BIG MACS AND RADIO SHACKS: ANTITRUST POLICY FOR BUSINESS FORMAT FRANCHISES

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In the last thirty years, a quiet revolution has been taking place in the retailing of goods and services. As of 1979, almost 32% of all retail sales were made through franchised outlets.[1] From 1960 to 1970, the number of franchised units increased at a rate of 8.8%, compounded annually,[2] and the number of franchisors increased even more rapidly. As a new type of business organization, franchising, in all its forms, is an unqualified marketplace success.

Within the general category of franchise arrangements, business format franchising is the most recent development. More traditional franchising arrangements are established primarily to accomplish product distribution for a remote manufacturer.[3] These product distribution franchises typically authorize a retailer to sell the manufacturer's products under a contractual arrangement which provides some incentives for good retailer performance, some retailer protection from intrabrand competition, and some manufacturer protection from actual or potential interbrand competition from the retailer.[4] In contrast, business format franchises involve a different and

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1. INDUSTRY AND TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY 1977-1979 at 11 (1979). This figure was predicted to rise to 34% in 1982. INDUSTRY AND TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY 1980-1982 at 11 (1982).

2. Ozanne & Hunt, *Economic Effects of Franchising*, University of Wisconsin School of Business, published a report of the SENATE SMALL BUSINESS COMMITTEE, IMPACT OF FRANCHISING OF SMALL BUSINESS, S. REP. No. 1344 at 79, 91st Cong. (1970) [hereinafter cited as Ozanne & Hunt].

3. Product distribution franchising handles a larger volume of business—$287 billion in sales in 1981, INDUSTRY AND TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY 1979-1981 at 1-3, and $332 billion in 1982, FRANCHISING IN THE ECONOMY 1980-1982, *supra* note 1, at 1.

4. This Article is one of a series discussing antitrust policy for vertical business relationships.

more fully integrated economic relationship in which the franchisor supplies know-how, and frequently facilities, for a complete business operation and the franchisee operates the business to produce and sell the good or service.[5] McDonald's hamburger franchises are a paradigm example. In the aggregate, this form of franchising is growing faster[6] than the traditional product distribution form, although it still accounts for fewer sales.

Traditional antitrust policy has had two basic conceptual problems in regulating franchise relationships in general and business format franchises specifically. First, antitrust has had problems with franchise agreements because they appear to restrict the marketplace freedom of legally independent entities.[7] Yet these legally independent entities are economically quite interdependent.[8] This is particularly true of business format franchises. Their specific contract provisions are used to enable the parties jointly to exploit economies and to pursue other economic objectives.[9] Yet the contract provisions that permit this joint exploitation appear to be restraints on the franchisee's freedom to behave competitively—and they can be so used.

Second, antitrust has traditionally regulated vertical business relationships with rules that determine the legality of each specific contractual restriction in the vertical business arrangement.[10] With product distribution franchising cases, a typical dispute is dealt with either as a tying arrangement[11] or by determining the legality of specific territorial restrictions or

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The others discuss antitrust policy implications of specific parts of this distribution contractual arrangement. Strasser, *Vertical Territorial Restraints After Sylvania: A Policy Analysis and Proposed New Rule*, 1977 DUKE L.J. 775; Strasser, *Antitrust Policy in Agreements for Distributor Exclusivity*, 16 CONN. L. REV. 969 (1984); Strasser, *An Antitrust Policy for Non-Franchise Tying* (forthcoming in the Emory Law Journal) [hereinafter cited as Strasser, *Tying*].

5. Included in the first section of this Article is a more comprehensive description of business format franchising. *See infra* text accompanying notes 22-93.

6. FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 3. The trend toward greater use of this kind of franchising was noted as early as 1967 in Jones, *The Growth and Importance of Franchising and The Role of Law*, 12 ANTITRUST BULL. 717, 722 (1967). The basic characteristics of the franchise relationship are described in Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 224 (1978): (1) The franchisor provides managerial assistance; (2) the franchisee agrees to operate the business in a manner stipulated by the franchisor; (3) the franchisee agrees to pay royalties, often on gross sales; and (4) the franchisor can terminate the franchisee for poor performance.

7. All vertical integration by contract, rather than by ownership, has this characteristic. However, with business format franchising, there are many more restrictions because a much higher degree of integration is achieved. *See* FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 4-11; Rubin, *supra* note 6, at 224-25. Where the independence of the franchisee is totally restricted, the economic impact is equivalent to vertical integration by ownership. *See, e.g.*, Katinsky v. Radio Shack, 524 F. Supp. 807 (D.N.J. 1980).

8. For a short discussion of the nature of this economic interdependence in product distribution arrangements, see Strasser, *Territorial Restraints*, *supra* note 4, at 785-94.

9. Ozanne & Hunt, *supra* note 2, at 26, discuss this as cooperation. Preston, *Restrictive Distribution Arrangements: Economics Analysis and Public Policy Standards*, 30 L. & CONTEMP. PROB. 506, 507 (1965), describes restrictive distribution arrangements as mechanisms which transfer some of the decision-making authority from one business unit to the control of another business unit.

10. *See, e.g.*, Spray-Rite Serv. Corp. v. Monsanto, 684 F.2d 1226 (7th Cir. 1982), *aff'd*, 52 U.S.L.W. 4341 (1984), discussing sequentially, resale price maintenance, boycotts, the compensation program, and shipping policies to distributors; Krehl v. Baskin-Robbins Ice Cream Co., 664 F.2d 1348 (9th Cir. 1982), in which the plaintiff's complaint sought relief for, respectively, a tying arrangement, an unlawful horizontal market allocation, and a vertical price fixing arrangement. *See generally* Baker, *The Supreme Court and The Per Se Tying Rule: Cutting The Gordian Knot*, 66 VA. L. REV. 1235, 1252 (1980).

11. The classic case is Siegel v. Chicken Delight, Inc., 448 F.2d 43 (5th Cir. 1971). For recent

exclusivity requirements.[12] While individual rules have generated controversy,[13] both scholarly literature and most cases have applied this restraint-by-restraint approach without apparent criticism or re-evaluation.

Business format franchising cases are currently decided with reference to one of two conceptual approaches. The more traditional of these continues this restraint-by-restraint approach, emphasizing the application of traditional tying law. *Siegel v. Chicken Delight, Inc.*[14] is one of the cornerstones of this approach and a typical example. There the defendant franchisor required franchisees to purchase equipment and supplies from it at inflated prices in exchange for the right to use its business methods and trademark. The excess profits on equipment and supplies were, presumably, the franchisor's compensation for creating and maintaining the franchise system. The court applied traditional tying law to find, first, that the trademark was a separate product from the equipment and supplies and, second, that the trademark's uniqueness established its market power. The system was thus held to be an illegal tying arrangement.[15] This approach causes the legality of a business format franchise to turn, primarily, on whether license of the trademark is a separate product from either the business format or any of the specific parts of the franchise. Unfortunately, the approach is frequently used in the cases today.[16]

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discussions in the scholarly literature which take this approach, see Baker, *supra* note 10; Comment, *A New Approach to Legality of Franchising Tie-Ins*, 129 PA. L. REV. 1267 (1981); Note, *Trade Mark Franchising and Antitrust Law: The Two-Product Rule For Tying Arrangements*, 27 SYRACUSE L. REV. 953 (1976).

12. Continental TV, Inc. v. GTE Sylvania, 433 U.S. 36 (1977) is the watershed decision on non-price vertical restraints. Resale price maintenance is also an issue presented in these cases although the Supreme Court's recent treatment of it indicates a continuing commitment to a per se rule in this area. Spray-Rite Services Co. v. Monsanto, 684 F.2d 1226 (7th Cir. 1982), *aff'd* 52 U.S.L.W. 4341 (1984); Arizona v. Maricopa County Medical Soc'y, 457 U.S. 332 (1982). This writer's other papers dealt with territorial restraints, non-franchise tying, and exclusive dealing arrangements and proposed new rules for determining the legality of these practices. *See supra* note 4.

13. The storm of scholarly commentary has continued since the 1977 Sylvania decision. Recent works include Zeleck, Sturn & Dunfee, *A Rule of Decision Model After Sylvania*, 68 CALIF. L. REV. 13 (1980); Posner, *The Next Step in Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 CHI. L. REV. 6 (1981); Hard, *A Criticism of Post-Sylvania Decisions and a Proposal to Make the Rule of Reason Reasonable Again*, 1980 UTAH L. REV. 795; Stewart & Roberts, *Viability of the Antitrust Per Se Illegality Rule: Schwinn Down, How Many To Go?*, 58 WASH. U.L.Q. 727 (1980); McGee, *Commentary: A Return To The Rule of Reason*, 58 WASH. U.L.Q. 763 (1980); Jinkinson & Foster, *Commentary: Per Se Rules Against Vertical Restraints: Down But Not Out*, 58 WASH. U.L.Q. 795 (1980); Devita, *The Facial Unreasonableness Theory: Filling In The Void Between Per Se and Rule of Reason*, 55 ST. JOHN'S L. REV. 729 (1981); Gerhart, *"The Competitive Advantages" Explanation for Intrabrand Restraints: An Antitrust Analysis*, 1981 DUKE L.J. 417; Baker, *Interconnected Problems of Doctrine and Economics in the Section One Labyrinth: Is Sylvania A Way Out?*, 67 VA. L. REV. 1457 (1981); Liebeler, *Intrabrand "Cartels" Under GTE Sylvania*, 30 UCLA L. REV. 1 (1982); Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982); Levmore, *Rescuing Some Antitrust Law: An Essay on Vertical Restrictions and Consumer Information*, 67 IOWA L. REV. 981 (1982).

14. 448 F.2d 43 (5th Cir. 1971).

15. *Id.* at 52.

16. *See, e.g.*, Roberts v. Elaine Powers Figure Salons, Inc., 708 F.2d 1476 (9th Cir. 1983); Midwestern Waffles, Inc. v. Waffle House, Inc., 1983-2 Trade Cases, ¶ 65,567 (N.D. Ga. 1982) (finding no liability because no injury was shown). Since *Siegel v. Chicken Delight*, the court has decided two tying cases which emphasize that tying is illegal only if the seller has real market power in the tied product. *See* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 104 S. Ct. 1551 (1984); United States Steel Corp. v. Fortner Enter., Inc., 429 U.S. 610 (1977). These holdings seem to raise serious questions about any conclusion that a particular franchisor has market power in its trademark.

