# **Foreword**

This report on *Competition Policy and Vertical Restraints: Franchising Agreements* explores the application of competition policy to vertical relationships in the context of franchised distribution systems. It opens with an economic analysis of franchising and the vertical restraints in such agreements. It goes on to describe the competition policy framework which governs franchising agreements in OECD Member countries, including laws, regulations and jurisprudence. They are then critiqued in light of the economic concepts presented at the beginning of the report. In this respect, the Secretariat proposes an analytical framework which could be used by competition authorities when examining franchising agreements.

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# Preface by the Committee on Competition Law and Policy

This report by the OECD Secretariat analyzes the treatment by competition policy authorities of franchise agreements and of vertical restraints they might contain. The issues are important and, in some countries, the subject of ongoing discussion and debate.

The Committee on Competition Law and Policy has not endorsed the report's analysis or conclusions. The report therefore does not represent the views or policies of competition authorities in Member countries or the European Community. The report and its conclusions remain under the responsability of its authors, the OECD Secretariat.

# **Executive Summary**

# Competition Policy and Vertical Restraints: Franchising Agreements

This report reviews the application of competition policy to retail franchising, a form of distribution that has spread rapidly across the OECD in the last several decades<sup>1</sup>. The report analyses the economic effects of vertical franchise agreements, evaluates competition policies towards vertical franchise contracts, and makes proposals for future developments in competition policy.

To provide the greatest possible guidance for future policy development, the report evaluates the competitive consequences of a full range of vertical restraints, including provisions such as vertical price restrictions, that now are unacceptable in most Member countries. The report's evaluations assume that a primary objective of competition policy is to maximise economic efficiency — the sum of consumer and producer surplus. The report recognises that competition policy may have other objectives — for example, the preservation of economic independence for legally independent downstream firms (including the ability of those firms to set prices freely and to pass on cost savings), concern over preserving competition in local markets, social or distributional consequences, the willingness to protect specific (e.g., traditional) forms of business, the integration of the Common Market under the Treaty of Rome — but discussion of these objectives is beyond the scope of the report.

Member countries differ in their definition of retail franchising. Several Member countries and, in particular, the European Economic Community consider a relationship to be a franchise only if it involves substantial transfer of know-how and continuing assistance; franchising is distinguished from selective or exclusive distribution, which do not share these characteristics. Only relationships fitting this definition of franchising are covered by the EC regulation setting out competition policy for franchise agreements. Other Member countries include a wider range of distribution relationships in the category of franchises. Many apply a general competition policy towards vertical contracts without defining whether the contract establishes a franchise relationship.

The report concentrates on competition policy issues raised by franchising as more narrowly defined, but in order to be relevant to policy in all Member countries it also discusses more general issues relevant for analysing a broad group of vertical relationships. The report does not, however, cover exhaustively competition policy towards all producer-distributor relationships, such as exclusive or selective distribution, encompassed by broader definitions of franchising.

#### **Economics of franchising and vertical restraints**

The economic effects of franchise agreements are grouped into two general categories: effects on vertical co-ordination and on market competition.

Franchisor and franchisee together form a single vertical structure of production. The decisions of this structure, some taken by the franchisor and some by the franchisee, determine the nature and quality of the product or service supplied, its costs of production, and the price at which it is sold; in other words, these decisions determine the economic efficiency with which the product or service is supplied. The terms of a franchise agreement organise the vertical relationship between franchisor and franchisee and help co-ordinate what otherwise would be independent decisions.

Vertical co-ordination often requires special attention. Decisions on pricing, on quality, on retail effort, and on choice of inputs all may affect the profits not only of the franchisee or franchisor making the choice, but the profits of the other. If franchisees compete with each other, decisions by one franchisee also may directly affect the profits of other franchisees. If a franchisee or franchisor acting independently ignores these spillover effects and chooses in order to maximise only its individual profit, the choice will fail to maximise the aggregate profits of the vertical structure. Consequently including provisions that increase co-ordination in a franchise agreement often will increase the aggregate profits of the vertical structure.

Three categories of co-ordinating provisions or vertical restraints can be distinguished. First, decisions can be co-ordinated by giving the franchisor direct control over franchisee decisions: for example, by giving franchisors the right to specify retail services or quality, or retail prices. Second, contract provisions can restructure incentives; for example, by using a two-part tariff that combines a fixed franchise fee plus pricing of variable inputs at marginal cost, the franchisee is made to feel the full effect of his decisions on aggregate profits, or by using tie-ins the franchisor can impose the same markup over marginal cost on several inputs used by the franchisee. Third, where there are spillover effects between franchisees, vertical restraints can reduce or eliminate intrabrand competition, and thereby reduce or eliminate the externality; for example, by granting exclusive franchise territories or specifying minimum retail prices, competition and externalities among franchisees can be reduced or eliminated.

Typically more than one type of vertical restraint can be used to deal with a particular problem of vertical control, and different combinations of vertical restraints may be used to deal with a particular combination of problems. Which vertical restraints will best deal with the problems faced by a particular franchise system will depend in part on how much information franchisor and franchisee each have and thus on which one can make more informed decisions, and on the willingness of each to bear risk.

Vertical restraints that improve vertical control over and co-ordination of decisions may increase economic efficiency as well as profits. Provisions that eliminate double price markups both reduce retail prices and increase profits;

economic efficiency increases as both components of total surplus, profits and consumer surplus, increase. Provisions that reduce the extent to which vertical or horizontal externalities discourage the supply of retail services and efforts may result in a more efficient supply of service and quality to consumers, especially if otherwise there would be substantial free-riding on retail services or investments in reputation. Provisions that allow the vertical structure to realise more of the productive value of its investments in know-how may efficiently encourage investments in productive know-how.

On the other hand, the vertical structure will use its control to maximise its own profit, which may or may not also increase economic efficiency. For example, the choice of product quality or retail service that maximises profit will not necessarily be the choice that maximises consumer surplus or total surplus; as a result vertical restraints that increase control over retail service and quality may increase economic efficiency and also perhaps consumer surplus, but will not necessarily increase either. Provisions that allow profitable price discrimination may or may not increase efficiency. The greater the competition from other suppliers faced by the franchise system, however, the more the franchise system will be constrained to make choices that benefit consumers, and therefore, the more likely it is they will make choices that increase economic efficiency and consumer surplus as well as profits.

Franchise agreements generally include provisions that insure substantial co-ordination between franchisor and franchisee. While the franchisor and franchisees may remain legally independent, economically they may function much like a single vertically integrated entity. Franchising sometimes can vertically integrate decision-making more effectively than internal integration under common ownership. Even if a franchise system is a single vertically integrated entity, competition from other brands and from other franchise systems or other distribution systems may prevent the franchise system from exercising market power.

The extent of competition from other brands and retailers, however, may be affected by the terms of franchise agreements. The terms of a franchise agreement may reduce competition among existing suppliers by increasing the risk of cartelisation — although only in market environments conducive to cartelisation. Franchise agreements also may reduce market competition in the long run if vertical restraints can be used to erect substantial entry barriers and if competition is not already substantial. On the other hand, franchise agreements also can promote entry and competition. When franchise agreements increase profits without raising entry barriers, either through increased efficiency or increased oligopolistic co-ordination, they promote entry. When franchise agreements increase the returns that can be earned from investments in know-how, they promote investment in know-how, which in turn may lead to entry and both new brands and new retailers. Where franchising improves access to capital, it promotes entry.

Several lessons can be derived from this analysis. *First*, no simple conclusions can be drawn whereby any particular type of vertical restraint — territorial restrictions, tie-ins, vertical price restraints, etc. — will inevitably

improve economic efficiency or reduce it. All types of vertical restraints may either increase or decrease efficiency, since the same provision may have quite different economic effects in different contexts. For example, territorial restrictions may promote efficiency if there would otherwise be extensive free riding on retail services, but they may be used by franchisors as part of a strategy that reduces interbrand competition. And different provisions sometimes may have very similar effects; for example, free riding may be reduced by either territorial or price restrictions.

Second, market structure and the extent of interbrand competition from other brands and retailers is a crucial factor in the analysis of the effects of vertical restraints in franchise agreements. Where the franchise system faces strong competition both from other brands and from other retailers, there is little potential for any type of vertical restraint used by the franchise to reduce economic efficiency. Strong competition at both levels insures efficiency both of upstream supply and of distribution services.

Third, where general market conditions leave open the question of whether a vertical restraint will increase or reduce efficiency, economic analysis provides guidance for identifying those specific circumstances in which a particular restraint may reduce competition or efficiency, or increase efficiency. For example, economic analysis identifies circumstances in which exclusive dealing might be used to raise entry barriers and circumstances in which reduced intrabrand competition might increase efficiency because it prevents free riding.

*Fourth*, the analysis should consider both long- and short-run effects of vertical restraints. Even if a vertical restraint has a negative or ambiguous effect in the short run, its net long-run effect may be positive because the restraint leads to increased entry or investment in intellectual property.

Fifth, the analysis should consider what is the most likely alternative to a vertical restraint. Vertical restraints are one means of integrating decision-making; if a particular restraint is not available, the alternative may be not less integration but a different method of vertical organisation, for example, common ownership, which is neither more efficient nor more likely to promote either interbrand or intrabrand competition.

#### Review and evaluation of competition policies toward franchising

Many Member countries have no specific competition policy for franchise agreements. Instead, general competition policy, and in particular general policy towards various vertical restraints, is applied to franchise agreements.

In contrast, the EEC does have a competition policy position specifically applicable to franchise agreements. A block exemption regulation of the European Commission, Regulation No. 4087/88, specifies those provisions that are acceptable in a franchise agreement and those that are not acceptable (or more precisely provisions that may be included and those that may not be included in an agreement that qualifies for the exemption provided by the regulation). The regulation

carefully defines the characteristics a relationship must have to be considered a franchise and to qualify for the exemption; among other requirements, there must be a substantial transfer of know-how and continuing assistance by the franchisor. Franchising is distinguished from other forms of distribution, namely selective and exclusive distribution, and the provisions acceptable in each type of distribution under EEC competition policy differ somewhat.

A review of competition policy in various jurisdictions towards particular provisions in franchise agreements finds a generally favourable attitude towards territorial restrictions, but with some differences in treatment. In many countries, territorial restrictions are judged under a rule of reason and are acceptable unless found to have anticompetitive effects. This position was taken in the United States by the Supreme Court in a wide-ranging opinion in the *GTE Sylvania case*. In the EEC, limited territorial restrictions are acceptable under the franchise block exemption, but more "absolute" territorial restrictions are not given the goal of market integration under the Treaty of Rome, parallel imports must be possible and customers must not be prevented from purchasing from the franchisee of their choice, in part to insure the preservation of some intrabrand competition.

