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Hugo A. Hilgendorff\_III

Terence M. Troyer

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## CONTROL OF NON-INTEGRATED DISTRIBUTION SYSTEMS: FRANCHISES AND FREE COMPETITION

In recent years the desire of an established business to acquire efficient new outlets for its products and the desire of individuals to become independent businessmen for a minimum capital outlay have combined to produce the "franchise"<sup>1</sup> system, in which the established company supplies the individual with a trademark, trade name or trademarked product, absorbs a large part of the capital requirement and provides continuing advice on methods of operation.

The ends of the parties, however, are not entirely compatible. The franchisor seeks to control the business of his franchisee in order to obtain the most efficient distribution of his goods. Because of his usually superior bargaining power, he can impose certain control devices which may result not only in loss of independence by the franchisee, but also in antitrust violations.

This comment will consider three of the most common control devices against the background of their anticompetitive consequences: (1) maintenance of resale prices; (2) limitation of the market in which the franchisee may operate; and (3) restrictions on the source of products in which the franchisee deals.

### I. PRICE FIXING

Price fixing, vertical or horizontal,<sup>2</sup> has been held a per se violation of the antitrust laws when it has not been achieved pursuant to a state fair trade statute.<sup>3</sup> Price fixing is considered a per se violation because of the direct anticompetitive effects which result whether or not the price-fixing party is dominant in the relevant market.<sup>4</sup>

In seeking to evade the rule against price fixing,<sup>5</sup> franchisors have made use of consignment agreements, devices additionally attractive because of the protection which they may offer against interference by franchisees' creditors.<sup>6</sup> Conceptually, under consignment law the franchisee is merely the

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<sup>1</sup> Franchise—"the right granted to an individual or group to market a company's goods or services in a particular territory." Webster's Third New International Dictionary (1963). In this comment the term franchise is taken to include not only the arrangement where a dealer sells the trademarked goods of a producer under his own or the producer's trade name, but also where the dealer is licensed to use a trademark in his own production of the goods.

<sup>2</sup> Vertical price fixing is that occurring between parties on different distribution levels; horizontal price fixing is that occurring between parties on the same distribution level.

<sup>3</sup> *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964). State fair trade laws may be enacted pursuant to the Miller-Tydings Amendment to the Sherman Act, 50 Stat. 693 (1937), 15 U.S.C. § 1 (1964) and the McGuire Act, 66 Stat. 632 (1952), 15 U.S.C. § 45 (1964).

<sup>4</sup> *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

<sup>5</sup> Some indirect methods of price maintenance may be legally employed. General advertising of a suggested retail price by the franchisor may be effective—provided there is no agreement between franchisor and franchisee to fix prices. Where franchisor sells the product to franchisee, he may also set his price so that the average franchisee can make a profit if he sells at the suggested price but not if he sells for less.

<sup>6</sup> See U.C.C. § 2-326.

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franchisor's agent, and the price set by the franchisor is not a resale price because title remains in the franchisor until purchase by the consumer. The Supreme Court, however, has not allowed niceties of form to control over anticompetitive substance. In *Simpson v. Union Oil Co.*,<sup>7</sup> the Court held that use of a consignment agreement to achieve retail price maintenance was illegal under Section 1 of the Sherman Act.<sup>8</sup> Similarly, in *Atlantic Ref. Co. v. FTC*,<sup>9</sup> the court of appeals affirmed a determination that use of a consignment agreement to maintain prices during a gasoline price war was a violation of the Federal Trade Commission Act.<sup>10</sup>

Where the franchisor sells the trademarked goods to the franchisee, he may seek to justify price fixing on the ground of protecting his trademark against degradation by discount selling. However, even if the buying public associates low price with poor quality as assumed, discount selling does not generally degrade a trademark. Much of a suggested or fixed<sup>11</sup> price is allowance for a franchisee's overhead. A discount franchisee having lower overhead costs may reduce the price without an appreciable sacrifice in profit. Since the cost of all goods in his store is lower, the trademarked item retains the relative position of price superiority which it enjoys in nondiscount stores. Thus the buyer who shops only at the discount store is not misled by its price as to its quality, and the buyer who shops at both types of stores knows the quality of goods for which he is shopping.

Where the franchisee manufactures the trademarked goods,<sup>12</sup> an argument in justification of price fixing is that unless the franchisee observes minimum prices, he will not realize a sufficient return through sales to maintain the product quality required by the franchisor. A similar argument is the basis of state minimum milk price statutes.<sup>13</sup> The situations, however, are not analogous; and it is doubtful that the professed purpose of the ar-

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<sup>7</sup> *Supra* note 3.

<sup>8</sup> As amended, 50 Stat. 693 (1937), as amended, 15 U.S.C. § 1 (1964):

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

<sup>9</sup> 344 F.2d 599 (6th Cir. 1965), cert. denied, 34 U.S.L. Week 3201 (U.S. Dec. 7, 1965) (No. 558).

<sup>10</sup> §5, as amended, 52 Stat. 111 (1938), as amended, 15 U.S.C. § 45 (1964):

(a) (1) Unfair methods of competition in commerce, and unfair or deceptive acts or practices in commerce, are declared unlawful. . . .

(6) The Commission is empowered and directed to prevent persons, partnerships, or corporations, except banks, common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to the Federal Aviation Act of 1958, and persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act, 1921, as amended, except as provided in section 227(a) of Title 7, from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce.

<sup>11</sup> Price fixed pursuant to a state fair trade statute.

<sup>12</sup> See, e.g., *Denison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403 (5th Cir. 1962), where licensor manufactured nothing but merely advertised the goods made by its licensees.

<sup>13</sup> See, e.g., Mass. Ann. Laws ch. 94A, § 10 (1958).

rangement will be accomplished because franchisees will not voluntarily observe the quality standard when by so doing they will make less profit.

