d 176 (4th Cir. 1956); Coca-Cola Co. v. J. G. Butler & Sons, 229 Fed. 224 (E.D. Ark. 1916). See also Savon Gas Stations Number Six, Inc. v. Shell Oil Co., 309 F.2d 306 (4th Cir. 1962), *cert. denied,* 372 U.S. 911 (1963); Bascom Launder Corp. v. Telecoin Corp., 204 F.2d 331 (2d Cir.), *cert. denied,* 345 U.S. 994 (1953); L. S. Good v. H. Daroff & Sons, Inc., 5 CCH Trade Reg. Rep. ¶ 72027 (N.D. W. Va. 1967).

that such a provision may also be on safer ground when coupled with the license of trademark rights, as often occurs in a franchising situation.[72]

Where, however, an exclusive-selling provision results from a horizontal arrangement,[73] or tends to result in monopoly or monopoly control by either the franchisor or franchisee,[74] or is part of an illegal resale-price-maintenance scheme,[75] it is illegal. In a sense, exclusive selling is an extension of the right to refuse to deal and is judged by many of the same standards.[76]

In building stronger sellers by protecting the new sales and manufacturing entries from intrabrand competition and in building stronger manufacturers by providing them effective marketing systems at minimum investment, exclusive selling increases the intensity of interbrand competition and can result in an overall increase in competition.[77]

2. Exclusive Buying

Exclusive-buying provisions have not had as clear a judicial history. Before the passage of the Clayton Act, exclusive-buying provisions were considered legal except when accompanied by an attempt to monopolize or fix prices.[78] The Clayton Act, in forbidding tying agreements, prohibited exclusive-buying agreements that are likely "to substantially lessen competition or tend to create a monopoly."[79] The cases interpreting this provision of the Clayton Act have looked at different factors in determining legality, including impact on a properly defined market,[80] quantitative substantiality, *i.e.*, the foreclosure of competition in a substantial share of the market,[81] and the seller's market dominance.[82]

The cases specifically dealing with exclusive-buying provisions in franchising or similar arrangements seem to have adopted a test of legality under which the arrangements will be sustained where there is a valid business reason for them, unless competing sellers are being deprived of adequate access to market

72 See Huber Baking Co. v. Stroehmann Bros. Co., 252 F.2d 945 (2d Cir.), *cert. denied,* 358 U.S. 829 (1958). For some of the legally permissible limits on intrabrand competition when trademarks are involved, see Humble Oil & Ref. Co. v. Standard Oil Co., 363 F.2d 945 (5th Cir. 1966), *cert. denied,* 87 S. Ct. 714 (1967).

73 See Flintkote Co. v. Lysfjord, 246 F.2d 368 (9th Cir.), *cert. denied,* 355 U.S. 835 (1957).

74 Hershey Chocolate Corp. v. FTC, 121 F.2d 968 (3d Cir. 1941).

75 Kiefer-Stewart Co. v. Seagram & Sons, Inc., 340 U.S. 211 (1951); Dr. Miles Medical Company v. John D. Park & Sons Co., 220 U.S. 373 (1911).

76 *Compare* United States v. Colgate & Co., 250 U.S. 300 (1919), *with* United States v. Parke, Davis & Co., 362 U.S. 29 (1960).

77 See Lewis & Hancock, The Franchise System of Distribution, 41-42 (1963); Averill, *Antitrust Considerations of the Principal Distribution Restrictions in Franchise Agreements,* 15 Am. U.L. Rev. 28, 33-39 (1965); Chadwell, *Antitrust Aspects of Dealer Licensing and Franchising,* Proceedings of the Fifth Annual Corporate Counsel Institute 58, 65-69 (1966); Handler, Statement Before the Small Business Administration, reprinted in 11 Antitrust Bull. 417, 421-24 (1966); Weisbard, *Resale Price Maintenance, Exclusive Dealing and Tying Arrangements,* 46 Chicago Bar Rec. 357 (1965).

78 See Robinson, *Restraints on Trade and the Orderly Marketing of Goods,* 45 Cornell L.Q. 254, 275 (1960). See also Paley, *Antitrust Pitfalls in Exclusive Dealing Recent Developments under the Sherman, Clayton and FTC Acts,* 37 Notre Dame Lawyer 499 (1962).

79 See note 46 *supra.*

80 Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320 (1961). See also Northern Pac. Ry. v. United States, 356 U.S. 1 (1958); Brown Shoe Co. v. United States, 370 U.S. 294, 330 (1962).

