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COMMENTS

ANTITRUST LIMITATIONS ON PRICE MAINTENANCE, MARKET DIVISION, AND QUALITY CONTROLS IN FRANCHISE AGREEMENTS

by Beverly A. Neblett

The essential feature of a franchise arrangement is the continuing nature of the relationship between the franchisor and franchisee.[1] Reciprocal benefits and duties constitute the basis of the relationship and are required, both from a legal and a commercial standpoint, by the mutual dependency and the public identification of the franchisor and franchisee with the same products, brands or services. The franchisor, who generally offers a commodity which is protected by trademark or service mark registration, may sell either a license to retail the particular product or service or the right to conduct a business with an established name and operations format. During the term of the franchise agreement the franchisor is responsible for quality control, management training, advertising, product development, and management services. The purchaser of the franchise, the franchisee, operates as an independent businessman, but is responsible to the franchisor for the maintenance of a standardized operating procedure and product quality.

Franchising has been in the commercial limelight since World War II because of the expanding number of franchise operations and the unique advantages which the franchise arrangement offers to both parties.[2] During this same period franchising has come under both political and judicial scrutiny. While the Small Business Administration has encouraged franchise investment,[3] Congress has been concerned with the elimination of unfair trade practices.[4] Moreover, the Federal Trade Commission and the Antitrust Division of the Department of Justice have taken a closer look at franchise practices with respect to federal antitrust laws.[5] From this governmental examination, and from private litigation, three principal

[1] J. CURRY, PARTNERS FOR PROFIT 17 (1966); H. KURSH, THE FRANCHISE BOOM 13 (1962); E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION 8 (1963).

[2] Franchising in its modern form began early in the twentieth century when automobile manufacturers and petroleum refiners licensed retailers to sell their product in assigned territories. A. TUNICK, ARE YOU READY FOR FRANCHISING? 2 (Small Business Administration Small Marketers Aids No. 115, 1967). Franchising came to be utilized not only in product or service retailing but also in the licensing of an entire business operating with trademark rights. *See* Fels, *Franchising—Some Legal and Financial Considerations*, in CREATIVE BUSINESS FINANCING (V. Nordin ed. 1968). For a brief account of the historical origins of franchises, see J. ATKINSON, FRANCHISING: THE ODDS-ON FAVORITE (1968).

[3] *See* Zeidman, *The Growth and Importance of Franchising—Its Impact on Small Business*, 12 ANTITRUST BULL. 1191 (1967).

[4] *Hearings on S. 2507 and S. 2321 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 90th Cong., 1st Sess. (1967).

[5] Prior to his recent appointment as Assistant Attorney General for the Antitrust Division, Richard W. McLaren stated, "It is well known that the emphasis in antitrust enforcement has been placed increasingly on what are regarded in official circles as anticompetitive practices at the distribution level." McLaren, *Territorial Restrictions, Exclusive Dealing, and Related Sales Distribution: Problems under the Antitrust Laws*, 11 PRACT. LAW. 79 (April 1965).

categories of franchising practices have emerged within the purview of federal antitrust statutes: price maintenance, market division, and quality controls.

While federal law as embodied in the antitrust statutes clearly considers resale price maintenance as restrictive of free economy, the status of market division and quality controls as illegal restraints of trade under federal law is less certain. Judicial formulation of legal standards to test the legality of the latter two categories of franchise practices has been a difficult task.[6] Supreme Court decisions have demonstrated substantial disagreement among the Justices over the nature and impact of restrictions placed on a franchisee in order to achieve market division and quality control.[7] The difficulty in determining the impact of these restrictions on competition arises not only from the variety of franchise operations, but also from the twofold effect of such arrangements since franchise restrictions may have an impact on both interbrand and intrabrand competition. For example, it is possible for a franchise distribution system to be, simultaneously, a restraint of trade with regard to intrabrand competition and a stimulus to interbrand activity.[8]

The majority of antitrust decisions relevant to franchise practices involve section 1 of the Sherman Antitrust Act.[9] This section has remained the touchstone of antitrust enforcement[10] and of recovery in treble damage suits based on illegal marketing schemes.[11] A charge of "continuing theoretical discontinuities"[12] is directed at inconsistent judicial applications of the "rule of reason"[13] under the specific language of section 1 that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States . . . is declared to be illegal."[14] In particular, the charge is directed at the

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[6] The variety of products and services distributed by the franchising method makes generalization hazardous. For example, franchising is frequently discussed in terms of three broad types of systems—product retailing, retail business licensing, and licensing of trademarks for processing plants. These are in turn subdivided into at least fifty subgroups and subclassifications. PRACTISING LAW INSTITUTE, BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE 9 (Commercial Law & Practice Course Handbook Series vol. 10, 1968).

[7] *See* Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division*, 74 YALE L.J. 775, 779 (1965).

[8] *See* note 82 *infra*, and accompanying text.

[9] Sherman Act, 15 U.S.C. § 1 (1964).

[10] The Department of Justice may institute a criminal action or a civil suit against antitrust violations. Under 15 U.S.C. § 1 (1964) any person who makes an illegal contract or illegally conspires or combines in violation of 15 U.S.C. §§ 1-7 (1964) is guilty of a misdemeanor and is subject to either a fine or imprisonment, or both. Under 15 U.S.C. § 4 (1964) the United States Attorney General may direct suits in federal courts to restrain violations. Criminal cases are ordinarily brought "only against hard core violations, such as price fixing, which the violators would be bound to know were illegal." N.Y. Times, June 14, 1969, at 42, col. 1 (city ed.).

[11] 15 U.S.C. § 15 (1964) provides that "[a]ny person . . . injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . and shall recover threefold the damages by him sustained . . . ."

[12] Bork, *supra* note 7, at 777.

[13] The "rule of reason" was formulated in 1911 in Standard Oil Co. v. United States, 221 U.S. 1 (1911). In that case the Court stated that under section 1 of the Sherman Act a "standard of reason" was to be applied and that restraints were to be considered unlawful only if they were "undue" or "unreasonable." *Id.* at 1.

[14] Sherman Act, 15 U.S.C. § 1 (1964).

"failure to be clear about the scope of the per se concept,"[15] under which a proven contract, combination, or conspiracy is considered unreasonable without inquiry into its purpose or effect upon competition. Certain combinations are thus illegal per se "irrespective of the factual situation which may be offered in their defense . . . ."[16]

Disagreement over the impact of vertical restrictions on competition, particularly in a franchise context, is not confined to the courts. Some commentators argue that franchising which restricts intrabrand competition generally promotes interbrand competition by diffusing control and ownership of retail outlets.[17] It is pointed out that franchising offers an alternative to vertical integration and to increased ownership of retail or wholesale distributorships by manufacturers. These commentators conclude that territorial restrictions and quality controls should be governed by a test based upon the rule of reason taking into consideration the special features of the franchise system. Other writers believe that features of what they term "true franchising" should be tested by a determination of reasonableness, but that features of other franchising systems should be judicially screened on a per se basis.[18] The "true" franchise is apparently distinguished because of its smaller economic size and the exclusive identity of the franchisee with the franchisor's trademark.

Consideration of the per se doctrine is crucial in drafting a franchise agreement, in deciding whether conduct is unlawful, and in determining the quantum of proof necessary to establish a violation of the antitrust laws. If the precise limits of the concept's application are indefinite, the franchisor and franchisee are forced to act at their peril or to draft franchise agreements of uncertain legality. The purpose of this Comment is to discuss the recent developments in federal antitrust law which have broadened the scope of the per se doctrine and which are reshaping the obligations and the relationship of the franchisor and franchisee.

I. PRICE FIXING

Strict Per Se Illegality. The per se concept is most clear in its application to price fixing,[19] without regard to the horizontal or vertical nature of the

[15] Bork, *supra* note 7, at 777. The Supreme Court gave a summation of the per se rule in Northern Pac. Ry. v. United States, 356 U.S. 1, 5 (1958):

> There are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of *per se* unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unreasonable—an inquiry so often wholly fruitless when undertaken.

[16] Dieterich, *Antitrust Considerations in Licenses and Franchise Contracts*, in SOUTHWESTERN LEGAL FOUNDATION, SEVENTH INSTITUTE ON PATENT LAW (1969).

[17] Handler, *Recent Antitrust Developments*, 112 U. PA. L. REV. 159, 176 (1963); Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 LAW & CONTEMP. PROB. 506 (1965). *See also* Gould & Yamey, *Professor Bork on Vertical Price Fixing*, 76 YALE L.J. 722 (1967); Bork, *A Reply to Professors Gould and Yamey*, 76 YALE L.J. 731 (1967).

[18] *See* notes 165, 166 *infra*, and accompanying text.

[19] *See* A. PHILLIPS, MARKET STRUCTURE, ORGANIZATION AND PERFORMANCE 113, 201 (1962).

price control.[20] The foundation for this statutory application was laid in *Addyston Pipe & Steel Co. v. United States*[21] and *Dr. Miles Medical Co. v. Park & Sons*.[22] In *Addyston* a horizontal price fixing scheme among competing manufacturers was held illegal. The reasonableness of the prices, the Court held, was not a question open to the courts at common law and would not justify the price fixing scheme under the antitrust law. *Dr. Miles* involved a private suit brought by a manufacturer of drugs against a wholesale company which had induced dealers to violate contract restrictions on resale prices. The express vertical agreements between the manufacturer and its retailers were held void as illegal restraints on the alienation of commodities and illegal contracts under the Sherman Act. Although the agreements were vertical, the Court's language indicated that a similar result would have occurred if the dealers had horizontally agreed upon the same price restrictions. Thus, a contract between dealers horizontally fixing prices would also be "injurious to the public interest and void."[23]

Subsequent cases have demonstrated that any combination with the purpose of price fixing among competitors by either direct[24] or indirect[25] means would incur per se treatment. Price fixing was broadly defined in *United States v. Socony-Vacuum Oil Co.*[26] to include "more than the mere establishment of uniform prices."[27] A group of major oil companies had instituted buying programs whereby each company would purchase surplus gasoline from independent refineries which were selling the gasoline at distress prices. These programs were held to constitute a species of price fixing or manipulation. In earlier cases the per se doctrine was applied to a combination for the purpose of price fixing only if the cooperating competitors controlled the relevant market.[28] In *Socony-Vacuum Oil Co.*, however, the Court stated that market dominance is not essential to the establishment of a per se violation.

Illegality in the Franchise Context. A franchise relationship offers no exception to the per se application of the Sherman Act to a vertical com-

[20] There are several classifications of combinations or restraints, including horizontal, chain, and vertical types. "The horizontal combination brings together firms at the same stage of production, turning out the same product, and selling it in the same market. . . . The chain combination unites companies at the same stage of production that sell the same product in different local markets. . . . Vertical integration reaches forward or backward or both to combine firms at successive stages of production." C. WILCOX, PUBLIC POLICIES TOWARD BUSINESS 95-96 (rev. ed. 1960). The "chain" classification is usually considered as a horizontal combination, and thus the fundamental distinction is between horizontal and vertical restraints.