According to economic analysis, however, territorial restrictions may enhance efficiency by limiting competition, and in such cases stricter territorial limitations that eliminate competition more completely may increase rather than reduce efficiency. Furthermore, even a complete elimination of competition may not reduce economic efficiency if competition from other brands and distributors is sufficiently strong. More generally, it is difficult to distinguish among territorial or customer restrictions on the basis of whether their strictness will promote or decrease efficiency.

Territorial restrictions are not the only non-price vertical restraint often found acceptable. Many Member countries consider exclusive dealing, tying arrangements, refusals to deal, and non-competition provisions acceptable in many, although not all, circumstances.

In contrast to the treatment of territorial and other non-price vertical restrictions, competition policy in nearly all jurisdictions considers the vertical control of retail prices by franchisors unacceptable. This contrast in legal treatment of price and non-price restrictions is not paralleled by a clear contrast in their likely effect on economic efficiency. Either price or non-price vertical restrictions may improve economic efficiency; indeed territorial restrictions and resale price maintenance are alternative tools for reducing intrabrand competition in order to prevent horizontal externalities among franchisees and free riding. On the other hand, either territorial restrictions or price restrictions, in particular market circumstances, potentially may reduce competition and allow increased exercise of market power.

While detailed analysis sometimes is necessary to determine the economic effects of provisions, the practice of always relying on case-by-case analysis to determine competition policy treatment can increase enforcement costs — costs of analysis and litigation for competition policy authorities and for business, and costs of legal uncertainty for business. These enforcement costs also should be

considered in designing competition policy rules. Rules that both match treatment to economic effect and have low enforcement costs are desirable, but sometimes tradeoffs will be unavoidable between the lower enforcement costs of simpler rules and the lower costs from a better matching of policy treatment with economic effect of rules involving more analysis. The costs that rules can impose by prohibiting the use of provisions where they would actually improve efficiency will be reduced to the extent that firms can use alternative restraints that achieve similar efficiencies.

When simple rules are to be used, designing a particular set of rules to fit the particular characteristics of franchise agreements may improve their performance. Simple rules designed for franchise agreements can take account of the general characteristics of extensive use of trade-marks or brand-names, or, under a narrower definition of franchising, of the use of know-how. Specific franchise rules also can consider how use of a common business format affects the role of intrabrand competition.

#### **Conclusions**

Competition policy may have a number of objectives other than increasing economic efficiency. To the extent that economic efficiency is an objective, however, the report's conclusions about how franchise provisions affect economic efficiency are relevant for policy design.

First, both non-price and price vertical restraints may either promote or reduce economic efficiency, and may be either procompetitive or anticompetitive. Consequently, a competition policy that makes a particular vertical restraint either always acceptable or always unacceptable will not match the treatment of that vertical restraint to its effect on economic efficiency in all circumstances.

Second, competition policy should consider market structure in determining when a vertical restraint is acceptable. Vertical restraints are very unlikely to harm economic efficiency or reduce competition in a properly defined market when its structure — its level of concentration, conditions of entry, and dynamics — insure that the franchise will face vigourous competition from other franchise systems or from products or services distributed in other ways. Conversely, in less competitive markets the risk is much greater that vertical restraints can be used to reduce competition or otherwise reduce economic efficiency.

Third, it is competition in a relevant product and geographic market that is most important for determining the effects of franchise provisions on economic efficiency. The relevant market may include products of other franchise systems or of producers using distribution systems other than franchising. Therefore in analysing vertical restraints, competition policy should focus on the extent of competition in the market from other brands and from other retail distribution systems, rather than only on intrabrand competition. Vertical restraints may reduce intrabrand competition without harming economic efficiency. With sufficient competition from other brands and retailers, the franchisor will be unable to reduce economic efficiency by exercising market power over pricing or the choice of

quality in a properly defined market even if intrabrand competition is completely eliminated.

Policy design also must consider enforcement costs. One way to reduce the enforcement costs of case-by-case analysis is to develop enforcement guidelines. Guidelines can increase the predictability of reviews by competition policy authorities. The guidelines also may reduce the cases requiring detailed analysis by including criteria and procedures for identifying those cases where there is a risk of anticompetitive effects and where more detailed analysis may be necessary.

More generally, enforcement costs may be controlled by establishing different rules or enforcement guidelines depending on the state of competition in the franchisor's market. As a broad framework for making policy treatment contingent on market conditions, the report proposes distinguishing three market situations:

- Franchisors with small market shares in unconcentrated upstream and downstream markets, and new or established franchisors attempting to enter a new market could have quasi-automatic permission to include either non-price or price restrictions in franchise agreements; only the minimal analysis needed to establish competitive market conditions is necessary to determine economic effect.
- Franchise systems that are non-negligible and well-established in their market could face a more detailed inquiry into the extent of competition in their market and, if then necessary, into the effects of proposed vertical restraints.
- Franchise systems with a dominant position in their market could require a more detailed justification to show that proposed vertical restraints do not pose substantial risks for interbrand competition, would enhance efficiency, and that comparable efficiency benefits cannot be realised with lower risks for interbrand competition.

In the first market category, where franchise systems face substantial competition from other brands and retailers, there is a strong argument for establishing clear market structure criteria so as to determine whether franchises qualify for a safe harbour within which both non-price and price vertical retraints are allowed. This policy would pose little risk for economic efficiency so long as the criteria were set to insure competitive market conditions, and enforcement costs could be kept low by establishing criteria based on easily determined measures of market structure. Specific choices of market structure indicators and their critical values could be tailored to judgments in different jurisdictions about enforcement costs and the appropriate breadth of the safe harbour.

The design of policy rules towards franchise agreements in the other two market categories involves more difficult tradeoffs between enforcement costs and allowing policy evaluations to determine whether provisions help or harm efficiency. One possibility would be to do sufficient additional analysis to determine if markets are competitive even though the safe harbour criteria are not satisfied. Additional analysis might evaluate whether other basic conditions exist

that would allow provisions, for example, to promote collusion or restrict future entry. If simple rules are used, rules of rebuttable presumption or *per se* rules with carefully defined safe harbours would allow somewhat greater flexibility than uniform *per se* legality or illegality.

The report recognises that there is a wide range of possible rules, and the same rules may not be most efficient in all jurisdictions. The report also recognises that objectives other than economic efficiency may be considered. To the extent that economic efficiency is an important objective, however, the report makes three basic recommendations for policy towards franchise agreements:

- Competition policy should recognise the range of different purposes, some enhancing and some reducing efficiency, that may be served by vertical provisions in franchise agreements.
- Serious consideration should be given to establishing policies towards franchise agreements that make the acceptability of provisions contingent on realistic indicators of market competition.
- Serious consideration should be given to developing market structure criteria for a safe harbour within which franchise agreements would be allowed to include both price and non-price vertical restraints.

# Chapter I

# Introduction

This report examines the treatment of retail franchising agreements by competition authorities. An analysis of competition policy and franchising is timely because of developments over the last ten to fifteen years both in franchising itself and in competition policy analysis. By drawing on the most recent economic studies, this report aims at improving understanding of the reasons for franchising as a form of business organisation. The report also reviews the laws and jurisprudence from Member countries. From these elements, it aims to devise an effective analytical framework that competition officials may apply when reviewing franchising agreements.

#### **Basic issues**

Franchising has become an increasingly important method of retail distribution in most Member countries. Differences across countries in the definition of franchising and limitations of data make precise quantification impossible, but scattered information confirms the impression of rapid growth. When the European Court of Justice considered franchising in 1986, the opinion of the Advocate General reported that it was developing rapidly within the European Economic Community, with the number of franchise systems within the Federal Republic of Germany rising from 85 in 1978 to 200 in May 1982, while in France there were more than 300 systems in 1981 which grew by 1985 to 500 systems with 25 000 participating shops and 8 per cent of total retail sales<sup>2</sup>. A 1985 discussion of franchising in the United Kingdom reported that surveys of British Franchise Association Members indicated the number of retail outlets operated by BFA members grew from 1 906 in 1978 to 4 300 in 1982, and annual retail sales grew from £154 million in 1978 to £400 million in 1982<sup>3</sup>.

Franchising presents important and difficult issues for competition policy. On the one hand, its success in the market-place suggests that it is a form of distribution that can offer real commercial advantages and efficiencies. It is important that competition policy not stifle the development of efficient distribution systems, which in themselves can promote competition in the economies of Member states. At the same time, franchising involves a close contractual relationship between franchisee and franchisor. While they remain legally independent, franchising involves considerable co-ordination and integration between them. To achieve this co-ordination, franchise agreements typically include mutual commitments that restrict their behaviour; in other words, franchise agreements typically include

vertical restraints. Frequently these restrictions reduce intrabrand competition between franchisees in the same network. Competition policy is faced with difficult issues of analysis and evaluation in deciding which vertical restraints are desirable in what circumstances.

Over the last 10 to 15 years, there also have been significant changes in competition law and policy in several Member countries that affect the treatment of vertical restraints. Moreover, economic thinking in several Member countries on the effects of vertical restraints has evolved considerably. Much of this new analysis is focused on how vertical restraints can be used to control potential inefficiencies in a vertical structure. Such problems can arise, for example, when a franchisee does not reap the full benefits of his efforts or is not charged with the full costs of his action. Contract provisions, or vertical restraints as they often are called, can then potentially improve efficiency by "internalising the externalities". Other aspects of the new analysis have refined the understanding of when vertical restraints may not serve to improve efficiency and when they may reduce market competition.

This report focuses on the effect on economic efficiency of vertical restraints in franchise agreements, and of competition policies toward vertical restraints in franchise agreements. The report distinguishes circumstances in which vertical restraints in franchise agreements enhance economic efficiency (the sum of consumers' surplus and producers' profits or surplus)<sup>4</sup> from those in which a vertical restraint is desirable only privately, that is, from the point of view of the franchisor and franchisee. In many market circumstances the restrictions in franchise agreements are most likely to promote both economic efficiency and private profitability. As later chapters will demonstrate, however, in certain market environments some vertical restraints may be profitable for the franchisor and franchisee but reduce consumer surplus and overall economic efficiency. In addition, the report considers how the choice of policy toward franchising is affected by enforcement costs — the costs to competition policy authorities and business of litigation and the costs to business of legal uncertainty. These costs can be thought of as another aspect of the overall impact of policy on economic efficiency.

