

# Trademark Franchising and Antitrust: The Trouble with Tie-ins

J. Thomas McCarthy\*

*The recent boom in franchising has all but revolutionized the distribution of goods and services in America. This revolution, however, has not been without its share of problems. Professor McCarthy examines one of the most troublesome of these problems: franchisor control over franchisee purchasing. Franchise contracts frequently obligate franchisees to purchase their equipment and supplies from the franchisor or his designated sources. These provisions deprive franchisees of their freedom to select from among competing suppliers, and, conversely, foreclose suppliers from competing for the franchisees' business. After an extensive analysis, Professor McCarthy concludes that these restrictive clauses effect a tie-in of supplies and equipment to the franchisor's tradename, and that in most cases this tie-in will fall within the per se proscription of section 1 of the Sherman Act.*

Tom is one of twelve mattress manufacturers throughout the United States franchised to make and distribute mattresses under the widely advertised *Sleep-Rite* trademark. Under the terms of this franchise, Tom is to manufacture *Sleep-Rite* mattresses strictly according to the franchisor's specifications in order to assure uniform quality and appearance of *Sleep-Rite* mattresses nationally. In addition, Tom's franchise obligates him to buy all his mattress stuffing from the franchisor. Mattress stuffing of comparable grade and quality is available on the open market at a substantially lower price, but Tom's franchise prevents him from buying it and forecloses other sellers of mattress stuffing from competing for Tom's purchases. Dick is franchised to install *Zzow* mufflers, a nationally known brand manufactured by Dick's franchisor. Dick's franchise requires that he buy his tools, welding rods, and business forms exclusively from sources designated by the franchisor, who in turn receives a commission from the designated suppliers on their sales to *Zzow* dealers. Dick must pay substantially more to obtain these supplies from the designated sources than he would have to pay on the open market. Harry owns a *Hot Chick* fried chicken take-out franchise. The appearance and operation of the franchise are governed by a manual of standard operating proce-

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\* Associate Professor of Law, University of San Francisco. B.S. 1960, University of Detroit; LL.B. 1963, University of Michigan.

dures furnished by the franchisor. The manual requires, among other things, that Harry buy all his equipment, fixtures, cleaning supplies, and paper goods from or through the franchisor. Again, because of this restriction, Harry must pay more for these items than he would have to pay on the open market, and competing suppliers are foreclosed from soliciting Harry's trade.

Tom, Dick, and Harry are chafing under these restrictions imposed by their franchisors. Their freedom to select from among competing products in the open market has been limited, and, conversely, suppliers have been foreclosed from competing for these franchisees' business.

This Article examines the legality of restrictions on the franchisee's sources of supply in light of recent developments in federal antitrust law. In particular, it argues that franchise agreements of the sort described result in a tie-in of supplies to the franchisor's trademark license; that this tie-in is an unlawful extension of the trademark monopoly and a per se violation of the Sherman Act; and that there is often neither legal nor economic justification for permitting this tie-in to be imposed. Part I discusses the nature of franchising and offers explanations for its recent popularity. Part II defines tie-ins in the context of franchising and discusses the antitrust consequences. Part III covers the various defenses to franchise tying.

## I

### FRANCHISING: THE RENT-A-NAME BUSINESS

#### *A. The Popularity of Franchising*

Franchising has rapidly become one of America's chief methods of distributing goods and services. Franchising presently accounts for ten percent of the gross national product and at least 25 percent of all retail sales. At least 400,000 businessmen are franchisees, and 70 to 90 billion dollars worth of goods are sold through franchised outlets.<sup>1</sup> Many factors account for the rapid growth of this method of distributing goods and services.

Through franchising, a franchisor is able to maintain a large number of consumer outlets to distribute his products without having to in-

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1. FEDERAL TRADE COMMISSION, STAFF REPORT ON LEGAL PROBLEMS IN CONNECTION WITH FRANCHISE AGREEMENTS 6 (1969) [hereinafter cited as FTC STAFF REPORT]. For franchising statistics, see *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., ser. 1., pt. 1 (1967) [hereinafter cited as 1967 Senate Hearings]; AMERICAN MANAGEMENT ASSOCIATION, PARTNERS FOR PROFIT: A STUDY OF FRANCHISING 11 (1966); H. BROWN, FRANCHISING: TRAP FOR THE TRUSTING 2 (1969); NEWSWEEK, Nov. 10, 1969, at 88-91; TIME, Apr. 18, 1969, at 88, col. 1.

vest his own money in the retail end of the operation. This is perhaps the prime advantage of franchising as an alternative to company-owned sales outlets. A vast distribution system can be quickly established with a relatively small investment by the franchisor. The capital of many small franchisees supports the rapid rise of sales outlets.<sup>2</sup>

In addition, the fact that each franchisee is investing his own money leads to a high degree of motivation for him to work hard to be successful.<sup>3</sup> Such motivation is, at least in theory, much stronger than the salary motivation of a manager who is merely an employee. In fact, most franchisees actually do work long, hard hours.<sup>4</sup>

Another explanation for the success of franchising is the strong psychological drive among many Americans to be independent and to accomplish something of significance during their lifetime. The prospect of owning a franchise promises satisfaction of this natural desire by giving the franchisee the impression of having a business of his own.<sup>5</sup> Becoming a franchisee is particularly attractive to the individual of moderate means who wants to go into business for himself. Instead of going it alone in strange waters, a person can associate himself with a large organization and sell something that is proven, standardized, and well-advertised.<sup>6</sup> His initial investment in a franchise, usually between 5000 and 15,000 dollars,<sup>7</sup> is likely to be within his reach, even though he may have to mortgage his home to raise the money.<sup>8</sup>

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2. E. LEWIS & R. HANCOCK, *THE FRANCHISE METHOD OF DISTRIBUTION* 14 (1963).

3. AMERICAN MANAGEMENT ASSOCIATION, *supra* note 1, at 15.

4. Successful franchisees often have to work from 60 to 80 hours a week. E. LEWIS & R. HANCOCK, *supra* note 2, at 71.

5. See *id.* at 14. Some claim that franchising is the key to "black capitalism," H. KURSH, *THE FRANCHISE BOOM* 146 (1968); Address by Federal Trade Commissioner Mary Gardiner Jones, ICLE Seminar on Franchising, Ann Arbor, Michigan, Sept. 7, 1968, but there is little reason to expect less racial prejudice in franchising than in any other business area. See Shuman, *The Future of Franchising and Trade Regulations*, 14 *HOW. L.J.* 60, 63 (1968).

6. Some franchise boosters go so far as to claim that while a franchisee has a 90 percent chance of success, an independent small businessman has a 90 percent chance of failure within the first year. See *1967 Senate Hearings* 183. Most small businesses that fail, fail within the first four years of opening. E. LEWIS & R. HANCOCK, *supra* note 2, at 90. Only about ten percent of new franchisees fail within the first four years. J. COMMONWEALTH CLUB OF CAL., Feb. 17, 1969, at 63.

7. H. BROWN, *supra* note 1, at 4; *1967 Senate Hearings* 188. Some franchisors will extend credit to the franchisee to enable him to pay off the large initial franchise fee. A & W Root Beer Company maintains its own loan and finance corporation, which will loan up to 7,500 dollars to franchisees. E. LEWIS & R. HANCOCK, *supra* note 2, at 33.

8. See, e.g., Advertisement for "Mr. Sharp" Sharpening Center Franchise, *MODERN FRANCHISING MAGAZINE*, Nov. 1969, at 67. ("All it takes to cut you in on this amazing opportunity is a very modest investment in equipment and a modest franchise fee!"); Advertisement for AAMCO Transmission Repair Franchise, *id.* ("You need

### B. *The Nature of Franchising*

The rhetoric of franchise advertising promises that franchising is the last hope for the Jeffersonian ideal of a nation of small, independent businessmen.<sup>9</sup> The only new twist claimed is that the franchisee is now given a friendly boost on the road to success by the business-wise franchisor. Franchising has been characterized as everything from a panacea against increasing concentration and bigness in business to a fig leaf hiding a new kind of investment fraud.<sup>10</sup> Yet an exact definition of franchising is difficult to formulate.

It is useful to start with what franchising is not. Franchising is not a system of company-run outlets staffed by hired clerks.<sup>11</sup> On the other hand, a franchisee is not a fully independent small businessman.<sup>12</sup> A franchise thus does not really fit into the fixed galaxy of traditional antitrust stars. Franchising is a compromise between two quite different methods of getting goods into the consumer's hands.<sup>13</sup>

The Federal Trade Commission defines a franchisee as a "quasi-independent" businessman,<sup>14</sup> distinguishing a franchisee from a truly independent small businessman by noting that "some form of control over the franchisee is an essential ingredient of the franchise system."<sup>15</sup>

The 1971 California Franchise Investment Law defines a franchise as an agreement by which:

- (a) A franchisee is granted the right to engage in the business of of-

no mechanical ability or repair experience to be an AAMCO distributor . . . experienced AAMCO Executives will assist and work with you on a daily basis").

9. H. BROWN, *supra* note 1, at 3. At the 1966 Senate Hearings, franchising was referred to as "the last frontier for the small businessman." *Hearings on S. 191 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 89th Cong., 2d Sess. 497 (1966).

10. *Compare* United States v. Arnold, Schwinn & Co., 388 U.S. 365, 386 (1967) (Stewart, J., concurring and dissenting) ("[F]ranchising promises to provide the independent merchant with the means to become an efficient and effective competitor of large integrated firms. . . . The . . . manufacturer is assured qualified and effective outlets for his products and . . . the franchisee enjoys backing in the form of knowhow . . . and financial assistance)," with H. BROWN, *supra* note 1, at 103 ("The franchise agreement presently in use by most franchisors is an instrument of repression").

11. *But see* Shuman, *supra* note 5, at 62: "In reality the distinction between a franchisee and the manager of a branch of a chain is analogous to the distinction between a bonded servant and a slave."

12. "The commercial umbilical cord running from the franchisor to the franchisee certainly makes their relationship something less than one of autonomy." *Id.* "There are too many restrictions imposed by the franchisors on the franchisees to regard them as independent." *1967 Senate Hearings* 361.

13. "Franchising is not an industry, rather it is a new form of business organization." Shuman, *supra* note 5, at 63. *Cf.* AMERICAN MANAGEMENT ASSOCIATION, *supra* note 1, at 13.

14. FTC STAFF REPORT 7.

15. *Id.*

fering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and  
(b) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and  
(c) The franchisee is required to pay, directly or indirectly, a franchise fee.<sup>16</sup>

This broad definition of franchising covers a wide range of business relationships. Most of these relationships, however, fall into three basic categories.<sup>17</sup> First, there are the manufacturing franchises, like Tom's *Sleep-Rite* mattress franchise, in which the franchisor exploits some manufacturing process, secret formula, or the like by licensing others to manufacture and distribute the end product under the franchisor's trademark.<sup>18</sup> Second, there are the distributing franchises, like Dick's *Zzow* muffler shop, the primary purpose of which is to provide the franchisor with a system for marketing his wares, either at the wholesale<sup>19</sup> or retail<sup>20</sup> level. Third, there are the so-called licensing or chain-style franchises, like Harry's *Hot Chick* chicken take-home, in which the franchisor is primarily interested in exploiting a valuable trademark by licensing its use to franchisees who agree to operate retail outlets in accordance with the franchisor's detailed instructions.<sup>21</sup> It is this third form of franchising that is most appropriately called the "rent-a-name" business, for the franchisee is literally paying for use of the franchisor's tradename, with its attendant goodwill, in his business. In marketing this kind of franchise, the franchisor typically invests a large initial sum to develop a franchise idea for a standardized product or service, chooses a catchy trademark and advertises it extensively, picks likely locations for franchised outlets, and, finally, sells franchises to people who dream of being successful, independent businessmen. Once

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16. CAL. CORP. CODE § 31005 (West Supp. 1971). The California Franchise Investment Act was signed into law on September 18, 1970, and became effective on January 1, 1971. See generally Comment, *Franchise Regulation in California*, 17 U.C.L.A.L. REV. 1101 (1970). Similar definitions are found in A. GLICKMAN, FRANCHISING § 2.01 (1970); C. ROSENFELD, THE LAW OF FRANCHISING 11 (1970).