Several reasons suggest the conclusion that courts will not permit a franchisor to justify price fixing on the ground of trademark protection. Price fixing decreases the independence of the franchisee to a degree incommensurate with the trademark protection obtained by the franchisor. Other methods of protection which engender less anticompetitive effects may be employed. Further, there are already decisions holding price fixing illegal per se<sup>14</sup> and others severely limiting the use of consignment devices for price-fixing purposes.<sup>15</sup>

## II. DIVISION OF MARKET

In *White Motor Co. v. United States*,<sup>16</sup> the Supreme Court intimated<sup>17</sup> that a different standard might be applied to vertical divisions of market—those imposed by and for the benefit of a noncompetitor<sup>18</sup>—than that applied to horizontal divisions<sup>19</sup>—those arranged between competitors. The Court did not, however, indicate what that standard would be.<sup>20</sup> This section of the comment discusses the use of vertical divisions in the franchise operation. Such divisions are accomplished in two ways: the geographical area in which a franchisee may sell can be limited, or the type of customer to whom he may sell can be restricted.

Two methods are commonly used in limiting the geographical area in which a franchisee may sell.<sup>21</sup> In the "exclusive" territorial division, the franchisor guarantees that no other franchise will be established within the territory. The franchisee, in turn, agrees to concentrate his business within the territory, to insure that it is adequately covered, and not to solicit business or make sales outside the territory. He may, however, sell to anyone who comes into the territory. In the "closed" territorial division, the fran-

<sup>14</sup> E.g., *United States v. Socony-Vacuum Oil Co.*, supra note 4.

<sup>15</sup> *Simpson v. Union Oil Co.*, supra note 3; *Atlantic Ref. Co. v. FTC*, supra note 9.

<sup>16</sup> 372 U.S. 253 (1963).

<sup>17</sup> The Court refused to adjudicate the matter on summary judgment. On remand, White signed a consent decree. *United States v. White Motor Co.*, 1964 Trade Cas. 79762 (N.D. Ohio).

<sup>18</sup> A threshold question is whether a vertical division of market differs in any respect from a horizontal division. Even when it is determined that a division has been imposed by the franchisor for his own benefit and not at the instigation of his franchisees, the division produces precisely the same effect on competition as does a horizontal agreement. The reality of the situation is that the franchisor, for his own reasons, seeks to obtain the benefits of noncompetitive marketing for his franchisees. Part of the benefits he succeeds in providing will then be reflected in his own business. In justification of this type of arrangement it has been suggested that the anticompetitive effect is ancillary to the franchisor's legitimate ends; perhaps it is more correct to say that the franchisor's ends are ancillary to the restraint on competition.

<sup>19</sup> A horizontal division of market is illegal per se. *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951).

<sup>20</sup> It is expected that cases now before the Court will fill this gap. *United States v. Sealy, Inc.*, 1964 Trade Cas. 80070 (N.D. Ill.), prob. juris. noted, 86 Sup. Ct. 58 (1965) (No. 238); *United States v. General Motors Corp.*, 234 F. Supp. 85 (S.D. Calif. 1964), prob. juris. noted, 380 U.S. 940 (1965) (No. 820, 1964 Term; renumbered No. 46, 1965 Term).

<sup>21</sup> *Sandura Co. v. FTC*, 339 F.2d 847 (6th Cir. 1964).

chisee is completely prohibited from selling to anyone who does not maintain a place of business (or residence if the product is of a type sold to individuals) in his territory. In both instances, there is at least a tacit understanding that all other franchisees will be similarly bound and that the territories will not overlap. Both exclusive and closed arrangements are subject to vigorous attack by the Government and private litigants.<sup>22</sup>

The purpose for which territorial divisions are employed and which is said to justify their use is to provide solutions for the following problems. First, suitable franchisees cannot be attracted without a guarantee of sufficient territory to provide an adequate profit.<sup>23</sup> Second, franchisees are unwilling to supplement their franchisor's national advertising with the local promotion required for saturation unless they are assured that the fruits of their labor will return solely to them.<sup>24</sup> And third, if permitted to sell the franchisor's product without territorial restraint, franchisees will compete with one another for the easier or larger sales without expending sufficient effort to make the more difficult or smaller ones.<sup>25</sup>

Although use of either closed or exclusive territories will provide a solution for these problems, exclusive territories will do so somewhat less efficiently than closed territories.<sup>26</sup> First, exclusive territories used to attract franchisees would need to be larger than equivalent closed territories since exclusive territories are not as effective in guaranteeing a market. Second, a franchisee with an exclusive territory would be assured a return from his advertising investment only if he was reasonably competitive with neighboring franchises. Third, the franchisor would be forced to design and enforce some method—such as a quota system—of requiring franchisees to cultivate their own territories adequately.

In spite of the economic inefficiency of exclusive territories, they are preferable to closed territories because they impose less of a restraint on competition.<sup>27</sup> The effect of establishing closed territories is to create local monopolies in the franchisor's product.<sup>28</sup> A consumer must deal with "his" franchisee if he wishes to purchase that product, no matter how unfavorable the terms. A system of exclusive territories, however, merely makes it convenient to deal with the franchisee in the consumer's home territory. If sufficiently attractive terms are available elsewhere, the consumer will deal there,

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<sup>22</sup> Exclusive territories have been attacked in *Snap-On Tools Corp. v. FTC*, 321 F.2d 825 (7th Cir. 1963); *Schwing Motor Car Co. v. Hudson Sales Corp.*, 138 F. Supp. 899 (D. Md.), *aff'd per curiam*, 239 F.2d 176 (4th Cir. 1956), *cert. denied*, 355 U.S. 823 (1957). Closed territories have been attacked in *Sandura Co. v. FTC*, *supra* note 21; *Denison Mattress Factory v. Spring-Air Corp.*, *supra* note 12; *United States v. Sealy, Inc.*, *supra* note 20.

<sup>23</sup> See *Sandura Co. v. FTC*, *supra* note 21.

<sup>24</sup> See *White Motor Co. v. United States*, *supra* note 16, at 269 (Brennan, J., concurring).

<sup>25</sup> See *Snap-On Tools Corp. v. FTC*, *supra* note 22, at 829. See generally Hearings on S. 1396 Before the Subcommittee on Patents, Trademarks, and Copyrights of the Senate Committee on the Judiciary, 87th Cong., 1st Sess. (1961).