[21] 175 U.S. 211 (1899). *See also* United States v. Joint Traffic Ass'n, 171 U.S. 505 (1898); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897).

[22] 220 U.S. 373 (1910).

[23] *Id.* at 408.

[24] *See* United States v. McKesson & Robbins, Inc., 351 U.S. 305 (1956); United States v. Line Material Co., 333 U.S. 287 (1948); United States v. Univis Lens Co., 316 U.S. 241 (1942).

[25] National Macaroni Mfrs. Ass'n v. Federal Trade Comm'n, 345 F.2d 421 (7th Cir. 1965) (agreement among competing manufacturers to change the content of food products).

[26] 310 U.S. 150 (1940).

[27] *Id.* at 222.

[28] For example, where manufacturers formed an association controlling eighty-two per cent of the vitreous pottery industry, the members were convicted of violating section 1 by combining to limit sales and to fix prices. United States v. Trenton Potteries Co., 273 U.S. 392 (1927).

bination between a manufacturer and a wholesaler or retailer to prevent price reductions.[29] In particular, section 1 of the Act will prevent a franchisor, who has licensed a franchisee to sell a product or service, from dictating a unit price for advertising purposes.[30] Thus, in the franchising of restaurants it is apparently illegal to supply menus to the franchisee with the prices set by the franchisor even though the menu is copyrighted and has trademark features. The position of the Federal Trade Commission makes it clear that the franchisor should either advertise without indicating prices or expressly permit the particular franchisee to decide prices for local advertising.[31]

Normally a combination of either a horizontal or vertical nature seeks to keep prices above a certain minimum. In a 1967 Supreme Court decision, *Albrecht v. Herald Co.*,[32] no exception to the rule of per se illegality was made for a "franchise" arrangement which gave the franchisee a monopoly because there was no interbrand competition. In that case a newspaper terminated the distributor's exclusive dealership when he exceeded the predetermined *maximum* price level. The Court followed the single Supreme Court precedent invalidating maximum price controls which are horizontally agreed upon by two competitors and imposed upon their retailers.[33]

The application of the per se rule to the price restraint in *Albrecht* has been criticized as failing to consider "whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition."[34] Indeed, the newspaper in *Albrecht* claimed that its purpose for imposing price ceilings was to protect the public from the effects of the absence of interbrand competition at the distribution level.[35] Typically the depressing effect of interbrand competition on prices would tempt the franchisor to impose *minimum* prices. However, absent fair trade protection,[36] conduct by the

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[29] In Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965), the trial court had held as illegal provisions in pre-1955 franchise agreements which required dealers "[t]o maintain prices on products designated in, and as per Carvel Standard Operating Procedure and not to conduct any reduced price sales of these items without written consent from Carvel." *Id.* at 509. No appeal was taken from that portion of the judgment.

[30] According to the General Counsel of the Federal Trade Commission:

> A recent study has been made within the Commission of several problems of franchising, and it has been concluded that when used in connection with franchise arrangements, price fixing or tampering with prices is unlawful *per se*, as it is when found in other situations. . . .
>
> The advertising of the franchisee's prices by the franchisor, and his supplying of menus with prices to be used by the franchisee, strongly imply an agreement between them to sell the franchised product at a fixed price.

Letter from John V. Buffington, General Counsel, to Beverly A. Neblett, June 6, 1969. *See also* FTC Advisory Opinion No. 278, Aug. 23, 1968.

[31] *Id.*

[32] 390 U.S. 145 (1968).

[33] Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, 340 U.S. 211 (1951).

[34] Handler, *Through the Antitrust Looking Glass—Twenty-First Annual Antitrust Review*, 57 CALIF. L. REV. 182, 196 (1969), citing Justice Brandeis in Chicago Board of Trade v. United States, 246 U.S. 231 (1918). *See* note 40 *infra.*

[35] Justice Harlan placed considerable significance on this alleged purpose in his dissenting opinion in Albrecht v. Herald Co., 390 U.S. 145, 156 (1968).

[36] A statutory exception to illegal price fixing was created by Congress in the Miller-Tydings

franchisor to enforce price restrictions is illegal per se and subjects the franchisor to liability in an action for treble damages.[37] Even if franchisees in a given area prefer uniform prices, any horizontal combination could subject each participant to liability for treble damages to other franchisees or to the franchisor.[38]

Exceptions to Per Se Illegality.[39] Although the horizontal-vertical distinction does not significantly affect the result in cases involving price fixing, an exception to the per se doctrine has developed which is related to the market structure in which the alleged violation occurred. The exception, based upon the manufacturer's right to choose wholesalers and retailers with whom he will deal in a vertical relationship,[40] may offer a still viable principle to guide the dealings between the franchisor and his franchisees. The reasoning behind the exception was first expounded by the Supreme Court in *United States v. Colgate & Co.*[41] In upholding a demurrer to an indictment alleging a combination to fix resale prices in violation of the Sherman Act, the Court distinguished *Dr. Miles* on the ground that Colgate had not entered into a contract or agreement with its retailers. It had simply refused to deal further with those who would not maintain suggested minimum prices. The Court concluded with the troublesome passage that:

> In the absence of any purpose to create or maintain a monopoly, the act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell.[42]

The *Colgate* doctrine was narrowed by cases which extended the per se rule from express to implied agreements.[43] An unlawful combination was

Act Amendment of 1937, 15 U.S.C. § 1 (1964) (amending § 1 of the Sherman Act), and in the McGuire Fair Trade Act, 15 U.S.C. § 45 (1964).

[37] *See* Note, *The Franchisor as Plaintiff in Treble Damage Actions: An Antitrust Anomaly*, 49 B.U.L. REV. 322 (1969).

[38] One franchisee could recover treble damages from other franchisees if they had imposed prices on him coercively. *See* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968). The Court rejected the use of the *in pari delicto* doctrine as a bar to an antitrust damage suit brought by franchisees against the muffler manufacturer. However, the Court could not agree as to why it did so. As the opinion of Justice Black indicated, the franchisee's participation had not been "voluntary in any meaningful sense." *Id.* at 139. Apparently the decision would not apply to situations where the plaintiffs had actively and voluntarily participated. In such situations recovery by the franchisee would be barred.

[39] The 1952 McGuire Amendment to the Federal Trade Commission Act created a statutory exemption from the federal antitrust statutes prohibiting resale price maintenance agreements where state legislation authorized an exemption. 15 U.S.C. § 45 (1964). *See* note 36 *supra*.

[40] A group of cases excepts certain horizontal conduct involving price maintenance. Sugar Institute, Inc. v. United States, 297 U.S. 553 (1936); Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933); Cement Mfrs. Protective Ass'n v. United States, 268 U.S. 588 (1925); Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925); Chicago Bd. of Trade v. United States, 246 U.S. 231 (1918). However, these cases do not represent a "line" of reasoning and offer no guideline for conduct among franchisees or franchisors. As one commentator explains, "The authorities upholding loose-knit arrangements are extremely sparse, deal mainly with *sui generis* statements of fact, and have little precedential force." M. HANDLER, ANTITRUST IN PERSPECTIVE 26 (1957).

[41] 250 U.S. 300 (1919).

[42] *Id.* at 307.

[43] Federal Trade Comm'n v. Beech-Nut Packing Co., 257 U.S. 441 (1922); Frey & Son, Inc. v. Cudahy Packing Co., 256 U.S. 208 (1921); United States v. Schrader's Son, 252 U.S. 85 (1920).

found in the course of conduct of a drug company in *United States v. Parke, Davis & Co.*[44] In the absence of a contract or agreement the company enlisted some of its retailers and wholesalers in order to force other retailers to maintain suggested minimum prices. Parke, Davis went "beyond mere announcement of his policy and the simple refusal to deal"[45] by seeking and obtaining assurances of compliance among its retailers and by using the acquiescence of some to gain assurance from others. Relying on the *Parke, Davis* decision, the Second Circuit concluded that a summary judgment for the defendant was not proper in a case in which the manufacturer allegedly had refused to deal with the plaintiff because of noncompliance with a price schedule.[46]

The majority opinion in *Parke, Davis* has led to disagreement over the continuing significance of the *Colgate* doctrine.[47] The distinction drawn between mere refusal to deal and something "beyond" may be slight; nevertheless that "narrow channel"[48] of conduct is apparently intact and acknowledged as a "battered but durable precedent."[49] Thus, if a distributor initially and continuously refuses to acquiesce to resale price recommendations or demands by a manufacturer, he may be barred from recovery under the Sherman Act because the action of the manufacturer would be unilateral and any subsequent refusal to deal would fall within *Colgate*. As the *Parke, Davis* decision acknowledged and as the First Circuit demonstrated in *Quinn v. Mobil Oil Co.*,[50] the immunization from antitrust proscriptions afforded by *Colgate* will exist as long as the Sherman Act requires a contract, combination, or conspiracy.[51] The court in *Quinn* held that where a defendant oil company had unsuccessfully attempted to coerce a solitary dealer into agreeing to reduce his prices, the requisite combination for a section 1 violation was not shown by the pleadings.

The *Colgate* channel may have been further narrowed by *Albrecht*, in which the Supreme Court faced the problem of legal unilateral action versus illegal concerted action under section 1 of the Sherman Act. The Court found the necessary combination or contract in the actions of the defendant newspaper, a carrier hired solely to compete with the plaintiff, and a company employed to solicit customers for the carrier. However, a jury had found that the newspaper's attempted control and termination

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[44] 362 U.S. 29 (1960).

[45] *Id.* at 44.

[46] George W. Warner & Co. v. Black & Decker Mfg. Co., 277 F.2d 787 (2d Cir. 1960).

[47] *See, e.g.*, the dissenting opinion in United States v. Parke, Davis & Co., 362 U.S. 29, 49 (1960); Fulda, *Individual Refusals To Deal: When Does Single-Firm Conduct Become Vertical Restraint*, 30 LAW & CONTEMP. PROB. 590 (1965).

[48] According to the Second Circuit, "The Supreme Court has left a narrow channel through which a manufacturer may pass even though the facts would have to be of such Doric simplicity as to be somewhat rare in this day of complex business enterprises." George W. Warner & Co. v. Black & Decker Mfg. Co., 277 F.2d 787, 790 (2d Cir. 1960).

[49] Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals To Deal*, 75 HARV. L. REV. 655, 680 (1962).

[50] 375 F.2d 273 (1st Cir. 1967) (dismissal of former dealer's suit against oil company affirmed where amended complaint alleged termination of lease but failed to allege a combination). *But see* Broussard v. Socony Mobil Oil Co., 350 F.2d 346 (5th Cir. 1965).

[51] *See also* Tripoli Co. v. Wella Corp., 286 F. Supp. 264 (E.D. Pa. 1968) (summary judgment granted to defendant manufacturer who had refused unilaterally to deal with the plaintiff distributor because the plaintiff declined to maintain a resale price).

of the plaintiff were entirely unilateral and the circuit court had affirmed.[52] Nevertheless, the Supreme Court held that a concert of action was implied as a matter of law. According to one writer, the Court stretched "to the breaking point the combination concept" by indicating that if the plaintiff had once complied with the maximum price limit, he could have alleged under the *Parke, Davis* decision a combination between himself and the newspaper.[53] Moreover, he could have alleged a combination between the newspaper and his former customers.