While this report analyses vertical restraints from the perspective of economic efficiency, it is understood that there is an ongoing debate in Member countries concerning the extent to which competition policy should take account of political and social concerns beyond pure economic efficiency. It is understood that competition policy may have objectives other than economic efficiency — objectives such as economic independence, social or distributional consequences, or elimination of barriers to a single internal market as in the case of the EC<sup>5</sup>. Further, in some Member countries, competition policy towards franchising (and other forms of distribution) is based in part on an effort to eliminate traditions of cartel conduct in various sectors seemingly competitive in market structure. There is also on the part of some Member countries an effort, following the elimination of price controls, to ensure the free setting of prices by downstream firms. This report does not take sides in this debate, and a full discussion of how various policies would serve all these objectives is beyond its scope. Instead, this report presents an

analysis in terms of economic efficiency, which can then be considered to the extent desired, together with any other policy goals and concerns, to arrive at an overall policy. To the extent that competition policy is based on concerns and objectives other than economic efficiency, different policy conclusions on the appropriate treatment of provisions of franchise contracts could well follow<sup>6</sup>.

# **Definitions of franchising**

Retail franchising (i.e., excluding the licensing of industrial processes) is the subject of this report, but what is retail franchising<sup>7</sup>? The question is simple, but there is no simple, uniform definition that can be given in answer. In part, this is because different Member countries and jurisdictions use different definitions. Equally important, some Member countries and jurisdictions have a definition of franchising that affects the application of competition policy, while other countries and jurisdictions do not. Where there is no competition policy definition of franchising, the question becomes, what is generally understood to be a franchise? This question cannot always be answered with precision. Often a range of definitions are used for different purposes within the same country, and one of which can be identified as having particular relevance for competition policy. Since we have no definition of franchising accepted across all Member countries, we can point out only where there is agreement and where there are differences, and where franchising is a precisely defined term in competition policy and where it is not.

There seems a broad consensus that retail franchising is a form of retail distribution that involves at least the following elements:

- ownership by one person (the franchisor) of the rights to a trademark, brandname or other similar sign;
- the grant of a license to selected independent retailers, not agents, (the franchisees) to use the trademark, brandname or other sign in exchange for some agreed upon payment in order to provide retail products or services:
- a license (franchise) agreement establishing an ongoing contractual relationship between franchisor and franchisee of significant duration and specifying some set of obligations on the franchisee, the franchisor, or both<sup>8</sup>.

This list of characteristics identifies retail distribution systems in which there is a close and continuing relationship between producer and retail distributor and extensive use of the manufacturer's trademark or brand name. Not all distribution systems with these characteristics are considered franchises in all Member countries. Some Member countries and the European Community draw additional distinctions between various forms of retail distribution and the term "franchise" is reserved for distribution systems in which there is substantial use and transmission of the franchisor's know-how.

In the European Community countries, a distinction is generally made among at least three types of retail distribution in which trademark is prominent and there

is a continuing relationship between a producer and independent retailers; these three may be summarised as<sup>9</sup>:

- Selective distribution: the supplier undertakes to supply one or more dealers who satisfy certain objective quality standards. The dealer typically has the right to sell rival products;
- *Exclusive distribution:* over a given area, the manufacturer undertakes to sell to his distributor only. In return, the distributor is often, but not always, required to sell only his supplier's products<sup>10</sup>;
- iii) Franchise: franchise distribution systems may share the characteristics of selective or exclusive distribution, but in addition contracts generally cover such features as trade name, brand logos and symbols; most important there is communication of know-how and continuing technical assistance to the franchisee, and standardised products or services are sold according to standard business methods.

Competition law and policy in the EC itself distinguishes seven different forms of retail distribution relationships or systems, of which franchising is but one. In decreasing order of the degree of vertical integration, the seven are (1) distribution by integrated affiliate, (2) agency contracts, (3) franchise agreements, (4) exclusive distribution, (5) exclusive purchase agreements, (6) selective distribution, and (7) contracts between producers and independent distributors<sup>11</sup>. The term "franchise" is limited by the EC to distribution systems in which use of the franchisor's know-how and continuing assistance by the franchisor means franchisees use a common business format specified by the franchisor (see definition below).

The EC definition of franchising has direct legal significance for the application of competition law. The definition is codified in the Commission franchise block exemption regulation<sup>12</sup>, and franchise agreements that meet this definition and other terms of the regulation qualify for an exemption under EC competition law that allows them to include a variety of contract provisions. The provisions that are acceptable in franchise agreements differ from the provisions that are acceptable in exclusive or selective distribution contracts. Some individual Member countries also have definitions or criteria for franchising that are significant; for example, in France jurisprudence has distinguished franchising from other distribution systems for some purposes, and in Japan a Fair Trade Commission decree provides guidelines for applying competition law to franchises with generally understood characteristics.

Other OECD Member countries outside the EC do not have a definition of franchising that directly affects the application of competition policy. There is no definition of franchising that qualifies agreements for different treatment under competition law. There are definitions of franchising in these countries for a variety of other purposes, and these definitions may differ from those in other countries (as well as with each other), but none of these directly affect the application of competition law.

In countries without a competition policy definition, one can only look at the range of other definitions to see what is understood by franchising. Franchising can be defined for a variety of purposes: for legal purposes other than competition policy, for commercial purposes (such as membership criteria for franchise associations), and simply for general everyday usage. Definitions may differ not only from one country to another, but also for different purposes within a single country.

One difference across countries is worth particular note. Outside the EC, and especially in the United States and Canada, a distinction is not consistently drawn between franchising and other forms of distribution where there is a close relationship between manufacturer and distributor and extensive use of the manufacturer's name or logo. As a result, the label of "franchising" often is applied to a considerably wider range of distribution arrangements than in the EC countries.

A look at the definition of franchising in the United States, and comparison with EC practice, illustrates all these propositions about diversity in the defining of franchising: there may or may not be a definition of franchising significant for competition policy, franchising may be defined narrowly or broadly, and definitions for different purposes may vary within a country. First, US competition policy law and enforcement does not rely on distinctions between franchise and other distribution systems, and therefore no definitions with significance for competition policy enforcement have been developed. Second, in common parlance in the US almost any commercial relationship that involves licensing of a brand name or mark may be called a "franchise", a concept much broader than the EC definition. This broader concept also is found in the definitions the US Department of Commerce used for statistical data collection for some years<sup>13</sup>. Data were collected both for "business format franchises" and for "product and trade name franchises". Business format franchises were defined as being characterised by (among other things) "an ongoing relationship between franchisor and franchisee that includes...the entire business concept..." This corresponds roughly to the EC definition of franchising (although unlike the EC definition it has no legal significance for competition policy). Franchising also included produce and trade name franchises, where there is "an independent sales relationship between supplier and dealer in which the dealer acquire(s) some of the identify of the supplier", which clearly included forms of distribution that would not qualify as franchises under the EC definition.

Finally, the case of the United States illustrates how a variety of definitions of franchising may be in use simultaneously in the same country for different purposes. The relatively broad definitions of common usage and of the US Department of Commerce for data collection already have been described. At the same time, the definition of franchising used by the US trade association of franchisors, the International Franchise Association, specifies that the franchisor maintains "a continuing interest in the business of the franchisee in such areas as know-how and training...."<sup>14</sup>. This definition is much closer to the EC concept. Another set of definitions, the only legal definitions of franchising in the United States, appear in federal regulations and state laws requiring disclosure prior to franchise sales and setting restrictions on such matters as termination or non-

renewal of the franchise relationship and franchisor consent to ownership transfers of the retail business<sup>15</sup>. While the definitions of franchising in these laws and regulations vary (and are not directly intended for the purpose of competition policy), most require a transfer of franchisor know-how and bear a marked similarity to the definition of franchising used by the EC.

# The subject and organisation of the report

This report discusses competition policy toward franchising as and to the extent it is legally defined in Member countries. Where countries have established regulatory schemes for franchising that differ from those of exclusive or selective distribution arrangements, the report focuses on the competition policy toward franchising. If only for the practical difficulties of treating all these regulations in depth, distinctive policies toward exclusive or selective distribution will be dealt with only in passing. In particular, the report does not discuss fully the different competition policies of the EC toward other retail distribution systems. The competition policy of the EC, and of some Member countries, treats some provisions or vertical restraints differently depending on whether they are used in franchise distribution or another method of retail distribution. It is important for the reader to understand that in such cases the discussion in this report covers only the treatment of these provisions in franchise systems, and not in other methods of distribution<sup>16</sup>.

Where countries have no distinguishable competition policy towards a definable group of franchise agreements, the report necessarily must discuss the more general competition policy toward vertical contracts and the most likely application of these policies to franchise agreements. Where there might be confusion, the term "business format franchising" is used to distinguish the narrower concept of franchising with transfer of substantial know-how from other forms of distribution.

Furthermore, the report deals only with the regulation of franchising under competition law and policy. Hence it touches only in passing, if at all, on the existence of other laws regulating franchising. Some laws and regulations, for example, require specific disclosure by franchisors to potential franchisees of the risks and likely profitability of investing in a franchise. Such rules certainly have effects on competition, for example by making the market for franchising more transparent and competitive, but they are more in the nature of investor protection regulation than competition regulation and thus are only touched on here.

The organisation of the report is as follows. Chapter II presents the economic analysis of franchising and vertical restraints in franchise contracts. Chapter III describes the general competition law framework in Member countries governing franchising agreements. Chapter IV describes the legal provisions and competition policy jurisprudence in Member countries for the particular types of provisions that might be found in franchise agreements. Chapter V reviews and analyses these laws and jurisprudence in the light of the economic concepts outlined earlier. The chapter also considers how the choice of competition policy may be affected by

enforcement costs and the desire for legal certainty and by objectives other than economic efficiency. Lastly, Chapter VI presents the conclusions of the report and an analytic framework that could be used by competition policy authorities to review franchise agreements.

# Chapter II

# The Economics of Franchising and Vertical Restraints

Franchising is one method of organising the vertical production process of supplying goods or services to consumers. As already pointed out, the success and growth of franchising in many Member countries suggests that franchising can be an efficient means of supplying some types of goods and services. This chapter focuses on how franchisors and franchisees may wish to use various contractual provisions, or vertical restraints as such provisions often are termed, to organise, control and co-ordinate their activities, and on the effect of these provisions on economic efficiency.