The other conceptual approach to business format franchise cases is more concerned with evaluating the franchise's actual impact on competition. This approach has only recently been developing in the cases. *Principe v. McDonald's Corp.*[17] is both the watershed and an excellent example. The franchisee sued alleging an illegal tie of McDonald's trademark license to lease of the land and building for the franchise location. The court avoided conventional tying law by finding that only one product—a business format franchise—was present. Lease of the land and building "is an essential ingredient of the franchised system formula for success. . . . [I]t is often unrealistic to view a franchise agreement as little more than a trademark license."[18] Properly understood, the business format franchise is an interdependent "bundle of franchise benefits and obligations"[19] and it should be so analyzed under antitrust law. This view of the business format franchise as one interrelated transaction, both for tying-law purposes and for determining the appropriate unit for antitrust analysis, has been followed in several recent cases.[20] This is the proper approach.

This Article argues two points. The first is that the traditional restraint-by-restraint approach should not be used to analyze the competitive impact of business format franchising. As *Principe* and its progeny have recognized, this new form of business organization is a unitary package transaction, not a piecemeal accumulation of specific trade restraints and other contract rights. Evaluation of its costs and benefits to the parties, as well as its ultimate competitive impact, must be done by looking at the transaction as a whole. The old rules about the legality of specific parts of the business format franchise, particularly tying arrangements, should not be applied to this new form of business organization. Those rules were developed to regulate different kinds of commercial conduct with different costs and benefits to the parties and different impacts on competition. This is particularly true of tying and other rules which have been applied to vertical business relationships; they are themselves controversial and under serious attack.[21] Ultimately, competitive impact is the concern of antitrust policy. Yet this is the one question not even posed, much less answered, by the traditional tying-law approach of *Siegel v. Chicken Delight*. The interdependence of the business format franchise's constituent parts demands a new approach to determining the antitrust legality of business format franchises.

Second, this Article argues that courts must take account of this inter-

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However, this has not been extensively considered in recent post-*Fortner* cases concerned with franchising.

17. 631 F.2d 303 (4th Cir. 1980).

18. *Id.* at 309. *Accord* Kypta v. McDonald's Corp., 671 F.2d 1282 (11th Cir. 1982) (dictum).

19. *Principe*, 631 F.2d at 307.

20. *See, e.g.*, Kypta v. McDonald's Corp., 671 F.2d 1282 (11th Cir. 1982); Levine v. McDonald's Corp., 1983-1 Trade Cases (CCH) ¶ 65,270 (D. Ct. Ariz. 1983); Krehl v. Baskin-Robbins, 664 F.2d 1348 (9th Cir. 1982). The same view of franchise agreements as one interrelated exchange has been applied in some product distribution franchise cases. Beltone Elect. Corp., 91 FTC 884 (FTC, 1978); California Glazed Prod., Inc. v. Burns and Russell Co., 708 F.2d 1423 (9th Cir. 1983). *See also* Phillips v. Crown Cent. Petroleum Corp., 602 F.2d 616, 628 (4th Cir. 1979) ("Slightly different considerations apply when the tying agreement is part of an otherwise valid franchise arrangement, since the very essence of a franchise is the purchase of several related products in a single competitively attractive package").

21. *See* authorities cited *supra* notes 4 and 13.

relation of the parts of the business format franchise, as *Principe* and some other recent cases have done. A conceptual structure for such analysis is proposed. The nature of the business format franchise requires that a franchisor be able, for example, to restrict the degree of intrabrand competition among its franchisees. If it cannot do so, the franchisor and its franchisees will not enter the franchise arrangement because they will be unable to secure some of its important economic advantages. In this situation, a decision to prohibit specific restrictions on intrabrand competition must allow for the whole franchise arrangement's impact on competition; this is what is at stake with restrictions essential to the franchise arrangement. While courts can and should limit franchisors to those restrictions mandated by the nature of the franchise relationship, courts must permit use of those restrictions if the existence of the franchise has a positive impact on competition. This impact is typically positive.

This Article first discusses the nature of business format franchises by reviewing their costs and benefits as commercial exchanges. Next, after a brief review of the goals of antitrust, it analyzes the likely procompetitive benefits and anticompetitive harms of the business format franchise. Finally, a new conceptual structure for evaluating the competitive implications of a particular arrangement in a particular market setting is proposed. The general conclusion is that business format franchises should be permissible except where they create or support existing entry barriers. Yet where business format franchises are permissible, the social and political goals of antitrust require that specific restrictions on franchisee conduct be limited to those required by the nature of the franchise relationship.

A. The Nature of the Franchise Relationship

Business format franchises are used to accomplish several legitimate economic and commercial objectives. The first of these is to achieve economies of scale. There are economies of large scale in creation and commercial exploitation of start-up information, operational information and know-how, and advertising and promotion to create brand preference. However, actual operation of the franchised business also presents some diseconomies of large scale. These include the difficulty of managing a geographically dispersed business, the difficulty of providing adequate on-the-job supervision of employees who work in small units, and perhaps the intrinsic economies of the operations performed on a scale that consumer demand mandates. Business format franchising often permits parties to exploit these economies of both large and small scale.[22]

Parties also use business format franchises to ameliorate the costs of dealing in imperfect vertical markets. In theory, perfectly competitive vertical markets would achieve all available economies and produce the greatest

22. Caves & Murphy, *Franchising: Firms, Markets and Intangible Assets*, 42 So. Econ. J. 572, 574-76 (1976). *See generally* Comment, *supra* note 11, at 1272-76; *Distribution Problems Affecting Small Business, Hearings Before the Subcomm. on Antitrust and Monopoly of the Comm. of the Judiciary*, 89th Cong., 5 (testimony of Eugene P. Foley, Administrator of the Small Business Administration) [hereinafter cited as Distribution Problems].

consumer welfare[23] possible. In fact, markets never work perfectly and until recently, little of the literature of microeconomics has dealt with the imperfections of vertical markets.[24] Recent work in economics has persuasively argued that some form of coordinating internal organization will frequently be substituted for uncoordinated vertical market transactions to respond to market imperfections of vertical markets. These imperfections include transaction costs, imperfect information, opportunism, bounded rationality, and the problems of dealing in small numbers markets.[25] As will be discussed more fully below, business format franchising is a form of partial vertical integration by contract which is used to substitute a degree of internal organization for uncoordinated vertical market transactions to lower these costs.[26] It achieves a higher degree of integration, typically, than the other forms of vertical integration by contract; it does so by imposing more exacting contractual requirements on the parties. The remainder of this section discusses the economic nature of franchise relationships and the contractual provisions they require.

1. *Economies of Large Scale: Franchisor Operations Information, Know-how, and Brand Preference*

In most business format franchise arrangements, the franchisor furnishes substantial information and know-how about both starting the franchise outlet and operating it. The franchisor has a strong incentive to provide real help to its franchisees in this regard—if, as a group, the franchisees are not profitable, ultimately the franchisor will not be profitable either. Further, because the franchisor can create this knowledge once and then distribute it to all its franchisees, there are real economies of scale in

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23. The term "consumer welfare" is a technical economics term. For a general discussion, see SAMUELSON, ECONOMICS 633-35 (10th ed. 1976); FERGUSON & GOULD, MICROECONOMICS THEORY 454-57 (Irwin, 4th ed. 1975). Two assumptions are critical: first, that all consumers are able to express their preferences for goods and services precisely in their willingness to pay for those goods and services; and second, that their social well being is reflected by maximizing the amount of goods and services which can be bought.

24. Several recent works have focused directly on the operation of vertical markets. *See generally* WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market vs. Non-Market Allocation, Analysis and Evaluation of Public Expenditures: The PPB System*, (Joint Economic Committee, 1969), 47-64; WARREN-BOULTON, VERTICAL CONTROL OF MARKETS: BUSINESS AND LABOR PRACTICES (1978); PORTER, INTERBRAND CHOICE, STRATEGY AND BILATERAL MARKET POWER (1976); Klein, Alchian & Crawford, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Gerhart, *The "Competitive Advantages" Explanation for Intrabrand Restraints: An Antitrust Analysis*, 1981 DUKE L.J. 417; SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 78-80 (2d ed. 1980).

25. WILLIAMSON, *supra* note 24, at 104-05, discusses transaction costs, bounded rationality, and opportunism. PORTER, *supra* note 24, discusses all of these and adds critically important ideas of the nature of business strategy. Arrow, *supra* note 24, particularly discusses transactions costs. Williamson, *Markets and Hierarchies: Some Elementary Considerations*, 63 AM. ECON. REV. (papers and proceedings) 316 (1973), focuses on the importance of information. Information is also emphasized in WARREN-BOULTON, *supra* note 24, ch. 2. Kaserman, *Theories of Vertical Integration: Implications for Antitrust Policy*, 23 ANTITRUST BULL. 483, 485-92, surveys all of this literature. *See generally* Posner, *The Chicago School of Antitrust Analysis*, 127 PENN. L. REV. 925, 951 (1979); Comment, *supra* note 11, at 1272-76.

26. *See infra* notes 27-47 and 63-86 and accompanying text.

centralizing this function.[27]

The start-up assistance provided by franchisors can be substantial. In 1970, it was reported that over half of all fast-food franchisors selected the franchisee's business site and 96.7% required site approval.[28] Eighty percent provided for the use of a building specifically designed for a franchisee operation.[29] By definition, the franchisor determines products or services to be sold in a business format franchise. Further, required accounting systems should improve franchisees' cost information and the resulting pricing decisions.[30] Virtually all franchisors provide start-up supervision.[31] Given the difficulties faced by all new businesses, particularly new retailing businesses, this assistance is a significant aspect of the franchise relationship.

Similarly, the available evidence indicates that business format franchisors provide substantial continuing operational assistance to their franchisees. The same 1970 study found that 78% of fast food franchisors required franchisees to participate in a formal training program,[32] and 61% provide an operating manual.[33] While specifics varied, the majority of fast food franchisors had specific operational standards which franchisees were required to meet.[34] These standards specify particulars of franchisee operations, purchasing, employee relations, marketing, and accounting.

The significance of franchisor creation and transfer of information should not be minimized. The 1970 study indicated that many franchisees had not operated a business prior to obtaining the franchise[35] and most became small franchised operations, owning only one franchise.[36] Such small, newly established retail businesses with inexperienced managements are the ones most in need of sophisticated management information and least able to

27. On the importance of information exchange as a motivation for vertical integration, see authority cited *supra* note 23. For a survey of the discussion of scale economies of vertical integration generally, see SCHERER, *supra* note 24, at 88-109. Information exchange is characteristic of vertical integration generally; however, more information is typically exchanged in business format franchising. Rubin, *supra* note 6, at 224, discusses managerial assistance as one of the characteristics of the franchising arrangement.

28. Ozanne & Hunt, *supra* note 2, at 126.

29. *Id.* at 131.

30. *Id.* at 226, discusses specific provisions related to accounting restrictions and the variations among different franchisor systems. That study found that 76% of franchisors insisted on the right to audit each franchisee's books, 63% required franchisor approval of each franchisee's accounting methods, 79% required periodic reports from each franchisee, and 74% had format specifications for those reports.