<sup>26</sup> See *Sandura Co. v. FTC*, *supra* note 21, at 856.

<sup>27</sup> *White Motor Co. v. United States*, *supra* note 16; *Sandura Co. v. FTC*, *supra* note 21; *Snap-On Tools Corp. v. FTC*, *supra* note 22.

<sup>28</sup> *White Motor Co. v. United States*, *supra* note 16, at 278 (Clark, J., dissenting).

even if this is somewhat inconvenient. Thus competition between franchisees is completely foreclosed by closed territories,<sup>29</sup> but is only restrained in some degree by exclusive territories.<sup>30</sup>

For this reason and because exclusive territories can protect legitimate business interests adequately, it is submitted that any arrangement establishing a system of closed territories should be declared illegal per se.<sup>31</sup> Because exclusive territories are less restrictive and because they provide a solution to the problems discussed above, use of this device may be justified in some circumstances.<sup>32</sup>

When the market is divided by restricting the type of customer to whom the franchisee may sell, two possibilities exist: the right to sell to those customers may be reserved either to the franchisor or to a favored class of franchisees. When the franchisor reserves the right of sale to himself, a horizontal division of market exists.<sup>33</sup> If the franchisee can effectively compete with the franchisor for the business of the proscribed customers, this is illegal per se.<sup>34</sup> If the franchisee cannot effectively compete, there is no substantial effect on competition and thus no illegality.<sup>35</sup> However, the existence of such an agreement would give rise to a strong presumption of the franchisee's ability to compete, if the agreement is to be more than mere form. Conversely, if the agreement is merely formal, no harm is done by outlawing it. Consequently, any reservation by the franchisor of exclusive right of sale to certain customers ought to be declared illegal per se.

If the exclusive right of sale to certain customers is reserved to a favored class of franchisees, no per se illegality exists.<sup>36</sup> Thus arguments advanced in justification of this device may be examined. In the *White* case defendant argued that favored customers must be assured of receiving customary discounts, of being capably assisted to determine their requirements and the most advantageous method of filling them, and of being adequately serviced after sale.<sup>37</sup> Since *White* felt it could not depend on every dealer to perform these functions satisfactorily, it reserved all right of sale to itself. If the right had been reserved to certain more capable and dependable franchisees, the restraint on commerce might have been justified.

Both customer restrictions with right of sale reserved to a class of franchisees and exclusive territorial divisions present the courts with the same problem: Will economic expediency be permitted to justify restraints on competition? In answering this question, the courts must consider the weight of the economic arguments said to justify the restraint and the extent of the restraint to be justified.<sup>38</sup> A reasonably pressing economic requirement

<sup>29</sup> *Ibid.*

<sup>30</sup> *Snap-On Tools Corp. v. FTC*, supra note 22.

<sup>31</sup> *Contra, Sandura Co. v. FTC*, supra note 21.

<sup>32</sup> See pp. 360-63 *infra*.

<sup>33</sup> *United States v. Klearflax Linen Looms, Inc.*, 63 F. Supp. 32 (D. Minn. 1945).

<sup>34</sup> *Timken Roller Bearing Co. v. United States*, supra note 19.

<sup>35</sup> *Snap-On Tools Corp. v. FTC*, supra note 22, at 836.

<sup>36</sup> See *White Motor Co. v. United States*, supra note 16; *Roux Distrib. Co.*, 55 F.T.C. 1386 (1959).

<sup>37</sup> 372 U.S. at 273-74.

<sup>38</sup> See *Board of Trade v. United States*, 246 U.S. 231, 238 (1918).

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will justify a slight restraint on competition, but any serious restraint must be enjoined. The economic arguments have been separately discussed above. To determine the nature of the restraint, "the line of commerce, i.e., the type of goods, wares, or merchandise, etc., involved must be determined . . . on the basis of the facts peculiar to the case."<sup>39</sup> This line of commerce may be found to include only the specific branded item<sup>40</sup> or all products of a similar nature.

If the line of commerce includes only the specific branded item, that is, if competition is primarily intra-brand rather than inter-brand, it is the effect on the ultimate consumer that concerns the court. He is constrained to take all his business in a line of commerce to a single individual and to deal with that individual on his terms. Such an arrangement probably violates Section 3 of the Clayton Act as tending to create a monopoly.<sup>41</sup>

If the line of commerce is found to include all products of a similar nature to the branded item, that is, if competition is primarily inter-brand rather than intra-brand, the only adverse effect is on the franchisees themselves. It appears that such a minor restraint, imposed from the signing of the franchise agreement on knowledgeable businessmen who voluntarily accepted the restraint in order to deal in the franchisor's product, is entirely reasonable in view of the benefits the franchise system receives from these restrictions.<sup>42</sup>

### III. RESTRICTIONS ON SOURCE

Two methods by which a franchisor may restrict the source of products purchased by his franchisee are tying arrangements and exclusive dealing arrangements.

[A] tying arrangement may be defined as an agreement by a party to sell one product but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier.<sup>43</sup>

An exclusive dealing arrangement may be defined as an agreement by one party to purchase, sell or otherwise deal only in products supplied or approved by another.<sup>44</sup>

Although the concepts are clearly distinct, classification of actual agreements as one or the other is difficult. Generally, an agreement attacked as a tying arrangement may also be attacked as an exclusive dealing arrangement because the typical tying arrangement includes a requirements contract for

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<sup>39</sup> *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961).

<sup>40</sup> As where the product involved is bought chiefly for the prestige of its brand name—e.g., perfume or fashionable clothing—or where it is distinct enough from its nearest imitator to have acquired a market of its own—e.g., foodstuffs, potables, or automobiles. See *International Boxing Club v. United States*, 358 U.S. 242 (1959); *United States v. Guerlain, Inc.*, 155 F. Supp. 77 (S.D.N.Y. 1957).

<sup>41</sup> Cf. *Standard Oil Co. v. United States*, 337 U.S. 315 (1949).

<sup>42</sup> *Snap-On Tools Corp. v. FTC*, supra note 22.

<sup>43</sup> *Northern Pac. Ry. v. United States*, 356 U.S. 1, 5 (1958).