When a franchisor and franchisee sign a franchise contract, both are likely to be agreeing to contract terms that restrain or modify their behaviour. Those restrictions can affect both the prices at which they offer their products or service to consumers and the quality and other characteristics of those products or services. In many market circumstances, such contract provisions can improve the efficiency with which franchisor and franchisee supply their products or services, and may also lead to increased competition. In other market circumstances, however, some contract provisions, often the same contract provisions, have the potential to reduce competition or economic efficiency. As the discussion in this chapter shows, careful analysis of market conditions and the functioning of particular contract terms often is needed to understand the purpose and effect of the various types of conditions that firms might wish to include in franchise contracts.

# **Definition of economic efficiency**

Since this report evaluates the impact of franchise contract terms from the standpoint of their effect on overall economic efficiency, it is important to be clear about the definition of economic efficiency and its implications.

By definition, economic efficiency is increased when total surplus is increased<sup>17</sup>. Total surplus is defined as the sum of both consumer surplus and producer surplus, or somewhat more loosely as the sum of consumer surplus and the economic profit of suppliers. It should be stressed that under this definition economic efficiency considers the effects on all producers and all consumers, not just on an individual firm and consumers of its product; the concept refers to the global efficiency with which the overall economy functions. In addition, the concept of economic efficiency encompasses both technical efficiency — the production of any given quantities of outputs with the least possible amount of

inputs — and allocative efficiency — the allocation of society's resources to produce a mix of goods and services preferred by consumers. Improvements in either allocative or technical efficiency will increase the total surplus, and thus increase overall economic efficiency as defined. The objective of maximising total surplus sometimes is described as the objective of maximising economic or social welfare.

This definition has a number of implications. First, the objective of economic efficiency is an aggregate measure of economic welfare that is concerned with the total surplus generated, but not with its division between consumer and producer surplus. Economic efficiency will be improved by a change that reduces consumer surplus if there is a still greater increase in producer surplus or profit<sup>18</sup>. A motivation for including the surpluses of all economic agents (both consumers and firms) is that firms' profits are redistributed to consumers and available for consumption expenditure on other goods or services, or are reinvested in the firms in order to increase future output and consumption<sup>19</sup>. For a variety of reasons, however, including concerns about income and wealth distribution and about the difficulty of measuring total surplus, it sometimes is judged that competition policy should be concerned only with the maximisation of consumer surplus, rather than of total surplus. The analysis in this report of the effects of various contract provisions on total surplus often discusses separately their effect on the components of total surplus, consumer surplus and profits; therefore the analysis generally also may be used to evaluate the effects of vertical restraints, and of competition policies, on consumer surplus alone. Second, the criterion of economic efficiency also does not consider distributional effects among individual consumers. A change that increases economic efficiency, and indeed overall consumer surplus, may improve the position of some individual consumers while leaving others worse off<sup>20</sup>. Finally, the objective of economic efficiency is concerned with the overall functioning of markets, since that is a means of promoting efficiency, but not with the fate of individual firms. In other words, the objective of economic efficiency is concerned with the state of competition, but not with the viability of individual competitors or firms.

This chapter of the report analyses the likely effect on economic efficiency of particular contract terms, or vertical restraints, in franchise agreements. This analysis does not consider the legal status of these provisions in Member states which is considered in detail in the following chapters. For analytical completeness, this chapter considers a full range of vertical restraints that franchisors and franchisees might wish to include in franchise agreements, including both vertical restraints legally acceptable in most Member countries, and other restraints — such as resale price maintenance or strict territorial exclusivity — that are not allowed in many Member countries. The economic analysis of a particular contract term or vertical restraint does not imply that that provision is acceptable in any Member country.

#### Overview: evaluating vertical restraints in franchise agreements

#### Vertical structure

From the viewpoint of economic analysis, a franchise agreement organises a vertical relationship between the supplier (whether a manufacturer or not) of one or more intermediate inputs — the franchisor in this case — and a downstream firm — the franchisee — that uses those inputs<sup>21</sup>. Often know-how is one of the most important of these intermediate inputs. The franchisee uses these inputs, generally together with other inputs, to itself supply a product or service. In the retail franchises considered in this report, the products or services are supplied to final consumers, rather than being themselves intermediate inputs into another production process.

Seeing franchisor and franchisee as part of a single vertical structure of production is central to the economic analysis of franchising. The decisions of this vertical structure, some taken by the franchisor and some by the franchisee, determine the nature and quality of the product or service being sold, the costs of production, the price at which the product or service is sold, and finally the quantity sold. From the standpoint of the firms, these decisions determine the total profits earned by the vertical structure, whose division between franchisor and franchisees will be determined in large part by the terms of the franchise agreement. From the standpoint of economic efficiency, those decisions determine the total surplus generated by the vertical production process.

These decisions of franchisor and franchisee are in turn affected by the terms of the contract they make, the franchise agreement. Contract terms affect decisions either by placing direct obligations on franchisor or franchisee, or by restructuring their incentives so they are motivated to make different choices. The terms of the franchise agreement therefore affect both the profitability of the vertical structure and the economic efficiency with which it supplies products or services.

The vertical structure established by a franchise agreement may be thought of economically, if not legally, as an intermediate form of vertical integration. Unlike the case of a fully integrated business, the franchisor does not own the franchise outlets. (Many franchisors do, however, combine franchising and marketing through outlets belonging to the company.) Yet clauses in the franchise agreement result in considerable de facto integration and co-ordination of decision-making between franchisor and franchisee. This "external integration" carries with it mutual commitments that distinguish a franchise from less integrated vertical structures with looser contractual relationships between upstream supplier and distributor<sup>22</sup>.

The effects on profitability and efficiency of the contract provisions that implement varying degrees of external integration are the focus of a now extensive economic literature on vertical contracts<sup>23</sup>. The analysis here of franchise agreements, a particular type of vertical contract, is an application of this analysis.

#### Private motivations and social welfare in vertical contracting

There is a lively academic debate and growing literature about the motivations for including various provisions in vertical contracts, including franchise agreements, and about the impact of these provisions on economic welfare. Some analysts argue that vertical restraints do not increase the monopoly power of the vertical structure, but instead are designed to improve the efficiency with which the vertical structure supplies products or services. Because of market competition, new business practices, including provisions in franchisee agreements or other vertical contracts, emerge only if they improve economic efficiency. Consequently, vertical restraints generally improve economic efficiency as well as the profits of the firms. According to this analysis, because businessmen "know their business", they can do the best job of determining what contract terms will be most efficient, and they should not be second-guessed by policy-makers or economists. These writers typically argue that vertical restraints can harm competition and efficiency only when they really are agreements that implement horizontal collusion.

Other analysts question such a strong presumption that vertical restraints enhance efficiency. While agreeing that vertical restraints may enhance efficiency in many circumstances, they find other circumstances in which they can reduce rather than increase economic welfare or market competition.

This report takes the position that vertical restraints, including those in franchise agreements, are best understood by analysing them from two perspectives. The first perspective is that of the firms signing the contract: how will the provisions affect their profits? The second is that of social welfare: what is the impact on economic efficiency of such provisions in the franchise agreement?

Franchisor and franchisee have a private profit motive for signing franchise agreements, and for including the terms in those contracts labelled vertical restraints<sup>24</sup>. Franchise agreements, and the vertical restraints they may include as terms, can increase the total profitability of the vertical structure, and larger total profits divided between franchisor and franchisee have the potential for increasing the profits earned by each.

The private motive of increased profit certainly need not be inconsistent with vertical restraints being economically efficient. Producer profit is a component of total surplus, and a vertical restraint that increases profits also will improve economic efficiency unless the increase in profits is offset by a larger decrease in consumer surplus. Furthermore, as we will see, vertical restraints that eliminate inefficiencies often benefit consumers directly and increase consumer surplus as well as profits. To give two examples, vertical restraints may lower retail prices by eliminating multiple, excessive price mark-ups, or may increase the supply of retail services that consumers value by reducing free rider problems.

On the other hand, since consumers obviously are not parties to franchise agreements, franchisor and franchisee need not limit themselves to contract terms that improve consumer surplus, as well as their own profits, unless forced to do so by competitive market forces. Vertical restraints that increase profits nonetheless

may reduce total surplus because consumer surplus falls by more than the increase in producer surplus or profit. Thus vertical restraints that franchisor and franchisee have a private profit incentive to adopt may or may not also increase economic efficiency.

# Aspects of the evaluation

Several general considerations should be kept in mind when evaluating the impact on economic efficiency of contract provisions in franchise agreements.

First, it is important to consider the alternative options. The provisions of a franchise agreement implement a degree of external integration. In evaluating the economic effect of a provision, one should remember that the alternatives include not only the absence or modification of that provision, but the choice of more complete integration. A particular contract provision — for example an exclusive dealing obligation that a franchisee not handle products that compete with those of the franchisor — may seem restrictive compared to more loosely integrated distribution arrangements, but neither unusual nor particularly restrictive compared to the alternative of internal integration in which the manufacturer owns his own retail outlets.

Second, the evaluation should consider the effects of vertical restraints both in the short term and long term. These may differ. For example, suppose some practice limits competition in the short run, enabling the franchise firms to earn greater profits. The evaluation of the practice should consider whether these revenues are returns to some initial investment that otherwise would not have been made. In other words, negative effects in the short run may (but also may not) turn into positive effects in the long run — although certainly claims that this will occur must be examined closely to avoid excusing behaviour with clearly anticompetitive effects in the short run because of speculative and uncertain benefits claimed in the long run.

# Organisation of the analysis

The analysis in the remainder of this chapter is organised as follows. First, the report briefly describes the types of vertical restraints, firms might wish to include in franchise agreements. This is followed by more detailed discussions of the use of vertical restraints to improve vertical co-ordination between franchisor and franchisee, of the choice between external and internal integration, and of the effects of vertical restraints on interbrand competition. A final section draws together general lessons from the detailed analysis.

### **Definition of franchise contract provisions**

A vertical contract can consist of little more than a specification of the intermediate input purchased and of the uniform price per unit of that input.

Franchise agreements, however, usually include other provisions that set the terms for transfers from one party to the other (generally monetary transfers from the franchisees to the franchisor and technological or know-how transfers from the franchisor to the franchisees), and provisions that may restrict the behaviour of the franchisor, the franchisee, or both. As a matter of terminology, we will label all contract provisions, other than a uniform unit price for the intermediate input, as "vertical restraints". The most important provisions are described below, together with some comments on the circumstances in which their use will be feasible. As already pointed out, this analysis lists vertical restraints that firms might want to include in franchise agreements, without limiting the analysis to those legally acceptable in Member countries.