17. Chadwell & Rhodes, *Antitrust Aspects of Dealer Licensing and Franchising*, 62 NW. U.L. REV. 1, 3 (1968); see Pollock, *Antitrust Problems in Franchising*, 15 N.Y.L.F. 80, 114 (1969).

18. See, e.g., *United States v. Sealy, Inc.*, 388 U.S. 350 (1967); *United States v. Serta Assoc.*, 296 F. Supp. 1121 (N.D. Ill. 1968), *aff'd mem.*, 393 U.S. 534 (1969).

19. See, e.g., *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

20. See, e.g., *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968); *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966).

21. See, e.g., *Susser v. Carvel Corp.*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965); *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970), *appeal docketed*, No. 25,908, 9th Cir., July 1, 1970.

under way, the franchisor exercises substantial control over the franchisee in his day-to-day operations.

### C. *The Inequities of Franchising*

The franchisee, by definition not wise in the ways of business, is presented with a form contract prepared for the franchisor by a battery of highly skilled attorneys. This contract is usually presented on a take-it-or-leave-it basis,<sup>22</sup> and few of them are negotiated in the legal sense. Relying on the glowing representations of the franchisor's agent, the franchisee readily signs without much perusal of the contract terms. What the terms really mean becomes apparent only after the franchisee launches into the daily operation of his new business.<sup>23</sup>

Most franchise contracts can be legally characterized as a skeleton of a trademark license fleshed out with the many duties and restrictions imposed upon the franchisee.<sup>24</sup> The failure to comply with any of these terms generally gives the franchisor the power to terminate, often with disastrous results for the franchisee's personal investment.<sup>25</sup> One of these terms will often obligate franchisees to buy required supplies and materials only from the franchisor or its designated sources.<sup>26</sup> It is to this restriction that this Article is addressed.

The franchisor has obvious interests in making sure that the franchisees' purchases are rigidly controlled and are made from designated sources. If the franchisor itself sells to the franchisee, it has a ready-made market for its goods, and the increased sales increase profits. If it merely designates the suppliers from whom the franchisee must buy, the franchisor will often obtain a kick-back in one form or another from

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22. An attorney representing a potential franchisee testified before a Senate subcommittee that he objected to various unfair conditions in the form contract. He was told by the franchisor, "This is a take it or leave it proposition. We don't need them. They need us." 1967 Senate Hearings 195. Another attorney in a similar position was told by the franchisor, "I'm in the food business, and have been in it all my life. I shouldn't practice law, and you shouldn't practice the food business." H. KURSH, *supra* note 5, at 95. Franchise contract forms should properly be placed in the category of "adhesion contracts." 1967 Senate Hearings 356. The Supreme Court, in *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968), recognized that franchisees cannot bargain over the terms of the franchise contract. See Comment, *The U.C.C. and Franchise Agreements*, 1969 DUKE L.J. 959, 992.

23. H. BROWN, *supra* note 1, at 20-21.

24. AMERICAN MANAGEMENT ASSOCIATION, *supra* note 1, at 49; FTC STAFF REPORT 7.

25. H. BROWN, *supra* note 1, at 24. Many franchisors forbid dealers from including the dealer's goodwill in selling a dealership to a new franchisee. *Id.* at 23; see, e.g., *Meyer v. Ford Motor Co.*, 275 Cal. App. 2d 90, 79 Cal. Rptr. 816 (3d Dist. 1969).

26. H. BROWN, *supra* note 1, at 4.

the favored supplier.<sup>27</sup> Many franchisors choose to rely on mark-ups or kick-backs on the sale of operating supplies and materials as a major source of income.<sup>28</sup> For some, this is their only source of continuing income.<sup>29</sup> Many appear to favor this system because the amount the franchisee is paying is less apparent than an outright royalty.<sup>30</sup>

Since most franchisors charge an initial amount to grant the franchise at the beginning of the relationship,<sup>31</sup> and thereafter realize profits by charging some form of royalty measured by the franchisee's sales performance,<sup>32</sup> it is argued that there is no good reason to prevent the franchisor from collecting royalties in the form of profits or commissions on sales of tied-in goods to franchisees.<sup>33</sup> Some franchisors also claim that the tie-ins permit them to buy in quantity and thus enable the franchisees to buy more cheaply than if they made their own purchases.<sup>34</sup> Sometimes this is true; often it is not.<sup>35</sup> Another justification advanced for these restrictions is the maintenance of quality control—that is, control over the quality of products and services that the public receives from the franchisee. The franchisor argues that he must control quality by designating sources of supply or else he may be held to have abandoned rights in his trademark by uncontrolled licensing.<sup>36</sup>

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27. See cases cited note 21 *supra*.

28. E. LEWIS & R. HANCOCK, *supra* note 2, at 31; see H. KURSH, *supra* note 5, at 104. See also H. BROWN, *supra* note 1, at 16. The sole income of the Chicken Delight franchisor is derived from the sale of paper products. See *Chicken Delight Eastern, Inc. v. Ro-Eu Paper Co.*, 1968 Trade Cas. ¶ 72, 504 (N.Y. Sup. Ct. 1968), *rev'd*, 32 App. Div. 2d 945, 303 N.Y.S.2d 839 (1969).

29. See cases cited note 21 *supra*.

30. AMERICAN MANAGEMENT ASSOCIATION, *supra* note 1, at 45. "This procedure on the part of the franchisors is quite justified. A completely straightforward approach with the unvarnished facts would sell few franchises." *Id.* at 46. The new California Franchise Investment Law requires franchise agreements to disclose whether or not, and on what terms, the franchisor requires the purchase of needed supplies from designated sources. CAL. CORP. CODE § 31111 (1) (West Supp. 1971).

31. See note 7 *supra* and accompanying text.

32. Basic royalty rates may range from two percent to over seven and one-half percent of gross sales. Added to this are various hidden charges, such as advertising fees, signs, lease fees, equipment, and inventory charges. H. BROWN, *supra* note 1, at 10-14.

33. See notes 205-10 *infra* and accompanying text.

34. See AMERICAN MANAGEMENT ASSOCIATION, *supra* note 1, at 45-46; FTC STAFF REPORT 21.

35. The price to franchisees may sometimes be equal to, or lower than, the open market price for such items. The franchisor who makes quantity purchases and passes along savings to franchisees may give the franchisees a lower than open market price. But if the franchisor pockets these savings, or requests a fee from the designated supplier, or both, the price to the franchisee may be greater than the open market price.

36. Both the common law and federal trademark law require the licensor of a mark to maintain quality control over goods and services supplied by licensees to

Closely related to quality control is the franchisor's interest in maintaining a consistent image among all its franchisees. Image itself is important so that each franchisee will be identified as a part of the franchise operation. For example, it is not uncommon for a traveler to recognize a franchised restaurant from a familiar sign, a particular type of roof, or some other architectural feature and, as a result, be able to anticipate the interior decor, the menu, and even the taste of the food.<sup>37</sup> Deviations from the set level of quality and image by an individual franchisee will not only adversely affect the franchisor's royalty income and ability to sell new franchises, but, as poor quality at one franchised outlet is attributed by the consumer to the whole franchise system, it will also tend to cut down on profits of all franchisees in the system. Thus maintenance of uniform image and quality is important to both the franchisor and franchisee.<sup>38</sup>

Regardless of the asserted interest, the fact remains that the franchisor is controlling many of the franchisee's business decisions. Control over a businessman who should be an independent decisionmaking entity immediately looks suspect to the antitrust attorney.<sup>39</sup> Such restrictions deprive franchisees of their independent business judgment in choosing where they will buy needed supplies and equipment. Conversely, those who could sell to the franchisee but for the franchise contract restrictions are also unhappy.<sup>40</sup> The freedom of choice of both are foreclosed.<sup>41</sup>

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consumers under the mark. See 15 U.S.C. §§ 1055, 1115(b), 1127 (1964); *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959). If quality control is not maintained, the mark is in danger of being deemed abandoned. See *Land O'Lake Creameries, Inc. v. Oconomowoc Canning Co.*, 221 F. Supp. 576 (E.D. Wis. 1963), *aff'd*, 330 F.2d 667 (6th Cir. 1964). See notes 167-98 *infra* and accompanying text.

37. See J. CURRY, *PARTNERS FOR PROFIT* 39 (1966). In *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970), the court rejected two additional arguments raised by a franchisor for controlling purchasing decisions of franchisees: First, that it provided a convenient accounting device for compensation of the trademark license; and, second, the franchisor's assurance of a continuing source of supply of essential items. *Id.* at 850.

38. See notes 159-68 *infra* and accompanying text for a discussion of the goodwill defense.

39. "[I]ndependent" businessmen, bearing the risk of success or failure, must not be treated as economic serfs by powerful franchisors." Baker, *Another Look at Franchise Tie-Ins After Texaco and Fortner*, 14 ANTITRUST BULL. 767, 772 (1969). Antitrust policy dictates that a risk-taking businessman must also be a decision-making businessman. See *Simpson v. Union Oil Co.*, 377 U.S. 13 (1964).

40. See, e.g., *Advance Business Sys. & Supply Co. v. SCM Corp.*, 415 F.2d 55 (4th Cir. 1969); *Arthur Murray, Inc. v. Reserve Plan, Inc.*, 406 F.2d 1138 (8th Cir. 1969).

41. One writer has asserted that "to a large degree, the franchisor is able to exert better control over franchisees than he would over ordinary employees." H. BROWN, *supra* note 1, at 29. This is not to imply that most franchisees are nothing



But since, by definition, any franchise system involves some quantum of control over the franchisees, the question becomes how much control may be exercised in light of the antitrust goal of freedom of choice for all risktaking, decisionmaking entities in the market.<sup>42</sup> This brings up a basic conflict between two opposing government policies: the antitrust law's prohibition of vertical control over dealers and the requirement that trademark owners exercise quality control over their licensees.<sup>43</sup> The federal courts have long wrestled with the analogous dichotomy between antitrust law and patent licensing,<sup>44</sup> but the trademark-antitrust conflict has just recently become the subject of widespread litigation in the context of modern franchising arrangements. Because a judge must decide whether a certain contractual right of control of a franchisor over a franchisee is legal or illegal under the antitrust laws, the competing trademark and antitrust policies must be reconciled, and each must give way to some degree in each case.