31. *Id.* at 137, reports that 124 out of 125 franchise sources studied provided start up supervision. While the period of supervision varied, the median was two weeks.

32. *Id.* at 134. While only 46% of all franchisees had taken such a course, 91% of franchisors gave some on the job training. *Id.* at 135.

33. *Id.* at 209.

34. *Id.* at 202-55 discusses the frequency of use of a large number of specific franchisor controls. The question of maintenance of standards is dealt with *id.* at 221. Franchisor standards were required in the following proportions: cleanliness standards were enforced by 61% of the franchisors, food quality standards by 82%, operations by 76%, inventory control by 27%, and product line control by 61%. *Id.* at 202-55.

35. *Id.* at 113. Ozanne & Hunt estimate that 36% to 67.9% of all franchisees were new businesses in the fast-food industry. In 1970, this amounted to between 13,700 and 25,800 new business outlets which were not previously in existence.

36. *Id.* at 102. Ozanne & Hunt report that 72% of all franchisees operated only one unit. However, there has been a mild recent trend toward both franchisor repurchase of some franchisee operations and growth of multi-unit franchisees.

purchase it independently. By specialization, the franchisor can achieve economies of scale in creating high quality information well tailored to franchisee needs and economically provide it when it is most needed. Further, in the study, franchisor provision of assistance was almost always positively correlated with franchisee income.[37]

For example, consider the site selection services provided by McDonald's, as described in the *Principe* case.[38] Site selection requires extremely specialized knowledge, which would be difficult for an inexperienced franchisee to purchase at any price or to afford if available. McDonald's has one site selection office; as a result it can provide very high quality service, economically, to a large number of franchisees, improving the commercial prospects of each.

Similarly, business format franchisors are able to exploit economies of scale both in creation of brand preference for the franchised product or service and in protection of the brand image through monitoring of franchisee quality control. Much of the creation of brand preference for the franchised goods or services is accomplished through national advertising. In both hiring specialists to create the advertising and in purchasing the advertising exposure, a franchisor can spread the costs over a larger volume of product sales (by franchisees) and thus achieve economies of large scale.[39] In addition, the buying power associated with large-scale nationwide promotion may permit the franchisor to bargain for lower prices which reflect pecuniary economies.[40] Further, a coordinated nationwide promotional campaign is more likely to give consumers a sufficiently concentrated exposure to achieve the "threshold effect"[41] which makes consumer advertising more effective.

Such franchisor advertising will likely serve as a source of product differentiation.[42] If effective product differentiation is accomplished, price competition at the retail level will be blunted and more of the decisions about product or service characteristics will be effectively transferred to the

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37. *Id.* at 158-59. Ozanne & Hunt reported a positive correlation between franchisee perception of high quality assistance and franchisee income. They also found a positive correlation between franchisor provision of training and franchisee income, *id.* at 134, and between franchisor specification of building design and franchisee income, *id.* at 131. These correlations are not determinative because they do not control for other factors. However, they are evidence supporting the general conclusion that franchisors do provide meaningful operational assistance to franchisees.

38. Principe v. McDonald's Corp., 631 F.2d 303 (9th Cir. 1980).

39. Carstensen, *Vertical Restraints and the Schwinn Doctrine: Rules for the Creation and Dissipation of Economic Power*, 26 CASE W. RES. 771, 775 (1976), discusses this use of national advertising by manufacturers of goods generally to presell products to consumers. *See generally* Comanor & Wilson, *The Effect of Advertising on Competition: A Survey*, 17 J. ECON. LIT. 453, 467 (1979). Scherer, *supra* note 24, at 108-18, discusses promotional economies of scale and vertical integration generally.

40. SCHERER, *supra* note 24, at 109-11.

41. This threshold effect is discussed briefly in SCHERER, *supra* note 24, at 109. The basic concept is that advertising messages must be repeated some minimal number of times to cross the threshold of consumer consciousness and induce a consumer decision to buy the advertised product.

42. *See generally* Mueller, *Sources of Monopoly Power: A Phenomenon Called Product Differentiation*, 18 AM. U.L. REV. 1 (1968). Evaluating the impact of this product differentiation on competition is a complex matter. *See infra* notes 105 and 112-14 and accompanying text. *See generally* Comanor & Wilson, *supra* note 39. The importance of brand loyalty and franchising is noted in FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 14.

franchisor.[43] Yet this can only happen if the franchisor can effectively police performance by the franchisee to insure that goods or services sold measure up to the standards expressed or implied by the advertising.

Monitoring franchisee performance is crucial. In a business format franchise, the franchisee is actually providing the final product or service; franchisee performance has a direct impact on the product or service's image. This performance embodies the product image and must support national advertising and other promotion for them to be effective.[44] For example, if a local McDonald's provides unfit hamburgers, the chain's image will be harmed. The real problem here is that each franchisee has an incentive to lower the quality of the product or service by cutting costs if that franchisee does not think that its action will have a noticeable impact on the overall product image and resulting demand.[45] If all other franchisees maintain quality, the cost cutter can reason, sales should not fall much from his reductions. Thus, he would expect to profit by most of the costs saved. If all franchisees behave this way, product image and, ultimately, the value of the franchise and the trademark will decline.[46] All vertically integrated operations require policing to respond to these problems. Because the franchisee can have so much impact on image, business format franchising has a particularly great need for effective policing.

Typically, the franchisor can most cheaply police franchisee performance. The franchisor sets standards for the product or service and for the conduct of business operations. It has a strong economic interest in insuring high quality performance by franchisees to protect the value of its franchises and, ultimately, its trademark. Further, there should be economies of scale

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43. PORTER, *supra* note 24, Ch. 3, argues effectively that such use of national advertising to create consumer demand will give the retail level operation more of the characteristics of those selling convenience goods rather than shopping goods. More of the decision-making power of the distribution process is transferred upstream. While this argument is phrased in terms of traditional product distribution, the analytical points are also valid for franchising. Porter discusses the use of manufacturer level advertising to create product differentiation for products sold as convenience goods. *Id.* at 25.

44. Porter notes that in all forms of franchising, the franchisee's performance embodies some of the characteristics of the good or service sold to the consumer. However, the franchisee's performance is much more important with business format franchising. PORTER, *supra* note 24, at 19. Caves & Murphy argue that this importance is reflected in the fact that there is a greater degree of franchisor ownership of franchises where the franchisee's embodiment of the product or service characteristics is particularly important. Caves & Murphy, *supra* note 22, at 6. The guarantee theory of the franchisor's trademark is traditionally presented as one of the justifications for the franchisor restrictions. *See* Note, *Trademarks as Tying Products: The Presumption of Economic Power*, 50 ST. JOHN'S L. REV. 689 (1976). This theory implicitly recognizes the same importance of embodiment of the franchised products characteristics. See Philips v. Crown Cent. Petroleum Corp., 602 F.2d 616 (4th Cir. 1979), for a discussion of this theory and the alternative representation of origin trademark theory in the cases.

45. This is similar to the "cream skimming" or "free rider" problem frequently discussed in justifications offered for specific restrictions in product distribution franchises. For a brief survey, see Strasser, *Territorial Restraints*, *supra* note 4, at 798-99 and authorities cited therein. In a business format franchise, the free riding is on the product image. This is, in turn, a particular example of the problem of "subgoal pursuit" discussed in Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953 (1979), and is a specific example of the opportunistic behavior discussed in WILLIAMSON, *supra* note 24, at 26-30 and 84-85.

46. Caves & Murphy, *supra* note 22, at 577-81.

in performing the policing with specialized franchisor employees.[47]

To summarize this point, business format franchising permits the franchised operation to achieve economies of large scale in creation and use of managerial information and know-how, and in creation and protection of product image through advertising, promotion, and policing of franchisee performance.

2. *Economies of Small Scale: Decentralized Management and Franchise Fees*

Business format franchising is intrinsically decentralized in the operations that actually make and supply goods or services to the consumer. Retailing dominates this form of franchising[48] and much of the value of what is retailed is created by franchisee performance.[49] These characteristics present a potential dilemma for business format franchising systems; local operations are difficult to manage centrally but the quality of management supervision is critical to success of the system. As discussed above, franchisor monitoring of franchisee performance is characteristic of these operations. However, the costs of accomplishing day to day management by a remote centralized organization are so great that they cause diseconomies of large scale in providing it. Yet business format franchising may also resolve this potential dilemma. Instead of attempting local management control through a centralized hierarchial organization, business format franchising is structured to give local franchisees an entrepreneurial incentive to supervise and manage carefully.[50]

An example of this local entrepreneurial effort is the fact that franchises are virtually always operated as independent businesses in that franchisee profits are determined by the amount that receipts exceed costs. This fundamental characteristic is often obscured by emphasis on the specific assistance provided to franchisees, discussed above,[51] and the specific restrictions on their operations, to be discussed below.[52] Franchisees who do not manage their local operations well will simply be less profitable. Moreover, available evidence indicates that franchisees perceive that they have substantial control over their operations;[53] this perception provides a strong incentive for real entrepreneurial effort. As a consequence, franchisees work long hours

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47. Williamson, *supra* note 43, at 975-80. Rubin, *supra* note 6, at 226-30, develops the same conclusion on a theoretical level, working from the theory of the firm. Baker, *supra* note 10, at 1276-77, supports this idea as part of his proposed new analysis for tying arrangements.

48. FRANCHISING IN THE ECONOMY 1979-1981, *supra* note 3, at 3; FRANCHISING IN THE ECONOMY 1980-1982, *supra* note 1, at 11.

49. Caves & Murphy, *supra* note 22, at 577-78.

50. Franchising, as a new form of business organization, blurs the bright line which is traditionally assumed to exist between internal organization and external market controls. Rubin, *supra* note 6, at 223. Thus, franchising arrangements serve the function of giving the franchisee a share of the profits as an incentive to perform well. *Id.* at 226-30. Caves & Murphy, *supra* note 22, at 581-83, argue that less company ownership is in fact observed where entrepreneurial effort is needed. However, this empirical conclusion is based on observation of all franchises, not just business format franchises.

51. *See supra* notes 27-43 and accompanying text.

52. *See infra* notes 63-86 and accompanying text.