<sup>44</sup> *Judson L. Thomson Mfg. Co. v. FTC*, 150 F.2d 952, 955 (1st Cir.), cert. denied, 326 U.S. 776 (1945).

the tied product.<sup>45</sup> Some agreements, therefore, must be found legal under both tests described in the two succeeding sections.

### A. Tying Arrangements

Several issues must be considered to determine that a given franchise agreement constitutes a tying arrangement before the agreement can be found illegal on that ground.

The first issue to be considered is separability. In order for an agreement for the sale of goods to constitute a tying arrangement, there must be at least two separate products which are the subjects of the agreement.<sup>46</sup> An agreement for the sale of products which, upon analysis, are seen to be but different faces of the same item<sup>47</sup> or which, when taken together, form a common unit of commerce or a system,<sup>48</sup> does not fall within the definition. In *United States v. Jerrold Electronics Corp.*,<sup>49</sup> the following indicators which aid in the determination of whether a sale of products is one of a system or is a tying arrangement are set forth: (1) Do other manufacturers sell the products separately; (2) are all systems sold made up of the same parts; (3) is the price determined by a lump sum for the system or by a total of pieces; and (4) is purchase of the entire system mandatory? Answers of "no" to question 1, "yes" to questions 2 and 4, and "lump sum" to question 3 indicate that the agreement is for the sale of a system, but the answer to no one question is controlling.

In cases where a producer is licensed to use a trademark, a related issue is whether the trademark is a tying product. Decisions have answered this question both ways. In *Susser v. Carvel Corp.*,<sup>50</sup> a private antitrust action, the franchise agreement between Carvel and its franchisees required the franchisees to purchase from it, or from approved sources, all ingredients, such as mix and cones, which formed a part of the finished product. The court, by way of dicta, indicated that the agreement might constitute a tying arrangement, with the Carvel trademark the "tying item."<sup>51</sup> In contrast, the Federal

<sup>45</sup> See *Northern Pac. Ry. v. United States*, supra note 43 (transportation for products manufactured on land sold by defendant must be obtained from it); *International Salt Co. v. United States*, 332 U.S. 392 (1947) (lessees of salt dissolving machines must buy salt from lessor); *International Business Machs. Corp. v. United States*, 298 U.S. 131 (1936) (lessees of business machines must buy all punch cards for use therewith from lessor). But see *United States v. Loew's Inc.*, 371 U.S. 38 (1962) (television stations must take undesired moving pictures in order to obtain desired ones). An agreement for exclusive dealing, however, does not include a tying arrangement.

<sup>46</sup> *Associated Press v. Taft-Ingalls Corp.*, 340 F.2d 753 (6th Cir.), cert. denied, 86 Sup. Ct. 47 (1965). The situation in which a franchisee purchases goods from a franchisor for resale, as distinguished from use, will generally not present the issue of separability because the transaction is in completed goods.

<sup>47</sup> *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594 (1953), where advertising space in defendant's morning and evening newspapers was found by the Court to be the same item, potential readership.

<sup>48</sup> *United States v. Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), aff'd per curiam, 365 U.S. 567 (1961).

<sup>49</sup> *Ibid.*

<sup>50</sup> 332 F.2d 505 (2d Cir. 1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965).

<sup>51</sup> *Id.* at 519.



Trade Commission in a proceeding<sup>52</sup> brought under Section 5 of the Federal Trade Commission Act<sup>53</sup> against Carvel on the same franchise agreements indicated that the trademark alone was not a tying product.<sup>54</sup>

The view taken by the Commission seems preferable. The classic view of a trademark is that it is not property, as is a patent or copyright, and that it has no existence apart from the goods or services to which it attaches.<sup>55</sup> The fact that trademark licensing is now permitted by statute<sup>56</sup> has not changed the essential nature of a trademark.<sup>57</sup> Therefore, a trademark cannot be a product in the sense in which that word is used in the majority of tying arrangement cases.<sup>58</sup> This determination, however, does not preclude an agreement of the *Carvel* type from being considered a form of exclusive dealing arrangement.<sup>59</sup>

If it is determined that the franchise agreement under consideration, in either a resale or licensing situation, involves two separate products, the question arises as to whether the tied product must come from the franchisor. The cases in which tying arrangements have been found and held unlawful have not presented such a situation.<sup>60</sup> However, the court considered this question in *Denison Mattress Factory v. Spring-Air Co.*<sup>61</sup> There, a provision of the trademark licensing agreement specified a source, other than the franchisor, of certain materials to be used in the manufacture of the trademarked product. The court denied the existence of a tying arrangement, indicating that the lack of a tied product sold by the franchisor was the reason for its finding.<sup>62</sup> It is arguable, however, that the reason that no tying arrangement existed was that there was no tying product.<sup>63</sup>

*Atlantic Ref. Co. v. FTC*<sup>64</sup> is implicitly contrary to the *Denison* position. There, an agreement between an oil company and a tires, batteries and accessories (TBA) manufacturer concerned the sale of sponsored TBA to the oil company's dealers. The Court found no tying arrangement, apparently because there was no agreement conditioning the sale of gasoline to dealers on the purchase by them of TBA. However, it did find that the essential characteristic of a tying arrangement—"the utilization of economic power in one market to curtail competition in another"<sup>65</sup>—was present, although the oil

<sup>52</sup> Carvel Corp., No. 8574, FTC, July 19, 1965.

<sup>53</sup> As amended, 52 Stat. 111 (1938), as amended, 15 U.S.C. § 45 (1964).

<sup>54</sup> Carvel Corp., supra note 52 (giving the alternate ground of lack of separability).

<sup>55</sup> Id. at 8.

<sup>56</sup> Lanham Act § 10, 60 Stat. 431 (1946), as amended, 15 U.S.C. § 1060 (1964).

<sup>57</sup> Carvel Corp., supra note 52.

<sup>58</sup> *United States v. Loew's Inc.*, supra note 45; *International Salt Co. v. United States*, supra note 45; *International Business Machs. Corp. v. United States*, supra note 45; *United Shoe Mach. Corp. v. United States*, 258 U.S. 451 (1922).