In 1926 two exceptions to the per se illegality of price fixing were recognized in *United States v. General Electric Co.*[54] The Supreme Court sanctioned General Electric's vertical control of the prices of lamps which it sold by consignment and its horizontal control of the prices charged by its patent licensee, Westinghouse.[55] The consignment exception, based on an agency relationship, was narrowed by the Court in *Simpson v. Union Oil Co.*[56] to exclude a nominal consignment. Union Oil had exercised price controls in over 4,000 retail stations through consignment agreements which the lessees of the outlets were required to sign and which contained provisions retaining title to the gasoline in the company. A lease was not renewed if the lessee failed to maintain the price schedule. The Supreme Court found a violation of the Sherman Act and granted a partial summary judgment for the plaintiff, a terminated dealer. A per se violation of the Sherman Act occurs, the Court held, when "a 'consignment' device is used to cover a vast gasoline distribution system, fixing prices through many retail outlets," and in such cases "the antitrust laws prevent calling the 'consignment' an agency."[57] The Court distinguished *United States v. General Electric Co.* by determining that the earlier holding rested exclusively on patent law. This determination led the dissent in *Simpson*[58] to conclude that *General Electric* had thus been overruled because its actual basis was the finding of a bona fide agency and because the consignment arrangements were very similiar to those employed by Union Oil. Regardless of the impact of *Simpson* on the *General Electric* decision, in ordinary circumstances involving parties of more balanced economic strength "an owner of an article may send it to a dealer who may in turn undertake to sell it only at a price determined by the owner."[59]

The Sherman Act requirement of a contract, combination, or conspiracy presented no problem to the Supreme Court in *Simpson* since the consignment agreement between the oil company and the plaintiff supplied the necessary element of a contract. Moreover, there was proof of a large scale program of price fixing among all the dealers. The consignment

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[52] 367 F.2d 517 (8th Cir. 1966).

[53] Handler, *supra* note 34, at 187; *see* Albrecht v. Herald Co., 390 U.S. 145, 150 n.6 (1968).

[54] 272 U.S. 476 (1926).

[55] An exception to the general illegality of horizontal price fixing exists where a patentee fixes the price at which a patented product may be sold by a manufacturing licensee. *See* cases cited in Dieterich, *supra* note 16.

[56] 377 U.S. 13 (1964).

[57] *Id.* at 21.

[58] *Id.* at 25 (Stewart, J.).

[59] *Id.* at 21.

contract, the Court concluded, was used coercively to maintain gasoline prices as effectively as the *Parke, Davis* techniques of price control had been used.

A final exception to the per se illegality of resale price maintenance under section 1 of the Sherman Act occurs when a manufacturer or franchisor submits suggested price lists to a distributor. Where the facts indicated that a manufacturer only "advised" its retailer and made no attempt to enforce its price suggestions, the Third Circuit held that a finding of illegal price fixing was clearly erroneous.[60] In addition, the fact that two other retail stores had voluntarily gone along with the price lists did not make them co-conspirators. The court of appeals emphasized that "conscious parallelism has not yet read conspiracy out of the Sherman Act entirely."[61] In *Susser v. Carvel Corp.*[62] the recommendation of retail prices by a franchisor, absent coercion, was held to be insufficient to establish illegal price fixing. To protect the franchisor, the Carvel agreement provided that the recommendation was "in no manner binding upon the dealer"[63] and that the franchisee was permitted to advertise at prices of his own choosing. Carvel also appointed a representative board of governors from the dealers to act as a medium for the interchange of ideas and to make price recommendations.

II. TERRITORIAL AND CUSTOMER RESTRAINTS

The Horizontal-Vertical Distinction. In cases not involving the licensing of a patent,[64] the horizontal-vertical distinction has played an important role in determining the application of the per se concept to territorial or

[60] Klein v. American Luggage Works, Inc., 323 F.2d 787 (3d Cir. 1963).

[61] *Id.* at 791, citing Theatre Enterprises, Inc. v. Paramount Film Distrib. Corp., 346 U.S. 537, 541 (1954).

[62] 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted,* 381 U.S. 125 (1965). *See also* Columbus Coated Fabrics Corp., 55 F.T.C. 1500 (1959), wherein the Commission said that suggested retail prices without an agreement and without enforcement of their maintenance were legal. *Cf.* United States v. Container Corp. of America, 393 U.S. 333 (1969) (a non-franchise situation where an agreement among a few dominant sellers to exchange price information whenever requested was held per se illegal). According to E. LEWIS & R. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION 3 (Small Business Administration Management Research Summary 1966): "The most common policy of franchisors regarding the pricing of their goods and services by franchisees is to issue a suggested price list and let the franchisee set prices in terms of his own competitive situation. Some franchisors establish the maximum price the franchisee may charge, and some specify the exact prices at which the franchised products must be sold."

[63] The Second Circuit approved a revised franchise agreement which provided that: "The dealer shall have the right to sell Carvel's Frozen Dairy Product and/or other items authorized for sale by him under the terms of this agreement at any price that the dealer determines. Wherever Carvel recommends a retail price, such recommendation is based upon Carvel's experience concerning all factors that enter into a proper price, but such recommendation is in no manner binding upon the dealer." 332 F.2d at 509. The plaintiffs, franchised dealers, alleged that Carvel's course of conduct had maintained prices illegally. For example, for purposes of quality control, Carvel had prescribed in the operating manual only 10¢ and 20¢ cones. The Second Circuit approved the principle followed by the trial judge that "the mere existence of a means whereby retail price levels are recommended is not sufficient to establish a violation of the Sherman Act, unless there is a showing of an attempt to enforce a price structure upon the retail tradesmen." *Id.* at 510.

[64] A patentee may place territorial restrictions on a licensee of the patent. 35 U.S.C. § 261 (1964) provides: "The applicant, patentee, or his assigns . . . may in like manner grant and convey an exclusive right under his application for patent, or patents, to the whole or any specified part of the United States."

customer divisions of a market. Although horizontal boycotts and market division among competitors have been compared to illegal price fixing and, under most circumstances, have been held illegal per se, until 1967 vertical restrictions were tested in federal courts by a broad determination of their reasonableness.[65]

Horizontal market divisions may involve both territorial and customer restraints which are deemed illegal per se.[66] Often, such restraints are part and parcel of illegal price fixing schemes and under such circumstances, condemnation of the price fixing will envelop the market division as an aggregation of trade restraints.[67] A similar result will occur if vertical restraints on the market are integrated with illegal resale price fixing.[68] Thus, as Justice Douglas pointed out in *Albrecht*, in private suits for treble damages "[w]hether an exclusive territorial franchise in a vertical arrangement is *per se* unreasonable is a much mooted question."[69] However, if there is no integration of restraints in the vertical arrangement, customer and territorial restrictions will be tested separately.

Horizontal in Substance: Vertical in Form. Generally, in any "operating"[70] franchise there are restrictions on the territory in which the franchisee may operate.[71] Given the lingering uncertainty of the law with regard to vertical territorial or customer restraints and the relative certainty of the per se illegality of horizontal restraints, "[t]he primary danger with respect to a vertical territorial restriction is that it may be regarded as a horizontal conspiracy."[72] In two Supreme Court decisions the Government won injunctions against horizontal restraints initiated by licensees, although the restraints were vertical in form. The *United States v. General Motors Co.*[73] case concerned customer restrictions on car dealers in the Los Angeles area. A number of the dealers asked General Motors to prevent other dealers from selling through local discount houses. The Supreme Court

[65] *See* Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795 (1962). In contrast, vertical restrictions were held illegal in some states under antitrust legislation passed contemporaneously with the Sherman Act. One example of vigorous state enforcement is Texas. In that state, contracts of sale, lease, and dealership and franchise agreements are void if they contain territorial or customer restrictions. Patrizi v. McAninch, 153 Tex. 389, 269 S.W.2d 343 (1954). Among the narrow exceptions to the Texas antitrust statutes are contracts of agency. Barr v. Southwest Wholesale Furniture & Appliance Co., 331 S.W.2d 343 (Tex. Civ. App. 1960). *See also* 13 BAYLOR L. REV. 295 (1961).

[66] Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959) (combination of manufacturers, distributors, and a retailer to boycott another retailer); Fashion Originators' Guild of America, Inc. v. Federal Trade Comm'n, 312 U.S. 457 (1941) (agreement by guild members to boycott retailers engaging in "style piracy"); Eastern States Retail Lumber Dealers' Ass'n v. United States, 234 U.S. 600 (1914) (agreement among members of a retailer's association to boycott wholesalers who sold directly to the retail trade).

[67] United States v. Sealy, Inc., 388 U.S. 350 (1967); Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951).

[68] United States v. Bausch & Lomb Optical Co., 321 U.S. 707 (1944).

[69] Albrecht v. Herald Co., 390 U.S. 145, 154 (1968) (concurring opinion).

[70] With an "operating" franchise contract the franchisor allows the franchisee to operate one or several franchises but not to subfranchise. A second type of contract is the "area franchise" arrangement, which allows the franchisee to engage in subfranchising in a large territory. A. LAPIN, EXPANDING SALES THROUGH FRANCHISING 3 (Small Business Administration Management Aids No. 182, 1968).

[71] *See* G. GLICKMAN, 15 BUSINESS ORGANIZATIONS, FRANCHISING § 4.02(2) (1969).

[72] McLaren, *supra* note 5, at 80.

[73] 384 U.S. 127 (1966).

found a "classic conspiracy in restraint of trade"[74] under section 1 of the Sherman Act. That the franchised dealers were selling through discount houses in violation of their dealer contracts was no defense to the conspiracy charge. The Court found "joint and collaborative action . . . pervasive in the initiation, execution, and fulfillment of the plan"[75] to eliminate discounters from access to the market. Although price fixing was not an issue, the Court noted that inherent in the conspiracy was an added and substantial restraint upon price competition and that "the *per se* rule applies even when the effect upon prices is indirect."[76]

The Court again examined the substance of territorial restraints in *United States v. Sealy, Inc.*[77] The Sealy mattress company was charged with resale price fixing and illegal territorial allocation. An injunction against the price fixing was not appealed. However, the Government appealed from the finding of the district court that under the rule of reason the allocation of mutually exclusive territory among Sealy licensees was not proved unreasonable in violation of section 1 of the Sherman Act. As an opening remark, the Supreme Court explained that:

> Because this Court has distinguished between horizontal and vertical territorial limitations for purposes of the impact of the Sherman Act, it is first necessary to determine whether the territorial arrangements here are to be treated as the creature of the licensor, Sealy, or as the product of a horizontal arrangement among the licensees.[78]

Because the Sealy licensees owned substantially all of the Sealy stock and exercised control of the corporation, the Court found that the territorial arrangements were the creature of horizontal action. Thus, the Sealy violation could be distinguished, in the Court's view, from vertical restraints[79] and could come within the per se condemnation of prior cases. This strict condemnation was appropriate, moreover, because, in the view of the majority, the territorial restraints were a part of the unlawful price fixing, which "underline[d] the horizontal nature of the enterprise."[80]

Justice Harlan, who had concurred in the *General Motors* decision, disagreed with the majority's characterization of the Sealy arrangements as horizontal. He argued in his dissent[81] that, as a vertical restraint, the legality of the restraint was properly determined by the rule of reason. According to Justice Harlan:

> With respect to vertical restrictions, it has long been recognized that in order to engage in effective *interbrand* competition, some limitations on *intrabrand* competition may be necessary. Restraints of this type 'may be allowable protections against aggressive competitors or the only practicable

[74] *Id.* at 140.
[75] *Id.* at 143.
[76] *Id.* at 147.
[77] 388 U.S. 350 (1967).
[78] *Id.* at 352.
[79] In White Motor Co. v. United States, 372 U.S. 253 (1963), the Supreme Court hesitated in applying the per se concept to vertical restraints, but overcame its hesitation in United States v. Arnold, Schwinn & Co., 388 U.S. 365 (1967). *See* text accompanying notes 105-08 *infra.*
[80] 388 U.S. at 356.
[81] *Id.* at 358.

means a small company has for breaking into or staying in business . . . and within the "rule of reason" . . . .'[82]

For the large number of independent franchisors the *Sealy* and *General Motors* decisions have obvious significance. The franchisor should be advised not to cooperate in the event that franchisees act collectively to restrain certain of their members. Indeed, the franchisor should take affirmative steps and request that the horizontal restraints be discontinued.