53. Ozanne & Hunt, *supra* note 2, at 43 and 152-54.

and often have other members of the family substantially involved.[54]

To some degree, the structure of franchise fees also reflects the need for local management. Virtually all franchisors require payment of a lump sum franchise fee.[55] This will require aspiring franchisees to self-select for profitability potential.[56] In addition, investment in the franchise operation is often substantial.[57] These fees and investments create strong franchisee incentives for good management. Franchisor requirements of payment of a percentage of gross receipts are typically used,[58] but the high profit on marginal sales should more than offset any franchisee incentive to sell less.[59] This system of payments does provide incentive for good franchisee performance to maximize profits.[60] Such gross receipt fees can be viewed as a form of crude profit sharing between franchisor and franchisee, giving each a greater commitment to the interdependent relationship.[61]

In theory, franchisors can charge franchisees by requiring them to purchase equipment and supplies at inflated prices, taking their fees in the form of excess profits on the tied sales.[62] In recent years, antitrust has been quite hostile to this sort of tying arrangement. Given that a fee based on gross receipts should accomplish the objective of varying franchisee payments according to success in using the business format, it seems unlikely that such mandatory purchases will be used as a source of substantial revenue.

54. *Id.* at 146-47, notes that the median franchisee works a 60-hour week and that 56.4% of the spouses of franchisees work full-time in the franchise.

55. *Id.* at 123 reports that the median franchise fee in 1970 was $7,500.

56. Caves & Murphy, *supra* note 22, at 578-81.

57. *See, e.g.*, Principe v. McDonald's Corp., 631 F.2d 303 (4th Cir. 1980) and Krehl v. Baskin-Robbins Ice Cream, 664 F.2d 1348 (9th Cir. 1982). FRANCHISING IN THE ECONOMY 1979-1981, *supra* note 3, gives extensive breakdowns for all franchising arrangements, including product distribution franchising.

58. Ozanne & Hunt, *supra* note 2, at 163, report that 88% of franchisors require gross receipts payments and that all the rest of the franchisors had tied sales of goods and supplies. Subsequently, Siegel v. Chicken Delight, Inc., 448 F.2d 43 (5th Cir. 1971) held that such tied sales could be per se illegal, and it is unlikely that many franchisors continue this practice. *See generally* Rubin, *supra* note 6, at 334.

59. *Cf.* Comment, *supra* note 11, at 1285, arguing that gross receipts fees will induce franchisees to sell less.

60. Rubin, *supra* note 6, at 226, argues that the incentive will be to maximize sales rather than profits.

61. The available evidence indicates that these fees are typically not a high percentage of gross. Ozanne & Hunt, *supra* note 2, at 163, found that the median franchise fee was 4% of gross receipts, but that the fees varied from 1% to 18%. However, they could be a high percentage of net return.

62. It appears that a good bit of this sort of tying was done earlier in the history of product distribution franchises. Ozanne & Hunt, *supra* note 2, at 160, reported that 70% of franchisors tied the purchase of some supplies. They also reported that 23% required purchase of at least some equipment. *Id.* at 40. They did find a correlation between a large volume of franchisee supplies bought from franchisors and reduced franchisee income. *Id.* at 162. It is unlikely that much of this tying continues today. *See supra* note 58.

For statistical information on the dollar amounts involved, see, FRANCHISING IN THE ECONOMY 1979-1981, *supra* note 3, charts 12-14. These are for all franchising, including product distribution. For an example of mandatory leases and gross receipts payments used currently, see, Principe v. McDonald's Corp., 631 F.2d 303 (4th Cir. 1980) and Kypta v. McDonald's Corp., 671 F.2d 1282 (11th Cir. 1982).

3. *Restrictions Designed to Respond to Imperfections in Vertical Markets*

If vertical markets worked perfectly and costlessly, the economies of large and small scale discussed above would be achieved in independent, unrelated market transactions by parties responding rationally to the least cost transactions available. Yet, because vertical markets do not work perfectly or costlessly, parties use contractual vertical integration to ameliorate the effects of imperfections. Such vertical integration should make it possible to achieve some internal organization and coordination in vertical markets.[63] This section discusses both the kinds of market imperfections that are significant in business format franchising situations and the kind of contractual restrictions that parties are likely to use in response.

Imperfection in the creation and exchange of information is one of the primary market imperfections vertical integration can address.[64] Although the traditional analysis of perfect markets assumes free and perfect information, information is never perfect and never costless. Information is different from most economic goods in one respect; once information is created it can be re-used because one person's use of information does not diminish its value nor exclude use by others. For these reasons, unrestricted markets may undersupply information and the parties must establish incentives for both its creation and dissemination. As discussed above, available economies of scale create a strong incentive for franchisors to supply start-up and operational information.[65] Yet franchisors will be willing to do so only if they can be assured that the information so supplied will not eventually be used by franchisees of competing franchisors.[66] Consequently, most agreements either restrict franchisees to exclusive dealing with the franchisor or prohibit franchisee competition with the franchisor.[67] Without such protection, franchisors would be discouraged from supplying this information because of the reasonable expectation that it would be used to strengthen competitors.

Within any vertically integrated system, there is also a need for information to flow upstream from the retail level, here from the franchisee to the franchisor. Since the franchisee is closest to the ultimate consumer market, he should have knowledge which is useful to creating demand and anticipating fluctuations. Similarly, the group of franchisees in the aggregate should have something to contribute to the management system supplied by the franchisor.[68] As the system becomes increasingly integrated, there should be

63. For a survey of conventional economic thinking on market imperfections, see authorities cited *supra* notes 24-27; Strasser, *Territorial Restraints*, *supra* note 4; text accompanying notes 4-7; and Strasser, *Tying*, *supra* note 4, at n. 43.

64. *See generally* Williamson, *supra* note 24.

65. *See supra* notes 24-34 and accompanying text.

66. Rubin, *supra* note 6, at 230-31.

67. Ozanne & Hunt, *supra* note 2, at 250, found that 52% of franchisors prohibited franchisee competition within a certain mileage radius after termination, and 60% restricted franchisee competition for a specified number of years after termination. Overall, 67% of franchisors had some sort of restriction on franchisee competition after termination. *Id.* at 234. Further, a franchisor that owns the land and building and leases it to a franchisee will necessarily control future competition from that location.

68. *See generally* Note, *Restricted Channels of Distribution Under the Sherman Act*, 65 HARV. L. REV. 795, 809-13.

useful information flowing in each direction. Yet the franchisee will be unwilling to communicate information to the franchisor without some assurance that the franchisor will not provide the information to the franchisee's intrabrand competitor.[69] Thus, a franchisor must provide a degree of insulation from intrabrand competition if its franchisees are to perceive themselves as part of an integrated system and act accordingly. Typically, this insulation will take the form of geographic dispersion of franchisees with territorial restrictions on movement.[70]

In addition to information problems, vertical markets often subject parties to a risk of opportunistic behavior by the other party.[71] In business format franchising, this risk may arise from (1) the incentive to save costs by diminishing product or service quality; (2) problems of dealing in small numbers markets; and (3) the opportunity to exploit the other party's sunk cost in transaction specific investments. The remainder of this section surveys the parties' likely responses to this problem.

Franchisee incentive to dilute product or service quality and the franchisor monitoring to preserve quality are discussed above.[72] In addition to monitoring, the franchisor will want to impose specific standards for many aspects of the franchisees' operations as well as for the end product or service.[73] Tying restrictions, which require franchisees to buy from either the franchisor or an approved supplier, will also respond to this problem, although the strict tie may not be necessary.[74] As a positive incentive, the franchisor may use some protection from intrabrand competition to increase the margins of franchisees and fund expenditures for product quality or selling services.[75] While this is certainly not the only source of funds for such an investment, it is one reasonably well tailored to the task. Finally, franchisors will likely restrict franchisee transfer of the franchise.[76] However, this justifies only the limited restriction of requiring resale to a competent operator.

When the markets in question have only a few participants, their operation may cease to approximate perfect competition.[77] In this circumstance, parties begin to consider, in bargaining, the likely reaction of competitors

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69. Distribution Problems, *supra* note 22, at 45.

70. In consumer retailing, restriction of franchisees to customers from a particular geographic area will usually not be workable. This is especially true in retailing convenience goods and services. The statement in the text assumes that price restrictions are and will continue to be illegal. Arizona v. Maricopa County Medical Soc'y, 457 U.S. 332 (1982). Thus, this will not be a feasible alternative. *See* Gerhart, *supra* note 24 and Pitofsky, *In Defense of Discounters: The No-Frills Case for a Per Se Rule Against Vertical Price Fixing*, 71 GEO. L.J. 1467 (1983) for analytical support for this continuing illegality. Ozanne & Hunt, *supra* note 2, at 56, found that 60% of franchisors have exclusive territories and 86% of franchisors said they assigned territories at the time of study.

71. *See* authority cited *supra* note 25.

72. *See supra* notes 44-47 and accompanying text.

73. *See* authorities cited *infra* notes 82-86.

74. The need to maintain product quality is not a sufficient justification for the tying arrangement in most circumstances. *See* Strasser, *Tying*, *supra* note 4, at 5-10.

75. For a discussion of the use of restrictions on intrabrand competition to increase distributor margins to fund selling services, see Strasser, *Territorial Restraints*, *supra* note 4, at 794-813; Strasser, *Exclusive Dealing*, *supra* note 4, at 978-80.

76. Ozanne & Hunt, *supra* note 2, at 247, report that 83% of franchisors use such restrictions in the franchise agreements.

77. *See* Strasser, *Exclusive Dealing*, *supra* note 4, at 981-84.

and other parties to the transaction. When other firms in the market use vertical integration, by contract or ownership, to tie up a substantial proportion of the available market participants, a "percentage effect" may cause parties to fear the onset of a small numbers market.[78] In business format franchising, this fear causes franchisor concerns about the availability of high quality franchisees and franchisee concerns about availability of franchises from high quality franchisors. The fear in either case is that the small numbers market will lead to excessive competition for the other party's business. The likely reaction is use of longer term agreements to postpone such an occurrence.[79] Franchisors can increase their control over the franchisee's goodwill by owning the building and leasing it, because most of the goodwill attaches to the franchised operation at that location.[80] In general, franchisors will want to increase their control over the entire integrated operation.[81] Franchisees will likely seek specific restrictions on intrabrand competition to protect themselves from a franchisor using such competition to exercise market power over them in the future. Franchises also are likely to seek assurances of continuity; this is discussed below.[82]

The third type of opportunistic behavior likely to arise in a business format franchise is an attempt by one party to exploit the value of specific economic rents that arise from transaction specific investments made by the other party.[83] For example, the franchisee has made a specific investment of his time and his capital in the building, equipment, start-up training, and working capital. Much of the value of this investment is transaction specific in that, if the franchise were terminated, the franchisee would realize much less than he invested because of the high costs of converting the invested time and capital to another use. The building, equipment, and training are specialized to an operation with this franchisor; trademark and contract restrictions would virtually preclude his operating another similar business.

78. This "percentage effect" is discussed in Edwards, *Vertical Integration and the Monopoly Problem*, 17 J. OF MKTG. 404, 407 (1953). For example, assume a market of 10 distributors, 5 of which are tightly tied to one supplier. Suppliers without affiliated distributors have only 5 potential distributors. In this situation, if a second supplier ties up 3 of the independents, that supplier removes 60% of the available independents even though he has tied up only 30% of the distributor market.