81 Standard Oil Co. v. United States, 337 U.S. 293 (1949).

82 Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346 (1922).

outlets.[83] Again, this position would seem to be stronger where a trademark (which is often involved in franchising) is present.[84] Where, however, the arrangement results in an undue restriction of outlets available to competing sellers, it is illegal.[85]

By providing more effective sellers who can concentrate their efforts on a limited line of products and by providing a more dedicated marketing system, exclusive-buying provisions increase the intensity of interbrand competition, and the overall level of competition is thereby heightened.[86]

3. Territorial Restrictions

Territorial restrictions on the franchisee's sales activities have generated the bulk of current franchise antitrust litigation. This was one of the issues in *White Motor*, was involved in *General Motors*, and is one of the prime questions in both *Sealy* and *Schwinn*.

Pending the Supreme Court's decisions in *Sealy* and *Schwinn*, the reported cases allow territorial restrictions as long as they are vertically initiated and imposed, can be justified by a sound business reason, and do not unduly restrict competition in the industry involved.[87] Where the impetus for such restrictions is horizontal[88] or they cannot be justified by a sound business reason,[89] they are illegal per se.

Despite the sustained attack mounted on territorial restrictions by the Department of Justice, there are many sound reasons for sustaining them. The quotation from the *Schwinn* opinion[90] shows one of them. Moreover, where the territorial restriction is entirely vertical and is justified by business and competitive reasons, it can stimulate interbrand competition by providing the best distribution for a product through a healthy chain of dealers who are free from the distractions of intrabrand competition and can concentrate on interbrand competition.[91]

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83 Dehydrating Process Co. v. A. O. Smith Corp., 292 F.2d 653 (1st Cir.), *cert. denied,* 368 U.S. 931 (1961); Reliable Volkswagen Sales & Serv. Co. v. World-Wide Automobile Corp., 182 F. Supp. 412 (D.N.J. 1960). See Northern Pac. Ry. v. United States, 356 U.S. 1 (1958). See also United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960). *Cf.* Osborn v. Sinclair Ref. Co., 324 F.2d 566 (4th Cir. 1963); Switzer Bros. v. Locklin, 297 F.2d 39 (7th Cir. 1961), *cert. denied,* 369 U.S. 851 (1962).

84 See Baker v. Simmons Co., 307 F.2d 458. (1st Cir. 1962).

85 International Staple & Mach. Co., 59 F.T.C. 1080 (1961). *Cf.* United States v. Arthur Murray, Inc., 1958 Trade Cas. ¶ 69192 (W.D. Mo. 1958) (consent decree).

86 See Averill, *supra* note 77, at 39-44; Chadwell, *supra* note 77, at 65-69; Handler, *supra* note 77, at 424-27; Weisbard, *supra* note 77.

87 Sandura Co. v. FTC, 339 F.2d 847 (6th Cir. 1964); Snap-On Tools Corp. v. FTC, 321 F.2d 825 (7th Cir. 1963). See also Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403 (5th Cir. 1962); Buro Hall Corp. v. General Motors Corp.; 124 F.2d 822 (2d Cir.), *rehearing denied,* 130 F.2d 196 (1942).

88 United States v. Arnold Schwinn & Co., 237 F. Supp. 323, 342 (N.D. Ill. 1965). *Cf.* United States v. General Motors Corp., 384 U.S. 127 (1966).

89 United States v. Volkswagen of America, Inc., 182 F. Supp. 405 (D.N.J. 1960). *Cf.* Virginia Excelsior Mills, Inc. v. FTC, 256 F.2d 538 (4th Cir. 1958).

90 See text accompanying note 67 *supra.*

91 See Lewis & Hancock, *op. cit. supra* note 77, at 22-24; Averill, *supra* note 77, at 51-60; Chadwell, *supra* note 77, at 65-69; Handler, *supra* note 77, at 427-32; Jones, *Control of Distributors' Activities,* 26 ABA Antitrust Section 68, 68-76 (1964); witness also the possible Robinson-Patman (§ 2 of the Clayton Act) value of such restrictions in Perma Life

4. Customer Restrictions

Customer restrictions have also played a role in the current franchise antitrust litigation. Such provisions were involved in *White Motor* and *Schwinn*, along with the franchises' territorial restrictions. As a result, the judicial history of such provisions has been extensively related to that of territorial restrictions.