Recent Challenges to Vertical Restraints. Few Supreme Court decisions considered the legality of territorial and customer restrictions in a vertical context until 1963. One reason for the lack of judicial comment or consideration was that "during the first 60 years of the Sherman Act, despite the widespread use of such restrictions, apparently not a single one was ever challenged by the Department of Justice."[83] Moreover, a series of cases had upheld such restraints unless they were ancillary to a price fixing scheme or unless the manufacturer imposing the restrictions had a monopoly.[84] Thus, in *United States v. Klearflax Linen Looms*[85] customer restrictions were struck down under section 2 of the Sherman Act by a federal district court because the licensor had an absolute monopoly on the source of the product. The sole manufacturer of linen rugs imposed the vertical restrictions on its distributors for the purpose of preventing *intrabrand* competition between itself and the distributors in the bidding for government contracts. Although there were no other customer restraints, the manufacturer instructed its jobbers not to bid for government contracts and, in one instance, refused to deliver the unfinished rugs to a jobber who had underbid Klearflax. While Klearflax had illegally refused to sell the rugs, the court noted that a limitation on the amount of goods sold by the manufacturer to each distributor might be justified even thought the limitation could make it difficult for the distributor to compete.[86]

In 1948 the Department of Justice reported that it considered vertical territorial and customer restrictions illegal per se.[87] This administrative challenge resulted in some modification of contracts in the automobile and other industries during the 1950's. Most of the Department's complaints and those of the Federal Trade Commission ended in consent decrees.[88]

[82] 388 U.S. at 359 (citing White Motor Co. v. United States, 372 U.S. 253, 263 (1963)). Note that Justice Harlan also dissented in Albrecht v. Herald Co., 390 U.S. 145, 156 (1968), but concurred in part and dissented in part with Justice Stewart in United States v. Arnold, Schwinn & Co., 388 U.S. 365, 382 (1967).

[83] Pollock, *Franchising, Customer Restrictions and Building a Better Mouse Trap*, 46 CHICAGO B. REC. 378 (1965).

[84] Chicago Sugar Co. v. American Sugar Ref. Co., 176 F.2d 1 (7th Cir. 1949), *cert. denied*, 338 U.S. 948 (1950); Fosburgh v. California & Hawaiian Sugar Ref. Co., 291 F. 29 (9th Cir. 1923); Baran v. Goodyear Tire & Rubber Co., 256 F. 571 (S.D.N.Y. 1919); Revlon Prods. Corp. v. Bernstein, 204 Misc. 80, 119 N.Y.S.2d 60 (Sup. Ct. 1953), *aff'd per curiam*, 285 App. Div. 1139, 142 N.Y.S.2d 364 (1955).

[85] 63 F. Supp. 32 (D. Minn. 1945). *See also* Roux Distrib. Co., 55 F.T.C. 1386 (1959).

[86] 63 F. Supp. at 41.

[87] *Hearings Before the Subcomm. on Automobile Marketing Legislation of the House Comm. on Interstate and Foreign Commerce*, 84th Cong., 2d Sess. 362 (1956).

[88] *E.g.*, United States v. Rudolph Wurlitzer Co., 1958 Trade Cas. ¶ 69,011 (W.D.N.Y. 1958); United States v. Philco Corp., 1956 Trade Cas. ¶ 68,409 (E.D. Pa. 1956).

However, in *United States v. White Motor Co.*[89] a federal district court for the first time granted a summary judgment against a leading manufacturer of trucks on the basis of both unlawful price fixing and customer and territorial restraints. The franchise contracts provided that neither the distributors nor the dealers could sell to the government and expressly limited sales to certain territories. The district court found that the price fixing was not an integral part of the distribution system, and White Motor appealed only from the ruling against the legality of the territorial restraints. Without a finding of an integrated scheme and without the benefit of detailed findings on the impact of the territorial restraints, the Supreme Court[90] did not follow an earlier decision[91] which had applied the per se concept to an integrated price fixing and distribution scheme. The majority concluded that the proper rule of law should be determined after a trial. It set the problem of deciding whether the per se concept would apply in a vertical-horizontal context:

> Horizontal territorial limitations, like 'group boycotts, or concerted refusals by traders to deal with other traders' . . . , are naked restraints of trade with no purpose except stifling of competition. A vertical territorial limitation may or may not have that purpose or effect . . . . We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a 'pernicious effect on competition and lack . . . any redeeming virtue' . . . and therefore should be classified as *per se* violations of the Sherman Act.[92]

White Motor revealed considerable disagreement among the members of the Court.[93] Justice Brennan, in a separate concurring opinion, fragmentized the possible violation into two distinct problems. He cautioned against analogizing a truly vertical territorial restraint to horizontal divisions of markets or to resale prices maintenance. He further suggested that vertical and horizontal restraints could be distinguished by their effect upon interbrand competition. Justice Clark, joined by Justice Black and the Chief Justice, dissented on the ground that admittedly White Motor was restraining competition among its dealers and thus a remand would be futile because "the rule of reason is inapplicable to agreements made solely for the purpose of eliminating competition."[94] Justice Clark found that the customer and territorial restraints composed "one of the most brazen violations of the Sherman Act that I have experienced in a quarter of a century."[95] Moreover, they were completely analogous to horizontal restraints and "their intended and actual effect is the same as, if not even more destructive than a price fixing agreement or any of its *per se* counterparts."[96] In effect, the dissent abolished the distinction between interbrand and intrabrand competition.

[89] 194 F. Supp. 562 (N.D. Ohio 1961).

[90] White Motor Co. v. United States, 372 U.S. 253 (1963).

[91] United States v. Bausch & Lomb Optical Co., 321 U.S. 707 (1944).

[92] 372 U.S. at 263.

[93] Justice Douglas wrote the majority opinion. Justice Brennan concurred. *Id.* at 264. Justices Clark and Black and Chief Justice Warren dissented. *Id.* at 275. Justice White did not participate.

[94] *Id.* at 281.

[95] *Id.* at 276.

[96] *Id.* at 279.

Reasonable Vertical Restraints. In *White Motor* the Court was unable to benefit from additional inquiry into the impact of vertical restraints on competition because the company entered into a consent decree before the trial materialized.[97] Thus the question of law remained undetermined. When territorial restrictions were challenged by the Federal Trade Commission under section 5 of the FTC Act,[98] the courts measured the restrictions by the rule of reason on the basis of full evidentiary hearings. In each case the restraints were found to be reasonable. In the first, *Snap-On Tools Corp. v. FTC*,[99] the franchised dealers maintained designated routes and sold out of mobile, walk-in trucks. The dealers were free to sell to any customers who entered the territory. Following Justice Brennan's emphasis in *White Motor* on interbrand versus intrabrand competition, the Court examined the record and concluded that it failed to demonstrate that Snap-On's "vertically imposed territorial franchisees have the same pernicious purpose and have the same inhibitory effects upon competition as horizontal divisions of markets."[100] The record demonstrated to the Court that the market divisions were prompted by reasonable business expectations, that there was no illegal price fixing scheme, and that the territories promoted, rather than suppressed, "in a broad, meaningful way" competition between Snap-On and other manufacturers of similar products.[101] This interbrand competition would justify "a minimal curtailment of intrabrand competition among its dealers."[102] Although *Snap-On* was brought under section 5 of the FTC Act, the court followed the rule of reason under section 1 of the Sherman Act, noting that Snap-On was not in a monopoly position, nor did it have a monopolistic purpose.

The Seventh Circuit decision in *Sandura v. FTC*[103] involved closed territories given by a failing company to attract distributors and to protect their large investments in advertising to re-establish the Sandura product. Under those circumstances the court upheld the restrictions as increasing "the competitive good that flows from interbrand competition without any showing of detriment to intrabrand competition."[104]

Per Se Illegality in Schwinn. *Sandura* and *Snap-On* set the stage for the 1967 decision in *United States v. Arnold Schwinn & Co.*[105] Facets of the bicycle company's franchise distribution system were the basis of charges of price fixing, illegal allocation of territories, and customer restrictions in violation of the Sherman Act. Under its challenged distribution plans, Schwinn franchised wholesale distributorships to serve areas in which retail stores were also franchised. As Schwinn's agent, the distributor could

[97] 1964 Trade Cas. ¶ 71,195 (N.D. Ohio 1964).
[98] 38 Stat. 719 (1914), *as amended*, 15 U.S.C. § 45 (1964).
[99] 321 F.2d 825 (7th Cir. 1963).
[100] *Id.* at 833, quoting the concurring opinion of Justice Brennan in White Motor Co. v. United States, 372 U.S. 253, 267-68 (1963).
[101] 321 F.2d at 831.
[102] *Id.* at 832.
[103] 339 F.2d 847 (7th Cir. 1964).
[104] *Id.* at 858.
[105] 388 U.S. 365 (1967).

sell or send bicycles only to franchised outlets in its area. The outlets understood that they should not sell to unfranchised dealers or discount houses. Noncompliance resulted in threats of termination.

The issues on direct appeal to the Supreme Court were the legality, absent evidence of illegal price fixing, of the customer restrictions (1) on distributors and retailers where goods were sold and (2) on wholesale distributors where the goods were consigned.[106] Since the source of the restrictions was Schwinn, the Supreme Court emphasized that the restrictions were vertical in nature. Invoking the "ancient rule against restraints on alienation,"[107] the Court held that customer restraints where goods were sold were illegal per se:

> Once the manufacturer has parted with title and risk, he has parted with dominion over the product, and his effort thereafter to restrict territory or persons to whom the product may be transferred—whether by explicit agreement or by silent combination or understanding with his vendee—is a *per se* violation of § 1 of the Sherman Act.[108]

Applying the rule of reason to the consignment distribution plan, the Court upheld the customer restrictions on distributors in such transactions as being reasonably necessary to meet the competition of more powerful manufacturers.