79. Ozanne & Hunt, *supra* note 2, at 122, report that the average length of the franchise agreements studied was 15 years. The agreements varied in length from 1 year to 60 years.

80. This is a common arrangement. For an example, *see* Principe v. McDonald's Corp., 631 F.2d 303 (1980). There may be other motivations for franchisor ownership of the building. However, franchisor ownership of the building will decrease the franchisee's transaction specific investment and, possibly, its commitment to the relationship.

81. Hunt & Nevin, *Power in the Channel of Distribution: Sources and Consequences*, 11 J. OF MKTG. RES. 186, 192 (1974) found that control of land and control of the building were two important sources of power in a franchisor relationship.

82. *See infra* notes 83-86 and accompanying text.

83. Economic rents are defined as returns to factors of production which have an inelastic supply. *See* SAMUELSON, ECONOMICS 561-62, 566-68 (10th ed. 1976). A transaction specific investment is one in which there are substantial costs involved in converting the subject of the investment to another transaction or another use; such investments give rise to a situation similar to that created by economic rents and the returns so generated are referred to as quasi rents. Klein, Alchian & Crawford, *supra* note 24, at 298; Caves & Murphy, *supra* note 22, at 578-81, list the following five ways by which a franchisor can recapture these rents: 1) franchise fees and nonreturnable deposits; 2) royalties on gross sales; 3) taxes on current inputs; 4) franchisor supply of fixed facilities; 5) provision for recapture of the franchise business, often on a pretext of violation of the franchise agreement.

Thus it must either be sold to the franchisor's new franchisee or converted to another use for which it will likely be of much less value.[84] In this situation, the franchisor can realize a large profit by either terminating the franchise for contrived reasons or by refusing to approve a transfer of it and then buying it himself.[85]

Franchisors also make transaction specific investments, including training the franchisee, and franchisor investment in the building, equipment, or local operation of the franchisee. These investments are transaction specific in that, if the franchisee performs badly, the franchisor will not be able to recoup the investments completely. Further, the franchisor's general investment in trademark and product image are transaction specific to the extent that a particular franchisee can injure the image by poor performance. Franchisors will be concerned to protect against the possibility of franchisee exploitation of these investments.

Each party's concerns about this potential for exploitation may effectively prohibit reaching agreement on the franchise unless the parties can reassure each other that they will not engage in such exploitation. Such reassurances are frequently made in the specific contract provisions. Franchisors are given the power to terminate franchisees for poor performance and to require approval before sale or transfer. Franchisees, on the other hand, are typically not given a power of termination in the agreement. Such a power would be a meaningful protection only if accompanied by waiver of the post termination non-compete provisions. While franchisors approve most transfers and, in general, try to reassure franchisees by their behavior under the agreements, the terms of the agreements are widely perceived to be one-sided, protecting the franchisor at the expense of the franchisee.[86] In all likelihood this is a reflection of the bargaining strength of the parties. Certainly, franchisees will be concerned to try to negotiate protec-

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84. Muller, *Franchising and the Antitrust Laws: The "Territorial" Problem*, 9 ANTITRUST L. & ECON. REV. 59-60 (1977), refers to this as the franchisor "confiscating" part of the value of the franchise. Brown & Cohen, *Franchise Equities*, 63 MASS. L. REV. 109 (1978), argue that franchisees primarily fear termination by their franchisor.

85. Abusive termination of a franchisee is one of the primary concerns in state legislation enacted in the last few years and aimed at regulating the franchise relationship in general. For a survey of that regulation, see Down, *Franchise Regulation: Comprehensive State Regulation Now Unnecessary*, 49 UMKC L. REV. 292 (1981). As of the writing of that article, 15 states had such comprehensive schemes. *See id.* at 292, nn. 1 & 2.

The Federal Trade Commission now requires franchisors to make a number of specific disclosures about business conditions and the franchise relationship; the disclosures are to be made to potential franchisees. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. §§ 436-436.3 (1985). The justification for this requirement is that franchisees lack both the sophistication and the bargaining power to obtain such information otherwise. State law developments are surveyed in FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 9-10; FRANCHISING IN THE ECONOMY 1979-1981, *supra* note 3, at 4.

For an excellent comprehensive study of state and FTC regulation of franchising arrangements, see Zeidman, Ausbrook & Lowell, *Franchising: Regulation of Buying and Selling A Franchise*, [May-June] 74 TRADEMARK REP. (BNA) No. 283, at A4-A84 (1983). One specific study of product distribution agreements in the automobile industry concluded that state regulation of this franchise arrangement strengthened distributor market power, reduced supplier's ability to control distribution and raised vehicle prices to the consumer. Smith, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125 (1982).

86. Ozanne & Hunt, *supra* note 2, at 55; Brown & Cohen, *supra* note 84.

tion from improper termination or strategic use of intrabrand competition by franchisors.

4. *Capital in the Business Format Franchise*

Business format franchises present two general questions about provision of capital: (1) whether this form of business organization changes the cost of capital; and (2) which party supplies capital for franchisee operations. In general, the cost of capital is a function of the risk of the enterprise using it, as perceived by the capital supplier. Ultimately, the availability of capital must be seen as simply an extreme form of the question of cost. Business format franchising should reduce the business risk of both franchisor and franchisee operations to the extent that this arrangement permits realization of available economies, provision of improved management information, and amelioration of market imperfections.[87] If this reduction of risk can be communicated to capital suppliers it should reduce the cost of capital.

However, information is not free to capital suppliers. By reducing capital suppliers' information impactedness[88] the business format franchise should make capital less expensive. Affiliation with a large, established and experienced franchisor will improve the perceived risk position of franchisees. The business format, the subject of the franchise, will reassure lenders that the franchisee will have access to needed managerial assistance and information. Where this can be coupled with favorable information on the failure rates of this franchisor's franchisees, reduction of the degree of risk perceived should be substantial.[89] Taken together, this real reduction of both business risks and investor information impactedness about business risks should lower capital costs and improve capital availability for franchisees.

Consideration of the second question, whether franchisors supply capital to franchisees, does not give such unequivocal results. It is generally agreed that there are economies of scale in raising capital.[90] These economies support the prediction that franchisors would raise capital centrally and distribute it to franchisees. However, the scanty evidence available indicates that in fact franchisees provide most of their own capital.[91] Thus, the

87. Rubin, *supra* note 6, at 226, argues that franchisees could reduce the risk of their investments in the franchise by buying shares in the operation of all other franchisees. While this would diversify the investment, individual franchisees are unlikely to perceive less risk in other people's operations, which they do not control, than they perceive in their own. Thus this solution is less attractive to them even if it is, in theory, less risky and hence less costly.

88. For a discussion of information impactedness, see WILLIAMSON, *supra* note 23. *See generally* Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON., 233, 260 (1979); Williamson, *The Economics of Antitrust: Transaction Cost Considerations*, 122 U. PA. L. REV. 1439, 1458-60 (1974).

89. The failure rates of new franchises should provide evidence of the real risks entailed. However, evaluation of this evidence is complex and controversial. *See* the introduction in Ozanne & Hunt, *supra* note 2.

90. SCHERER, *supra* note 24, at 104-09.

91. Ozanne & Hunt, *supra* note 2, at 123, found that banks contributed 40% of the start-up funds, 28% came from franchisees' personal savings, and only 8.7% came from franchisors. The court in *Principe*, 631 F.2d at 311, noted that to begin a franchise, franchisees must invest "over $100,000." In *Krekhl*, 644 F.2d at 1356, n.20, the court noted that a Baskin-Robbins franchise can be begun for "as little as $40,000." *See generally The Impact of Franchising on Small Business:*

theoretical possibility of lower capital costs through centralized capital raising is not supported by available evidence.

5. *The Business Format Franchise as One Interrelated Exchange*

A business format franchise is a contractual arrangement made to accomplish specific economic objectives. The contractual arrangement typically establishes a commercial relationship in which the franchisor provides management information and know-how, national advertising and promotion and, frequently, building plans (sometimes even a building for lease). The franchisor is typically given the responsibility of monitoring franchisee operations and performance, as well as the right to establish standards and to terminate the franchise when standards are not met. Typically, franchisors agree to restrictions on their power to grant franchises that would compete directly with the existing franchisee. This last restriction, however, is supported by the franchisor's self interest. In exchange, the franchisee agrees to comply with the operating and product standards set and, in general, to operate the franchise in the prescribed format. Franchisees also agree to some kind of territorial restrictions to blunt the potential for intrabrand competition; other specific restrictions can also be used for this purpose.[92] To protect the information supplied by franchisors, franchisees typically will agree either not to compete with the franchisor, or to deal exclusively with the franchisor.

As recognized in several recent cases,[93] this contractual arrangement is one interrelated exchange and it should be so treated for purposes of antitrust policy. The economic realities of the parties' relationship dictate an exchange with these general characteristics. The parties will only establish the franchise relationship if they are allowed to use contract provisions that respond to these economic realities. If some of the needed provisions are made illegal by antitrust law and no good substitutes are available, the parties will simply not enter into business format franchises, but will substitute entirely different forms of business organization. For example, if franchisors cannot obtain contractual assurance that the operational know-how which they provide will not eventually be used to compete with them, they will not supply the information. Without the supply of this information, one of the primary economic justifications for these arrangements will disappear and, perhaps more importantly, one of the primary franchisee attractions of the relationship will cease. Society will lose the potential benefits to competition resulting from the franchise agreement. In light of these facts an antitrust evaluation of the competitive implications of, for example, an exclusive dealing restriction must consider the competitive implications of the entire transaction. This is true for any restriction or other contractual provision which is essential to realizing one of the underlying objectives of the arrangement.

Hearings Before the Subcomm. on Urban and Rural Econ. Dev. of the Select Comm. on Small Business, 91st Cong., 2d Sess. (1970) (testimony of Diaz, *Distribution Problems*, *supra* note 22, at 34).

92. For example, intrabrand competition may also be restricted by location clauses, customer restrictions and resale price maintenance, depending on ultimate consumer demand and shipping characteristics.

93. *See* cases cited *supra* notes 19 and 20.

For these reasons, antitrust policy dictates evaluation of the competitive impact of this contractual arrangement as a single economic transaction. Separate evaluation of the competitive impact of specific provisions in the contractual arrangement, even if possible, will not accurately show the competitive impact of the whole franchise relationship. Of course, the analysis should allow for the fact that a particular contractual provision may not be necessary to the substance of a particular exchange. For example, in the circumstance posited above, legitimate protection of the franchisor might be accomplished by less than a comprehensive exclusive dealing provision. Some protection from intrabrand competition, however, must be permitted if the franchise transaction is to take place at all.