Hence, although the Supreme Court's pending decision in *Sealy* may effect a change in the law, the reported cases allow customer restrictions as long as they are vertically initiated and imposed, can be justified by some valid business reason, and do not unduly restrict competition.[92] Where the customer-restriction provision meets these tests, it can stimulate more effective interbrand competition and can possibly avoid entanglements with some of the provisions of the Robinson-Patman Act.[93]

5. Quality Control of Trademarked Goods

Since quality control is the central feature of any franchise, it is interesting to note that quality-control restrictions have seldom been litigated independently. Quality control, often as a defense, has been considered in connection with franchise exclusive-buying provisions.[94] This general acceptance of quality-control restrictions probably results from the express requirement of the trademark law that a trademark licensor exercise control over the use of his trademark to assure that the public is not thereby deceived.[95]

Two cases, however, have considered this issue somewhat independently. Both concerned soft ice cream franchises, one a Dairy Queen franchise and the other a Carvel franchise. In the first,[96] the franchise agreement required the use by the franchisees of a Dairy-Queen-approved soft ice cream mix and other food items. Several creameries made the mix, and the franchisor had no interest

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Mufflers, Inc. v. International Parts Corp., 5 CCH TRADE REG. REP. ¶ 71802 (N.D. Ill. 1966).

There is some possibility, whether the Supreme Court declares the territorial restrictions in *Sealy* and *Schwinn* illegal or not, that Congress will exempt such territorial restrictions in franchise situations where

> the product or products which is or are the subject of such exclusive territorial franchise agreement or contract are in free and open competition with products of like grade and quality produced by persons other than the supplier, and where the purchaser under such exclusive territorial franchise agreement or contract is in free and open competition with other vendors of like or similar merchandise within the territorial area defined by such agreement of contract and is not inhibited by the terms of such agreement or contract from dealing in like or similar products or persons other than the supplier. S. 2549, 89th Cong., 1st Sess. (1965).

This may become an active question in Congress while the Supreme Court is considering the *Sealy* and *Schwinn* cases.

92 *Cf.* C.B.S. Business Equip. Corp. v. Underwood Corp., 240 F. Supp. 413 (S.D.N.Y. 1964); Roux Distrib. Co., 55 F.T.C. 1386 (1959).

93 46 Stat. 1526 (1936), 15 U.S.C. § 13(1964). See Averill, *supra* note 77, at 60-64; Chadwell, *supra* note 77, at 65-69; Handler, *supra* note 77, at 432-33; Jones, *supra* note 91, at 68-76; Pollock, *Franchising, Customer Restrictions, and Building a Better Mousetrap*, 46 CHICAGO BAR REC. 378 (1965).

94 *E.g.*, Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 410-11 (5th Cir. 1962).

95 Lanham Act, § 5, 60 Stat. 429 (1946), 15 U.S.C. § 1055 (1964). See E. F. Prichard Co. v. Consumers Brewing Co., 136 F.2d 512 (6th Cir. 1943). *But see* 2361 State Corp. v. Sealy, Inc., 263 F. Supp. 845 (N.D. Ill. 1967), where the question of quality control in the case of a supplier of private-label goods was peripherally involved.

96 Engbrecht v. Dairy Queen Co., 203 F. Supp. 714 (D. Kan. 1962).

in the mix and received no commission on its sale. The same was true of most of the other products to be purchased by the franchisees. The district court sustained these restrictions against a charge of tying. In the second case,[97] the court went even further and sustained a requirement that the Carvel franchisees purchase the supplies used in the end product from the franchisor. The court of appeals looked at the reason for the restriction and the franchisor's market position and sustained the purchasing requirement against a charge of per se illegality.

Quality control can be anticompetitive only when tied into a system of required purchasing from the franchisor or franchisor-approved sources. Even in such cases, however, it is necessary for the franchisor — and desirable for the franchisee — to protect the trademark and goodwill connected with the goods or services involved and thus to protect the name and goodwill of both the franchisor and franchisee. In doing so, quality control promotes rather than suppresses competition.[98]

6. Termination Problems

Generally speaking, of course, the question of whether a franchisor can terminate a franchise is a question of general contract law. Where the franchise provides, however, for termination on notice or periodic renewals — perhaps yearly[99] — a problem arises. When the franchisor exercises his unquestioned contractual right to terminate, may he still be liable for his actions if they were motivated by an improper purpose?