## II

### TYING AND FRANCHISING

Restrictions on the franchisee's choice of supplies and suppliers are subject to attack as unlawful tying arrangements, which are forbidden by federal antitrust law.<sup>45</sup> However, the leading case law directly in point, *Susser v. Carvel Corp.*<sup>46</sup> and the subsequent Federal Trade Com-

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more than modern versions of an indentured servant. Most franchisees are contented, moderately successful people who have no reason to complain of their lack of freedom. In fact, they may be only too happy to have the franchisor tell them what to do and how to do it. However, the small number of reported franchise antitrust cases is not necessarily evidence of franchisee content. Franchisees who do chafe under restrictions do not generally bring suit until after the parties have had a complete falling-out. Only then will they have the incentive to sue to recoup losses. See, e.g., *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968); *Osborn v. Sinclair Ref. Co.*, 286 F.2d 832 (4th Cir. 1960), 324 F.2d 566 (4th Cir. 1963).

42. Pollock, *supra* note 25, at 107. Every kind of franchise restriction "is, by its very nature, a control of the free competitive activities of the franchisor or franchisee, in short, a 'restraint of trade.'" FTC STAFF REPORT 9. The "central policy" of the antitrust laws is opposed to "contracts which take away freedom of purchasers to buy in an open market." *FTC v. Brown Shoe Co.*, 384 U.S. 316, 321 (1966).

43. It can also be argued that a franchisor's legitimate interest in maintaining a standard of quality and consistent image among franchisees should be placed in the scales along with the trademark law's requirement of quality control in licensing. That is, the franchisor may have a valid business interest in maintaining greater uniformity of quality and image than trademark law demands. As a defense of supply source control, these arguments are to be balanced against antitrust prohibitions against vertical control over purchasing decisions of independent franchisees.

44. See, e.g., *United States v. General Elec. Co.*, 272 U.S. 476 (1926).

45. See, e.g., *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969).

46. 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965).

mission action,<sup>47</sup> held that such restrictions were not tie-ins and that even if they were, they were not unlawful under then applicable antitrust standards. This part examines *Carvel* decisions in their historical perspective and concludes that, even if correct when decided, they are no longer controlling because of subsequent antitrust developments.

### A. Development of the Tying Doctrine

[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>48</sup>

A tie-in occurs when a buyer is forced to buy item *X* in order to get a desired item *A*. By assumption, the buyer would rather buy item *X* (the tied item) either elsewhere or not at all, but he wants item *A* (the tying item) so badly that he agrees to purchase both. The economic evil of tying arrangements is that they foreclose competition in the market for item *X*. The seller is using whatever competitive advantage he may have in the market for item *A* to restrain trade in the market for item *X*.<sup>49</sup> The greater a seller's competitive advantage in the market for item *A*, the greater his ability to foreclose trade in item *X*.

Because "[t]ying agreements serve hardly any purpose beyond the suppression of competition,"<sup>50</sup> they "fare harshly under the laws forbidding restraints of trade."<sup>51</sup> Tie-ins are susceptible to attack under section 1 of the Sherman Act,<sup>52</sup> section 3 of the Clayton Act,<sup>53</sup> and section 5 of the Federal Trade Commission Act.<sup>54</sup> However, the con-

47. *Carvel Corp.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,298 (F.T.C. 1965).

48. *Northern Pac. Ry. v. United States*, 356 U.S. 1, 5-6 (1958). In *Brown Shoe Co. v. United States*, 370 U.S. 294, 330 (1962), the court noted:

The usual tying contract forces the customer to take a product or brand he does not necessarily want in order to secure one which he does desire. Because such an arrangement is inherently anticompetitive, we have held that its use by an established company is likely "substantially to lessen competition" although only a relatively small amount of commerce is affected.

49. See, e.g., *Northern Pacific Ry. v. United States*, 356 U.S. 1, 5-6 (1958). "[A] tie-in has the likely additional vice of permitting minor or inferior items in a seller's line to ride to market on the back of his major superior item." Turner, *Tying Arrangements*, 72 HARV. L. REV. 50, 73 (1958).

50. *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949).

51. *Times-Picayune Pub. Co. v. United States*, 345 U.S. 594, 606 (1953). See notes 48-49 *supra*.

52. 15 U.S.C. § 1 (1964); see, e.g., *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969).

53. 15 U.S.C. § 14 (1964); see, e.g., *United States v. Jerrold Elec. Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961); *Advance Business Sys. & Supply Co. v. SCM Corp.*, 415 F.2d 55 (4th Cir. 1969).

54. 15 U.S.C. § 45a (1964). Section 5 empowers the Federal Trade Commission to proceed against "unfair or deceptive acts or practices." See *FTC v. Texaco*, 393 U.S. 223 (1968).

cept of tying as a restraint of trade first arose not in the context of anti-trust law, but as a basis for the misuse defense in patent infringement suits. In *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*,<sup>55</sup> plaintiff licensed another company to manufacture and sell motion picture projectors incorporating the plaintiff's patented film transport device. Under the terms of the license the patented device could only be used to project films in which the plaintiff had a financial interest.<sup>56</sup> The Court held this to be a misuse of the plaintiff's patent and refused to enforce the tying condition.<sup>57</sup> It reasoned that by tying the use of plaintiff's film to use of his film transport device, the plaintiff was attempting to extend his monopoly over the patented invention beyond its statutory scope<sup>58</sup> to cover commerce that he could not lawfully monopolize.<sup>59</sup> The rationale of the *Motion Picture* case was announced as a general rule of law in *Carbice Corp. of America v. American Patents Development Corp.*<sup>60</sup> While recognizing that a patentee can prohibit entirely the manufacture, use, or sale of the patented invention, or can grant licenses "upon terms consistent with the limited scope of the patent monopoly,"<sup>61</sup> the Court held that a patentee

may not exact as the condition of a license that unpatented materials used in connection with the invention shall be purchased only from the licensor . . . . The limited monopoly to make, use, and vend an article may not be "expanded by limitations as to materials and supplies necessary to the operation of it."<sup>62</sup>

Not only has the Court consistently prevented the employment of judicial machinery to effectuate patent tie-ins,<sup>63</sup> but, in addition, it has even withheld the enforcement of legitimate patent rights from patentees who misuse their patents by imposing tie-ins.<sup>64</sup>

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55. 243 U.S. 502 (1917).

56. *Id.* at 506-07.

57. *Id.* at 519.

58. Patentees are given a statutory monopoly over the manufacture, use, and sale of their inventions. 35 U.S.C. § 154 (1964).

59. 243 U.S. at 510-18. The Court has applied the so-called patent misuse doctrine in a variety of cases to deny relief to patentee-plaintiffs who have attempted by various means to extend the patent monopoly beyond its statutory scope. *See, e.g.,* Zenith Corp. v. Hazeltine Research, Inc., 395 U.S. 100 (1969) (royalties based on sales of unpatented products); Walker Process Equip., Inc. v. Food Mach. & Chem. Corp., 382 U.S. 172 (1965) (fraud); Brulotte v. Thys Co., 379 U.S. 29 (1964) (post-expiration royalties); Straus v. Victor Talking Mach. Co., 243 U.S. 490 (1917) (price-fixing); Bauer & Cie v. O'Donnell, 229 U.S. 1 (1913) (same).

60. 283 U.S. 27 (1931).

61. *Id.* at 31.

62. *Id.*, quoting *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502, 515 (1917).

63. *E.g.,* *Mercoid Corp. v. Mid-Continent Inv. Co.*, 320 U.S. 661 (1944); *Leitch Mfg. Co. v. Barber Co.*, 302 U.S. 458 (1938).

64. *E.g.,* *B.B. Chemical Co. v. Ellis*, 314 U.S. 495 (1942); *Morton Salt Co. v. G.S. Suppiger Co.*, 314 U.S. 488 (1942).

The Supreme Court first used tying as a basis for an antitrust violation in 1922 in *United Shoe Machinery Corp. v. United States*.<sup>65</sup> The Court affirmed an injunction under section 3 of the Clayton Act<sup>66</sup> striking down the conditions on which United Shoe leased patented shoe manufacturing equipment, which required lessees to purchase other machinery and incidental supplies only from United. The Court noted that United Shoe was the dominant supplier of shoe manufacturing equipment with approximately 95 percent of the national market,<sup>67</sup> and that this was sufficient to render the tie-ins violative of the Clayton Act.

In *International Salt Co. v. United States*,<sup>68</sup> International had conditioned the lease of its patented salt-using machines on the lessees' agreement to purchase their salt requirements from International. Without investigating International's dominance in the market for salt machines, the Court held that it was unreasonable per se to foreclose any significant or substantial amount of commerce by means of a tying clause.<sup>69</sup> It found that International's annual sales of 100,000 tons of salt worth 500,000 dollars was neither insignificant nor insubstantial.<sup>70</sup> Thus, the tie-in was a violation of both the Sherman and Clayton Acts.<sup>71</sup>

In 1953 the scope of illegality of tying was considerably, although temporarily, narrowed. In *Times-Picayune Publishing Co. v. United States*,<sup>72</sup> a New Orleans newspaper publisher required advertisers to place ads either in both its morning and evening papers or in neither. The Supreme Court, after an extensive review of its previous tying decisions, summarized the Sherman and Clayton Act standards of illegal tying:

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.<sup>73</sup>

Applying the Sherman Act standard just announced, the Court found

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65. 258 U.S. 451 (1922).

66. 15 U.S.C. § 14 (1964).

67. 258 U.S. at 455.

68. 332 U.S. 392 (1947).

69. *Id.* at 396.

70. *Id.* at 395-96.

71. *Id.* at 396.

72. 345 U.S. 594 (1953).

73. *Id.* at 608-09.

that Times-Picayune did not occupy a "dominant" or "monopolistic" position in the relevant market and therefore reversed a judgement for the Government.<sup>74</sup>

The *Times-Picayune* strict "market dominance" test was relaxed five years later in *Northern Pacific Ry. v. United States*.<sup>75</sup> Northern Pacific sold and leased land only on condition that buyers and tenants agree to use Northern Pacific to ship commodities raised or manufactured on the land. The Supreme Court affirmed summary judgment for the Government under what appears to be the present Sherman Act test for legality of tying arrangements: Tying is illegal per se whenever the defendant has "sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product and a 'not insubstantial' amount of interstate commerce is affected" in the tied market.<sup>76</sup> If the Clayton Act, rather than the Sherman Act, is invoked, the crucial word "and" is changed to "or."<sup>77</sup> In *Northern Pacific*, the Court clearly left behind *Times-Picayune's* requirement of "monopoly power" or "dominance" and implied that the requisite economic power might be sufficiently evidenced by the mere existence of tying agreements.<sup>78</sup>

This test was refined in *United States v. Loew's Inc.*,<sup>79</sup> the television block-booking case. There the Court held that where the tying item is patented or copyrighted, "the requisite economic power is presumed,"<sup>80</sup> noting that "[e]ven absent a showing of market dominance, the crucial economic power may be inferred from the tying product's crucial desirability to consumers or from its uniqueness in its attributes."<sup>81</sup> The Court emphasized that "sufficient economic power" over the tying item is not to be equated with monopoly power in the sense of section 2 of the Sherman Act.<sup>82</sup>

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74. *Id.* at 611, 628.

75. 356 U.S. 1 (1958).

76. *Id.* at 6.

77. In *Times-Picayune*, the Court had noted that under the Clayton Act's "narrower standards," "the requisite potential lessening of competition is inferred" from either power over the tying item or a restraint of a "substantial volume of commerce" in the tied item. 345 U.S. at 608-09. This dichotomy between the Sherman Act and the Clayton Act "has never had any functional justification . . . ." Handler, *Antitrust: 1969*, 55 CORNELL L. REV. 161, 162 (1970).

78. 356 U.S. at 7-8.

79. 371 U.S. 38 (1962).