B. Digression On The Goals of Antitrust

Antitrust is a body of law which seeks to promote competition. However, there is a continuing debate on the reason for promoting competition. Indeed, the recent strength, vigor, and hostility of this debate require discussion of this topic in any antitrust policy proposal.[94] There seems to be general agreement that pursuit of economic efficiency is one of the ultimate goals of antitrust; the controversy concerns the legitimacy and relative importance of social and political goals.

Economic efficiency, if ever actually attained, would result in the allocation of society's scarce resources to produce the goods and services for which people are most willing to pay.[95] Since efficiency results from the operation of perfectly competitive markets, antitrust policy seeks to make markets work more competitively. Thus, the argument runs, antitrust should protect competition because competition produces efficiency and efficiency is a good thing. Stated non-exclusively, this goal for antitrust is relatively uncontroversial.[96] The controversy arises when pursuit of efficiency is proposed as the only goal of antitrust.[97] In this writer's view, such an approach is clearly too narrow.

While economic competition is important for its potential to generate economic efficiency, it is important for other reasons too. Specifically, the process of competing has a beneficial impact both on the economy and on society generally. The law's concern has always been to protect competitive market structures and competitive market processes as well as to promote economic efficiency.[98]

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94. For a survey of the recent discussions, see Strasser, *Exclusive Dealing*, *supra* note 4, at 994-99. These include Flynn, *Commentary: The Function and Dysfunction of Per Se Rules In Vertical Market Restraints*, 58 WASH. U. L.Q. 767 (1980); Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140 (1981); Redlich, *The Burger Court and the Per Se Rule*, 44 ALBANY L. REV. 1 (1979). This Article is intended to articulate a policy proposal for business format franchising, rather than to contribute to the debate over ultimate goals.

95. *See generally* SAMUELSON, *supra* note 83, at 633-35.

96. *See, e.g.*, Fox, *supra* note 94. However, Redlich, *supra* note 94, appears to question whether efficiency is even one appropriate goal for antitrust.

97. For an example of such an argument, see Posner, *supra* note 25, and authorities cited therein. This appears to be the policy position taken by both the former head of the Antitrust Division of the Department of Justice, William Baxter, and the current Chairman of the Federal Trade Commission, James Miller.

98. *See* Dewey, *The Economic Theory of Antitrust: Science or Religion?* 50 VA. L. REV. 413,

For convenience, these social and political goals can be divided into two groups. The first is the objective of making economic activity self-policing. If the economy is self-policing, less public regulation will be required and the political ideal of limited government can be more fully accomplished. Free entry is both a condition for such markets and a result of their existence. Self-policing markets also cause decentralization and diversity of economic decision making, which is again both a condition and a desired result.

The second group of social and political goals can be collectively described as populist ones. Competitive market processes are important here for three reasons. They provide freedom and independence of entrepreneurial opportunity. Further, their tendency toward diversity and decentralization will discourage concentration of economic power and the related concentration of political power. In addition, competitive market processes are related to the populist goal of an economy made up of small business units. While this last goal has traditionally been considered important, pursuit of absolute smallness has become increasingly questionable in a modern economy.[99]

The truly difficult question for antitrust policy is the proper balance among these goals when pursuit of some conflicts with achievement of others. Of course, the conflict will often not arise. In many situations protection of competitive market processes will coincide with pursuit of their efficient results.[100] Indeed, promotion of efficiency can often be undertaken by protecting competitive market structures and processes. Yet a conflict can arise in a particular case when pursuit of competitive market processes and structures conflicts with pursuit of a specific efficient result. In this situation, there is no substitute for the hard decision making required for reasoned accomodation of these diverse goals.[101] The remaining section of this paper presents an analytic structure for determining the impact of business

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428-31 (1964). Under this view, competition is viewed as a process rather than a group of specific efficient results. Fox, *supra* note 94, at 1146, concludes: "The isolation of efficiency as the sole goal of antitrust requires a conscious rejection of equally dominant values that underlie the antitrust statutes." *See generally* Bohling, *Franchise Termination Under the Sherman Act: Populism and Relational Power*, 53 TEX. L. REV. 1180, 1187 (1975); Bohling, *A Simplified Rule of Reason for Vertical Restraints: Integrating Social Goals Economic Analysis and* Sylvania, 64 IOWA L. REV. 461, 476-77 (1979); Flynn, *supra* note 94, at 776.

99. Fox, *supra* note 94, at 1176, questions the wisdom of pursuit of small business size in the Supreme Court opinions of the 1960s and early 1970s.

100. This point is developed in Elzinga, *The Goals of Antitrust: Other than Competition and Efficiency, What Else Counts?*, 125 U. PA. L. REV. 1191, 1194-1203 (1977).

101. Fox, *supra* note 94, argues that the policy prescriptions will frequently be compatible. Indeed, if competition is viewed as a process, rather than an end result, then by definition operation of particular market processes equals efficiency. Much of the debate arises because of the great concern manifested by the Warren Court with social and political goals, sometimes at the expense of competitive market structures. Flynn, *supra* note 94, at 782, comments:

> The establishment of a sensible and desirable balance among these often competing and conflicting goals within the context of a bewildering array of potential factual circumstances cannot be achieved by mechanical invocation of artificial economic models or venerable legalisms from another age. A flexible, but structured, methodology is required. The relative weight of the competing goals of antitrust policy raised by vertical market restraints, the facts of the case, and the qualitative effect of the category of restraint involved on the ideal of a competitive process as the rule of trade must all be weighed sensitively, efficiently, and inductively by the legal process.

format franchises on competition. This structure establishes a framework for balancing these diverse policy goals.

C. The Competitive Impact of Business Format Franchising

1. *Pro-competitive Impact: Making Both Parties More Effective Competitors*

This Article argues that business format franchising is a new form of business organization, one which affords the participants specific economic advantages over other forms of organization. In simplest terms, these advantages will make both the franchisor and the franchisee more effective competitors and, consequently, improve the quality of interbrand competition.[102]

As stated previously, business format franchising can be used to achieve economies of scale in the creation and use of managerial information, services, and know-how.[103] As these economies are realized, franchisors will be stronger competitors. However, the fact that one franchesee's use of information does not diminish its value to others will cause franchisors to seek restrictions on use of the information and services. This will likely take the form of restrictions on the franchisee's engaging in competitive business during the term of the franchise agreement and for a specified period thereafter. Thus, to gain a competitive advantage offered by business format franchising, antitrust policy must tolerate a restriction on the franchisee's behavior.[104]

A similar difficulty arises with economies of scale in franchisor creation of brand preferences. Subject to one qualification to be considered later, achieving these economies is good for competition.[105] Yet franchisors will not make the expenditures necessary to create a brand preference unless they are permitted to police the operations of franchisees to insure that the products or services delivered are in fact consistent with the brand image promoted. Indeed, policing the performance of franchisees to maintain consistent quality is part of the way franchisors create a brand preference; franchisee performance embodies many of the characteristics of the product or service sold. Once again, the economies of scale can be achieved only by tolerating substantial franchisor control over franchisee operations.

In actually making the product or delivering the service, there may be substantial diseconomies of large scale, as argued above.[106] The franchise system is one way to avoid these diseconomies. Yet franchisees will be more

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102. *Krehl*, 664 F.2d at 1356, concluded that this was the net impact of the franchising arrangement under consideration there. Ozanne & Hunt, *supra* note 2, at 93-98, estimated that the failure rates for new franchisee units in 1969 were from 1.3% to 6.7%; in 1969-70, 6.4% of all of the franchisor systems studied went out of business. Ozanne & Hunt qualified this later number with the observation that the real rate of failure must be much higher. For a discussion of the use of economies as an antitrust defense, see generally Williamson, *Economies As An Antitrust Defense Revisited*, 125 U. PA. L. REV. 699 (1977).

103. *See supra* notes 27-47 and accompanying text.

104. *See, e.g.*, Rubin, *supra* note 6, at 230-32.

105. As discussed more fully in Section 2, such brand preferences are one type of product differentiation which can be a barrier to entry.

106. *See supra* notes 48-62 and accompanying text.

likely to deliver high quality goods and services and to promote the product locally if they are less concerned about intrabrand competition. In essence, this is the franchisee's investment in product image; the franchisee is more likely to make the investment if he expects to reap all the local rewards from it. Although providing a level of protection from intrabrand competition does not guarantee a good franchisee performance, such protection does create one positive incentive for good performance.[107]

Further, business format franchising should improve coordination among economically interdependent entities and thereby improve their ability to compete. Franchisors and franchisees are economically interdependent—the ultimate success of each depends on performance by the other. Business format franchising uses an accumulation of specific contractual restrictions and provisions to encourage franchisees to regard themselves as part of one interdependent system and, thus, to actively collaborate with franchisors to improve their joint performance. If this happens, franchisees will begin sending information to franchisors about shifts in supply and demand, customer preferences, and possibly, specific points of operating information. In turn, franchisors will collect, assimilate, and refine this information and distribute it to all other franchisees. Ideally, the parties will collaborate to maximize their competitive output and performance. Yet significant restrictions on intrabrand competition will be required to reach this point. Franchisees view other franchisees as potential intrabrand competitors. They will not provide information to franchisors unless assured it will not be used against them by other franchisees. Without protection from intrabrand competition, franchisees will not perceive their interdependence with other franchisees, and ultimately, this will make it difficult for the system to operate interdependently. Similarly, franchisors must be given some protection from competition by franchisees using assistance the franchisors have provided.

2. *Potential Harms to Competition: Foreclosure and Entry Barriers*

In general, franchising agreements are unlikely to be anticompetitive. However, at least in theory, franchising agreements have the potential for harmful impact on competition. This section proposes ways to evaluate this potential in specific cases. One theoretical possibility is the potential for creation of entry barriers.[108] As an abstract proposition, the potential for new entry into a market is an important limitation on the competitive conduct of firms.[109] Where new entry is barred, or at least made more difficult, existing firms enjoy relief from a competitive market's restraining influences.[110] This

107. *See supra* text accompanying notes 44 and 45.

108. While franchisor level cartelization or oligopolistic coordination are anticompetitive possibilities, they will not be separately discussed here. Such behavior should be no more difficult to detect in a franchising context than in any other context, and the customary prohibitions and enforcement mechanisms against it should be available.

109. For a recent discussion of the importance of entry barriers, see Fox, *supra* note 94, at 1179; PORTER, *supra* note 24, at 125-30. For a general discussion, see Strasser, *Exclusive Dealing, supra* note 4, at 984-90; Strasser, *Vertical Territorial Restraints, supra* note 4, at 815-21.