### Franchise fee

The definition of a franchise fee used here for analytical purposes is more limited than it sometimes is in common business usage. Here it specifies a particular structure of payments by franchisee to franchisor. Franchisees pay franchisors for products or other inputs purchased and the right to use the franchisor's brand name, know-how or business methods. By definition, a franchise fee is a payment where the amount due does not depend on the quantity of an intermediate input purchased from the franchisor; in other words, a franchise fee is a fixed amount the franchisee must pay to continue to be part of the franchise system<sup>27</sup>. A franchise fee provision creates a simple two-part "wholesale" tariff, consisting of the franchise fee plus a price per unit of intermediate input purchased, that determines how much a franchisee pays the franchisor<sup>28</sup>. This non-linear tariff is an alternative to specifying the amount due with a linear tariff consisting only of uniform per-unit price for the intermediate input. Other forms of non-linear tariffs also might be specified in franchise agreements: for example, progressive rebates on the quantity bought by the franchises. Different payment structures affect all the "targets" of franchise agreements: the motivations and choices of franchisees and franchisors, the allocation of risk between them, and their division of profits.

A franchisor needs very little information to enforce a simple franchise fee provision: he needs only to keep a check on who carries his products (otherwise the fee provision would be subject to arbitrage on the franchisees' side: one of the franchisees could buy the whole quantity in order to resell it to other franchisees). Clearly this will present very little problem for a business format franchisor. The ability to use more general non-linear tariffs may be limited by the information necessary to enforce them (or by legal restrictions). To avoid the possibility of arbitrage the franchisor may have to observe not only the quantity of each intermediate input bought by each franchisee, but also the quantity actually sold by each; otherwise, the franchisees could set-up a secondary market, making the non-linear pricing policy ineffective<sup>29</sup>.

#### Royalties or commissions

Royalties are another way of specifying franchisee payments to the franchisor. Unlike a franchise fee whose fixed amount does not vary with changes in a franchisee's output or sales, royalty payments are variable and their amount varies with a franchisee's sales, measured either in units or in revenue. Royalty fees also are distinguished (under this economic definition) from payments whose amount depends on the quantity of an input that the franchisee buys from the franchisor; the royalty due depends on the franchisee's sales and does not vary if the franchisee uses more or less of the franchisor's inputs to produce and sell a given level of output. To enforce a royalty or commission provision, the franchisor must be able to monitor the franchisee's unit sales or revenue.

# Price provisions

A price provision, sometimes known as resale price maintenance, specifies the final price that franchisees charge consumers. Variants of this restriction include specifying only a price ceiling, specifying only a price floor, non-binding "recommendations" for a retail price or price floor, and recommended retail prices advertised by the franchisor. Resale price maintenance or price floors may be hard to enforce if price cuts, or their equivalent, cannot be detected and prevented at reasonable cost. Hidden discounts include not only secret price cuts, but also non-monetary concessions such as extra, unregistered services, free delivery, and so forth.

# Quantity fixing

This provision specifies the quantity to be bought by the retailer. Variants of this restraint include quantity forcing, which imposes on the franchisee the obligation to purchase a minimum quantity, and quantity rationing, which specifies a maximum quota. If demand is known and depends on the final price only, and if the franchisee cannot resell to other franchisees or "throw away the good", quantity forcing is analytically equivalent in effect to a price ceiling, quantity rationing to a price floor, and quantity fixing to resale price maintenance. Another variant, which has somewhat different effects, is a provision requiring the franchisee to achieve a minimum sales revenue; when payments to the franchisor take the form of royalty payments, the minimum royalty payment could be set by this minimum level for sales revenue.

#### Territorial or customer provisions

Such provisions limit the territory or group of customers that a particular franchisee may serve. Provisions granting a franchisee an exclusive territory are common examples. These provisions, as used here, however, do not necessarily

refer to geographical territories; they may also refer to some other segment of the market. If for example the franchisor's products are distributed both by mail order and through retail stores, a "territory" that a franchisee is or is not allowed to serve might be that part of the market served by mail order. Other examples are the assignment of non-business customers to one group of franchisees and business customers to another, or the assignment of small business customers to franchisees while sales to large firms are reserved for franchisors or a different set of franchisees.

Provisions specifying exclusive territories may impose more or less strict restrictions on the franchisor and the franchisee. Less strict provisions do not completely limit a franchisee from selling only to customers in his own territory. Rather the franchisor commits himself not to compete actively with the franchisee in a given territory (either directly or through other franchisees) and the franchisee undertakes not to compete actively for customers in other territories. A common example is when the franchisor only dictates the location of establishments, but consumers are free to choose between them. Stricter provisions more completely specify customers or markets. The strictest territorial provisions completely divide the market among franchisees, specifying that the franchisee may deal with no consumer from outside his territory and, implicitly, specify the single franchisee with which each customer or potential customer must deal.

The ability to use such provisions will depend in part on the ability to write enforceable contracts specifying the characteristics of exclusive territory. Doing so is likely to be relatively straightforward if customers must be served from fixed retail locations and this is the only dimension of the territory specified. In other cases, the commitment of each party not to compete may be more difficult to enforce because of the possibility of competing indirectly or with parallel activities. The strictest provisions are likely to raise the most difficult enforcement issues; in particular, the franchisor must be able to trace consumers<sup>30</sup> and to prove, in case of cheating, that the franchisee was aware of their origin, or at least negligent in not obtaining the information<sup>31</sup>.

#### Exclusive dealing

Exclusive dealing restricts the franchisee, who agrees not to engage in any other business, or at least in any other business which competes directly with the franchisor's activities. A separate provision, full line forcing, obligates the franchisee to carry the franchisor's whole range of products. Full line forcing often is associated with exclusive dealing obligations, but either obligation may be included in an agreement without the other.

#### Tie-in

A tie-in provision requires the franchisee to buy one or more goods or intermediate inputs from the franchisor in addition to the inputs essential to maintaining his identity as part of the franchise network, thereby "tying" together the purchases. A "requirements contract" is a type of tie-in which requires the franchisee to buy all inputs and/or pieces of equipment exclusively from the franchisor. Use of a tie-in requires that the franchisor can verify the source of the inputs used by the franchisees, particularly if the inputs provided by the franchisor are priced above the market price for such inputs.

# Other provisions

The clauses set out above do not exhaust the list of provisions franchisors and franchisees might wish to include in franchise contracts. Direct controls or obligations on franchisors or franchisees are likely to be particularly important. Clauses may specify the technical help or professional training the franchisor is obligated to provide, or specify levels of quality or service that franchisees must maintain. Other types of clauses are found in franchise agreements. For instance, if the franchisor is in charge of national advertising for his line of products, the contract may include a provision to cover the corresponding costs. Still other clauses may limit the right of the franchisee to compete with the franchisor after termination of the franchise relationship.

#### Franchise contract terms and vertical control

Franchisors and franchisees can use contract provisions to co-ordinate and integrate their behaviour, thereby increasing profits and often economic efficiency.

Separate, decentralised decision-making by franchisor and franchisee may generate externalities that reduce both profits and efficiency. Franchisees and franchisors each make choices that affect the prices charged to consumers for the product and its nature and quality: choices of wholesale and retail price, choices of the level of services and quality, and choices of input mix. These variables are the "targets" that determine the profits of the franchise structure as a whole, and some target variables are set by the franchisor and some by the franchisee. The choices made by one party, often will affect the other's profits. When making choices to maximise their individual profits, however, franchisors and franchisees will ignore the effects of their choices on the other, failing to consider the full effect on the overall profits of the vertical structure. As a result such externalities often reduce economic efficiency. The analysis in this section looks at how vertical restraints can be used to overcome externalities that affect choices of prices, services and quality, and input mix.

Franchisors and franchisees can use vertical restraints for other purposes: to assign risk efficiently, and to protect intellectual property rights and limit opportunistic behaviour. And the contract provisions of the franchise agreement also determine the division of profits between franchisor and franchisees. These issues also are analysed in this section.

The economic literature often refers to such uses of vertical restraints under the general heading of vertical control, and the provisions themselves may give the franchisor the right to set standards or otherwise "control" franchisees. No coercion of franchisees is implied, however, as the resulting co-ordination of behaviour is likely to be in the interest of both franchisor and franchisee<sup>32</sup>. The analysis assumes that franchisees are not coerced into accepting contract provisions, and that neither party will sign a contract unless they are at least as well off as with the available alternatives<sup>33</sup>.

Which contract provisions franchisors and franchisees will want to include in their contract will depend on the particular vertical control problems that threaten profits. Different combinations of problems require different packages of provisions. The analysis considers successively different situations in which firms might want to use vertical restraints to increase profits, rather than analysing separately the uses or effects of particular vertical restraints or contract provisions. It would not be appropriate to analyse individual provisions separately, because many situations must be dealt with by a combination of contract provisions. This organisation also brings out three other central features of the role vertical restraints can play in franchise agreements: (a) the same vertical restraint can be used for different purposes, potentially with opposite effects on economic efficiency; (b) the same situation sometimes can be dealt with by different vertical restraints, or groups of restraints, that are more or less good substitutes (at least from the standpoint of profitability); and (c) sometimes one contract provision may be used in place of another to circumvent information or enforcement problems. For example, if the franchisee's sales or quality of service are costly to verify, the franchisor may want to use a tie-in to require use of an input that can serve as an indicator of sales or will help ensure some aspect of quality<sup>34</sup>.

This section first discusses how vertical restraints may be used to coordinate the choices of retail price, of retail services, of franchisor quality, and of input mix. It then goes on to discuss the use of vertical restraints to allocate risk, and prevent opportunistic behaviour. In each case we look first at what contract provisions can correct the co-ordination problem, and at the effect on consumer and total welfare. This section does not consider whether these provisions also affect the extent of competition faced by franchise systems; that issue is discussed in a later section.

# Choice of retail prices

When both franchisor and franchisee have discretion over price — that is both have some horizontal market power — their pricing decisions provide the classic illustration of how a vertical externality harms both profits and social efficiency<sup>35</sup>. The problem arises when franchisor and franchisee independently set simple uniform prices: the franchisor chooses the wholesale price paid by the franchisee for intermediate input and the franchisee chooses the retail price for the product or service sold to consumers.