Alternative Territorial Controls After Schwinn. By affirming the district court's application of the per se concept to territorial restrictions and by placing customer restraints in the same category, the Court in *Schwinn* struck at the basis of many franchise systems.[109] The decision has been criticized for not clearly defining the application of the per se rule to distribution restrictions imposed by a new, failing, or struggling company.[110] On the other hand, some have praised the *Schwinn* limitations on the use of vertical restraints as "sound in economics and in policy."[111] Certainly for the present, per se limitations on customer or territorial controls will have a definite and substantial impact on franchise operations which involve retail or wholesale distribution of a product.[112] Few arrangements of that category can utilize a consignment system in a practical

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[106] The dismissal of the price fixing charge was not appealed. The district court enjoined territorial restraints on goods sold to franchised distributors as illegal per se and the company did not appeal from the injunction. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323 (N.D. Ill. 1965).

[107] 388 U.S. at 380. *See also* the separate opinion of Justice Stewart, joined by Justice Harlan, concurring in part and dissenting in part. *Id.* at 391.

[108] *Id.* at 382.

[109] *See* E. Lewis & R. Hancock, The Franchise System of Distribution 41 (1963).

[110] Kittelle, *Territorial and Customer Restrictions Through Consignment or Agency—Schwinn or Sin*, 12 Antitrust Bull. 1007 (1967); Comment, *The Impact of the Schwinn Case on Territorial Restrictions*, 46 Texas L. Rev. 497, 510 (1968).

[111] Address by Edwin M. Zimmerman, First Assistant, Antitrust Division, Dept. of Justice, before the 1967 Federal Bar Association Convention, San Francisco, Calif., July 28, 1967.

[112] *But see* Janet Sales Corp. v. Lanvin Parfums, Inc., 396 F.2d 398, 406 (2d Cir. 1968), wherein the Second Circuit stated that the existence of a customer limitation clause "does not necessarily imply a *per se* violation." In *United States v. Arnold, Schwinn & Co.* the Supreme Court premised its finding of a per se violation on the fact that Schwinn had been "firm and resolute" in insisting on compliance. 396 F.2d at 406. Since the evidence in *Lanvin* on that issue was conflicting, the circuit court held that such an issue is best settled by the jury.

way, and the Court in *Schwinn* warned that it would scrutinize and discard that protective label where the dealer's functions were distinguishable from those of an "agent or salesman."

For the category of franchise systems concerned primarily with product retailing, the question then remains: What are the maximum restrictions which a franchisor may impose vertically to divide product distribution among his franchisees on the basis of territory or customer allocation? For example, can the franchisor impose customer restrictions indirectly by demanding contractual guarantees of minimum standards of service from his franchisees to protect his good will and trademark? Beyond maintaining a sometimes burdensome consignment system within the bounds set by *Simpson*, there are two contractual means which a franchisor may implement with judicial endorsement to achieve this division. Both were expressly approved by the district court on remand in *Schwinn*.[113]

The first means is the creation of "areas of prime responsibility" as the term has been used by the Department of Justice and by the Federal Trade Commission in consent decrees[114] and as mentioned by Justice Brennan in his concurring opinion in *White Motor*.[115] Under such a contractual provision the franchisee agrees to use his best efforts to promote the product in the given area, but there is no contractual restriction on his efforts outside the area. Although the terms of these provisions vary, they may provide for referral of inquiries to the franchisee and require the approval of the franchisor for any expansion of the area. In addition, the provisions may contain an express denial of any customer restraint.[116]

A clause granting the franchisee an area of primary responsibility will usually provide that the franchisor can terminate the relationship if the franchisee does not adequately represent the franchisor in the assigned area. There is some disagreement as to the effectiveness of such a clause in a franchise contract, especially when a high degree of enforcement could become an unreasonable restraint of trade.[117] The district court in *Schwinn* on remand indicated that termination would be proper if there was not adequate representation in the assigned territory. The legality of termination would be determined by the rule of reason. In a treble damages

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[113] 291 F. Supp. 564 (N.D. Ill. 1968).

[114] United States v. Rudolph Wirlitzer Co., 1968 Trade Cas. ¶ 69,011 (W.D.N.Y. 1968); United States v. Philco Corp., 1956 Trade Cas. ¶ 68,409 (E.D. Pa. 1956). *See also* Chadwell & Rhodes, *Antitrust Aspects of Dealer Licensing and Franchising*, 62 Nw. U.L. REV. 1, 15 (1967).

[115] 372 U.S. at 264.

[116] The following provisions are an example of a typical arrangement and were taken from a franchise agreement for the distribution of lawn sprinkler systems:

> Territory:
> The territory in which FRANCHISEE may exercise the rights granted hereunder shall be: ________________ In order to protect the interests of all [trademark name] franchisees, permit the orderly growth of the [trademark name] concept and encourage maximum penetration of all market areas, FRANCHISEE agrees not to provide [trademark name] services within any area assigned to another franchisee without his written approval in advance; provided that the franchisee may sell products and services to any prospect who contacts him at the franchisee's office within the territory assigned regardless of whether or not such prospect's property is located within the above territory.

Since the agreement restricts services, but not sales, to the assigned territory, on its face it is not violative of the limitations on vertical restraints.

[117] *See* Snap-On Tools Corp. v. Federal Trade Comm'n, 321 F.2d 825, 832 (7th Cir. 1963).

suit[118] subsequent to *Schwinn*, a federal district court refused to grant summary judgment to a defendant manufacturer who allegedly had terminated the plaintiff's distributorship because of sales made beyond the range of its service facilities. The contract stated that "to provide after-sales service in a satisfactory manner dealers are forbidden to make shipments beyond the normal range of their service facilities."[119] The court denied the motion because it felt that evidence was needed "of the course of dealing between the parties and of such other circumstances as will develop the actual marketing relationship between them,"[120] *e.g.*, evidence that the distributor was an agent of the manufacturer.

The second means to achieve market division is the location clause. Such a provision is clearly a more effective technique than assigned areas, but is impractical for a manufacturer like Snap-On Tools Co. which had dealers operating from mobile trucks. There are generally three ways for a franchisor to control distribution through location clauses. Some agreements specify that the franchisor has the right to approve the exact location and building of each of the franchise operations. Other franchisors may agree to secure an option on a particular site and make it available to the franchisee. As a third alternative, the franchisor may own the facilities and lease them to the franchisee. No antitrust problems should arise unless the franchisor uses the lease-renewal or location approval in a coercive manner.[121] The Supreme Court in *General Motors* declined to question the legality of the location clause in dealer contracts at the urging of the Government,[122] while the Second Circuit has upheld their legality.[123]

The location and area of primary responsibility clauses may be the maximum contractual restrictions which the antitrust laws allow for *Schwinn*-type distribution arrangements. It is unclear whether greater restrictions will be permitted for franchise systems which require greater controls for trademark purposes.[124] The broad language of *Schwinn* would seem to foreclose any absolute restraints on a franchisee's sales by customer or territorial designation under any circumstances. If the *Schwinn* holding is not limited in future cases, the only other restriction which a franchisor could impose upon a franchisee would be an announcement of a policy of market division and a unilateral refusal to deal with any party violating the policy.

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[118] Sherman v. Weber Dental Mfg. Co., 285 F. Supp. 114 (E.D. Pa. 1968).

[119] *Id.* at 115.

[120] *Id.* at 116.

[121] *Cf.* Simpson v. Union Oil Co., 377 U.S. 13 (1964).

[122] United States v. General Motors, 384 U.S. 127, 140 (1966).

[123] Boro Hall Corp. v. General Motors Corp., 124 F.2d 822 (2d Cir. 1942). The Supreme Court of Texas held that a location clause did not violate the state antitrust statutes in Ford Motor Co. v. State, 142 Tex. 5, 175 S.W.2d 230 (1943).

[124] In Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951), the allocation of territory among manufacturers of a product was held to go far beyond protection of the tradename "Timken." According to the Court, on the basis of the "ancillary" theory of United States v. Addyston Pipe & Steel Co., 175 U.S. 211 (1899), the agreement was violative of the Sherman Act because it was not ancillary to a valid trademark licensing transaction. However, in Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403, 409 (5th Cir. 1962), the circuit court distinguished *Timken* and found that the agreement to divide sales territories went no further than protection of the Spring-Air trademarks. Thus the territorial division was upheld.

III. QUALITY CONTROLS

Lanham Act Requirements. Trademark ownership and licensing create a relevant context for a discussion of the desirable quality controls on the franchised manufacturer and retailer. Indeed, a primary and functional objective of any franchise system coincides with an objective of the Lanham Act:[125] uniformity and maintenance of standards of quality in both services and goods throughout business enterprises operating with the same mark. To satisfy the requirements of the Act, a franchisor may employ a variety of methods to enforce prescribed standards. For example, the franchise agreement may provide for the inspection, supervision, or testing by the franchisor,[126] and for training programs for the franchisee or his employees. An Operations Manual may supplement this control with more specific instructions.[127] While none of these methods falls within the purview of federal antitrust laws, quality controls achieved by restricting the purchases or sales by the franchisee will come under antitrust scrutiny. Because such restraints at the same time may satisfy the affirmative duties of the Lanham Act and may afford some of the most effective quality controls, they are perhaps the most difficult features of the franchise relationship to construct.[128]

There are many variations of restrictions on sales and purchases. One of the most common restrictions requires the franchisee to buy supplies from a number of approved sources.[129] A more direct means of quality control compels the franchisee to buy ingredients, parts, accessory items, or the product itself from the franchisor.[130] Frequently this direct means of quality control involves purchases of a tied product from the franchisor[131] or a sponsored product from another manufacturer at the insistance of the franchisor.[132] In order to insure adequate and prompt service, the franchisor may want the franchisee to focus his primary sales on the trademark product. This emphasis on high standards of service to protect the good will of an established brand name or the competitive needs of a new

[125] 15 U.S.C. §§ 1051-1127 (1964). The Lanham Act protects trademark or servicemark property rights by providing for federal registration of the marks. Section 1055 permits licensing of a mark to "related companies . . . provided such mark is not used in such a manner as to deceive the public." Control over the licensee is required by § 1127 which defines "related company" as "any person who legitimately controls or is controlled by the registrant . . . in respect to the nature and quality of the goods and services in connection with which the mark is used."

[126] Engbrecht v. Dairy Queen Co., 203 F. Supp. 714 (N.D. Kan. 1962).

[127] Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

[128] *See* Handler, *Recent Antitrust Developments—1965*, 40 N.Y.U.L. REV. 823, 852 (1965); Pearson, *Tying Arrangements and Antitrust Policy*, 60 NW. U.L. REV. 626 (1966); Comment, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 YALE L.J. 1171 (1963).