<sup>59</sup> See section on exclusive dealing arrangements, pp. 360-63 infra.

<sup>60</sup> See cases cited note 58 supra.

<sup>61</sup> 308 F.2d 403 (5th Cir. 1962).

<sup>62</sup> Id. at 410. "Here, there was no agreement by Spring-Air to sell any of the items involved, nor was there any condition requiring Denison to also purchase a different product from Spring-Air."

<sup>63</sup> See discussion of trademark as a tying product, pp. 356-57 supra.

<sup>64</sup> 381 U.S. 357 (1965), affirming *Goodyear Tire & Rubber Co. v. FTC*, 331 F.2d 394 (7th Cir. 1964).

<sup>65</sup> Id. at 369.

company was not the source of the sponsored product. The anticompetitive result will indeed be the same if an agreement conditioning the sale of gasoline is present, so that the source of the tied product should not be determinative of the existence of a tying arrangement—even in the case where the franchisor receives no pecuniary benefit from specification of source. Competition in a substantial portion of commerce may be foreclosed; injury to the franchisee and the consuming public through increased prices may result. It is submitted, therefore, that the fact that the source specified is other than the franchisor should not require a finding that no tying arrangement exists.

Only after the agreement has been found a tying arrangement, should the issue of its illegality be considered. Tying arrangements have been held illegal under both the Clayton<sup>66</sup> and the Sherman<sup>67</sup> Acts.<sup>68</sup> However, the tests for illegality under the two statutes differ. A violation under the Clayton Act is established when it is shown that the franchisor "enjoys a monopolistic position ["sufficient economic power"<sup>69</sup>] in the market for the 'tying' product, or if a substantial volume of commerce in the 'tied' product is restrained . . . ."<sup>70</sup> A violation of the Sherman Act is established when both conditions are shown to exist.<sup>71</sup>

There are several indicators of sufficient economic power in a franchisor: (1) A position of sales leadership in the market of the tying product;<sup>72</sup> (2) the existence of tying arrangements without any other explanation for their use;<sup>73</sup> (3) the desirability of the tying product to the purchaser;<sup>74</sup> and (4) uniqueness of the tying product similar to that afforded by a patent.<sup>75</sup> The presence of any one indicator may be the basis for finding sufficient economic power and illegality.<sup>76</sup> The second condition may be met by a showing of the

<sup>66</sup> § 3, 38 Stat. 731 (1914), 15 U.S.C. § 14 (1964):

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

<sup>67</sup> §§ 1, 2, 26 Stat. 209 (1890), as amended, 50 Stat. 693 (1937), as amended, 15 U.S.C. §§ 1, 2 (1964).

<sup>68</sup> *United States v. Loew's Inc.*, supra note 45; *International Salt Co. v. United States*, supra note 45. Tying arrangements may also be held unfair methods of competition in proceedings brought by the FTC pursuant to § 5 of the Federal Trade Commission Act, as amended, 52 Stat. 111 (1938), as amended, 15 U.S.C. § 45 (1964).

<sup>69</sup> *Northern Pac. Ry. v. United States*, supra note 43, at 6.

<sup>70</sup> *Times-Picayune Publishing Co. v. United States*, supra note 47, at 608.

<sup>71</sup> *Id.* at 609.

<sup>72</sup> *Northern Pac. Ry. v. United States*, supra note 43, at 19 (dissenting opinion).

<sup>73</sup> *Id.* at 8.

<sup>74</sup> *Id.* at 19 (dissenting opinion).

<sup>75</sup> *International Salt Co. v. United States*, supra note 45. It has been suggested that a trademark will supply the element of uniqueness. *Susser v. Carvel Corp.*, supra note 50, at 513.

<sup>76</sup> *United States v. Jerrold Electronics Corp.*, supra note 48, at 555.

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amount of commerce restrained by the agreement.<sup>77</sup> The facts of each case are controlling on the question of sufficient economic power or restraint of commerce; no generalization by type of franchise situation can be made.

Assuming a franchise agreement is found to be a tying arrangement and the franchisor possesses sufficient economic power so that the agreement would be held illegal, the question arises whether a defense based on the necessity of the agreement for trademark protection purposes can be sustained.<sup>78</sup> This defense may be available in two situations: (1) The franchisor of a trademark restricts purchases of ingredients by his franchisees to specified sources to insure uniformity of product quality among them; and (2) the franchisor sells products to his franchisees for resale under his trade name and restricts the source from which they may purchase complementary products. The principal purpose of the agreements is to protect the trademark or trade name.

The two *Carvel* cases<sup>79</sup> illustrate the first situation. There restrictions on the source of ingredients were imposed by the franchisor to insure uniform quality of the product to be made and sold by the franchisees so that the value of the trademark licensed would not be diminished. The Federal Trade Commission indicated in its opinion<sup>80</sup> that when the purpose of the restriction is only to protect the trademark and not to restrain trade, the restriction must be found an unreasonable means to the end of trademark protection in order that it be found unlawful. The court of appeals also indicated that such provisions might be justified for trademark protection where satisfactory substitute means were not available.<sup>81</sup>

The *Atlantic* case,<sup>82</sup> with its facts changed to include an agreement between Atlantic and its dealers conditioning the sale of gasoline on the purchase of sponsored TBA, is an example of the second situation.<sup>83</sup> The Court, however, did not discuss the defense of trademark or trade name protection to the charge of unfair competition.

Although the Lanham Act<sup>84</sup> requires employment of a method of quality control in order that a trademark license be valid,<sup>85</sup> the method of control is not taken from the reach of the antitrust laws.<sup>86</sup> Whatever the purpose of a tying arrangement, the anticompetitive effects are the same if franchisor's sufficient economic power is shown. Moreover, alternative methods of trademark protection which cause fewer anticompetitive effects are available to franchisors although they may require greater effort for enforcement and consequently entail greater cost. In *Susser v. Carvel Corp.*,<sup>87</sup> specifications

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<sup>77</sup> *International Salt Co. v. United States*, supra note 45.