The franchisor can be liable for failure to renew a franchise at the request of other dealers or because of a conspiracy with other franchisees to get rid of a troublesome (e.g., a discounting) dealer.[100] Similarly, a termination of a dealer's franchise for his refusal to respect a franchise provision that violates the antitrust laws (e.g., a tying provision) is actionable,[101] but a termination to enforce or create a valid franchise restriction is not.[102] There is the added possibility, however, that where the franchisee was a willing party to a contract provision

97 Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *petition for cert. dismissed*, 381 U.S. 125 (1965). Similarly, the FTC sustained the Carvel franchises' quality-control requirements against an attack based on the theory that they were illegal tying agreements or otherwise unfair trade practices violative of § 5 of the FTCA. Carvel Corp., 3 CCH TRADE REG. REP. (Dismissal Order 1965) ¶ 17298.

98 See LEWIS & HANCOCK, *op. cit. supra* note 77 at 34-41; Handler, *supra* note 77, at 433-35; Note, *Antitrust Problems in Trademark Franchising*, 17 STAN. L. REV. 926, 931-36 (1965); Rudnick & Rudnick, *Some Solutions to the Problems of Maintaining Quality Standards*, 11 ANTITRUST BULL. 509 (1966).

99 LEWIS & HANCOCK, *op. cit. supra* note 77, at 60. Note that many franchise agreements run for long periods: Chicken Delight, Dairy Queen and McDonald, 20 years; Dairy Delight, 15 years with right to 5-to-10-year renewal; Ben Franklin Stores and Dr. Scholl, 5 years. *Ibid.*

100 See Miami Parts & Spring, Inc. v. Champion Spark Plug Co., 364 F.2d 957 (5th Cir. 1966).

101 See Osborn v. Sinclair Ref. Co., 324 F.2d 566 (4th Cir. 1963). *Cf.* Poller v. Columbia Broadcasting Sys., Inc., 368 U.S. 464 (1962).

102 See Packard Motor Car Co. v. Webster Motor Car Co. 243 F. 2d 418 (D.C. Cir. 1957), *cert. denied*, 355 U.S. 822, *rehearing denied*, 355 U.S. 900 (1957), 357 U.S. 923 (1958); Madsen v. Chrysler Corp., 261 F. Supp. 488 (N.D. Ill. 1966). Automobile dealer franchise termination has its own particular problems. See Automobile Dealers' Day in Court Act, 70 Stat. 1125 (1956) 15 U.S.C. §§ 1221-25 (1964).

that violated the antitrust laws, his recovery against the franchisor on termination may be barred by the doctrine of *pari delicto*.[103] There can even be antitrust problems after a legal termination, in regard to noncompetition provisions contained in the franchise.[104]

Generally, as long as the franchisor has the right of termination under the franchise agreement, he can terminate or fail to renew the franchise with impunity if he does so independently, *i.e.*, not in cooperation with or at the request of other franchisees, and not to achieve a purpose prohibited by the antitrust laws.

C. *Guideposts*

Unless the Supreme Court entirely rejects the reasoning of the opinions of the lower federal courts when it decides *Sealy* and *Schwinn*, it is safe to say that such franchising restrictions are not illegal per se and will be sustained by the courts in some circumstances. The prime requisites seem to be:

1. They must be vertical in their inception (and if *Schwinn* is followed, in their application), and they must not result from a price-fixing or price-maintenance conspiracy; and
2. The franchisor cannot have so much market control that it can, by means of the terms of the franchises, effectively foreclose competition in a substantial portion of the market.

A franchise restriction that meets these basic qualifications must still meet the final test:

3. Is there an adequate business justification for the restriction?

What business justification will the courts recognize? The guidepost of *Brown Shoe* is that a substantial foreclosure of competition is bad, even when all the other qualifications for a valid franchise restriction are present. Where the purpose of the restriction, however, is part of an attempt to win position in a market, particularly if the market is dominated by the large companies, the courts have tended to consider the restriction necessary and justified by valid business reasons. Whether phrased in terms of actual control of the market or in terms of alternative outlets available for other manufacturers, the courts have tended to look to the position of the party imposing the restriction. When control is needed to give a new manufacturer an entry into the market and if there is adequate interbrand competition, the courts have sustained such restrictions if the other qualifications, lack of vertical or price-fixing aspects, exist.