Each firm chooses a price higher than marginal cost in order to maximise its own profit. The size of each mark-up, and thus of the overall "double mark-up", depends on the elasticity of demand faced by each firm, which in turn depends on the extent of interbrand and intrabrand competition. This "double mark-up" results

in a retail price set above the level that would maximise the aggregate profits of franchisor and franchisee together<sup>36</sup>. This happens because each firm's decisions generates a vertical externality, affecting the profits of the other firm as well as its own profits, but each firm ignores this "spillover". The franchisee makes any increase in the retail price that increases his own profits, ignoring the fact that those increases, because they decrease the quantity sold to consumers, also decrease the franchisor's profit (by an amount roughly equal to the reduction in the amount of intermediate input used multiplied by the wholesale mark-up). The franchisor marks up the wholesale price considering only the effect on his own profit, and not on the franchisee's.

This uncoordinated exercise of market power at both wholesale and retail levels reduces both the profits of the firms and economic efficiency. Franchisor and franchisee can increase aggregate profits by adopting contract provisions that eliminate the vertical externality and lower the retail price. Since correcting the externality leads to lower retail prices, it also benefits consumers and thus improves economic efficiency; this effect can be summarised as "there is nothing worse than a monopoly, except a chain of monopolies". Vertical restraints that only prevent double mark-ups have no effect on the extent of underlying market power, but they do benefit both consumers and firms by reducing both the private and social inefficiency of price-setting.

The conditions that can create double price mark-up problems may well exist in franchising relationships. The prominent role of brand names and trademarks in franchising suggests that the franchisor is supplying a differentiated product or service and may have at least limited discretion over price. Individual franchisees also are likely to have some discretion over price since their services often will be differentiated from those of other retailers, including those in the same franchise network, by location if by nothing else. Frequently competition from other brands, which may be offered by franchises or through other distribution systems, will limit the pricing discretion of franchisor and franchisee.

Even in markets that are monopolistically competitive with no entry barriers, franchises could be faced with limited double mark-up problems if fixed costs result in a minimum efficient scale for franchisees that limits the number of viable franchisees. In such markets, the limited market power conferred by brand name differentiation generally would not be considered a competitive problem so long as entry is relatively free. There still could be some efficiency-enhancing role for vertical restraints that limit double mark-up problems for incumbent firms.

The most direct way to eliminate the double mark-up is to use resale price maintenance to set a retail price ceiling. (Only a price ceiling is needed to solve this problem; a retail price floor does nothing to avoid a double mark-up problem.) An alternative, nearly as direct, is to force a minimum amount of sales; if the franchisee has discretion only over the retail price, he must choose the desired retail price level to make the specified sales. With either restraint, a uniform wholesale price set above cost can be used to distribute profits to the franchisor without affecting the retail price<sup>37</sup>.

Another way to keep the retail price down is to use two-part tariffs. The franchisor charges a wholesale price for the intermediate input just equal to his (marginal) cost, and a franchise fee. The franchise fee allows the franchisor to set the per unit wholesale price at cost without forgoing profit; the franchisor collects with the fee all (or part of) any supra-competitive profits earned by the vertical structure. Because the wholesale price is equal to marginal cost, the franchisee is residual claimant of the aggregate profit — i.e. he receives any marginal profit and suffers any marginal losses associated with a change in the retail price — and therefore has an incentive to choose the retail price which, given the cost and demand conditions prevailing in the market, maximises the aggregate profits.

Any of these contract provisions effectively prevent a double price mark-up in simple analytical models in which franchisor and franchisee have full information about present and future demand and cost conditions and there is no uncertainty and no risk. In practice, it is more difficult to design contract provisions. The value of franchisor control of the maximum retail price will be reduced if the franchisor finds it difficult to monitor the prices actually charged customers or if controls can be circumvented by reducing the quality of the product or service supplied. Even if there are no problems enforcing price ceilings, the franchisor must know the franchisee's demand and cost conditions to choose the price ceiling (or minimum quantity) that maximises aggregate profit<sup>38</sup>. If franchisees have better information than the franchisor about local demand and cost conditions, that is a reason to set a franchise fee plus a wholesale price equal to cost so that pricing decisions can be delegated to franchisees.

Lack of information and uncertainty, however, also create reasons why it may not be profit-maximising to set the wholesale price equal to marginal cost and collect all profits with the franchise fee. If the franchisor does not know all the demand and cost conditions that will be faced by franchisees, he will not know how high the franchise fee can be set<sup>39</sup>. If the franchise fee is set too high, profitable franchise situations will be lost. A fee set too low costs the franchisor profits and may do a poorer job of screening out less capable franchisees. The best reaction to these problems may be for the franchisor to set wholesale price above marginal cost rather than relying only on the franchise fee for all of his share of the profits, but then the double mark-up (and other problems discussed below) will remain<sup>40</sup>.

When franchisees face competition at the retail level, this changes the vertical co-ordination problem involved in setting the retail price, and may introduce new incentives for vertical restraints to induce the franchisee to set the profit-maximising retail price.

If competition is strong enough at the retail level to make franchisees price takers, it eliminates the double mark-up problem: perfect competition prevents a retail mark-up (beyond that necessary to cover retail costs). In a simple world, the franchisor could use a wholesale price set above marginal cost both to capture all profits and to control the retail price. This, however, assumes that aggregate profits are not affected by choices other than retail price, that the franchise network does not have to worry about the franchisee's level of effort, choice of quality, or choice of inputs, or about the allocation of risk. These issues are considered below.

Even when the only issue is setting retail price, however, there are limits to franchisor control through the wholesale price. First, franchisors must know local demand and supply conditions and changes in those conditions in order to set the wholesale price that yields the profit-maximising retail price. As pointed out above, when franchisees have better information, the franchisor might prefer to delegate the pricing decision. Retail competition prevents this solution because any incremental profits earned by the franchisee would be competed away. Retail competition also limits pricing to maximise profits if the profits of the franchise business could be increased by retail price discrimination. Retail competition typically would prevent price discrimination.

If for either reason intrabrand competition stands in the way of profit-maximising retail pricing, rather than simply helping by eliminating the double-markup problem, franchisors have an incentive to eliminate intrabrand competition by giving franchisees exclusive territories. Then franchisees can be made residual claimants who choose price mark-ups and who implement price discrimination to increase profits<sup>41</sup>. The effects on social welfare, however, are ambiguous. Price discrimination may either increase or decrease consumption and economic efficiency compared with a uniform price. If a franchisor tries to control retail price but has insufficient information to hit the target of the profit-maximising price, retail price may end up higher or lower than the profit-maximising price. This comparison between the full-information profit maximising price and the limited-information profit maximising price is, however, irrelevant to the social welfare assessment of the franchise provisions.

#### Choice of franchisee service and effort

Franchisees provide a variety of services that affect the sale of their products or services<sup>42</sup>. They can often provide sales efforts which increase the demand for the goods they distribute: free delivery, information and advice, after-sale services, and so forth. Franchisees also make choices that affect the quality or other characteristics of the products or service they sell: the freshness of the beer, the taste of the hamburger, the cleanliness of the retail premises, the safety of the car repair, the speed and responsiveness of service. Such services are likely to be particularly important to the commercial success of products or services supplied by business format franchises. The substantial transfer of know-how that characterises business format franchising suggests that franchisee efforts or services are important.

Retailer services can generate both vertical externalities between franchisor and franchisee and horizontal externalities among franchisees. Both externalities cause the individual franchisee to realise less than the full effect on aggregate profits of additional retail services, and therefore to provide a different level of retail services than the level that would maximise aggregate profits. When retail services have a substantial effect on aggregate franchise profits, as they often will, at least one party will have a strong profit incentive to adopt provisions in the franchise agreement that overcome the effects of these externalities. Even when

only one party benefits directly, if contract provisions can be found that redistribute any resulting increase in aggregate profits without imposing other offsetting costs, both parties can be given a profit incentive to adopt the provisions. While eliminating these externalities may allow the franchise system to choose a level of retail services that will increase profits, it will be less certain that doing so will increase consumer surplus or economic efficiency.

# 1. No competition among franchisees

If there is no competition at the franchisees' level, there can be no horizontal externalities between franchisees, but there may be problems of co-ordination between franchisee and franchisor. When deciding on the level of his effort or services, the franchisee considers only the effect on his own profit, not the effect on the total profit. If the franchisor charges a wholesale price higher than marginal cost, some of any increase in demand and net revenue generated by increased retailer service will go to the franchisor. Failing to take this vertical externality into account, the franchisee is likely to supply less retail service than would maximise aggregate profits. This vertical externality is exactly analogous to that which causes a franchisor to mark up the retail price too much.

An obvious remedy is for the franchisor to impose a direct control on the franchisee's provision of such services. (This is equivalent to solving the double marginalisation problem by the direct control of resale price maintenance.) Indeed franchise contracts often specify standards of service or quality that franchisees are to maintain. Indirect control devices also may be used; a tie-in provision gives the franchisor control of the quality of tied inputs.

Alternatively, the externality can be internalised by using the two-part tariff of a franchise fee plus a wholesale price set at marginal cost. When the franchisee is residual claimant of all marginal profits from retail services, he has an incentive to choose the level of retail service that maximises aggregate profits. We saw above that the same remedy of making the franchisee residual claimant could be used to deal with the problem of a double price mark-up. The use of this remedy for both problems represents a quite general principle: as long as all the choices necessary for maximising aggregate profits are undertaken by the franchisee (and as long as there are no complications such as those presented by incomplete information, uncertainty and risk, or costs of enforcing contracts) it is an optimal contract for the franchisor to "sell" his technological know-how for a fixed price (the franchisee fee), charge a wholesale price for any variable input equal to his marginal cost, and let the franchisee decide freely upon his actions. The franchisee then has an incentive to act to maximise aggregate profits, and the franchisor uses the franchisee fee to collect his share of the profits.

Implementing these simple remedies for the retail services vertical externality faces the same practical problems as the analogous remedies for the double price mark-up. Contract provisions specifying retail services may be difficult (or costly) to monitor and enforce, and franchisees may have better information than franchisors on local conditions relevant for determining the best level of retail

service. There also are drawbacks to relying too heavily on franchise fees when franchisors are uncertain about future profits.