80. *Id.* at 45.

81. *Id.*

82. *Id.*

## B. Franchise Tying: The Carvel Cases

### 1. *Susser v. Carvel Corp.*<sup>83</sup>

The first major test of franchise tying under the antitrust laws arose in respect to the Carvel Corporation's ice cream franchise system. Carvel operated a system of 400 franchised outlets along the East Coast to sell its brand of soft ice cream products. Nine former franchisees brought a treble damage action against their former franchisor, alleging various antitrust violations, including tying.<sup>84</sup>

The franchisees charged that before 1955, the franchise contracts forced them to buy all the equipment necessary to operate a store through Carvel and to buy all their paper goods, cones, extracts, spoons and the like only from Carvel-approved sources.<sup>85</sup> After the FTC started to investigate this practice, Carvel redrafted the contracts to require dealers to buy only those ingredients sold as part of the end-product to consumers from Carvel-approved sources.<sup>86</sup> Carvel itself produced no supplies, but designated approved suppliers from whom franchisees were required to buy. The franchisees contended that these restrictions amounted to a tie-in violation of both the Sherman and Clayton Acts. The franchisees submitted the antitrust phase of the case on the written documents, relying solely on a per se theory of violation. The trial court found for the defendant,<sup>87</sup> distinguishing away precedents imposing liability on the

83. 206 F. Supp. 636 (S.D.N.Y. 1962), *aff'd*, 332 F.2d 505 (2d Cir 1964), *cert. dismissed as improvidently granted*, 381 U.S. 25 (1965).

84. Plaintiffs also alleged price-fixing and exclusive dealing. The trial court found that there was insufficient evidence of price-fixing and there was no exclusive dealing violation. 206 F. Supp. at 647-48, 650-51. The Second Circuit affirmed, noting that "the requirement that no non-Carvel products be sold at the retail level is reasonably necessary for the protection of Carvel's goodwill." 332 F.2d at 517.

85. Under the pre-1955 restrictive provision the franchisees were required "[t]o purchase only Carvel Special Formula Mix from a source of supply designated by Carvel," "[t]o purchase from Carvel all equipment necessary for the operation of the Store at Carvel standard prices," and "[t]o purchase and use only standard Carvel approved printed paper goods, napkins, cones, extracts, spoons, and all other Carvel products at standard market prices." 206 F. Supp. at 643.

86. The post-1955 restrictive clauses provided:

SIXTH: In order to safeguard the integrity of the Carvel trademarks, the Dealer agrees that he will purchase from Carvel or from approved sources designated by Carvel his entire requirements of Carvel's Frozen Dairy Product mix, toppings, flavorings and other ingredients, cones and any other items sold as part of the end product that is offered for consumption to the retail purchaser as scheduled in the Standard Operating Procedure Manual . . .

NINTH: . . . In the event that the Dealer desires to purchase his printed paper goods from sources other than Carvel, Carvel shall license manufacturers of such products to print the Carvel name thereon in connection with sales to the Dealer, with products made in accordance with Carvel standards.

*Id.* at 643-44.

87. Judge Dawson had nothing but praise for franchising in general:

The franchise method of operation has the advantage from the standpoint of

ground that none of them involved the sale of products to the public under the trademark of the person imposing the tying restrictions.<sup>88</sup> Further, the court held that the franchisees had not shown that the tying in question met the standard of per se illegality, positing the test to be whether Carvel occupied a "dominant position" as a franchisor of soft ice cream and whether there was a "substantial amount of commerce" tied up by the restrictions.<sup>89</sup>

The trial court emphasized the importance of the franchisor's legitimate interest in maintaining quality control over items sold under its trademark: "The cornerstone of a franchise system must be the trademark or tradename of the product. It is this uniformity of product and control of quality and distribution which causes the public to turn to franchise stores for the product."<sup>90</sup> Restrictions on accessory products were justified on the ground that they were "so closely related to the ice cream mix, that Carvel is entitled to designate approved sources of supply . . . ."<sup>91</sup> The plaintiffs' argument that quality could be insured by specification of standards was rejected, the court saying that this "would impose an impractical and unreasonable burden of formulation and policing."<sup>92</sup>

On appeal, the Second Circuit affirmed the trial court's decision.<sup>93</sup> Judge Lumbard wrote for the majority in part, but dissented on the issue of the illegality of Carvel's tying requirements. On this issue, Judge Friendly, joined by Judge Medina, affirmed the trial court's

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our American system of competitive economy, of enabling numerous groups of individuals with small capital to become entrepreneurs . . . .

The franchise system creates a class of independent businessmen; it provides the public with an opportunity to get a uniform product at numerous points of sale from small independent contractors, rather than from employees of a vast chain. The franchise system is therefore good for the economy.

*Id.* at 640.

88. *Id.* at 645.

89. *Id.* at 646.

90. *Id.* at 640.

91. *Id.* at 646.

92. *Id.* Judge Dawson also noted, "There was no indication that Carvel reaped any profit itself from any of the tie-ins." *Id.* However, Carvel received 25 cents per gallon commission on ice cream mix sold to franchisees by designated dairies. *Id.* at 640. An FTC Examiner investigating Carvel at the same time found that Carvel was making "inordinate profits" on the sale of products to its franchisees. *See* Carvel Corp., [1965-1967 Transfer Binder] TRADE REG. REP. § 17,298, at 22,427 (F.T.C. 1965).

93. 332 F.2d 505 (2d Cir. 1964). Since the Carvel franchise contracts required the dealer to sell only Carvel products, as well as requiring purchase of necessary additional supplies from Carvel-approved sources, the case had both exclusive dealing and tying features. The court recognized that the Supreme Court has "erected a much more stringent test of legality with which to measure tying arrangements than that which is applied to exclusive dealerships." *Id.* at 511. It concluded that in a case where the two kinds of restrictions overlap, the more strict test regarding tying arrangements should apply.

holding.<sup>94</sup> The two opinions differ in several important respects. One difference arose over whether Carvel had "sufficient economic power" with respect to the Carvel trademark to "appreciably restrain free competition" in the market for ice cream, cones, paper products, and the like. Judges Medina and Friendly equated "sufficient economic power" with "market dominance."<sup>95</sup> Applying this standard, they held that Carvel did not dominate the soft ice cream market. Judge Lumbard felt that such power "may be presumed from the use of the Carvel trademark as the principal feature of the Carvel franchise system."<sup>96</sup> He analogized to patent and copyright cases:

In all three cases, [patent, copyright, and trademark] the Congress has granted a statutory monopoly which places in the hands of the owner the right . . . to do as he will with the protected product. The value of the patent, copyright or trademark is, of course, directly proportionate to the consumer desirability of the protected product.<sup>97</sup>

On the issue of the amount of commerce tied up in ice cream mix, cones, paper products, and the like, Judge Lumbard looked to Carvel's 1960 sales of almost four million dollars in ingredients and other supplies to its franchisees and concluded that this was "not insubstantial."<sup>98</sup> The majority, on the other hand, compared this dollar amount to the total market for these products to arrive at market shares in the neighborhood of one percent and concluded that this was "insubstantial."<sup>99</sup>

The majority further held that even if the Carvel arrangement was an otherwise illegal tie-in under the Sherman Act, the franchisor's interest in maintaining quality control was a defense. In doing so, they apparently agreed with Judge Lumbard's assertion: "The only situation, indeed, in which the protection of good will may necessitate the use of tying clauses is where specifications for a substitute [for the tied product] would be so detailed that they could not practicably be supplied."<sup>100</sup> But the majority suggested the difficulty of "controlling

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94. *Id.* at 521. Judge Lumbard would have remanded the case to the district court for a further hearing on the issue of whether the requirements were necessary for quality control. *Id.* at 514-15.

95. *Id.* at 519.

96. *Id.* at 513.

97. *Id.*; see *United States v. Loew's Inc.*, 371 U.S. 38 (1962). There is in a sense no physical property right in a patent or copyright apart from the objects to which they relate; such intellectual property is purely a legal concept, and patents and copyrights are but dancing lights in lawyers' minds. However, they have economic reality in the sense that the judicial system will enforce such rights with the strong arm of the law. Thus, they have value as property. So also, a trademark is a legally enforceable right in a psychologically important trade symbol; in this sense, a trademark is likewise property in that it has a real and significant economic effect in the market.

98. 332 F.2d at 514.

99. *Id.* at 519.

100. *Id.* at 512, quoting *Standard Oil Co. v. United States*, 337 U.S. 293, 306 (1949).



something so insusceptible of precise verbalization as the desired texture and taste of an ice cream cone.”<sup>101</sup> Judge Lumbard again disagreed, saying that Carvel had made no more than a “sparse showing” that specifications were not practicable and noting that Carvel had surmounted this difficulty when giving specifications to suppliers for the proper preparation of ingredients. Indeed, Carvel had to do so, since it manufactured none of the ingredients sold to dealers.<sup>102</sup>

Despite their differences, the three judges all agreed on one crucial point: a franchisor’s trademark can be considered an economically severable tying item. “The true tying item was . . . the Carvel trademark.”<sup>103</sup>

## 2. *Carvel Corporation*<sup>104</sup>

A year after the Second Circuit’s decision, the Federal Trade Commission held that Carvel’s restrictions did not violate section 5 of the Federal Trade Commission Act. The FTC reached this conclusion by a route different in several important respects from that used by the Second Circuit. First, the Commission held that a trademark can never be categorized as a tying item: “Carvel’s franchise agreements cannot be regarded as tie-in arrangements because the trademark license conceptually cannot constitute a ‘tying’ product and, even if it could, it could never be regarded as a separable ‘product’ apart from the mix and commissary items to which it is attached . . . .”<sup>105</sup> Accepting this premise, there could be no tying, for there was nothing to which anything else could be tied.

Second, the FTC looked for proof of sufficient dominance in the soft ice cream market such that Carvel could use the trademark as a device to pressure dealers into taking tied items. It found that 37 percent of sales in the relevant market area did not amount to dominance.<sup>106</sup>

As to the asserted quality control defense, the Commission overruled its hearing examiner’s finding that, rather than limiting sources

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101. 332 F.2d at 520.

102. Judge Lumbard also noted that the Dairy Queen franchisor managed to establish specifications and enforced them by periodic inspections. Dairy Queen did not require franchisees to buy from approved sources, but allowed them to buy from anyone, provided that specifications were met. *Id.* at 515.

103. *Id.* at 519 (Friendly & Medina, JJ.); *id.* at 513 (Lumbard, J.). The proposition that a franchised trademark can be a tying item was followed in *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970), *appeal docketed*, No. 25,908, 9th Cir. July 1, 1970, and is also implicit in the results of *Arthur Murray Inc. v. Reserve Plan Inc.*, 406 F.2d 1138 (8th Cir. 1969), and *Temperato v. Horstman*, 321 S.W.2d 657 (Mo. 1959).

104. [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,298 (F.T.C. 1965).

105. *Id.* at 22,425. But see note 97 *supra*.