[129] Engbrecht v. Dairy Queen Co., 203 F. Supp. 714 (N.D. Kan. 1962). The Dairy Queen franchise agreement provided that franchisees "would use cones, cups, containers, topping, flavoring, coloring and like materials such as could meet the standards of quality and specifications determined by the [franchisor] and . . . the prices of any suppliers so designated should be in line with the prices of others engaged in a similar business . . . ." *Id.* at 716.

[130] Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358 (2d Cir. 1958).

[131] Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965). The Carvel franchise obligated each franchised dealer to purchase directly from Carvel or from a source approved by Carvel his supply not only of the basic Carvel ice cream mix, prepared under a secret formula, but also certain other products used in either the preparation or sale of the Carvel ice cream products. 332 F.2d at 511.

[132] *See* note 169 *infra*.

company may force the franchisor to demand that the franchisee refrain from selling even those items which are not in competition with the trademark products of the franchisor. If the franchisor carries several lines with different trademarks or a variety of items under one trademark, the franchisee may be restricted to a particular line or one product.[133] Courts are faced with the problem of dissecting compounded controls when the franchisor places restrictions on both sales and purchases.

Antitrust Restrictions. In many cases restrictions couched in terms of purchase requirements may have the same effect as direct restraints on sales and differ from such restraints only in terminology. But more often the purpose and effect of restrictions on purchases present important differences and incur stricter treatment under antitrust law. Controls which have the purpose and effect of preventing the franchisee from handling competing products are treated generally as exclusive dealing arrangements,[134] while tying arrangements involve restraints on purchases of the franchisee.

Quality controls restricting sales and purchases of a franchisee come within a number of federal antitrust and regulatory statutes. When the

[133] Nelson Radio & Supply Co. v. Motorola, 200 F.2d 911 (5th Cir. 1952), *cert. denied*, 345 U.S. 925 (1953). In the franchise agreement Motorola, the franchisor, reserved an exclusive right to sell certain communication equipment.

[134] An "exclusive dealing" arrangement places restrictions on the franchisee and the discussion of quality controls in section III of this Comment is limited to the legality of controls which a franchisor may impose on a franchisee. However, a common corollary to dealing restrictions on the franchisee is a reciprocal restriction on the franchisor whereby the franchisor agrees not to franchise or to sell products to another retailer in a given area. Thus, the franchisee is granted an "exclusive dealership." Absent monopoly power, restraints on the commercial activity of the franchisor which enables one franchisee to have an exclusive dealership in an area, have been uniformly upheld by the federal courts when the restraints were attacked by another franchisee whose dealership has been terminated. In such cases the legality of an exclusive dealership is based on the manufacturer's right, as recognized in United States v. Colgate & Co., 250 U.S. 300 (1919), to exercise his own independent discretion as to the parties with whom he will deal. Schwing Motor Co. v. Hudson Sales Corp., 239 F.2d 176 (4th Cir. 1956). *See also* Ace Beer Distribs., Inc. v. Kohn, Inc., 318 F.2d 283 (6th Cir. 1963); Packard Motor Car Co. v. Webster Motor Car Co., 243 F.2d 418 (D.C. Cir. 1957); Brosious v. Pepsi Cola Co., 155 F.2d 99 (3d Cir. 1946); E.A. Weinel Constr. Co. v. Mueller Co., 289 F. Supp. 293 (E.D. Ill. 1968). According to the Federal Trade Commission: "The law is clear that exclusive dealership contracts are virtually *per se* legal, absent monopolization or absent effective competition at the buyer and seller levels." Columbus Coated Fabrics Corp., 55 F.T.C. 1500 (1959). However, the Fourth Circuit remanded a case to determine whether an exception based on agency principles should be made to the general rule that exclusive dealerships are terminable without antitrust consequences. It was reasoned that the franchisee acted as an agent in establishing retail outlets and had apparently spent a considerable sum of money in reliance upon the franchise. Therefore, the trial court was instructed to entertain facts to decide if the franchisee was entitled to damages. Allied Equip. Co. v. Weber Eng'r Prods., Inc., 237 F.2d 879 (4th Cir. 1956).

In Texas when a terminated retailer or franchisee has sued the franchisor, the courts have denied relief to the plaintiff, thus reaching the same result as suits in federal courts involving refusals to deal. The Texas courts, however, have used exactly opposite reasoning. Exclusive dealerships are held to violate Texas antitrust statutes. Climatic Air Distribs. v. Climatic Air Sales, Inc., 162 Tex. 237, 345 S.W.2d 702 (1961); Albin v. Isotron Corp., 421 S.W.2d 739 (Tex. Civ. App. 1967); Robison v. Roberts, 279 S.W.2d 484 (Tex. Civ. App. 1955), *error ref.*; Grand Prize Distrib. Co. v. Gulf Brewing Co., 267 S.W.2d 906 (Tex. Civ. App. 1954), *error ref.* The exclusive dealing contract is deemed to be void; therefore the manufacturer or franchisor has been denied recovery of royalty payments, Patrizi v. McAninch, 153 Tex. 389, 269 S.W.2d 343 (1954), and indebtedness, Morris v. J.I. Case Credit Corp., 411 S.W.2d 783 (Tex. Civ. App. 1967). An exception to the general rule in Texas that exclusive dealership agreements are void exists where an agency relationship is involved or where the agreement is collateral to a lease for premises owned by the franchisor or seller who agrees not to sell to anyone other than the lessee. Schnitzer v. Southwest Shoe Corp., 364 S.W.2d 373 (Tex. 1963).

general language of the Sherman Act proved inadequate to test exclusive dealing arrangements,[135] the Clayton Act[136] was passed to fill the gap in the antitrust laws. Its construction is the crucial key to the legality of such arrangements in most cases. The Clayton Act expressly prohibits both kinds of restrictions under certain circumstances, but the specific language of section 3 of the Act limits its application:

> It shall be unlawful for any person . . . to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented . . . or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodity of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.[137]

Quality controls also may be subject to scrutiny under the anti-merger section 7 of the Clayton Act,[138] sections 1 and 2 of the Sherman Act,[139] the Robinson-Patman Act,[140] and section 5 of the Federal Trade Commission Act.[141]

Despite this impressive array of federal statutes, exclusive dealing arrangements and, less frequently, tying arrangements withstand antitrust charges. The broader rule of reason or a quasi per se test permitting the introduction of evidence justifying an exclusive dealing restriction, rather than a strict per se test, is applied to test the legality of these restraints in cases involving alleged violations of section 1 of the Sherman Act and section 3 of the Clayton Act. A franchisor legally may require the licensee of a trademark to obtain the franchisor's approval of suppliers of ingredients or parts, unless the circumstances of a monopoly or unfair trade practices exist.[142] Under the protective umbrella of trademark requirements, contract provisions designating suppliers have been upheld by the courts of the Fifth[143] and Second Circuits.[144] In addition, because a *substantial* lessening of competition is required under section 3 of the Clayton Act, the courts have been unable to fashion a strict per se doctrine to be applied to tying agreements.

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[135] *E.g.*, Whitwell v. Continental Tobacco Co., 125 F. 454 (8th Cir. 1903); *and see* cases cited in M. Handler, Trade Regulation 542 (4th ed. 1967).

[136] 38 Stat. 731 (1914), 15 U.S.C. §§ 12, 13, 14, 19, 20, 21, 22-27, 44 (1964), 29 U.S.C. §§ 52, 53 (1964).

[137] 15 U.S.C. § 14 (1964).

[138] *Id.* § 18.

[139] 26 Stat. 209 (1890), *as amended*, 15 U.S.C. § 1 (1964).

[140] 38 Stat. 730 (1914), *as amended*, 15 U.S.C. § 13 (1964); *see* Stanton v. Texaco, Inc., 289 F. Supp. 884 (D.R.I. 1968) (price discrimination).

[141] 38 Stat. 719 (1914), *as amended*, 15 U.S.C. § 45 (1964).

[142] Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

[143] Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403 (5th Cir. 1962).

[144] Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

Exclusive Dealing. There are two types of exclusive dealing contracts which the courts have examined: requirements contracts and agreements that the buyer will not carry a competing line.[145] Early cases determined the illegality of such contracts or agreements by finding that the seller occupied a dominant position in the relevant market.[146] Thus, the illegal effect of substantially lessening competition was shown by proof of control over two-fifths of the retailers in a market.[147] In the last two decades the attitudes of the Supreme Court and the Federal Trade Commission have fluctuated in their treatment of exclusive dealing provisions. In *Standard Oil Co. v. United States*,[148] a 1949 decision, the Supreme Court indicated that, regardless of the fact that Standard did not have a dominant position in the market, the requirements contract should be subject to a quasi per se test. The Court, adopting a "quantitative substantiality" standard of proof,[149] held that the qualifying clause of section 3 was satisfied by proof that the contract covered "a substantial share of the line of commerce affected."[150] A gross business sales totaling 6.7 per cent of the total sales in the relevant market was deemed to be a substantial share of the market. Thus, it was unnecessary for the Government to demonstrate that competitive activity had actually diminished or probably would diminish. Moreover, Standard's evidence of an increase in the number of its competitors was properly excluded. While lower courts[151] varied in the application of the *Standard Oil* decision, the Federal Trade Commission failed to follow the Court's standard of proof and continued to examine all relevant factors, including evidence of new competition in the market.[152]

In the 1960's the courts and the Federal Trade Commission reversed their positions with regard to the standard of proof necessary to establish a violation in exclusive dealing cases.[153] The Supreme Court in *Tampa Electric Co. v. Nashville Coal Co.*[154] stressed the need "to weigh the probable effect of the contract on the relevant area of effective competition,"[155] regardless of the fact that a substantial share of the market might be affected. In *Brown Shoe Co.*,[156] however, the Federal Trade Commission utilized its broader authority under section 5 of the FTC Act, and applied a quasi per se test to declare illegal the restrictions on independent shoe retailers who, nevertheless, were called franchisees of Brown Shoe. Viola-

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[145] *See* note 134 *supra* for the scope of the discussion of exclusive dealing arrangements and for a brief account of the legality of exclusive dealership contracts.

[146] Fashion Originators' Guild v. Federal Trade Comm'n, 312 U.S. 457 (1941); *cf.* Pearsall Butter Co. v. Federal Trade Comm'n, 292 F. 720 (7th Cir. 1923).

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

[148] 337 U.S. 293 (1949).

[149] *Id.* at 298.

[150] *Id.* at 314. The Court followed the reasoning of International Salt Co. v. United States, 332 U.S. 392 (1947), and stated that the test of substantiality for the applicability of the Clayton Act to requirements and tying contracts should be the same.

[151] *E.g.*, Transamerica Corp. v. Board of Governors, 206 F.2d 163 (3d Cir. 1953).

[152] Maico Co., 50 F.T.C. 485 (1953).

[153] *See* ANTITRUST DEVELOPMENTS 1955-1968, SUPPLEMENT TO THE REPORT OF THE ATTORNEY GENERAL'S NAT'L COMM. TO STUDY THE ANTITRUST LAWS, MARCH 31, 1955 (prepared by ABA Antitrust Section 1968).

[154] 365 U.S. 320 (1961).

[155] *Id.* at 329.