Despite these limitations, the provisions found in franchise agreements can enable franchise partners to avoid or reduce the effects of vertical externalities and to better co-ordinate their choice of retail services. Better co-ordination can improve aggregate franchise profits, but the effect on consumer surplus, and thus on economic efficiency, is not so clearly positive as the effect of eliminating a double price mark-up. Eliminating the double price mark-up reduces price, which unambiguously increases consumer welfare. Eliminating the vertical externality affecting the choice of retail services will increase the supply of retail services, but taken by itself that also generally increases costs and the retail price. (Assume that the choice of retail price already is controlled by resale price maintenance, so the improved co-ordination does not extend to retail pricing.) The effect on consumer surplus depends on whether or not the extra services are worth the increase in price to consumers.

The increase in services and price may be profitable without increasing consumer surplus. When choosing the level of services to provide, firms ask: how many more consumers could be attracted by offering more services, taking into account the increase in cost and price? A profitable increase in services will increase sales, and obviously the consumers who make these purchases find the increase in service worth the increase in price and are better off. Other consumers, however, who bought the products before the increase in services and price and continue to buy, may be made worse off because they would prefer fewer services and lower prices. A loss of consumer surplus by consumers who continue to buy will be ignored by the firms. Thus an increase in retail services can increase profits without necessarily increasing aggregate consumer surplus or total surplus<sup>43</sup>. When the franchisor/franchisee structure enjoys considerable market power, additional retail services may be valued quite differently by, on the one hand, the firms and consumers who are induced to buy when retail services (and price) are increased and, on the other hand, by consumers who would buy the product with or without the additional retail services. (Note, however, that if, contrary to the assumptions of this section, consumers have sufficiently good alternatives, an increase in services and price is unlikely to reduce consumer surplus because most consumers who would be made worse off by the change can switch to an alternative brand.)

In sum, where competition from other brands and retailers does not prevent the franchise from exercising some market power, theory alone provides no unequivocal answer on the welfare effects of allowing better control of retail services, and empirical tests are rather difficult to implement. Franchise agreements can always be used to increase profits, and may well have a positive impact on consumer welfare if the provision of customer services affects profits and consumer surplus in similar ways. If, however, such services have greater effects on profits than on consumer surplus, which may be the case in the absence of tough competition among franchisors, then provisions that increase vertical control of services may decrease consumer surplus. If the latter divergence is important, then the total surplus, measured as the sum of profits and consumer surplus, can be reduced<sup>44</sup>.

### 2. Competition among franchisees

When several franchisees compete with each other, the supply of retail services may be affected by horizontal externalities as well as vertical externalities. Before considering this possibility, however, we look at the influence of retail competition on the ability of the franchise structure to choose the level of services that maximises profits in the absence of horizontal externalities.

#### i) Control of retail services

Competition among retailers or franchisees constrains franchisees' choices of retail service. Retailers must supply services adapted to consumers' preferences since, when they have a choice, consumers will choose the retailers who offer the best package of price and services<sup>45</sup>. The package that consumers prefer, however, may not be the package that maximises profits. The level of services that maximises profits may be either higher or lower than the level enforced by competition. Therefore there can be a private profit incentive to reduce or eliminate intrabrand competition if competition from retailers selling other brands is limited; doing so then could allow franchisees to supply a level of retail services that would not survive greater retail competition<sup>46</sup>. To achieve this result, the franchise agreement should include a package of vertical restraints that (a) eliminates competition among franchisees, and (b) eliminates vertical externalities that distort the choice of both retail price and retail services in the absence of franchisee competition. One such package would be a combination of exclusive territories and a franchise fee plus wholesale price equal to marginal cost.

Such provisions may have beneficial or detrimental effects on the consumer and total welfare. Perfect competition among retailers both eliminates double mark-up distortions and ensures that, given the wholesale price, retail franchisees supply the level of services that maximises welfare. Any franchisees providing less desirable price-service bundles (again given the wholesale price) would be pushed out of the market. This analysis, however, does not establish that social welfare will fall if the franchise agreement reduces intrabrand competition and gives the franchisor control over retail services as well as price. With retail competition, the franchisor can control retail prices (through his wholesale price) but not services. With control of both price and services, it may be profitable to choose a lower retail price, with the net result that consumer surplus increases (as do profits) even though the bundle of services provided at the lower price is not welfare optimal<sup>47</sup>.

#### ii) Horizontal externalities among franchisees

Competition among franchisees can reduce the supply of retail services by creating an externality among retailers or franchisees: the service provided by one retailer may directly benefit other retailers<sup>48</sup>. If a franchisee can realise, or appropriate, only part of the revenue created by the expenditure on retail service, this generally will reduce the profit-maximising level of retail service.

The most quoted analyses of this problem refer to the possibility for a retailer to "free ride" on services provided by other retailers. A well-known example arises when retailers provide pre-sale information (for instance, free brochures, salesmen's advice, demonstrations, etc.) to consumers who then go and buy from other retailers. Advertising provides another example; consumers can be informed by the advertising of one retailer or franchisee, and purchase from another<sup>49</sup>. Since the retailer who provides the services must charge a higher price to cover his costs, consumers have an incentive to visit the first retailer and then buy from another retailer whose costs and price are lower because he does not provide the pre-sale service. In extreme cases where a retailer who provides such services cannot appropriate any of the benefits from increased sales, no service will be provided.

Even in less extreme circumstances, such a horizontal externality gives rise to public good problems, in the sense that any one franchisee's effort benefits all (or many other) franchisees. Thus each franchisee would like to see these beneficial services provided, but each also would rather have the others provide it. In short, the franchisees (or more properly consumers) may have incentives to free ride on some retail services provided by other franchisees, which leads to insufficient levels of these services<sup>50</sup>.

It is important to realise, however, that free riding is not a problem for all retail services, but only when the retailer supplying the service cannot realise all the additional revenue generated. For example, free riding generally is not a problem for post-sale services, where access can be limited to customers who have purchased from the retailer. Free riding also is not a problem if it is efficient to charge separately for those services; this is another means for eliminating free riding on the supply of post-sale services<sup>51</sup>.

This form of free riding applies only to retail services that customers can consume independently of the basic product or service being retailed. In some circumstances, however, retail services that cannot be consumed independently still can generate a horizontal externality and be susceptible to free riding. The efforts of a franchisee to improve the perceived quality of his product may create a reputation for quality that increases the sales of other franchisees<sup>52</sup>. This reputation externality will only be important under certain conditions. First, consumers must believe that the quality they experience from one franchisee may apply to products sold by other franchisees. Consumers must be unable (or unwilling because it is too costly) to determine the quality provided by particular retailers before purchasing; otherwise they can base their purchases on actual rather than "reputed" quality. Second, franchisees who would free ride on the reputation created by other franchisees must find it profitable to do so; for example, free riding must not be unprofitable because it leads to losses of repeat business. Reputations created by good experiences can be lost by bad ones<sup>53</sup>.

The preservation of reputation and quality could be important for the profitability of many business format franchises. Part of the "product" some franchises offer for sale is a known and consistent level of quality which can be of value to consumers in lowering search costs and reducing risk<sup>54</sup>. Where this is important, the actions of an individual franchisee create spillovers by affecting both his own sales and the general reputation for consistent quality<sup>55</sup>.

Franchisors and franchisees can avoid these free rider problems either with contract provisions that obligate franchisees to provide specified services, or with vertical restraints that reduce the intrabrand competition that induces free riding. The effectiveness of direct controls will depend on the possibility, or cost, of writing enforceable contract provisions and of monitoring compliance by franchisees (since franchisees will have an incentive to evade the obligations and free ride)<sup>56</sup>. If the franchise system wants to tailor some retail services to particular locations, rather than to supply a uniform level of services from all franchisees, the effectiveness of direct controls also will depend on whether franchisors have enough information about local conditions to specify the most profitable level of retail services for individual franchisees.

The other approach is to protect franchisees from the intrabrand competition that erodes their return on retail services. Resale price maintenance, particularly the price floor prevents discounting and reduces consumers' incentives to buy from stores that do not provide the retail service. The larger margin on sales increases the incentive to provide services. Alternatively, exclusive territories eliminate free riding to the extent that they deter consumers from choosing among franchisees; stricter forms that divide markets more completely will eliminate free riding more completely. Either provision is likely to work best when combined with provisions for a franchisee fee and a wholesale price set at marginal cost. Otherwise, resale price maintenance or exclusive territories, by reducing retail competition, would solve the horizontal externality at the cost of exacerbating the vertical externality that leads to double price mark-ups or reduced supply of retail services.

Neither retail price floors nor exclusive territories are without problems for franchisees. First, neither may be completely effective. Price floors will not eliminate non-price competition, and franchisees would still have some incentive to free ride where possible and compete for customers with different services whose benefits do not spill over to other franchisees<sup>57</sup>. Assignments of exclusive territories will reduce but not eliminate free riding if they restrict but do not eliminate customer movements among franchisees. Second, each form of restriction, even if it completely eliminated free riding, may be an imperfect mechanism that imposes costs that reduce its profitability. Imposing the same price floor on all franchisees reduces profits when franchisees have different retail costs. The pattern of exclusive territories that best reduces free riding may differ from the pattern that otherwise would maximise profits. In either case, franchisors will have to balance benefits and costs (measured in profits) to decide whether to use the vertical restraint, which restraints should be used, and the level of the price floor or extent of the exclusive territories.

Where free riding would be extensive without vertical restraints, the welfare analysis is less ambiguous than above, since then the level (or uniformity) of services would be much too low, not only from the private perspective of profits but also from the perspective of the overall impact on total surplus including consumer surplus. This evaluation only applies, however, where free riding is a serious problem. It applies only if franchisees cannot appropriate the benefits of the services they supply — where retail services can be consumed independently of purchases, or where franchisees may benefit from reputations based on the efforts

of other franchisees — and less restrictive ways of making the benefit appropriable are not available at low cost<sup>58</sup>. In addition, consumers must act in a way that makes the spillover effect substantial. For example, the cost to consumers of consuming the retail service of one franchisee and buying elsewhere must be low enough relative to the cost of the retail service (and thus the difference in retail price) that consumers search out free riding franchisees. Problems of inappropriable benefits are likely to be less important where many sales are repeat business or markets are smaller (e.g. in small towns as opposed to large cities or along major highways).

Where franchisees can appropriate more (but not all) of the profits generated by retail services, free riding and the undersupply of services will be a less serious problem, and the welfare analysis again becomes ambiguous. Less than the profit-maximising level of services will be supplied, but restrictions whose effect is to increase both the supply of services and the retail price may or may not also benefit consumers and increase economic efficiency.