110. This statement must be qualified in one respect. Entry barriers will provide protection from competition only where the market is made up of a few firms. In one sense, the possibility of achiev-

is usually not a problem with franchising arrangements because there are few natural barriers to entry in the consumer goods and services markets where franchising predominates.[111] The remainder of this section discusses the three ways in which franchising arrangements themselves might deter entry; each theoretical possibility must be evaluated in specific cases.

First, franchising arrangements may deter entry by encouraging excessive product differentiation.[112] This differentiation involves persuading consumers that one product is better than another even though there is no identifiable, objective support for the claim. Such persuasion is typically accomplished by advertising designed to appeal to the consumer on grounds other than the merits of the product. Where extreme differentiation is effective, it deters entry by increasing cost—the new entrant must advertise to offset the differentiation of its established rival. Where the differentiation is stronger, entry is made relatively more expensive because customer preferences must be dislodged from entrenched competitors.[113] In an extreme case, differentiation may preclude entry by denying the potential entrant access to customers. In general, the result is higher concentration and greater profitability.[114] The difficulty is to ascertain the antitrust policy significance of these general, abstract possibilities of business format franchising.

Product differentiation entry barriers in franchising arrangements present a real policy dilemma. The conduct which leads to them—advertising and promotion—is also a basic reason for the franchise arrangement. Indeed, creating brand identification and brand loyalty, an essential part of the franchise exchange, is a mild form of the kind of extreme differentiation that can bar entry. Kept within bounds, it is a means of engaging in competition. Carried to unrestricted extremes, it interferes with competition.

Yet this theoretical dilemma is unlikely in most situations. Where the

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ing economies of scale in information and brand preference creation through the use of franchising arrangements will serve to deter new entry because the potential entrant will face more effective competitors. Yet an intelligent antitrust policy cannot condemn such conduct without reaching the absurd result of condemning all effective competition. SCHERER, *supra* note 24, at 258-60.

111. Ozanne & Hunt, *supra* note 2, at 76-77.

112. For a short discussion of product differentiation as a barrier to entry in general, see SCHERER, *supra* note 24, at 125-30.

113. Simply making new entry more expensive will deter some new entrants because they may not be able to afford this expenditure for differentiation as a "collective capital good." Caves & Porter, *From Entry Barriers to Mobility Barriers*, 1977 Q.J. ECON. 241. However, it can be argued that new entry must become relatively more expensive before antitrust policy should be concerned. The cost of dislodging established brand preferences is likely to be greater than the cost of establishing them in the first place. This is one form of "first mover advantage." For a general discussion of advertising as such an advantage, see Scherer, Book Review: *The Posnerian Harvest: Separating Wheat from Chaff*, 86 YALE L.J. 974, 996-1001 (1977); Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953, 972 (1979); SCHERER, *supra* note 24, at 375-405.

114. SCHERER, *supra* note 24, at 285-87, discusses the correlation frequently found between higher advertising to sales ratios (a surrogate measure for differentiation) and higher profitability. As Scherer notes, this correlation can logically support two alternative explanations. The first is that the differentiation blunts the impact of competition and thus permits a firm to earn excess profits. The second is that causation may run the other way, with higher profitability leading to more advertising. Only the first of these supports the existence of product differentiation. For further development of the arguments and conflicting interpretations of the empirical data see Goldschmid, Mann & Weston, *Advertising As An Impediment to Competition* in INDUSTRIAL CONCENTRATION: THE NEW LEARNING 114-61 (1974); Comanor & Wilson, *The Effect of Advertising on Competition: A Survey*, 17 J. ECON. LIT. 453 (1979).

franchisor operates in an essentially competitive market for the ultimate good or service, the costs to the franchisor of excessive differentiation should outweigh its benefits. It should become increasingly difficult for the franchisor to lure customers away from its competitors and also to retain existing customers. Where the franchisor does not operate in an essentially competitive market, this inherent limitation is less meaningful. There is greater opportunity to use differentiation for anticompetitive effect. Further, the extent to which consumers of the product or service are susceptible to differentiation is an important consideration. In general, this will depend on the nature of consumer demand.[115]

Franchising arrangements can also be used to foreclose other franchisors from access to potential franchisees.[116] Franchising arrangements create a close connection between franchisee and franchisor, such that a high degree of integration exists in their operations. As discussed above, franchisors can legitimately demand that franchisees not compete with them by working for another franchisor.[117] Because of this legitimate interest, regulation of the potential for foreclosure should not take the form of loosening the coordination between franchisor and franchisee or prohibiting the franchisor from limiting most instances of franchisee competition. Yet if most of the pool of potential franchisees are so restricted, a new entrant at the franchisor level would be effectively barred.

Accordingly, the key inquiry in every case must be the size of the pool of potential franchisees. Typically, this pool will consist of people who are attracted to the entrepreneurial ideal, have enough capital to get a franchise started, and can be taught the necessary basic management skills.[118] Where one franchisor dominates the ultimate consumer market, the existence of non-franchised market participants will be important because they are potential franchisees.[119] Unless the particular franchisor's business requires additional specialized knowledge or skills, this pool of franchisees is likely to be sufficiently large that effective foreclosure is improbable.[120]

Similarly, franchising arrangements are unlikely to cause entry barriers related to either the amount or cost of capital. If foreclosure is effective, a new entrant will be required to enter at both the franchisor and the franchisee levels. This will increase the amount of capital necessary and, by increasing the degree of risk associated with the whole enterprise, raise the

115. *See* PORTER, *supra* note 24, Ch. 6, applying this idea in testing the distinction between convenience and nonconvenience goods. Porter's thesis is stated in Ch. 1, at 49-52. Mueller, *supra* note 42, at 16, reviews the relatively high degree of concentration in consumer goods industry generally.

116. Conceptually, product differentiation is also a form of foreclosure—it forecloses franchisees of competing franchisors from consumers by tying up consumer demand. However, this is a different anticompetitive impact from the one discussed in the text.

117. *See supra* notes 63-86 and accompanying text.

118. Many franchisees are investors, and a relatively recent trend toward franchisees operating multiple units has been noted. FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 4.

119. This situation is analogous to tying arrangements in intermediate product markets. *See* Strasser, *Tying*, *supra* note 4, at 15-17.

120. *See generally* SCHERER, *supra* note 24, at 302-06, surveying the recent economics literature, which is skeptical that foreclosure is a frequent occurrence.

cost of that capital.[121] While this is theoretically possible, it is unlikely. Franchising arrangements can increase the amount of capital required by forcing a new entrant to make an investment in product differentiation to offset the differentiation of other franchisors. Yet this seems to be simply part of the investment necessary to enter the business format franchising field because a degree of such differentiation—brand identification—is part of the method of operation and essential to its success.

3. *Impact on Entrepreneurial Opportunity, Diversity and Deconcentration Goals*

The impact of franchising arrangements on antitrust's social and political goals is mixed but, on balance, positive. This mixture reflects antitrust's confused view of agreements between legally independent but economically interdependent entities. The presumption in antitrust is that one legally independent entity cannot restrain the freedom of competitive action of another legally independent entity. Yet within antitrust policy there also exists the conflicting presumption that economically interdependent parties should not be prohibited from pursuing their interdependent interests if this pursuit enables them to compete more effectively.[122] These two presumptions are potentially in conflict in most vertical restraint cases; in franchising cases, the conflict is direct and unavoidable. This section explores the antitrust policy implication of this conflict.

The evidence is relatively clear that franchising arrangements offer the possibility of entrepreneurial opportunity to franchisees who have not operated a business previously.[123] Given the tremendous success and continuing growth of business format franchising, it is reasonable to conclude that this method of doing business has created thousands of new businesses and given the possibility of entrepreneurship to many who would not have had it otherwise. However, the impact on entrepreneurial opportunity is not unqualifiedly positive. What is offered is only a limited entrepreneurship; the franchisee's operations are bound by a great number of restrictions, detracting from the extent of increased entrepreneurial opportunity. The goal of offering such opportunity is clearly established as an important one for antitrust.[124] Yet this goal can only be partially accomplished by franchising agreements because some restrictions on these new entrepreneurs are necessary for the franchise to exist in the first place. To maximize the availability of entrepreneurial opportunity, antitrust policy should seek to limit restric-

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121. For a discussion of the possibility of erecting capital cost entry barriers, see Strasser, *Territorial Restraints, supra* note 4, at 818-20; Strasser, *Distributor Exclusivity, supra* note 4, at 984-90.

122. This dilemma can also be seen in the confusion over how antitrust policy should respond to oligopolistic coordination where no collusion is shown. The interdependence referred to in the text should be viewed permissively by antitrust since recognition of it by firms in the market should improve their competitive performance.

123. Ozanne & Hunt, *supra* note 2, at 38, 113; FRANCHISING IN THE ECONOMY 1977-1979, *supra* note 1, at 1.

124. *See supra* notes 94-101 and accompanying text. *See also* Bohling, *Franchise Terminations Under the Sherman Act: Populism and Relational Power*, 53 TEX. L. REV. 1180, 1186-92, for a review of the cases which support this proposition. Redlich, *supra* note 91 at 35, explains the Schwinn case this way. *See generally* Kamenshine, *Competition versus Fairness in Franchising*, 40 GEO. WASH. L. REV. 197 (1971-72).

tions on franchisee operations to those actually mandated by the nature of the franchise relationship. To go further and prohibit restrictions that are truly necessary would ultimately decrease the availability of entrepreneurial opportunities by decreasing the use of franchising.

Franchising's impact on the goal of diversifying decision-making centers is equally mixed. Pursuit of diversity is certainly one of antitrust's goals.[125] By creating new business entities, business format franchising furthers this goal. However, the new entities created are only partially independent. Their choices of possible courses of action are substantially limited by the restrictions inherent in the franchising relationship. In this way, creation of these new business entities accomplishes only partial diversification. The available evidence indicates, however, that franchisees perceive themselves to have a large degree of independence.[126] This perception alone will cause them to behave, at least partially, as independent citizens of their local communities and actors in their local economies. Further, the alternative available to the antitrust policymaker is not franchisees who are not restricted, but rather some other form of business organization. Antitrust policy should maximize the diversification potential of franchising by permitting only those restrictions that are essential.[127] There is no basis for expecting additional diversification to be gained by prohibiting all restrictions in franchising agreements.

Finally, these arrangements have the potential to make at least a small, qualified contribution to the antitrust goal of deconcentration. To the extent that franchising agreements make the combined franchisor/franchisee entity a more effective competitor, they improve the chances for new entry and decrease concentration in some markets.[128] Where the alternative to franchising arrangements is complete vertical integration by ownership, franchising arrangements contribute to deconcentration because a franchisee has a greater degree of political and social independence than an employee. However, where the alternative to franchise arrangements is a looser form of integration by contract with fewer restrictions, use of franchise arrangements will not result in deconcentration. If franchising is the form of business organization chosen, it is not possible to predict *a priori* which alternative would be the second choice if franchising were not permitted.