106. *Id.* at 22,430.

of supply, Carvel could have prescribed specifications for the control of quality of items sold by franchisees. The FTC intimated that quality control was an adequate defense without proof that specification was an impracticable alternative to tying "where a trademarked product as distinctive as a food is involved."<sup>107</sup> At one point, the Commission appeared ready to hold that for such non-ice-cream items as toppings, cones, paper supplies and the like, specifications would be the proper way to assure quality control without locking the franchisees into one approved source.<sup>108</sup> However, the Commission reversed its hearing examiner even as to these products, holding that the amount of commerce foreclosed in these items was less than one percent and that any restraint would be "de minimus."<sup>109</sup> The Commission evidently disagreed with its hearing examiner's conclusion that Carvel had imposed buying restrictions not to protect the goodwill of its trademark, but to make "inordinate profits" by establishing a "captive market [its licensees] to which Carvel's mix and commissary items could be sold."<sup>110</sup>

### C. *Post-Carvel Developments*

Even if the *Carvel* decisions were correct when rendered, which is doubtful,<sup>111</sup> subsequent decisions by the Supreme Court have reduced their precedential value to all but naught.

#### 1. *Fortner Enterprises, Inc. v. United States Steel Corp.*<sup>112</sup>

In *Fortner* the trial court entered a summary judgment in favor of the defendant in a treble damage action brought under the Sherman Act alleging unlawful tying. The tying item was credit, specifically the loan services of United States Homes Credit Corporation, a wholly owned subsidiary of United States Steel. The tied item was pre-fabricated housing manufactured and sold by U.S. Steel. To obtain a real estate loan, the applicant had to agree to erect a pre-fab home made by U.S. Steel on each lot purchased with the proceeds of the loan. Plaintiff Fortner had received at least two million dollars in loans from U.S. Steel under this arrangement. He alleged that the pre-fab materials he was required to buy were priced unreasonably high and were defective, causing him loss of profits.

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107. *Id.* at 22,428.

108. *Id.*

109. *Id.*

110. *Id.* at 22,427.

111. Compare notes 75-82 *supra* and accompanying text with notes 93-99 *supra* and accompanying text.

112. 394 U.S. 495 (1969).

The trial court found that the defendant did not have sufficient market power over the tying product, credit, because plaintiff failed to show that U.S. Steel's credit terms were uniquely attractive.<sup>113</sup> The trial court went on to hold that the amount of interstate commerce affected was insubstantial, since only a very small percentage of available land was foreclosed to competing sellers of prefab homes by the contract with Fortner.<sup>114</sup>

Reversing, the Court, speaking through Justice Black, said that this was a misapplication of the traditional test for legality of tying arrangements. First of all, the Court noted that the two-part legal test of *Northern Pacific*<sup>115</sup> is only necessary to bring the per se rule into play. A plaintiff can still prevail on the merits if he can prove under the rule of reason that "the general standards of the Sherman Act have been violated."<sup>116</sup> Such an extended examination of proof cannot generally be undertaken in summary proceedings. Beyond this, the Court went on to hold that the allegations of the complaint, if proved at trial, might indeed bring this tying arrangement into the scope of the per se rule, as the Court redefined this rule's terms. First, the phrase "not insubstantial" amount of commerce affected in the market for the tied item, said the Court, had no reference to any percentage or market share, but was to be tested only in terms of dollar volume: "[N]ormally the controlling consideration is simply whether a total amount of business, substantial enough in terms of dollar-volume so as not to be merely *de minimus*, is foreclosed by the tie . . . ."<sup>117</sup> The Court held that almost 200,000 dollars in annual sales of homes to the plaintiff under the arrangement was neither "paltry" nor "insubstantial."<sup>118</sup> Furthermore, the Court went on to say that the true test of substantiality is the "total volume of sales tied by the sales policy under challenge, not the portion of this total accounted for by the particular plaintiff who brings suit."<sup>119</sup> Here, the annual sales foreclosed throughout the nation was four million dollars in 1960, and over two million dollars for each of the next two years. The Court concluded that "these sums could scarcely be regarded as insubstantial."<sup>120</sup>

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113. 394 U.S. at 499.

114. *Id.*

115. *Northern Pac. Ry. v. United States*, 356 U.S. 1 (1958); see text accompanying notes 75-78 *supra*.

116. 394 U.S. at 500.

117. *Id.* at 501.

118. *Id.* at 501-02.

119. *Id.* at 502. The rationale for not taking a "narrow focus" on the volume foreclosed by the tie is that "Congress has encouraged private antitrust litigation not merely to compensate those who have been directly injured but also to vindicate the important public interest in free competition." *Id.*; see *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134 (1968).

120. 394 U.S. at 502.

In a way, the Supreme Court was merely returning to the test used in *International Salt Co. v. United States*,<sup>121</sup> where the Court held that half a million dollars annual sales of salt foreclosed by the tie-in was not insubstantial.<sup>122</sup>

With respect to the other half of the per se test, the Court said that "sufficient economic power" does not mean a monopoly or even a dominant position in the market for the tying item. Economic power can be "sufficient" even though the seller's power is less than dominant and even though this less-than-dominant power exists only with respect to some of the buyers in the market. Sufficient power may be inferred from the tying product's "desirability to consumers or from uniqueness in its attributes."<sup>123</sup> Indeed, in a case where the agreement is economically detrimental to the agreeing party, the mere fact that the defendant was able to exact a tying agreement from some of its customers may be sufficient evidence of his power over the tying item.<sup>124</sup> This relaxation of standards is justified "because tying arrangements generally [serve] no legitimate business purpose that cannot be achieved in some less restrictive way, [and] the presence of any appreciable restraint on competition provides a sufficient reason for invalidating the tie."<sup>125</sup> All that is needed, therefore, is that the "seller can exert some power over some of the buyers in the market . . . ."<sup>126</sup> "[T]he proper focus of concern is whether the seller has the power to raise prices, or impose other burdensome terms such as a tie-in, with respect to any appreciable number of buyers . . . ."<sup>127</sup>

Under the *Fortner* facts, the Court found that competitors of U.S. Steel sold competitive homes for at least 400 dollars less than U.S. Steel. Since it is most unlikely that anyone would accept this higher price without coercion, the price differential alone suggests that U.S. Steel has some "special economic power" in the tying credit market. Here, the plaintiff said he accepted the tying condition because he could get 100 percent financing of his land purchases and that this was "unusually and uniquely advantageous to him."<sup>128</sup> No one else in the Louisville

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121. 332 U.S. 392 (1947). See notes 68-71 *supra* and accompanying text.

122. "It now seems clear that whatever the appropriate test may be for exclusive dealing arrangements, any tie-in which has more than a *de minimis* effect will meet this standard." Handler, *supra* note 77, at 164 n.18.

123. 394 U.S. at 503, quoting *United States v. Loew's Inc.*, 371 U.S. 38, 45 (1962).

124. *But see* Handler, *supra* note 77, at 165: "Thus the Court comes close to stating that the success of a tying arrangement constitutes its own proof of market power. If this were the Court's holding, no remand would be necessary. The fact, however, is that the case was remanded for a determination of defendant's market power."

125. 394 U.S. at 503.

126. *Id.*

127. *Id.* at 504.

128. *Id.*

money market offered comparable credit terms. The inference is that U.S. Steel's unique economic standing gave it special advantages in the money market. Therefore, to get a 100 percent loan, plaintiff agreed to purchase U.S. Steel prefabricated housing.<sup>129</sup>

A coherent legal standard of "sufficient economic power" over the tying item can be culled from the majority opinion in *Fortner*. It appears that the Court is asking two basic questions: First, have an appreciable number of buyers been forced to accept the tying terms; and, second, is there an objective economic explanation for why they accepted the tie-in?<sup>130</sup>

2. *The TBA Cases: FTC v. Texaco*<sup>131</sup> and *Atlantic Refining Co. v. FTC*<sup>132</sup>

In the so-called *TBA* cases, major gasoline manufacturers had "persuaded" their franchised service stations to sell only a certain brand of tires, batteries, and accessories (TBA). The gasoline companies received a commission in the form of a percentage of TBA sales through their franchised stations. The Court held that the FTC could find that this was an "unfair method of competition" under section 5 of the Federal Trade Commission Act.<sup>133</sup> The policy behind these cases is that a franchisor should not be permitted to use his leverage over franchisees to influence their purchasing decisions, and therefore should not be allowed to receive any payments or kick-backs from suppliers.<sup>134</sup> The Court noted that no supplier of TBA would be likely to pay commissions to a franchisor unless the franchisor is, by exerting influence on its franchisee's purchasing decisions, generating sales for the TBA supplier.<sup>135</sup> The *TBA* cases are even stronger precedent for the normal franchise tying case because in the *TBA* cases there were no contractual commitments by franchisees to purchase from franchisor-designated

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129. The first case to apply the *Fortner* tests to tie-ins was *Advance Business Sys. & Supply Co. v. SCM Corp.*, 415 F.2d 55 (4th Cir. 1969), which held a tie-in of paper to rented SCM copying machines illegal under the Clayton Act, and held the tie-in of service contracts to the sale of SCM paper illegal under the Sherman Act. A good-will defense was rejected. *Id.* at 68. Damages awarded a competitive supplier of paper included loss of sales and attorney's fees of over 35,000 dollars.

130. Professor Handler's analysis of Justice Black's opinion in *Fortner* leads to the conclusion that there are at least three separate bases for determining whether the requisite market power exists: First, a tying arrangement is its own proof of market power; second, market power exists whenever there is power to impose the tie-in; and, third, the seller's unique economic advantages over competitors. Handler, *supra* note 77, at 164-66.

131. 393 U.S. 223 (1968).

132. 381 U.S. 357 (1965).

133. 393 U.S. at 230-31; 381 U.S. at 367-68, 370.

134. See FTC STAFF REPORT 16.

135. 393 U.S. at 229.

nated suppliers.<sup>136</sup> Atlantic exerted and Texaco merely suggested their potential power of life and death over franchisees. In *Texaco* the Court went on to say, "The sales commission system for marketing TBA is inherently coercive."<sup>137</sup>

The *TBA* cases have significance beyond the bounds of the Federal Trade Commission Act, and can be cited in cases brought under both the Sherman and Clayton Acts.<sup>138</sup> The *Atlantic* Court itself noted that "the effect of this [TBA] plan is similar to that of a tie-in."<sup>139</sup> The tying aspects are found in the gasoline franchisors' implied threat that dealers who want to keep their franchises had best sell only the approved brand of TBA. Thus, TBA's are tied to the retention of the franchise. The fact that the gas refiners were distinct from the TBA manufacturers caused no problem for the Supreme Court; split ownership of the tying and tied products will not impede attacks on tying arrangements.<sup>140</sup>

### 3. *Siegel v. Chicken Delight, Inc.*<sup>141</sup>

The logical consequence of the post-*Carvel* cases was reached in the recent *Chicken Delight* decision. There, several Chicken Delight franchisees maintained a class action on behalf of about 650 of their fellows alleging illegal tying of paper packaging, dip, and spice mixes

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136. A distinction can be drawn between the gasoline dealers in the *TBA* cases and the ordinary franchisee. In the *TBA* cases the dealership contracts did not expressly set forth the requirement to sell a certain brand of TBA. The gasoline dealer put his lifetime savings into a station dealership and was *later* coerced into distributing only approved TBA. This is to be compared with the ordinary franchise tying case, where the tying requirements are set forth in the contract the franchisee signs. At least the franchisee sees the tying requirements in print, although he probably does not realize their significance. But the Supreme Court has recognized that potential franchisees have no bargaining power over the terms of the franchise contract and do not *voluntarily* accept all its terms. In the *Midas Muffler* case the Supreme Court held that franchisees accepted the whole franchise contract, legal and illegal provisions together, "solely because their acquiescence was necessary to obtain an otherwise attractive business opportunity." *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 139 (1968); see Millstein, *Current Status of Affirmative Defenses*, 38 ANTITRUST L.J. 111, 115 (1968). Therefore, there is no reason to treat the two relationships differently.