[156] 62 F.T.C. 679 (1963).

tion of the FTC Act was shown by the fact that the *largest* producer of shoes in the United States required retailers not to sell lines which would compete with its lines. The Supreme Court affirmed the Commissioner's use of the market dominance test,[157] but the history of illegal monopoly by Brown Shoe Co.[158] and the lack of identity between the company and its retailers distinguished the case from other cases involving exclusive dealing contracts.

By a rationale similar to that used in *Tampa Electric*, exclusive dealing contracts have been held to be legal where the particular arrangement had a reasonable economic basis and the seller did not have a monopoly.[159] For example, in a suit between an outboard motor distributor and the manufacturer, evidence of "squalor and poor organization," failure to give adequate dealer service to purchasers, and a poor accounting system justified a termination of the dealership when the distributor began to sell a competing line of engines.[160]

Perhaps the most significant case for the majority of franchise distributorships is *Susser v. Carvel Corp.*[161] which upheld an exclusive dealing arrangement on the basis of trademark protection. In order effectively to analyze the restraints placed upon the chain of 400 franchise ice cream stores, the court was required to dissect the price maintenance, exclusive dealing, and tying features of the Carvel franchise system. The charge of illegal exclusive dealing was based on a provision in the franchise contract which required the dealer to sell only Carvel trademark products. The court of appeals relied on the factor "which the Supreme Court had deemed significant in *Tampa Electric*—that of economic justification"[162] to uphold the limitation. Economic justification was found in *Carvel* in the licensing of the trademark. The court explained:

> The antitrust laws certainly do not require that the licensor of a trademark permit his licensees to associate with that trademark other products unrelated to those customarily sold under the mark . . . . Trademark licensing agreements requiring the sole use of the trademarked item have withstood attack under the anti-trust laws where deemed reasonably necessary, to protect the goodwill interest of the trademark owner . . . .[163]

One commentator has suggested that *Susser v. Carvel Corp.* should be read in connection with *FTC v. Brown Shoe Co.*[164] which he considers "unrelated to franchising of the type we encounter most of the time—entire retail business licensing."[165] Apparently the Federal Trade Com-

[157] Federal Trade Comm'n v. Brown Shoe Co., 384 U.S. 316 (1966), *rev'g* 339 F.2d 45 (8th Cir. 1964).

[158] *See* Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

[159] *E.g.*, Bascom Launder Corp. v. Telecoin Corp., 204 F.2d 331 (2d Cir.), *cert. denied*, 345 U.S. 994 (1953).

[160] Amplex of Md., Inc. v. Outboard Marine Corp., 380 F.2d 112, 114 (4th Cir. 1967).

[161] 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

[162] *Id.* at 516.

[163] *Id.* at 517.

[164] 384 U.S. 316 (1966).

[165] Fels, *Franchising; Legal Problems and the Business Framework of Reference—An Overview*, in BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE TRANSCRIPT 4, 47 (J. McCord & I. Cohen eds. 1968). He noted these distinguishing features: the secrecy of Carvel's formula, the

mission agrees with the distinction that Carvel was dealing with its own franchised outlets whereas Brown Shoe was dealing with retailer outlets which were not Brown Shoe stores.[166]

The *Colgate* doctrine, permitting a mere refusal to deal where the franchisee will not agree to sell exclusively the franchisor's product, has given a degree of protection to a franchisor's "right of customer selection."[167] This right has been invoked as a defense to antitrust charges by both franchisor and manufacturers and has been recognized by the courts in suits brought under the Sherman Act or the Clayton Act.[168]

To find a violation of either the Sherman or Clayton Act, a court must find that there is an agreement to deal exclusively and that the arrangement is unreasonable. The failure to plead the factual grounds for a conspiracy or agreement has prevented recovery in a number of treble damage suits.[169] However, the Government has been successful in proving a violation of section 1 by introducing evidence of oral agreements imposed by an oil company on its lessees to deal exclusively in its products or its sponsored "TBA" products.[170] In a suit involving the same oil company,[171] the Ninth Circuit held that both a manufacturer of a competing line of car wax and its distributors had a cause of action for treble damages against the oil company. As in price fixing cases, an illegal agreement may be shown by a course of conduct even though the written contract does not provide for exclusive dealing.[172]

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problem in policing the food product, and the complete involvement of the Carvel name in the entire operation of each.

[166] Federal Trade Commissioner Mary Gardner Jones has stated that "the distribution arrangements involved in the *Brown Shoe*, *Schwinn* and *GM* cases, in my judgment, were not what I would call pure franchising arrangements." Jones, *Franchising From the Standpoint of the Federal Trade Commission*, in BUSINESS AND LEGAL PROBLEMS OF THE FRANCHISE TRANSCRIPT 249, 263 (J. McCord & I. Cohen eds. 1968). Commissioner Jones then mentioned the *Carvel* case specifically: "The distinction between a distribution system such as I believe was involved in *Schwinn*, for example, and a true franchise arrangement such as was involved in the *Carvel* case is an important one." *Id.* at 264. Another indication of the Commission attitude toward entire business licensing is the voluntary dismissal of the *Carvel* suit. *See also* Wilson, *An Emerging Enforcement Policy for Franchising*, 15 N.Y.L.F. 1 (1969).

[167] McElhenney Co. v. Western Auto Supply Co., 269 F.2d 332, 337 (4th Cir. 1959). *See also* Hudson Sales Corp. v. Waldrip, 211 F.2d 268 (5th Cir. 1954); Nelson Radio & Supply Co. v. Motorola, 200 F.2d 911 (5th Cir. 1952), *cert. denied*, 345 U.S. 925 (1953).

[168] Timken Roller Bearing Co. v. Federal Trade Comm'n, 299 F.2d 839 (6th Cir. 1962); Leo J. Meyberg Co. v. Eureka Williams Corp., 215 F.2d 100 (9th Cir.), *cert. denied*, 348 U.S. 875 (1954). In each case no violation of the Clayton Act was found. For suits brought under the Sherman Act or both Acts see *supra* notes 159, 160, and *infra* note 169.

[169] Nelson Radio & Supply Co. v. Motorola, 200 F.2d 911 (5th Cir. 1952), *cert. denied*, 345 U.S. 925 (1953). The court stated that: "It is the well recognized rule that in pleading a conspiracy in an action such as this, a general allegation of conspiracy, without a statement of the facts constituting the conspiracy to restrain trade, its object and accomplishment, is but an allegation of a legal conclusion, which is insufficient to constitute a cause of action." *Id.* at 913-14. The factual defect consisted of the fact that a corporation cannot conspire with itself and its agents, who were employees of the franchisor-corporation. The *Nelson* holding was criticized in Walker Distrib. Co. v. Lucky Lager Brewing Co., 323 F.2d 1 (9th Cir. 1963), as going too far in requiring details in an antitrust complaint. Apparently a general allegation of conspiracy was sufficient to indicate a combination between the manufacturer and other distributors or one among the distributors.

[170] United States v. Richfield Oil Corp., 99 F. Supp. 280 (S.D. Cal. 1951), *aff'd per curiam*, 343 U.S. 922 (1952). "TBA" is the expression used frequently by the courts to denote tires, batteries, and accessories. *See also* note 175 *infra*.

[171] Karseal Corp. v. Richfield Oil Corp., 221 F.2d 358 (9th Cir. 1955).

[172] McElhenney Co. v. Western Auto Supply Co., 269 F.2d 332 (4th Cir. 1959).

Tying Arrangements. A tying arrangement constitutes a specific type of exclusive dealing contract in which two distinct products are involved. The buyer is forced to take an undesired second item in order to purchase the one he does want. Because of distinctions between exclusive dealing agreements and tying arrangements, courts have required greater justification before tying arrangements escape antitrust charges.[173] The gravamen of the tying arrangement is the use by the seller of his economic power in one market to lessen competition in another. Therefore, the amount of market foreclosure necessary to prove a violation of section 3 of the Clayton Act is significantly less for a tying arrangement than for an exclusive dealing contract.[174] A quasi per se rule is applied to tying arrangements under section 3 of the Clayton Act and section 1 of the Sherman Act.[175]

The Court's formulation of per se principles to test the legality of tying arrangements at times has been unclear because of the persistent problem of determining what degree of control over the market of the tying product is sufficient to support the inference that competition has been, or probably will be, lessened. In early cases under section 3 the inference that the seller dominated the market to the exclusion of any other was supported if the tying product were patented.[176] However, in *International Salt Co. v. United States*[177] the use of a patented machine to tie purchases of salt was not a controlling issue. It was not shown that equivalent machines were unavailable or that the defendant controlled the market of the patented machines. In determining that a summary judgment was proper, the Supreme Court held that proof of adverse economic consequences and the unreasonableness of the restraint was unnecessary since

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[173] *See* Austin, *The Tying Arrangement: A Critique and Some New Thoughts*, 1967 WIS. L. REV. 88 (1967); Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50 (1958). *See also* Advance Business Systems & Supply Co. v. SCM Corp., 287 F. Supp. 143 (D. Md. 1968).

[174] Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965); *cf.* Standard Oil Co. v. United States, 337 U.S. 293 (1949); *see* note 150 *supra*.

[175] A quasi per se rule has also been applied under § 5 of the Federal Trade Commission Act to arrangements which are similar to tying arrangements but involve two sellers acting in conjunction. The Federal Trade Commission in three related proceedings successfully attacked agreements between three major oil companies and major tire manufacturers for the promotion of TBA sales and for sales commissions to be paid to the oil company which promoted the TBA among its retailers. Federal Trade Comm'n v. Texaco, 393 U.S. 223 (1968); Atlantic Ref. Co. v. Federal Trade Comm'n, 381 U.S. 357 (1965); Shell Oil Co. v. Federal Trade Comm'n, 360 F.2d 470 (5th Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). In the *Texaco* case, Texaco did not contest the conclusions of the District of Columbia Circuit court (Texaco v. Federal Trade Comm'n, 383 F.2d 942, 946 (D.C. Cir. 1967)) and the Fifth Circuit in *Shell* that dominant economic power over gasoline dealers is "inherent in the structure and economics of the petroleum distribution system" (360 F.2d at 481). The Supreme Court in *Texaco* found that such a sales commission system is "inherently coercive" and has an adverse effect on competition in a not insignificant volume of commerce, based on an annual volume of purchases by retail dealers of $245,000,000. 393 U.S. at 230, 231. *See also* Osbur v. Sinclair Ref. Co., 286 F.2d 832 (4th Cir. 1960), where the circuit court treated the arrangement between Sinclair and Goodyear as a per se illegal tie-in arrangement.

Another type of arrangement related to tie-in agreements has come under recent attack by the Justice Department. Two cases were filed against reciprocal dealings as the sole alleged offense in violation of § 2 of the Sherman Act. N.Y. Times, June 14, 1969, at 1, col. 8 (city ed.). U.S. Steel Corp., charged with violation of the Act, entered into a consent decree.

[176] *See* Bowman, *Tying Arrangements and the Leverage Problem*, 67 YALE L.J. 19 (1957).