<sup>78</sup> In *United States v. Jerrold Electronics Corp.*, supra note 48, not a franchise situation, the court allowed use of a tying arrangement for the purpose of trademark protection only while defendant was in its infancy.

<sup>79</sup> *Susser v. Carvel Corp.*, supra note 50; *Carvel Corp.*, supra note 52.

<sup>80</sup> *Ibid.*

<sup>81</sup> *Susser v. Carvel Corp.*, supra note 50.

<sup>82</sup> *Atlantic Ref. Co. v. FTC*, supra note 64.

<sup>83</sup> See also section on exclusive dealing arrangements, pp. 360-63 infra.

<sup>84</sup> § 10, 60 Stat. 431 (1946), as amended, 15 U.S.C. § 1060 (1964).

<sup>85</sup> *Timken Roller Bearing Co. v. United States*, 341 U.S. 593 (1951).

<sup>86</sup> *Carvel Corp.*, supra note 52.

<sup>87</sup> *Supra* note 50.

for ice cream mix would be an effective and reasonable method of protection because the composition of the mix had been formulated so that the previously chosen sources could supply the franchisees.<sup>88</sup> Similarly, in *Atlantic*,<sup>89</sup> quality specifications for tires and other accessories would be effective and reasonable.<sup>90</sup>

For these reasons, it is submitted that trademark or trade name<sup>91</sup> protection should not be allowed as justification for an otherwise illegal tying arrangement.

### B. Exclusive Dealing Arrangements

Exclusive dealing arrangements are not illegal per se.<sup>92</sup> However, they may be attacked under several antitrust statutes. Besides Section 5 of the Federal Trade Commission Act,<sup>93</sup> which will be discussed below,<sup>94</sup> Sections 1<sup>95</sup> and 2<sup>96</sup> of the Sherman Act and Section 3 of the Clayton Act<sup>97</sup> apply; but if an exclusive dealing arrangement "does not fall within the broader proscription of § 3 of the Clayton Act, it follows that it is not forbidden by those of [Sections 1 and 2 of the Sherman Act]."<sup>98</sup> For these reasons, this subsection of the comment will be concerned only with Section 3 of the Clayton Act. The manner in which an exclusive dealing arrangement must be found to violate that statute is stated in *Tampa Elec. Co. v. Nashville Coal Co.*:<sup>99</sup>

*First*, the line of commerce, *i.e.*, the type of goods, wares, or merchandise, etc., involved must be determined. . . . *Second*, the area of effective competition in the known line of commerce must be charted by careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies. . . .

*Third*, and last, the competition foreclosed by the contract must be found to constitute a substantial share of the relevant market. That is to say, the opportunities for other traders to enter into or remain in that market must be significantly limited.<sup>100</sup>

On its face, this test seems to provide a complete solution. If a court

<sup>88</sup> See *Engbrecht v. Dairy Queen Co.*, 203 F. Supp. 714 (D. Kan. 1962); *Susser v. Carvel Corp.*, supra note 50, at 515 (opinion of Lumbard, C. J., dissenting in part).

<sup>89</sup> *Atlantic Ref. Co. v. FTC*, supra note 64.

<sup>90</sup> Specification of many sources of supply might be a reasonable alternative method if the point at which an illegal restraint of commerce no longer existed could be determined.

<sup>91</sup> Trade names are distinct from trademarks. *American Steel Foundries v. Robertson*, 269 U.S. 372 (1926). It is submitted, however, that the purpose of trade name protection should be treated no differently. If Lanham does not apply to trade names, the antitrust laws may be considered to have superseded the common law requirements of control.

<sup>92</sup> *Standard Oil Co. v. United States*, 337 U.S. 293 (1949).

<sup>93</sup> As amended, 52 Stat. 111 (1938), as amended, 15 U.S.C. § 45 (1964).

<sup>94</sup> See pp. 363-64, *infra*.

<sup>95</sup> As amended, 50 Stat. 693 (1937), as amended, 15 U.S.C. § 1 (1964).

<sup>96</sup> 26 Stat. 209 (1890), as amended, 15 U.S.C. § 2 (1964).

<sup>97</sup> 38 Stat. 731 (1914), 15 U.S.C. § 14 (1964).

<sup>98</sup> *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 335 (1960).

<sup>99</sup> 365 U.S. 320 (1960).

<sup>100</sup> *Id.* at 327-28.

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finds that a line of commerce has been restrained in a not insubstantial amount in any area of effective competition, it need go no further;<sup>101</sup> but this does not appear to be the course the courts have taken. The *Tampa* case goes on to indicate, obiter, that in deciding on substantiality, consideration should be given to economic arguments.<sup>102</sup> On this authority, subsequent cases have been willing to determine whether a restraint is reasonable in view of the ends sought to be achieved and the alternative methods available to achieve those ends.<sup>103</sup> Arguably, the language of section 3 precludes any such consideration; but if the courts are reading in an exception, the following considerations may be pertinent.

In *Denison Mattress Factory v. Spring-Air Corp.*,<sup>104</sup> the court upheld an arrangement between the licensor of a trademark and his manufacturer-licensee which required the manufacturer, *inter alia*, not to "manufacture or sell any other nationally advertised bedding products which are in competition with Spring-Air products except under Manufacturer's private brand name."<sup>105</sup> Since Denison was a manufacturer selling to wholesalers, the force of this provision was simply to prevent them from entering into similar licensing agreements with other owners of mattress trademarks.

The opinion does not make absolutely clear the reasoning which led to this result. Consideration of the exclusive dealing provision is combined with consideration of the restrictions which the licensor placed on the use of the specifications it supplied; as a result, it is not apparent which arguments apply to which provisions. The *Tampa* test is not mentioned although it seems pertinent. The cases cited<sup>106</sup> tend to support the proposition that a trademark may be abandoned by permitting continued infringement or by naked licensing.<sup>107</sup> Thus it appears that the court is concerned with quality control; but it is not clear that quality control is in any way affected by exclusive dealing provisions. Of course a licensor may prevent his licensees from placing his mark on goods not produced in accordance with the licensing contract,<sup>108</sup> and his licensees cannot force him to extend the range which his mark covers.<sup>109</sup> However, the agreement here prohibited dealing in competitors' products even though Spring-Air's mark was not used on them.