137. 393 U.S. at 229.

138. In *Osborn v. Sinclair Ref. Co.*, 286 F.2d 832 (4th Cir. 1960), the court held, in a private antitrust case, that requiring a Sinclair dealer to buy Goodyear TBA is an illegal tie-in under the Sherman Act. The dealer recovered overcharges and lost profits after termination. 324 F.2d 566 (4th Cir. 1963); accord, *Broussard v. Socony Mobil Oil Co.*, 350 F.2d 346 (5th Cir. 1965).

139. 381 U.S. at 371.

140. See note 138 *supra*. In *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495 (1969), the tying item was sold by a wholly owned subsidiary of the company that sold the tied item.

141. 311 F. Supp. 847 (N.D. Cal. 1970), *appeal docketed*, No. 25,908, 9th Cir., July 1, 1970.

to the Chicken Delight trademark.<sup>142</sup> Judge Harris ruled that the franchisees had established a per se violation of the Sherman Act by tying paper goods to the trademark license, and on this issue directed a verdict for the plaintiff-franchisees.<sup>143</sup> The court relied on *Susser v. Carvel Corp.*<sup>144</sup> to conclude that the Chicken Delight trademark license "was a tying item in the traditional sense."<sup>145</sup> The franchisor's argument that the "Chicken Delight System" is a single product was rejected: "In the economic context of present franchising trends, it is clear that a franchise license is marketable separate and apart from the various products which the franchisees are required to purchase from and through the franchisor."<sup>146</sup> With respect to the dual requirements of sufficient economic power and foreclosure of not insubstantial commerce, the court found these satisfied as a matter of law. Sufficient economic power over the trademark license, the tying item, was found in the "admittedly unique, registered trademark," by the inference of power from the very existence of many tying arrangements, and by analogy to the presumption of sufficient power where the tying item is the subject of a patent or copyright.<sup>147</sup> A "not insubstantial amount of commerce affected" in the market for paper and cooking supplies, the tied items, was found by reference to *Fortner's* test of something more than a de minimis dollar amount affected. "Millions of dollars" affected in the tied market was found not to be merely de minimis.<sup>148</sup>

#### D. Franchise Tying Today

Once it is established that the limitation of a franchisee's sources of supplies is a tie-in, it should be relatively easy to bring this restrictive practice within the per se proscriptions of section 1 of the Sherman Act as defined in *Fortner*. Sufficient economic power can be inferred from the fact that many franchisees accept this onerous provision. Indeed it may be that where the tying item is a registered trademark, sufficient

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142. The court of appeals has already upheld the class action nature of the suit. *Siegel v. Chicken Delight, Inc.*, 412 F.2d 831 (9th Cir. 1969), *aff'g* 271 F. Supp. 722 (N.D. Cal. 1967). See also DeLone, *The Use of Rule 23 Class Actions in Antitrust Litigation*, 38 ANTITRUST L.J. 101 (1968).

143. 311 F. Supp. at 851-52. A series of New York trial court decisions had previously held the Chicken Delight paper products requirements not to be illegal tying. The apparent basis was that only Chicken Delight packaging could keep the product hot. *Chicken Delight Eastern, Inc. v. A. Weitzmann's Sons*, 1968 Trade Cas. ¶ 72, 425 (N.Y. Sup. Ct. 1968). Contrary evidence was produced in the California litigation.

144. 332 F.2d 505 (2d Cir. 1964).

145. 311 F. Supp. at 849; see Keefee, *Chicken Delight Gets an Unhappiness Pill*, 56 A.B.A.J. 1009 (1970).

146. 311 F. Supp. at 849.

147. *Id.* at 849-50.

148. *Id.* at 850.

economic power should be presumed.<sup>149</sup> Furthermore, "not insubstantial" commerce will almost always be foreclosed under the *Fortner* test, which asks whether the total volume of tied-in sales to all franchisees in the system is de minimis.

Still, for the litigating franchisee, an important problem is to convince the court that a franchise tie-in in fact involves two separate items.<sup>150</sup> The first argument that the franchisor is likely to make is that he sells a single product—franchised business outlets—to his franchisees, and therefore there is no tie-in of separate items. The franchisor will argue that the trademark license and the designated supplies are but parts of this single item.

The determination of whether separate items are involved is basically a question of economics. Relevant questions are whether the items can be, and have been, sold separately<sup>151</sup>—that is, whether the industry in question treats the items as separate. This is a troublesome question in examining distributing franchises, where franchisees are primarily distributors for products manufactured by the franchisor. In such franchises, separation of tying from tied items may be very difficult. Here the crucial test is to determine the primary product or products of the franchisor being distributed through franchised outlets. If this is automobiles for car dealers and gasoline for gas stations, then requiring *other* products or services to be bought only from designated sources is correctly characterized as tying. Thus, it was held that General Motors could not force its dealers to use only the services of G.M.'s financing company.<sup>152</sup> However, if General Motors required only that its franchised dealerships sell exclusively G.M. autos, this could not be called a tying of autos to the G.M. trademark, but rather an exclusive

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149. Cf. *Fortner Enterprises, Inc. v. United States Steel Corp.*, 394 U.S. 495, 508 (1969).

150. "There is, at the outset of every tie-in case, including the familiar cases involving physical goods, the problem of determining whether two separate products are in fact involved." *Id.* at 507.

151. E.g., *United States v. Jerrold Elec. Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961), where the court, while recognizing that a manufacturer "cannot be forced to deal in the minimum product that could be sold," held that a community television antenna system was not a single product, but was composed of distinct items. The court looked to how the supplier treated the items (it charged for each item separately) and how the industry treated the items (no one other than defendant sold the system exclusively as a single package). 187 F. Supp. at 559; see *Advance Business Sys. & Supply Co. v. SCM Corp.*, 415 F.2d 55 (4th Cir. 1969) (tie-in of paper supplies to machine service); *Associated Press v. Taft-Ingalls Corp.*, 340 F.2d 753 (6th Cir. 1965) (A.P. news wires held not a single package; competitors treated wires as separate).

152. *United States v. General Motors Corp.*, 121 F.2d 376 (7th Cir. 1941); see *Arthur Murray, Inc. v. Reserve Plan, Inc.*, 406 F.2d 1138 (8th Cir. 1969).



dealing arrangement.<sup>153</sup> Similarly, a gasoline refiner might properly require its own brand of gas to be pumped from leased pumps and tanks bearing its trademark, but cannot require a dealer to sell only a designated brand of tires, batteries, and accessories without violating the prohibition against tying.<sup>154</sup>

In those franchises where the franchisor manufactures nothing itself, but really is in the business of selling a franchise package consisting primarily of the trademark license, it appears correct to characterize the trademark as the tying item and designated supplies as tied-in. Indeed the trademark license is the economic foundation of any franchise system.<sup>155</sup> Without it, the franchisee would be just another small businessman struggling to become known and accepted in the community. What the franchisee really wants is the right to use the franchised trademark, with all the goodwill and consumer recognition that goes with it. It is to obtain this valuable license that the franchisee surrenders his freedom to buy needed supplies in the free market. Other than the FTC's *Carvel* opinion,<sup>156</sup> this is what the courts have consistently held with respect to nonmanufacturing franchisors.<sup>157</sup> Nor is the fact that tied supplies may be essential to use of the tying item an indication that the items are an inseparable unit.<sup>158</sup>

### III

#### DEFENSES TO TYING

Tying arrangements serve hardly any purpose beyond the suppression of competition.<sup>159</sup>

This part discusses various defenses which may be raised to bring a franchise case within the "hardly" exception.

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153. See *Standard Oil Co. v. United States*, 337 U.S. 293 (1949); *Englander Motors, Inc. v. Ford Motor Co.*, 267 F.2d 99 (6th Cir. 1959).

154. See, e.g., *Lessig v. Tidewater Oil Co.*, 327 F.2d 459, 468-71 (9th Cir. 1964).

155. *Susser v. Carvel Corp.*, 206 F. Supp. 626, 640 (S.D.N.Y. 1962): "The cornerstone of a franchise system must be the trademark or tradename of the product."

156. *Carvel Corp.*, [1965-1967 Transfer Binder] TRADE REG. REP. ¶ 17,298 (F.T.C. 1965).

157. *Susser v. Carvel Corp.*, 332 F.2d 505, 519 (2d Cir. 1964); *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847, 849 (N.D. Cal. 1970); cf. *Perma Life Mufflers v. International Parts Corp.*, 392 U.S. 134, 141 (1968).

158. *International Salt Co. v. United States*, 332 U.S. 392 (1947) (tied salt tablets required to operate tying salt machine); *International Business Mach. Corp. v. United States*, 298 U.S. 131 (1936) (tied punch cards required to operate tying computer); *Advance Business Sys. & Supply Co. v. SCM Corp.*, 415 F.2d 55 (4th Cir. 1969) (tied copy paper required to operate tying copy machine); *United States v. Jerrold Elec. Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960) (tied electronic elements required to operate tying television system).

159. *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949).

### A. *Protecting Goodwill*

The most frequently asserted defense in franchise tying cases is that the tying clauses are necessary for the franchisor to preserve the value of his trademark by ensuring that uniform appearance and quality are maintained at all franchised outlets. The goodwill defense to tying was first approved by the Court in 1923 in *FTC v. Sinclair Refining Co.*,<sup>160</sup> where the Supreme Court approved an arrangement which conditioned the lease of pumps and tanks to service stations on the dealers' agreement to dispense only Sinclair gas through the leased pumps and tanks. The Court reasoned that this tie-in was needed to protect the goodwill of Sinclair gas by not allowing any inferior fuels to be sold through pumps bearing the Sinclair trademark.<sup>161</sup>

But while the existence of the defense is firmly established, its availability is highly restricted. In *International Business Machines Corp. v. United States*,<sup>162</sup> IBM conditioned the lease of its computers on the use of computer punch cards made by IBM. IBM argued that if other brands of cards were used in IBM computers, the computer might break down and customers would blame this on the IBM machine. The Court rejected the company's goodwill defense saying that there was a less restrictive alternative available to accomplish this legitimate end: the drafting of quality specifications for cards used in IBM computers.<sup>163</sup> The goodwill defense was also rejected in *International Salt Co. v. United States*.<sup>164</sup> The salt company asserted that its machines had to be used only with the highest quality salt, which, it claimed, only it manufactured. The Court answered that the way to keep the machines running efficiently was to prescribe quality specifications for the salt, not to require the lessees to use only its own.<sup>165</sup> In *Standard Oil Co. v. United States*,<sup>166</sup> the Court explained that the goodwill defense fails in the usual situation because specification of the type and quality of the product . . . is protection enough . . . . The only situation, indeed, in which the protection of good will may necessitate the use of tying clauses is where specifications for a substitute would be so detailed that they could not practicably be supplied.<sup>167</sup>

Similarly, the franchisor may argue that protection of goodwill

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160. 261 U.S. 463 (1923).

161. *Id.* at 475. The *Sinclair* case could be explained in retrospect as merely involving a form of exclusive dealership, rather than a tying arrangement. See text accompanying note 154 *supra*.

162. 298 U.S. 131 (1936).

163. *Id.* at 139-40.

164. 332 U.S. 392 (1947).

165. *Id.* at 397-98.

166. 337 U.S. 293 (1949).