[177] 332 U.S. 392 (1947).

the "volume of business affected" by the tying contracts was significant or substantial.[178]

The Supreme Court has since backed away from its holding in *International Salt.* In *Times-Picayune Publishing Co. v. United States*[179] two standards of proof for establishing the illegality of tying arrangements were discussed:

> When the seller enjoys a monopolistic position in the market for the 'tying' product, *or* if a substantial volume of commerce in the 'tied' product is restrained, a tying arrangement violates the narrower standards expressed in § 3 of the Clayton Act because from either factor the requisite potential lessening of competition is inferred. And because for even a lawful monopolist it is 'unreasonable, *per se*, to foreclose competitors, from any substantial market,' a tying arrangement is banned by § 1 of the Sherman Act whenever *both* conditions are met. In either case, the arrangement transgresses § 5 of the Federal Trade Commission Act.[180]

Control of forty per cent of the newspaper advertising market was insufficient to support a per se violation of the Sherman Act. Alternatively, the Court found that no tying problem existed because it considered that only one product was sold.[181]

Since 1953 the Supreme Court has revised the content of the dual test in *Times-Picayune* but not the form. In 1958 the requirement of a monopolistic position was redefined to mean "sufficient economic power to impose an appreciable restraint" in order to prove a per se violation of the Sherman Act.[182] The Court used the *International Salt* decision as the basis for upholding a summary judgment declaring the tying arrangement illegal.[183] The tying product was "strategically located"[184] land within economic distance of transportation facilities owned by the lessor and was essential to the business activities of some lessees. In a subsequent case the Court again rejected market dominance as the only test of whether a seller has the requisite economic power illegally to tie a product.[185] Absent market dominance, "the crucial economic power may be inferred from the tying products desirability to consumers or from uniqueness of its attributes."[186] In that case a copyright created a presumption of the requisite uniqueness.

A further definition of the degree of market power necessary to support a per se violation occurred in 1969 in *Fortner Enterprises, Inc. v. United States Steel Corp.*,[187] a decision which sharply divided the Court. Although the tying arrangement was said to be the "traditional kind,"[188] the significance of the particular tying product—credit—had not been

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[178] *Id.* at 396.
[179] 345 U.S. 594 (1953).
[180] *Id.* at 608-09.
[181] *Id.* at 614.
[182] Northern Pac. Ry. v. United States, 356 U.S. 1, 11 (1958).
[183] 142 F. Supp. 679 (W.D. Wash. 1956).
[184] 356 U.S. at 7.
[185] United States v. Loew's, Inc., 371 U.S. 38 (1962).
[186] *Id.* at 45.
[187] 394 U.S. 495 (1969).
[188] *Id.* at 498.

previously considered by the Supreme Court. In reversing a summary judgment for defendant corporation and remanding, the Supreme Court noted that proof of the uniquely advantageous terms of the credit raised questions of fact which could bring the arrangement under the per se rule. There were apparently three factors alleged by the plaintiff which compelled the Court to reverse the lower court's finding of insufficient economic power: (1) the substantial price differential of the tied product (prefabricated homes) over the current market price which in a truly competitive market the buyers would not have accepted, (2) "uniquely and unusually advantageous terms"[189] offered with the tying credit, and (3) evidence of the creditor's unique economic ability to provide 100 per cent financing at low rates. The two dissents in *Fortner*[190] not only questioned whether a tying arrangement was actually involved but also whether, assuming a tying arrangement, there was sufficient showing of any market power. Justice White felt that "low price in the tying product—money, the most fungible item of trade since it is by definition an economic counter—is especially poor proof of market power."[191]

The reach of the *Fortner* decision may be narrower than the "vast and destructive" effect speculated by the dissent of former Justice Fortas. As he pointed out, "[i]t is common in our economy for a seller to extend financing to a distributor or a franchisee to enable him to purchase and handle the seller's goods at retail, to rent facilities, to acquire fixtures or machinery for service to customers . . . ."[192] However, since the majority distinguished credit sales, which would involve only a single product, the *Fortner* decision may not apply to most credit transactions. Moreover, it may have no significance for "pure" franchise arrangements.

As the Supreme Court noted, on remand the defendants could either prove that they did not have a competitive advantage or could justify the tying arrangement by showing legitimate business purposes. Some cases have supplied examples of such legitimate reasons for tying arrangements. The First Circuit held that proof of a majority of dissatisfied customers was sufficient to justify a tying contract for the purpose of preventing complaints.[193] The Supreme Court found economic justification in a company's attempt to establish a new product line, but the lawfulness of the tying contract at its inception did not continue once the line was established.[194]

In credit transactions between a franchisor and the licensee of his trademark quality controls could justify a tying arrangement. Indeed, in *Susser v. Carvel Corp.*[195] there was involvement of the trademark in the entire business operation of the franchisee. The Second Circuit held that arrange-

[189] *Id.* at 505.
[190] *Id.* at 510 (White, J., joined by Harlan, J.); *id.* at 520 (Fortas, J., joined by Stewart, J.).
[191] *Id.* at 515.
[192] *Id.* at 524.
[193] Dehydrating Process Co. v. A.O. Smith Corp., 292 F.2d 653 (1st Cir. 1961).
[194] United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).
[195] 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

ments tying supplies may be immunized if the tying contract is useful in fulfilling the obligations of the Lanham Act and protecting the good will of the trademark licensor, or if the specifications for products to be substituted "would be so complex and detailed as to make it impracticable . . . to establish such specifications."[196] Judge Friendly not only found justification for the Carvel arrangement, but he agreed that Carvel's trademark lacked the prominence to give it sufficient economic power to create an illegal tying contract in the first place.

One aspect of the *Carvel* decision should be a source of caution to the franchisor, especially if machines or services are involved or if no trade secrets give the franchisor added economic justification.[197] Although Chief Judge Lumbard's discussion of the tying arrangement did not prevent affirmance of their validity, his attitude invites caution. He believed that the requisite economic leverage for an unlawful agreement could be presumed from the license of the Carvel trademark itself, buttressed by the "array of patents and subsidiary trademarks,"[198] which composed the tying product. Thus, the significance of the trademark was equated with the power generated by a patent or copyright. However, neither the Second nor the Fifth Circuit has accepted the disastrous implications of Chief Judge Lumbard's analogy for a small sized franchise distribution system of the Carvel type.[199] Moreover, the Federal Trade Commission refused to find that a tying arrangement was involved in Carvel's system. According to Commissioner Jones, "the sale to the licensee of the mix and other products cannot really be separated from the license. Both were necessary in combination to permit the dealer to exercise fully the license."[200]

IV. Conclusion

An overview of decisions affecting the legality of restraints in the three categories of franchise practices indicates that the courts are expanding the application of the strict per se test of unreasonableness under federal antitrust statutes and are continuing to develop a quasi per se test for tying arrangements. The expansion of a strict per se doctrine has limited the controls which a franchisor may maintain over a franchisee. Because of the *Parke, Davis* decision, proof of an implicit agreement from a course of conduct will satisfy the statutory demand for a combination under section 1 of the Sherman Act in any case challenging a restriction on price, territory, purchases, or sales of a franchisee. Territorial and customer restraints vertically imposed are expressly foreclosed except in an agency relationship.

The Supreme Court, in holding territorial or customer restraints on

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[196] 332 F.2d at 515.

[197] The law has a "high regard" for the protection of trade secrets. Handler, *Recent Antitrust Developments—1965*, 40 N.Y.U.L. Rev. 823, 858 (1965); *see* cases cited therein.

[198] 332 F.2d at 513. *See also* United States v. Guerlain, Inc., 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated and remanded*, 358 U.S. 915 (1958), *motion to dismiss granted*, 172 F. Supp. 107 (S.D.N.Y. 1959).

[199] Denison Mattress Factory v. Spring-Air Co., 308 F.2d 403 (5th Cir. 1962).

[200] Susser v. Carvel, 1965 Trade Cas. ¶ 71,435, at 80,887 (F.T.C. 1965).

goods sold illegal, applied the per se rule directly to features of franchise systems which are long established, considerably large and successful. It remains for future cases to determine whether the blanket language of the *Schwinn* case will be modified in cases involving new or failing companies. The emphasis on the horizontal-vertical distinction in *Sealy*, which was decided at the same time as *Schwinn*, provides the foundation for a narrowing of the *Schwinn* opinion. If the *Sealy* emphasis cannot serve that function, then the Court was misleading in its review of the per se illegality of horizontal restraints and recognition that vertical restrictions have a different character. If modification is made after the Court has had more opportunities to investigate the economic impact of various types of franchise systems, an exception to the *Schwinn* holding could be made on the basis of trademark protection required by the Lanham Act. However, it would be necessary for Congress to make a statutory exception to the antitrust laws for territorial and customer restrictions in a franchise context if the per se test is not to be applied to the majority of such restraints.[201] Regardless of what change the future may hold, for the present the position of the law with regard to vertical restraints for purposes of market division is similar to the approach of the early decisions condemning resale price fixing. It leaves a franchisor the hazardous alternative of announcing a policy which is potentially a per se violation and then refusing to deal with an uncooperative franchisee in the hope of proving unilateral action and establishing a *Colgate*-type precedent.

Admittedly, a per se rule has certain benefits, if the scope of its application is clear.[202] The difficult task of government enforcement of the antitrust laws is facilitated. In addition, implementing a per se doctrine will simplify private actions for treble damages to determine the legality of territorial restraints or tying arrangements in suits which otherwise would be too costly or too complex. The *Schwinn* decision may cause renewed efforts to stimulate intrabrand competition which is not detrimental to interbrand competition. For example, in granting a primary area of responsibility a franchisor will be prompted to offer protection to each franchisee by requiring the forwarding of inquiries from customers outside the franchisee's territory and at the same time promote competition among the licensees by permitting each to sell to the potential buyer.[203]

Exceptions to the strict per se rule have not been made because a fran-

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[201] Legislation has been proposed in Congress to permit territorial and customer restrictions vertically imposed by a franchisor. S. 2549, 89th Cong., 2d Sess. (1966); H.R. 974, 90th Cong., 1st Sess. (1967).

[202] *See* Comanor, *Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath*, 81 HARV. L. REV. 1419 (1968).

[203] An agreement of apparently recent date granting the franchisee a primary area of responsibility had the following clause, the legality of which is doubtful:

> When Licensee receives inquiry(ies) from any firm or organization having autonomous branches outside Licensee's territory, Licensee shall (attempt to sell [to] only those branches of said firm or organization located within Licensee's territory; and, simultaneously, shall) advise [the franchisor] Company of said inquiry(ies), and the addresses of those branches located outside Licensee's territory. Company then will alert all other Licensees in whose respective territories said branches are located.

If the phrase in parentheses—"attempt . . . shall"—is omitted the provision would be a legal restriction.

chise relationship exists between the parties to an illegal agreement. However, where a quasi per se rule is used or where the broader reasonableness test is applied, a franchise relationship which commonly is buttressed by trademark rights has provided economic justification to prove that a restraint is reasonable and thus legal. The courts have been most sensitive and willing to apply the rule of reason to the needs of a franchisor to protect his trademark and goodwill, and it is in the area of quality controls that the rule of reason should play the significant role.