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<sup>101</sup> Cf. *Standard Oil Co. v. United States*, supra note 92; *Mytinger & Casselberry, Inc. v. FTC*, 301 F.2d 534 (D.C. Cir. 1962); *Dictograph Prods., Inc. v. FTC*, 217 F.2d 821 (2d Cir. 1954), cert. denied, 349 U.S. 940 (1955); *Anchor Serum Co. v. FTC*, 217 F.2d 867 (7th Cir. 1954).

<sup>102</sup> 365 U.S. at 329, 334.

<sup>103</sup> *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965). See *FTC v. Motion Picture Advertising Serv. Co.*, 344 U.S. 392 (1953); *Englander Motors, Inc. v. Ford Motor Co.*, 267 F.2d 11 (6th Cir. 1959).

<sup>104</sup> 308 F.2d 403 (5th Cir. 1962).

<sup>105</sup> Id. at 406 n.4.

<sup>106</sup> *Bacardi Corp. of America v. Domenech*, 311 U.S. 150 (1940); *Saxlehner v. Eisner & Mendelson Co.*, 179 U.S. 19 (1900); *E.I. du Pont de Nemours & Co. v. Celanese Corp.*, 35 C.C.P.A. (Patents) 1061, 167 F.2d 484 (1948).

<sup>107</sup> A naked license of a trademark or trade name is one in which the licensor does not control the quality of the product identified by his mark or name.

<sup>108</sup> See Lanham Act § 33, 60 Stat. 438 (1946), as amended, 15 U.S.C. § 1115 (1964).

<sup>109</sup> Although a mark registered as applying to a certain product may be applied without infringement to a product of a sufficiently different type that consumers will

A possible justification for the provision in *Denison* lies in the consideration that the products involved tend to become identified in the mind of the consumer. If it becomes generally known that two competing trademarked products are both produced by the same company, each trademark loses some of that distinctiveness which is its principal asset; but the philosophy behind trademark law is opposed to this argument. The law assumes that a consumer will be confused by similar trademarks even though they show on their faces that the products so marked are produced by different companies.<sup>110</sup> Conversely, then, products marked with dissimilar labels will be thought of as distinct, even though they are produced by the same company. The few better informed consumers may be depended upon to have made the further discovery that the products are manufactured under different specifications.

If a trade name is licensed under the franchise agreement, a quality control problem does arise. Since a trade name may be held to have been abandoned if the owner grants a naked license or permits continued infringement,<sup>111</sup> a franchisor who has licensed a trade name must control the quality of all goods sold or produced as a part of the business which the name designates.<sup>112</sup> If his licensees sell goods which he has neither produced nor approved, clearly the licensor has no means of controlling the quality of those goods. But not all goods sold by the licensee are necessarily sold as a part of the business designated by the licensed name.<sup>113</sup> Those which are so dissimilar to goods sold under the license as to preclude the possibility of consumer confusion<sup>114</sup> and those which are clearly marked with another's trademark may be sold as a private enterprise on the part of the licensee. The licensor could not prevent his licensees from dealing in such goods under the guise of quality control.

The motive for most exclusive dealing arrangements is probably found in the franchisor's feeling that by limiting the franchisee's business to his own products, he increases the franchisee's incentive to push those products. Since the franchisee's whole livelihood depends on his sale of the franchisor's products, the franchisor can expect to realize a better return on the not inconsiderable investment he has made in his franchisee's business. This is clearly to the benefit of the whole system; but one of the purposes of the antitrust laws is to end situations where a person's whole livelihood depends on his sale of another's products.<sup>115</sup> Clearly such dependence puts the fran-

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not associate them, it does not seem that a licensee could claim the benefit of this provision and so use the mark. Arguably, he is estopped from denying that any use he makes of the mark takes place under the licensing agreement. In addition, the probability of consumer confusion is considerable when one person is using the same mark on two products—on one by license and on the other in his own right.

<sup>110</sup> Lanham Act § 32, as amended, 76 Stat. 773 (1962), 15 U.S.C. § 1114 (1964).

<sup>111</sup> *Ritz Associates, Inc. v. Ritz-Carlton Hotel Co.*, 35 Misc. 2d 425, 230 N.Y.S.2d 408 (Sup. Ct. 1962). Cf. 1 Nims, *Unfair Competition and Trade-Marks* 87 (4th ed. 1947).

<sup>112</sup> *Ritz Associates, Inc. v. Ritz-Carlton Hotel Co.*, supra note 111.

<sup>113</sup> *Contra, Susser v. Carvel Corp.*, supra note 103, at 517.

<sup>114</sup> Of course the possibility of consumer confusion is very great when a person sells two products, only one of which is identified by the trade name on his store. Thus the dissimilarity must be very substantial. Nonetheless, such dissimilarity can occur. But see *Susser v. Carvel Corp.*, supra note 103, at 517 (Christmas trees and ice cream).

<sup>115</sup> See *Standard Oil Co. v. United States*, supra note 92, at 315-21 (Douglas, J., dissenting).

chisee in a very unenviable position. Since in most cases he has only a short term contract renewable at the behest of the franchisor and since a major part of his investment of money and time is not recoverable, he is in a very poor bargaining position as against the franchisor.<sup>116</sup> As business conditions change, the franchisee may find himself unable to obtain a fair share of increased profits or to transfer to the franchisor his share of increased expenses. Although perhaps not reduced to the level of economic serfdom, the franchisee is in some ways in a worse position than an employee. He bears a substantial part of the risk of the joint venture without much prospect of gain.