167. *Id.* at 306.

and a uniform franchise image requires the tying of various secondary symbols such as decor, structure of outlet, uniforms of the franchisee's employees, and the like, to the franchise. However, if it is at all practical to draft specifications for these items and allow the franchisee to buy them on the open market, then tying need not be permitted.

The goodwill defense was raised in the recent *Chicken Delight* case,<sup>168</sup> the franchisor arguing that designating the franchisees' sources of paper goods, mixes, and cooking supplies was the most practical means of achieving uniformity throughout the franchise system. With respect to the tied-in paper goods, the court ruled as a matter of law that the franchisor failed to make out a defense because competing suppliers could easily comply with Chicken Delight's design specifications.<sup>169</sup> With respect to the tied-in mixes and supplies, however, the court appeared influenced by the Second Circuit's intimation in *Carvel* that specifications might not be practicable in the case of food products.<sup>170</sup> The court therefore put this issue to the jury, which found that specifications were not impracticable and the tie-ins therefore not justified.<sup>171</sup>

### B. Protecting the Trademark

When a trademark is involved, the goodwill defense may be joined with a separate but similar defense. The franchisor points to trademark law, which demands that a trademark owner maintain close control over the quality of products sold by licensees under the trademark. If it does not do this, the mark will be deemed abandoned. The franchisor then argues that the only way to maintain sufficient quality control to avoid such abandonment is to require that franchisees buy only from franchisor-approved sources.

To arrive at the present status of the law regarding trademark licensing, it is necessary to trace its development in two steps. In early common law, trademarks were thought to represent to the consumer only the source or origin of the product or service with which the trademark was used.<sup>172</sup> Under this early source theory of protection, trade-

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168. *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970).

169. *Id.* at 851.

170. *Id.* at 852. See text accompanying note 101 *supra*.

171. *Id.* at 852-53 (jury's verdict). The jury was instructed that:

Justification for a tie-in must be more than just a good business or economic reason which may be considered more profitable, less costly or otherwise advantageous. This is so because a tie-in restriction on buying is against public policy and may not be justified simply as a matter of choice of method of doing business.

Keefee, *supra* note 145, at 1010.

172. See, e.g., Note, *Antitrust Problems in Trademark Franchising*, 17 STAN. L. REV. 926, 927 (1965). Note, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 YALE L.J. 1171, 1174 (1963).

mark licensing was viewed as philosophically impossible, since licensing meant that the mark was being used by persons not associated with the real manufacturing "source" in the strict sense of the word. *Macmahan Pharmacal Co. v. Denver Chemical Manufacturing Co.*<sup>173</sup> was the landmark of the source theory in this country. It held that a trademark could not be licensed or assigned without the transfer of the entire business of the seller or licensor.<sup>174</sup> Under the source theory, franchising in the modern sense was impossible, because a franchisee is often selling products and services that do not come directly from the trademark owner.<sup>175</sup>

Starting in the 1930's a new concept of the function of trademarks arose.<sup>176</sup> This new approach abandoned the source concept in favor of a theory that a trademark did not necessarily indicate source, but rather quality.<sup>177</sup> That is, the consumer assumes that products sold under the same trademark will be of equal quality regardless of the actual producer of the goods.<sup>178</sup> This does not necessarily mean high quality, but merely equal quality, whether that quality is high, low, or mediocre. The tourist who ate in a Denny's restaurant in Los Angeles assumes that the food in a Denny's restaurant in Las Vegas will be of equal quality. He will probably not even stop to consider whether or not the food, service, or menus came from a single source. It was the development of the modern quality theory of trademarks that permitted the rise of franchising as we now know it.<sup>179</sup> The quality theory permits a trademark owner to license the mark and allow licensees to buy supplies from anyone, provided the licensor maintains quality control over products reaching consumers.

Passage of the Lanham Act<sup>180</sup> in 1946 firmly established the quality theory in American law.<sup>181</sup> Today, it is clear that trademark law permits the licensing of a trade symbol under any circumstances, pro-

173. 113 F. 468 (8th Cir. 1901). See also *Bulte v. Igleheart Bros.*, 137 F. 492, 498 (7th Cir. 1905); Comment, *Trademark Licensing: The Problem of Adequate Control*, 1968 DUKE L.J. 875, 877.

174. 113 F. at 474-75.

175. See Note, *Quality Control and the Antitrust Laws in Trademark Licensing*, 72 YALE L.J. 1171, 1175 (1963).

176. See, e.g., Grismore, *The Assignment of Trade Marks and Trade Names*, 30 MICH. L. REV. 489, 499 (1932); Isaacs, *Traffic in Trade-Symbols*, 44 HARV. L. REV. 1210 (1931); Schechter, *The Rational Basis of Trademark Protection*, 40 HARV. L. REV. 813 (1927).

177. Treece, *Trademark Licensing and Vertical Restraints in Franchising Arrangements*, 116 U. PA. L. REV. 435, 445 (1968).

178. *Id.* at 448; Note, *supra* note 175, at 1177.

179. Note, *supra* note 175, at 1177.

180. 15 U.S.C. §§ 1051 *et seq.* (1964).

181. See, e.g., *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959); *Alligator Co. v. Robert Bruce, Inc.*, 176 F. Supp. 377 (E.D. Pa. 1959).

vided that the licensor exercises quality control over goods and services that reach the consumer under the licensed symbol.<sup>182</sup> Indeed, the modern franchise method of distribution is really nothing more than a sophisticated program of vertical trademark licensing.<sup>183</sup>

Most franchised trademarks will be registered under the Lanham Act, which gives many procedural and substantive advantages beyond those of the common law.<sup>184</sup> The Lanham Act does not specifically allow licensing in so many words, but several of its provisions clearly contemplate licensing under the quality theory. The Act permits use of a trademark by a "related company," which is defined as "[a]ny person who legitimately . . . is controlled . . . in respect to the nature and quality of the goods or services in connection with which the mark is used."<sup>185</sup> It is obvious that in the franchising context, a franchisee is a "related company."

The Lanham Act sets up vague standards of permissible licensing: nondeceptive use<sup>186</sup> and legitimate quality control.<sup>187</sup> Courts interpreting the Lanham Act, therefore, have generally approved licensing which provides for quality control.<sup>188</sup> But failure to control quality results in abandonment of the trademark, for then the trademark ceases to retain any meaningful significance to consumers.<sup>189</sup> In practice, a finding of

182. See, e.g., *Turner v. HMH Publishing Co.*, 380 F.2d 224 (5th Cir. 1967), involving Hugh Hefner's franchising of Playboy clubs throughout the United States. Franchisees are required to meet standards relating to decor, design, and quantity and quality of food, beverages, and entertainment. Policing of standards is by the franchisor's executives and independent services, who "regularly and periodically visit the clubs . . ." *Id.* at 229.

183. See *Susser v. Carvel Corp.*, 206 F. Supp. 636, 640 (S.D.N.Y. 1962); FTC STAFF REPORT 7.

184. See, e.g., 15 U.S.C. §§ 1072 (1964) (nationwide constructive notice), 1065 (incontestability after 5 years' registration), 1121 (federal court jurisdiction irrespective of amount in controversy).

If a registered mark has become "incontestable," then registration is "conclusive evidence of the registrant's exclusive right to use the registered mark" in an infringement suit. *Id.* § 1115(b). But seven exceptions to incontestability are provided, two of which are relevant here: *Id.* § 1115(b)(3) ("That the mark has been abandoned by the registrant"); *id.* § 1115(b)(7) ("That the mark has been or is being used to violate the antitrust laws of the United States").

185. *Id.* § 1127. 15 U.S.C. § 1055 (1964) provides:

Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public.

186. *Id.* § 1055.

187. *Id.* § 1127.

188. See, e.g., *Turner v. HMH Publishing Co.*, 380 F.2d 224 (5th Cir. 1967); *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959). See also *Franchised Stores, Inc. v. Winter*, 394 F.2d 664 (2d Cir. 1968).

189. See Comment, *Trademark Licensing: The Problem of Adequate Control*, 1968 DUKE L.J. 875; Note, *supra* note 175. Failure to control licensee's use of a

uncontrolled licensing should not work a total abandonment of the mark, but a forfeiture of mark rights only in those geographic and product markets where the mark has not been adequately controlled.<sup>190</sup>

The courts have been hopelessly inconsistent in defining how much is needed to satisfy this quality control requirement. Some courts do not look beyond a contractual stipulation for control rights and inspection,<sup>191</sup> while others demand that actual control be exercised.<sup>192</sup> If the consumer is to be protected from confusion, it seems that some actual control is required.<sup>193</sup> But no court has said that the licensor must require licensees to buy supplies only from approved sources.

Under antitrust law, the franchisor seeking to justify source restrictions should have the burden of proving that it would be impractical to draft quality specifications and allow franchisees to buy their needed supplies anywhere in the market,<sup>194</sup> and that the test applicable to the goodwill defense should be applied. For while quality control at the source is perhaps the easiest way to control the quality of products,<sup>195</sup> antitrust law stands in the doorway. During the protracted congressional hearings on the Lanham Act in the 1940's, the Justice Department constantly reminded Congress of the dangers inherent in broadly sanctioning trademark licensing without regard to dangers to the economy. The Justice Department urged that liberal statutory approval of trademark licensing "would be used as colorable legal sanctions for contracts directed toward price control, against the production of competitive products, for allocation of markets, division of uses, and fixing chan-

trademark can also lead to a charge of false advertising. *Waltham Watch Co. v. FTC*, 318 F.2d 28 (7th Cir. 1963).

190. *Treece*, *supra* note 177, at 459; *see, e.g.*, *E.F. Prichard Co. v. Consumers Brewing Co.*, 136 F. 512 (6th Cir. 1943); *Broeg v. Duchaine*, 319 Mass. 711, 67 N.E.2d 466 (1946). *But cf.* *American Junior Aircraft Co. v. L.M. Cox Mfg. Co.*, 137 F. Supp. 175 (S.D. Cal. 1955).

191. "Judicial reluctance to consider the question of substantial actual control is a distinctive feature of cases decided since the Lanham Act." Comment, *supra* note 189, at 898; *see, e.g.*, *Wolfies Restaurant, Inc. v. Lincoln Restaurant Corp.*, 143 U.S.P.Q. 310 (N.Y. Sup. Ct. 1964).

192. *See, e.g.*, *Dawn Donut Co. v. Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959); *Huber Baking Co. v. Stroehehmann Bros.*, 110 U.S.P.Q. 349 (S.D.N.Y. 1956); *Morse-Starrett Prod. Co. v. Steccone*, 86 F. Supp. 796 (N.D. Cal. 1949). "The statute does not refer to a person whom the registrant has the *right to control*. The language is 'any person who . . . is *controlled* by the registrant.'" *Alligator Co. v. Robert Bruce, Inc.*, 176 F. Supp. 377, 379 (E.D. Pa. 1959).

193. "The courts should vigorously insist that a licensor *actually control* his licensees, in order to protect the rights of the litigants and to encourage all licensors to observe the control standards." Comment, *supra* note 189, at 903.

194. *See Standard Oil Co. v. United States*, 337 U.S. 293, 306 (1949).