On balance, franchising arrangements make a qualified contribution to the social and political goals of antitrust. This contribution can be maximized by limiting the franchise agreement to only those restrictions that are truly required by the nature of the franchising relationship. Pursuit of these goals justifies so confining the franchising agreement. However, the restrictions that are in fact essential must be permitted if the franchise is to exist at

125. See authorities cited *supra* note 124.

126. Ozanne & Hunt, *supra* note 2, at 43.

127. Jones, *The Growth and Importance of Franchising and the Role of Law*, 12 ANTITRUST BULL. 717, 727 (1967) states the problem well: "The central question confronting both business and the antitrust enforcement agencies today is to determine what are the essential elements of the franchise arrangement and what controls and obligations are necessary in order to maintain the essence of the true franchise system."

128. The sentence in the text assumes that these new franchisees will not completely displace other local entities who would otherwise have survived.

all. The last section of the article proposes a conceptual structure for applying these principles in specific cases.

D. CONCLUSION: A STRUCTURE FOR ANALYZING BUSINESS FORMAT FRANCHISING CASES

Several recent cases have correctly rejected the traditional view of the business format franchise as a tying arrangement and instead treated it as one interrelated exchange. *Principe v. McDonald's Corp.* recognized that the trademark and the leases on land and buildings were not separate products but part of the packaged "bundle of franchise benefits and obligations."[129] The court continued:

> It is often unrealistic to view a franchise agreement as little more than a trademark license . . . Given the realities of modern franchising, we think the proper inquiry is not whether the allegedly tied products are associated in the public mind with the franchisor's trademark, but whether they are integral components of the business method being franchised. Where the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie exists as a matter of law.[130]

This view of the business format franchise is clearly the correct one and should be made the prevailing rule of decision. In addition, the analysis should be extended by using the conceptual framework here proposed to decide when this interrelated exchange has a positive impact on competition and when it does not.

Business format franchising arrangements are a new form of business organization which are used to achieve specific economic results. They permit the parties to achieve economies of large scale in creation and exploitation of managerial information, skills and know-how, and in creation of brand preference among consumers. They permit the simultaneous exploitation of economies of small scale in franchisee operations at the level where goods and services are created and supplied. These economies are achieved because business format franchising gives each party a means to remedy market imperfections which would interfere with accomplishment of these results in uncoordinated vertical market transactions.

These arrangements have the potential for both positive and negative impacts on the competitive process. For this reason, a per se prohibition is inappropriate;[131] yet an open ended rule of reason inquiry has proved unsatisfactory in guiding courts' evaluations of the competitive significance of other vertical business practices.[132] A structured analysis, however, avoids both the inflexibility of a per se rule and the lack of focus of a rule of reason.

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129. 631 F.2d at 307.

130. *Id.* at 309. *See* authorities cited *supra* notes 18 and 20.

131. *See* Strasser, *Territorial Restraints*, *supra* note 4, at 830-33.

132. The doctrinal instability in the rules that regulate other vertical practices and the constant stream of proposals for new approaches to these practices provide persuasive evidence that the open-ended rule of reason inquiry is unsatisfactory. For recent scholarly literature, see authorities cited *supra* note 13.

Thus, the following two-part structure is here proposed.[133]

First, the court should determine if the franchising arrangement is being used to create or enhance entry barriers. The extent of product differentiation over and above that necessary for operation of the franchise should be evaluated. In addition to a direct inquiry into the extent of differentiation, an evaluation of the general state of interbrand competition should be helpful. Where there is effective interbrand competition, the brand preference identification is probably being used as a way of competing and should not be prohibited. Where the end product market is not competitive, there is greater chance that brand preference identification is being used to create or augment barriers to entry. The possible forclosure of potential franchisors from access to potential franchisees should also be instructive. Here, the pool of potential franchisees available to a new franchisor is critical, and as part of this inquiry, the ease or difficulty of entry at the franchisee level should be examined. Although other barriers to entry are not likely,[134] the possibility must be examined. Where entry is restricted, use of business format franchising's typical restrictions should be permitted only to accomplish new entry.

Typically, barriers to entry will not be a problem where the franchisor participates in a competitive market for the franchised product or service. In such a case, the franchise arrangement will usually have a net positive impact on the economic efficiency goals of antitrust. To preserve this procompetitive effect, antitrust courts should not limit the terms of the franchise agreement so much that it cannot accomplish the parties' legitimate objectives. Thus, specific restrictions in the franchise agreement which are necessary for it to accomplish its economic objectives must not be proscribed.

Specific restrictions in the franchise relationship can, however, have a negative impact on the social and political goals of antitrust by impeding the freedom of action of small, locally oriented, decentralized businesses. This anticompetitive impact is not decisive; the businesses so limited are economically dependent to such a degree that their real freedom of action is likely to be limited in any case. However, the anticompetitive impact should be curtailed by limiting the specific restrictions as much as possible. Thus, where entry barriers are not a problem, antitrust policy should permit those restrictions necessary for the franchise relationship to exist but should permit only those. This approach will achieve procompetitive efficiencies while minimizing anticompetitive harm to social and political goals.

Restrictions on the ability of the franchisee to compete with the franchisor's goods and services in the end product market typically take the

133. For further discussion of the nature of a structured rule of reason, see Strasser, *Distributor Exclusivity*, *supra* note 4, at 999-1001. The structure of antitrust rules has received substantial recent commentary. *See, e.g.*, Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984) and Markovits, *The Limits to Simplifying Antitrust: A Reply to Professor Easterbrook*, 63 TEX. L. REV. 41 (1984). The approach proposed is compatible with Professor John Flynn's excellent suggestion that the per se rule of reason dichotomy be viewed as different presumptions of illegality, rather than as hard and fast rules. Flynn, *Rethinking Sherman Act Section 1 Analysis: Three Proposals for Reducing the Chaos*, 49 ANTITRUST L.J. 1593 (1980).

134. *See supra* text accompanying note 121.

form of other restrictions on interbrand competition, such as exclusive dealing arrangements, or restrictions on franchisee competition after termination. They are justified by the franchisor's need to insure that information and services he provides will not be used competitively against him. Only restrictions reasonably tailored to this objective should be permitted.

Similarly, some restrictions on franchisees competing among themselves must be permitted. These may restrict franchisees to specified business locations or territories, or restrict the products or services that may be offered.[135] Whatever their form, these restrictions on intrabrand competition should be permitted to the extent they are required by the nature of the franchise relationship. They can reduce the incentive of individual franchisees to cheat on product or service image by cutting promotion and operations costs. Further, they can encourage franchisees to provide marketing and other information to the franchisor for distribution. In general, they provide a positive incentive to avoid opportunistic behavior, and they are one means by which the franchisor can offer reassurance that it will not enter the franchisee's local market after it has been developed by the franchisee. Where the facts of a specific case support one or more of these justifications, nonprice, intrabrand restrictions necessary to accomplish legitimate objectives should be permissible. Otherwise, they should be viewed with suspicion.

Resale price maintenance is a specific restriction on intrabrand competition (among franchisees) which deserves special mention. The evidence is reasonably clear that, when resale price maintenance is used in product distribution vertical arrangements, consumer prices rise.[136] This evidence is given both procompetitive and anticompetitive interpretations and there appears to be no consensus.[137] Unlike other restrictions on intrabrand competition, resale price maintenance provides a clear interbrand price signal which is potentially useful to facilitate horizontal collusion or interdependence at either the franchisor or the franchisee level. Because of the existence of other restrictions that can be used to blunt intrabrand competition,[138] resale price maintenance should not be permitted. Indeed, recent decisions have made it clear that the per se prohibition against all forms of vertical price fixing remains firmly in place.[139]

It is possible to justify many specific restrictions on the conduct of day-to-day franchisee operations. Such operations embody the product or service brand image; restrictions aimed at insuring quality are essential. The franchisor will invest in developing and promoting consumer demand only if the investment can be protected from erosion by franchisee conduct. The fact of such restrictions is also a franchisee assurance to other franchisees

135. *See supra* text accompanying notes 104-107.

136. SCHERER, *supra* note 24, at 592-93.

137. *Id.*

138. *E.g.*, territorial and customer restrictions.

139. Spray-Rite Service Corp. v. Monsanto Co., 52 U.S.L.W. 4341 (1984); Continental TV, Inc. v. GTE Sylvania, 433 U.S. 36 (1977); Arizona v. Maricopa County Medical Society, 457 U.S. 332 (1982). Special circumstances might justify a limited franchisor role in supervising franchisee prices, such as the nationwide promotion by the franchisor discussed in dictum in Jack Walters & Sons Corp. v. Morton Buildings, Inc., 737 F.2d 698 (7th Cir. 1984), if such consideration is permitted under the cases cited above.

that it will not undercut their attempts to maintain brand image and customer acceptance.

Franchisor use of tying arrangements, linking the purchase of two products, may also be justified.[140] Where there are trade secrets or trademarks to be protected, a requirement that the relevant products be purchased from the franchisor or a specific approved source may be justified.[141] Further, franchisor monitoring of franchisee sales may justify a tie in circumstances where there is no other effective means of monitoring.[142] Finally, technologically interdependent products may be tied by the franchisor to insure franchisee use of them.[143] When a tie between two products is used as part of the franchise package, its legality should be evaluated as a part of the package. Traditional tying rules are as inappropriate here as they are for the whole franchise package.

From an antitrust perspective the business format franchise system is one interrelated exchange of goods, services, restrictions on the parties' behavior, and specific requirements for day-to-day operations. As long as the system is not being used to create entry barriers, its impact should be procompetitive. Consequently, the specific restrictions necessary for the system to exist must be permitted. However, courts must still supervise the specific restrictions and requirements in franchise agreements to insure that franchisors are not compromising the social and political goals of antitrust with limitations on franchisee conduct that are not justified by the nature of that franchise relationship.

140. This statement applies only to a franchisor's use of a tie as part of a business format franchise, not to the rules generally applicable to tying arrangements. One of the themes of this article is that those rules should not be applied to the whole business format franchise or any parts of it.

141. This distinction was sometimes applied in the traditional tying law approach. *See supra* text accompanying notes 14 and 16. *See, e.g., Chock Full O'Nuts Corp.*, 83 FTC 575 at 643-56 (1973). The cases often found the tie legal by holding that the trademark is not a separate product. *See* authorities cited in AREEDA, ANTITRUST ANALYSIS 783-89 n.68 (3d ed. 1981).

142. This writer's views on the appropriate legal standard for non-franchise tying are presented in Strasser, *Tying, supra* note 4.

143. *Id.* at 6-8.