Under the language of section 3, restrictions on noncompeting goods are not illegal.<sup>117</sup> Yet the effect of such restrictions is in many ways similar to restrictions on competing goods. It is true that the effect on commerce is not as great since no single competitor possesses a guaranteed outlet from which all others are excluded, but the independence of franchisees may be threatened by such restrictions.<sup>118</sup>

It was previously stated that certain arrangements may be attacked as either tying or exclusive dealing. The question arises whether the result depends upon the theory used in the attack. A tying arrangement was seen to be illegal if (1) the vendor enjoys a monopolistic position in the market for the tying product or (2) a substantial volume of commerce in the tied product is restrained.<sup>119</sup> An exclusive dealing arrangement is illegal if a line of commerce is restrained in a not insubstantial amount in an area of effective competition.<sup>120</sup> It is submitted that the test for exclusive dealing is identical with the second test for tying arrangements. This implies that any arrangement which is not illegal as tying is likewise not illegal as exclusive dealing.<sup>121</sup> Thus if the attack can be made on either theory, it should be made on the theory of a tying arrangement.

### *C. Nascent Violations under the Federal Trade Commission Act*

It has long been recognized that there are many unfair methods of competition that do not assume the proportions of antitrust violations. . . . When conduct does bear the characteristics of recognized antitrust violations, it becomes suspect, and the Commission may properly look to cases applying those laws for guidance.<sup>122</sup>

Recent proceedings under Section 5 of the Federal Trade Commission Act<sup>123</sup> have indicated that the substance of the business practice under scrutiny will be controlling rather than its form.

<sup>116</sup> See, e.g., *Atlantic Ref. Co. v. FTC*, 381 U.S. 357 (1965).

<sup>117</sup> For text of statute, see note 66 *supra*.

<sup>118</sup> Cf. *Engbrecht v. Dairy Queen Co.*, *supra* note 88, at 719-20.

<sup>119</sup> See p. 358 *supra*.

<sup>120</sup> See pp. 360-61 *supra*.

<sup>121</sup> The possibility exists that economic necessity will be permitted to justify either a tying arrangement or an exclusive dealing arrangement. Thus the tests are not necessarily coextensive. However, the likelihood of such exceptions being engrafted onto the tests appears much greater in the case of exclusive dealing arrangements than in tying arrangements. Thus the conclusion stands.

<sup>122</sup> *Atlantic Ref. Co. v. FTC*, *supra* note 116.

<sup>123</sup> As amended, 52 Stat. 111 (1938), as amended, 15 U.S.C. § 45 (1964).

In *Atlantic Ref. Co. v. FTC*,<sup>124</sup> the sales-commission plan between Atlantic and Goodyear was struck down as an unfair method of competition, in substance a tying arrangement because of Atlantic's use of its economic power in the gasoline market to restrain competition in the TBA market. In form, however, it was not a tying arrangement because there was no agreement conditioning the sale of gasoline on the purchase of TBA.

A determination of substance follows the guidelines of the antitrust laws nonetheless. In *Carvel Corp.*,<sup>125</sup> the Commission found no unfair method of competition in a franchise agreement requiring the purchase of ingredients from a specified source because only one product was involved even when the form of the agreement was overlooked.

In *Brown Shoe Co. v. FTC*,<sup>126</sup> the Commission held that a contract between a shoe manufacturer and retail dealers wherein the dealers agreed to carry only Brown shoes in return for promotional services, which in form might be an exclusive dealing arrangement, was in substance akin to a tying arrangement with the services the tying product. The court of appeals, however, decided that even in substance the contract was not a tying arrangement due to the lack of any tying product.<sup>127</sup>

The cases illustrate that the Commission has sought to use its power to define unfair methods of competition not to extend the scope of the antitrust laws, but to keep pace with those businesses which hide their anticompetitive practices behind form alone.<sup>128</sup> Since the Commission is not limited to any specific definition of unfair competition, however, a franchisor in formulating trademark protection provisions must determine that his methods of control are not, in substance, anticompetitive.

#### IV. CONCLUSION

Although the various control devices have been treated individually, in many instances they are so interconnected as to defy separation. By the use of one control device, the franchisor can gain such ascendancy over his franchisees as to render them amenable to his "suggestions" concerning business practices, such as optimum resale prices, superior sources of supply and practical limitations on marketing. When competition has been substantially restrained, the courts have not hesitated to enjoin the use of an otherwise legal device which contributes to the restraint.<sup>129</sup>

It has been argued that a policy outlawing control devices in the franchise situation will result in vertical integration,<sup>130</sup> which is generally felt to be less desirable as it reduces independent businessmen to employees.<sup>131</sup>

<sup>124</sup> *Supra* note 116.

<sup>125</sup> No. 8574, FTC, July 19, 1965.

<sup>126</sup> 339 F.2d 45 (8th Cir. 1964), cert. granted, 86 Sup. Ct. 33 (1965) (No. 118).

<sup>127</sup> Compare *Judson L. Thomson Mfg. Co. v. FTC*, 150 F.2d 952 (1st Cir. 1945).

<sup>128</sup> Compare *United States v. Sun Oil Co.*, 176 F. Supp. 715 (E.D. Pa. 1959).

<sup>129</sup> See *Atlantic Ref. Co. v. FTC*, *supra* note 116.

<sup>130</sup> *Standard Oil Co. v. United States*, *supra* note 92, at 320 (Douglas, J., dissenting): "The elimination of these requirements contracts sets the stage for Standard and the other oil companies to build service-station empires of their own." See Notes in 6 B.C. Ind. & Comm. L. Rev. 318, 320 (1965) and 18 Vand. L. Rev. 222 (1964).

<sup>131</sup> See *Simpson v. Union Oil Co.*, 377 U.S. 13, 21 (1964).



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However, this is not likely to occur. If economic factors indicate the desirability of such integration, the franchisors will integrate; but the increased cost of less restrictive controls is unlikely to change the economic picture sufficiently to require integration in any but a few marginal instances. It is more likely that the increased expenses will be passed on, either in the form of higher prices or reduced quality of the product, to the franchisees and ultimately to the public. If these methods are not practical, the franchisor may increase the minimum investment necessary to enter into such a franchise arrangement. Thus the franchise will tend to be priced out of the market of the small investor.

It is clear that a business will employ the practices which seem least expensive. By outlawing these practices, costs are necessarily increased. However, Congress has decreed that free and open competition is paramount, and to this end the burden of increased costs must be carried.

HUGO A. HILGENDORFF III  
TERENCE M. TROYER