IV. Conclusion

Testimonials about franchising's effect in stimulating competition given by franchisors, franchisees, or attorneys representing the franchise industry are justifiably suspect. It is much more acceptable and convincing to refer instead to the testimonials of men like Judge Perry, who in considering the *Schwinn*

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103 Rayco Mfg. Co. v. Dunn, 234 F. Supp. 593 (N.D. Ill. 1964).

104 *Compare* Super Maid Cook-Ware Corp. v. Hamil, 50 F.2d 830 (5th Cir. 1931), *with* Hulsenbusch v. Davidson Rubber Co., 344 F.2d 730 (8th Cir. 1965), *cert. denied*, 382 U.S. 977 (1966). On the question of such restrictions prior to the execution of a franchise agreement, see Budget Rent-a-Car Corp. of American v. Fein, 342 F.2d 509 (5th Cir. 1965).

case said of franchising, "[B]y and large its effects are wholesome and it furnishes a means for enterprising individuals and businesses to continue developing our competitive society along with all of the bigness of all business."[105] Judge Dawson in the district court decision in *Susser v. Carvel Corp.* stated:

> The franchise method of operation has the advantage, from the standpoint of our American system of competitive economy, of enabling numerous groups of individuals with small capital to become entrepreneurs. . . . If our economy had not developed that system of operation these individuals would have turned out to have been merely employees. The franchise system creates a class of independent businessmen; it provides the public with an opportunity to get a uniform product at numerous points of sale from small independent contractors, rather than from employees of a vast chain. The franchise system of operation is therefore good for the economy.[106]

When all the factors are considered, franchising appears to be beneficial to competition and to the American economic system, especially in view of the new life it has given small business enterprises. But for franchising to exist successfully, it is necessary that there be certain restrictions upon the freedom of economic choice of both the franchisor and the franchisee. The principal restrictions necessary to successful franchising may include restrictions on selling, buying, territory, customers, and those to maintain quality. Although some restrictions are clearly necessary, there can often be reasonable dispute as to the necessity for any specific restriction in a given franchise situation. It seems clear, for example, that a franchised soft ice cream stand must have a protected territorial area if it is to succeed. It is not quite so clear, however, that the franchisor's quality control and trademark protection over that soft ice cream stand can be enforced only by an exclusive-buying contract.[107] The same questions of necessity, economics, convenience, and practicability can be raised in relation to each specific restriction. A critical question is: is there a valid business justification for the restriction imposed?

Accordingly, it is not argued here that franchising should be free from all antitrust restrictions. It is clear that many of the current per se rules, such as price fixing, should apply just as naturally to franchisor-franchisee price fixing as to any other form of price fixing or illegal resale-price maintenance.[108] All that is suggested is that the courts and the enforcement agencies recognize the competitive innovation that franchising has brought about and its effect in stimulating competition or at least in making competition by the new and developing companies possible in a market already stratified and often dominated

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105 United States v. Arnold, Schwinn & Co., 237 F. Supp. 323, 334-35 (N.D. Ill. 1965).

106 206 F. Supp. 636, 640 (S.D.N.Y. 1962).

107 *Compare, e.g.,* Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. denied,* 381 U.S. 125 (1965), *with* Engbrecht v. Dairy Queen Co., 203 F. Supp. 714 (D. Kan. 1962).

108 It is interesting, however, to consider the problems inherent in situations such as the McDonald Hamburger franchises, the International House of Pancakes franchises, and various other franchise operations where the *price* of the product or its *cost to the consumer* is a very important part of the franchisor's image and good will. See also Vess v. Fred Astaire Dance Studios Corp., 229 F.2d 892 (5th Cir. 1956).

by the large, fully integrated manufacturing-marketing enterprises. Undue concern by the courts and enforcement agencies for intrabrand competition in the case of a nondominant company is not only unnecessary, it may actually be harmful to overall competition.

It is axiomatic under the American antitrust laws that the mere fact that a restriction is a restraint of trade does not make it unlawful. Since the *Standard Oil* decision in 1911,[109] the "rule of reason" has governed our antitrust jurisprudence; and as a result it is necessary to show that a restriction unreasonably restrains trade before it can be found to have violated the Sherman or Clayton Acts. In determining whether the restrictions that are inherent in franchising are reasonable or unreasonable, one of the major factors which should motivate the decision of the courts and enforcement agencies is the overall procompetitive impact and effect of franchising.

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109 Standard Oil Co. v. United States, 221 U.S. 1 (1911).