195. It is undoubtedly easier and cheaper to exercise quality control by tie-ins of purchases than to inspect at the source of supply. *See Note, Antitrust Problems in Trademark Franchising*, 17 STAN. L. REV. 926, 933 (1965).

nels of distribution.”<sup>196</sup> To assuage the Justice Department, the final version of the Lanham Act limited licensing to situations where the mark was to be “legitimately” used by “legitimately” controlled persons.<sup>197</sup> “Legitimately” was taken to mean conduct in compliance with antitrust law.<sup>198</sup> In addition, the Lanham Act specifically denies the benefits of “incontestability” to any trademark which is used to violate the antitrust laws.<sup>199</sup> It can thus be argued that Congress subordinated the Lanham Act to the antitrust laws, and therefore it provides no defense to antitrust charges.<sup>200</sup>

Trademark law demands that the licensor have and exercise the right to conduct sampling and inspection, according to specifications, of all products and services supplied under the trademark.<sup>201</sup> From the consumer's viewpoint, the greater the identity of quality among franchised outlets, the better. But taken to its ultimate, this leads to completely centralized decisionmaking and control over supposedly independent franchisees who have invested their own capital.

The *Dairy Queen* cases<sup>202</sup> demonstrate that the specification of standards is a feasible way to maintain the necessary quality control and

196. Letter from Wendell Berge to Senator Pepper, Nov. 14, 1944, in *Hearings on H.R. 82 Before the Subcomm. on Trademarks of the Senate Comm. on Patents*, 78th Cong., 2d Sess., Ser. 4, pt. 1, at 58 (1944); see Note, *supra* note 175, at 1202.

197. See 15 U.S.C. § 1127 (1964).

198. See Note, *supra* note 175, at 1202; cf. 15 U.S.C. § 1115(b)(7) (1964).

199. 15 U.S.C. § 1115(b)(7) (1964). *Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena*, 298 F. Supp. 1309 (S.D.N.Y. 1969), held that use of a trademark in violation of the antitrust laws is not an affirmative defense in a suit for trademark infringement. That is, the Lanham Act merely makes the defense of misuse available to defeat the evidentiary effect (*i.e.*, incontestability) of a trademark registration. The court held that the trademark was not a competent producing cause which made possible the alleged antitrust violation. *Id.* at 1314-15. Anticipating the result of cases like *Zeiss*, ATTORNEY GENERAL'S NATIONAL COMM. TO STUDY THE ANTITRUST LAWS, REPORT 260 (1955), recommended the repeal of section 1115(b)(7), saying that it is “unnecessary, ambiguous and fosters unfair competition without deterring antitrust violations.”

200. In *Timken Roller Bearing Co. v. United States*, 341 U.S. 593, 598-99 (1951), the Court said: “Nor can the restraints of trade be justified as reasonable steps taken to implement a valid trademark licensing system . . . . A trademark cannot be legally used as a device for Sherman Act violation.” The courts have often held that competitors cannot use trademarks as part of a horizontal restraint of trade. See, *e.g.*, *United States v. Sealy, Inc.*, 388 U.S. 350 (1967); *Baker v. Simmons Co.*, 307 F.2d 458 (1st Cir. 1962); *The Gray Line, Inc. v. Gray Line Sightseeing Co.*, 246 F. Supp. 495 (N.D. Cal. 1965). But cf. *Denison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403 (5th Cir. 1962).

201. *E.g.*, *Waltham Watch Co. v. FTC*, 318 F.2d (7th Cir. 1963); see Comment, *supra* note 189.

202. *Av-Tiki Sys. v. McCulloch*, 133 F. Supp. 807 (S.D. Ill. 1955); *Medd v. Boyd Wagner, Inc.*, 132 F. Supp. 399 (N.D. Ohio 1955); *Capital Dairy Queen v. McCulloch's Dairy Queen*, 125 U.S.P.Q. 540 (Tm. T. App. Bd. 1960); *McCleod v. Crawford*, 176 Neb. 513, 126 N.W.2d 663 (1964); *Temperato v. LaBrot*, 358 S.W.2d 106 (Mo. App. 1962).

at the same time minimize restrictions on the franchisee's freedom of action. Dairy Queen franchisors set quality control standards for cones, cups, containers, topping, flavoring, and the like, and allowed franchisees to buy these supplies from any source. To maintain quality control, Dairy Queen reserved the right to inspect, sample, and test products sold by franchisees. The *Dairy Queen* approach shows that the setting of specifications for standards is a workable, as well as legal, method of quality control. But franchisees still objected to having to buy a patented ice cream freezer from Dairy Queen, saying that this constituted tying. This contention was rejected on the basis of the goodwill defense, but only on the ground that the franchisee-plaintiffs had failed to prove that any other type freezer would satisfy the quality standards of Dairy Queen.<sup>203</sup>

Often, a close examination of the facts of a given franchise system will reveal whether supply source tie-ins are really to maintain quality and protect goodwill or are really an attempt to hide mark-ups and kick-backs for the benefit of the franchisor.<sup>204</sup>

### C. Collection of Royalties

Franchisors have argued that, since they can legally set any royalty rate they wish for the use of their trademark, they ought to be able to collect royalties in the form of profits and commissions on the sale of tied-in supplies to their franchisee-licensees. The answer is found in the antitrust policy forbidding a foreclosure of sources of supply.<sup>205</sup> Antitrust policy would seem to demand that the franchisor get its return by means of open royalty payments which do not rely on forcing the franchisee to buy separate products at high prices from a source linked to the franchisor.<sup>206</sup>

In *Siegel v. Chicken Delight, Inc.*,<sup>207</sup> the court said: "Use of a tie-in cannot be justified as an accounting device for compensation for a trademark license . . . . [A]n accounting method which specified a percentage of gross from the franchisees is just as convenient and has none of the anti-competitive effects of a tie-in."<sup>208</sup> This position finds support in a consistent line of patent misuse cases,<sup>209</sup> which hold that

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

204. "[T]he purpose of the licensor in placing purchasing restrictions on his licensees may become a crucial element in a judicial evaluation . . . ." Wilson, *Some Problems Relative to Franchise Arrangements*, 11 ANTITRUST BULL. 473, 478 (1966).

205. See, e.g., *FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966).

206. *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970) *appeal docketed*, No. 25,908, 9th Cir., July 1, 1970.

207. 311 F. Supp. 847 (N.D. Cal. 1970).

208. *Id.* at 850.

209. E.g., *Zenith Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100 (1969); *Mercoid Corp. v. Mid-Continent Inv. Corp.*, 320 U.S. 661 (1944).



it is an illegal extension of a statutory monopoly to exact royalties by means of a tie-in.

In *Chicken Delight*, a variation of the royalty defense arose when the franchisor argued that there had been no damage incurred by overcharges on tied supplies, as the overcharges were to be offset by the "reasonable value" of the trademark license. Chicken Delight had continually advertised that it made no charges for the franchise and no royalties were assessed for the use of the trademark. The court refused to allow the franchisor to reapportion its income after litigation: "This court will not attempt to restructure the system of defendants into one which is legally constituted and then allow an offset for imaginary or suppositious royalty fees. Such would be directly contrary to the avowed policy of the Sherman Act."<sup>210</sup> It would appear that, having sold franchises on the representation that no royalty was to be charged, the franchisor is estopped from claiming to the contrary when its overcharges on tied items are challenged in court.

#### CONCLUSION

One does not get any special antitrust consideration by calling himself a "franchisor" or by captioning contracts as "franchises."<sup>211</sup> A franchised trademark can be an economically separable and significant piece of property so as to constitute a tying element under the antitrust laws.<sup>212</sup>

But in the context of franchising, antitrust policy and trademark policy lead in opposite directions. Trademark law and the protection of goodwill demands control over quality by the franchisor, while antitrust law demands independent decisionmaking by the risktaking franchisee.<sup>213</sup>

But when does quality control justify tying supply sources to the licensed trademark? The answer is: hardly ever. Effective quality control in no way requires trademark owners to designate their franchisees' suppliers. Both antitrust law and trademark law are satisfied by the simple alternative of quality specifications that allow the franchisee to buy from whomever he chooses, so long as he meets the quality standards.<sup>214</sup> The only possible exception is the rare case where it is impossible to draft meaningful specifications for quality.

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210. 311 F. Supp. at 852.

211. Wilson, *Enforcement Policy for Franchising*, 15 N.Y.L.F. 1, 3 (1969).

212. *Susser v. Carvel Corp.*, 332 F.2d 505, 514 (2d Cir. 1964), *cert. dismissed as improvidently granted*, 381 U.S. 125 (1965); *Siegel v. Chicken Delight, Inc.*, 311 F. Supp. 847 (N.D. Cal. 1970).

213. See note 39 *supra*.

214. "[T]he designation of several alternative suppliers, rather than one supplier,

The quality specification alternative will, of course, put a greater burden on the franchisor than if he could simply designate sources and supervise quality at the supply source. But mere convenience has never been a defense to charges of restraint of trade.<sup>215</sup> Congress and the courts have decided that the benefits of competition are worth the price of inconvenience and extra expense.<sup>216</sup> The social and economic benefits of allowing the franchisee freedom of choice are worth the price of greater burdens on the franchisor in achieving quality control: "[The] central policy of both § 1 of the Sherman Act and § 3 of the Clayton Act [is] against contracts which take away freedom of purchasers to buy in an open market."<sup>217</sup>

The franchisor who ties franchisees into designated supply sources merely to get a kick-back on sales to his franchisees is deserving of little sympathy: he is merely trying to deceive them as to the true extent of their royalty payments.<sup>218</sup>

The franchisee who is primarily a conduit through which products made by the franchisor flow to consumers is in a somewhat different position. He can legitimately be required to deal exclusively in his franchisor's line of products. But even such franchisee-distributors should not be forced to buy unrelated items from designated sources.

The *Fortner* case has undoubtedly made it much easier to prove a franchise tie-in. It is hard to imagine many franchises that would not satisfy the *per se* standards which it laid down. The *Carvel* cases appear to be relegated to the attic of old precedents,<sup>219</sup> as is illustrated by

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may be regarded as giving the franchisor adequate quality control. In still another case, quality standards or specifications may be all that the franchisor really needs." Wilson, *Legal Problems in Franchising: The Enforcement Agencies*, FRANCHISING TODAY: 1969, at 154, 157 (1969).

215. "[T]he policy of the antitrust laws is not qualified or conditioned by the convenience of those whose conduct is regulated." *United States v. Paramount Pictures, Inc.*, 334 U.S. 131, 159 (1947).

216. "Throughout the history of these [antitrust] statutes it has been constantly assumed that one of their purposes was to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units which can effectively compete with each other." *United States v. Aluminum Co. of America*, 148 F.2d 416, 429 (2d Cir. 1945) (L. Hand, J.).

217. *FTC v. Brown Shoe Co.*, 384 U.S. 316, 321 (1966).

218. FTC STAFF REPORT 47 (separate conclusions of Rufus E. Wilson, FTC Bureau of Restraint of Trade). See note 30 *supra* and accompanying text.

219. Thus, the FTC has said:

It is believed that the Commission's dismissal of *Carvel* should constitute no bar to the institution of proceedings against other similar franchise arrangements in circumstances in which it appears that the factual deficiencies found by the Commission in *Carvel* are not present. In such arrangements, insofar as they do not involve *per se* violations, the respondent must carry a heavy burden of establishing the reasonableness and necessity of any challenged restraints.

FTC STAFF REPORT 35.

the recent *Chicken Delight* decision.

Will franchising survive court-enforced freedom of choice for franchisees? Franchising as a method of distribution is just emerging from the cradle. It must learn to survive in the economy subject to the same antitrust rules of life as more traditional distribution patterns. But there seems little reason to doubt that franchising will survive and prosper and take its place as an answer to many problems in the complex economy of modern America.