### Choices of promotional effort or quality by franchisor

The franchisor may also provide choices that directly affect his franchisees' profits. He may, for example, undertake national advertising campaigns or improve the quality of the products distributed by his franchisees. Linear pricing, setting a uniform wholesale price with no franchise fee, is likely to induce the franchisor to spend less on promotional effort or quality than the amount that would maximise the aggregate profits of the vertical franchise structure. The franchisor's profit from additional sales is proportional to his own margin (the difference between the wholesale price and his marginal cost), whereas the total profit is proportional to the larger total margin, which also includes the retail margin (the retail mark-up over the wholesale price and the retail variable costs).

When the franchisor has to provide such efforts, the franchise contract must try to solve the problem either by stipulating the level of effort to be provided (if the franchisor can commit himself or the contract can be enforced), or by giving the franchisor incentives to provide the correct level of effort. The optimal franchise contract in this case would make the franchisor the residual claimant of marginal profits. This can be done by lowering the franchise fee and increasing the wholesale price, either directly or via the use of tie-ins (by forcing the franchisee to buy high-priced inputs). Alternatively, the franchisor may require high royalties. In all cases, however, it will be necessary to use resale price maintenance (or tough retail competition) to avoid double marginalisation problems.

When both franchisees and franchisor make choices that affect the profits of the other and both must be given incentives to make the efforts that maximise aggregate profits, the franchise structure faces a difficult problem. Giving franchisees an adequate incentive by charging a wholesale price equal to the marginal cost and recovering the profits through a franchise fee may reduce the franchisor's incentive to expand effort to maximise joint profits<sup>59</sup>. Indeed, since it is usually impossible to make both the franchisee and franchisor residual claimants, it may not be possible for the franchise structure to maximise profits fully when

incentives must be provided at both the upstream and downstream levels<sup>60</sup>. The contract can try to reduce the weight placed on incentives by directly specifying the obligations of franchisor or franchisee. When direct controls are insufficient, however, the franchise contract will have to reflect a compromise between the franchisor's and franchisees' levels of effort<sup>61</sup>.

## Franchisee choice of inputs

A franchisee typically will use several inputs, some of which he buys from the franchisor, and some from other sources. (In the fast food industry, for instance, the franchisee often buys food from the franchisor, but other materials and equipment elsewhere.) If the wholesale price for an input purchased from the franchisor is marked up above (marginal) cost, the franchisee has a profit incentive to substitute other inputs. From the standpoint of the vertical structure, however, this induces a distortion of the mix of inputs used that reduces aggregate profits. In choosing how much of the franchisor's input to consume, the franchisee ignores the effect on the franchisee will not choose the most efficient mix of inputs with the lowest (social) cost since the relative input mix no longer reflects the relative marginal costs of the inputs. As noted below, however, this is not necessarily the only way that the ability to substitute inputs affects economic efficiency.

In the purest case, the problem of input substitution arises only when different mixes of inputs can be used to produce precisely the same output; quality is unaffected by the substitution. In other cases, the input substitution also may affect the quality of output. In either case, there can be an input mix distortion, when and to the extent that input substitution by the franchisee is possible.

The input mix distortion disappears if the franchisor uses a two-part tariff: a franchisee fee plus wholesale price equal to marginal cost. There are, however, a variety of reasons why the franchisor may decide to mark-up the wholesale price above marginal cost<sup>62</sup>. One alternative solution is for the franchisor to buy other inputs subject to substitution and sell them to the franchisee, also marking up their price above marginal cost. Because their price has been marked up, a tie-in is likely to be necessary to require the franchisee to buy these other inputs from the franchisor. Tie-ins, however, work only to the extent that the franchisor can tie all inputs subject to substitution. An alternative is for the franchisor to use a royalty; a royalty is equivalent to a proportional mark-up on all inputs.

If the franchisee has market power, the tie-in or royalty will solve the input substitution problem, but the franchisee will still have an incentive to mark up retail price and restrict output. Another vertical restraint, such as a retail price ceiling or quantity forcing, would have to be used to eliminate this problem<sup>63</sup>. If, however, the franchisee faces enough competition at the retail level, the additional restraint will not be needed<sup>64</sup>.

If the only effect of solving the input mix problem were that franchisees chose a more efficient mix of inputs, economic efficiency as well as profits would increase. When the franchisor potentially has market power, however, this may not be the only effect. The ability of the downstream producer to substitute other (competitively supplied) inputs for that of the franchisor constrains the franchisor's profit-maximising price for his input. Freed of this constraint, the franchisor may be able to raise the price for the input (or inputs in the case of a tie), or otherwise extract more profits, so that the retail price increases rather than falls — even though the mix of inputs is more efficient. The rise in retail price may be great enough that the resulting loss in consumer surplus exceeds the gain in producer profits and total surplus falls. On the other hand, it is possible for the retail price to fall (since costs fall), so there is a gain in both consumer and producer surplus, or for retail price to rise little enough that producer surplus increases by more than the fall in consumer surplus. What happens depends on the elasticity of demand for the retail product or service, the elasticity of substitution between the various inputs, and on the extent to which competition allows price to be marked up above marginal cost at the retail level<sup>65</sup>.

### Allocation of risk

Uncertainty about future profits, and the risk it creates, will be a fact of life for most franchised business. Franchisors and franchisees who are risk-averse will have to be compensated for risk they must bear. This compensation becomes, in effect, part of the cost of supplying the product, and will be larger or smaller depending on the magnitude of the risk borne and on how risk-averse are those bearing it. The assignment of risk among those with differing degrees of risk-aversion therefore affects the total amount of these costs, and thus both the profits and the economic efficiency of supply.

The terms of the franchise agreement will determine how much risk is borne by the franchisor and how much by the franchisee. This can complicate the design of a franchise contract and the choice of vertical restraints. A number of problems of vertical co-ordination between franchisee and franchisor can be dealt with by making the franchisee the residual claimant on marginal profit. Making franchisees residual claimants, however, also makes them bear all of the risk. If franchisees are risk averse, they will have to be paid a premium — i.e. be given a larger share of the expected net revenue — to be willing to bear the risk. Since that leaves less profit for the franchisor, franchisors have a reason to reduce the risk franchisees bear<sup>66</sup>. The franchisor then faces a conflict between "insuring" the franchisee against risk and giving the franchisee incentives to make profit-maximising choices. A wholesale price equal to marginal cost and a high franchise fee gives the franchisee the incentives to make profit-maximising choices, but provides no insurance against risk. A higher wholesale price and lower franchise fee gives the franchisee better insurance, but distorts his incentives for choosing price (and other variables). Faced with this tradeoff, the best solution may be a wholesale price above marginal cost, providing at least partial insurance<sup>67</sup>. That in turn creates the potential for a variety of other problems, which then may have to be addressed by other vertical restraints.

Economic efficiency also is promoted by allocating risk away from franchisees if they are risk averse. Efficiency also may demand a tradeoff between

incentives and insurance, assuming tools cannot be found to avoid a tradeoff. The tradeoff that is most profitable for the franchisee, however, will not necessarily be the choice that is optimal from the standpoint of economic efficiency.

# Opportunistic behaviour and protecting returns to know-how

Franchisors and franchisees often will have to make relationship-specific investments that will lose much or all of their value if the franchise relationship is ended. Franchisors generally will have to invest in acquiring the know-how that is the basis of the franchise system. If returns to these investments are not assured through well-structured, long-term contracts, opportunistic behaviour is likely to prevent the party that makes such investments from realising the returns generated, resulting in the under-provision of such investments<sup>68</sup>.

Franchisors' incentives to invest in know-how or in developing particular franchises will be reduced if they cannot realise the full returns generated. If the franchise activity involves the franchisor's know-how, for instance, it is important for the franchisor to be assured that competitors will not benefit at the same time from any know-how, as they might if franchisees sell products that compete with those of the franchisor<sup>69</sup>. Franchisors will be less willing to make investments to help a particular franchisee if afterwards the franchisee can benefit from the franchisor's effort without paying fees or royalties by opening additional outlets or businesses that are not part of the franchise network, or by terminating the franchise relationship and continuing in a similar business.

Similarly, a franchisee will be reluctant to make specific investments, and to commit himself to pay franchise fees, if nothing prevents the franchisor from locating another franchisee next to him once the investment has been sunk, or from demanding a higher franchise fee to renew the contract that captures some of the returns on earlier sunk investments.

Various provisions can be used to prevent behaviour that would erode returns on sunk investments. Exclusive dealing provisions and other restrictions may be used to prevent franchisees from appropriating the benefits of know-how by using it to distribute competing goods or by engaging, directly or indirectly, in activities similar to those of the franchisor. Other provisions can prohibit franchisees from pursuing a similar business (and thus making use of franchisor know-how) for a period of time after the franchise relationship is terminated. Exclusive territories help ensure that franchisees will be able to earn a return on investments they sink. The agreement may specify investments that franchisor, franchisee, or both have to commit to the relationship and that might be forfeited if they try to behave opportunistically; this is referred to in the literature as requiring an "exchange of hostages". Finally, agreements can be written for a longer term to prevent opportunistic behaviour at renewal<sup>70</sup>.

The sort of problems described here can lead to insufficient investment from the standpoint of efficiency as well as profits. Contract provisions that allow the investor to capture more of the return generated therefore can improve efficiency as well as profits. Contract restrictions can be justified by this argument, however,

only to the extent that initial investments are important and the returns to those investments are lost or considerably reduced if the relationship is ended or the other behaviour being restricted is not prevented.

### Franchising versus internal vertical integration

A contract between supplier and retailer that contains none of the provisions we call vertical restraints — a contract that specifies little except the simple unit price — is not recognisable as a franchise agreement. Rather, such a simple contract represents a different organisation of the vertical structure: an unintegrated structure with contracts between autonomous firms. Legally franchisor and franchisee also are autonomous firms. Yet by writing franchise contracts with provisions that modify and constrain the behaviour of both franchisor and franchisee and that create an explicit or implied long term relationship, the firms establish a much more integrated organisation that allows relatively co-ordinated behaviour. The previous section has described how the co-ordination and integration made possible by such contract provisions can benefit both the firms, by increasing profits, and society, by increasing economic efficiency.

There is an alternative to either a completely integrated structure or the contractually integrated franchise structure. Moving along a continuum to greater integration, a manufacturer could co-ordinate upstream and downstream behaviour by organising it within a single firm and forming an integrated distribution sector, i.e. by having his own outlets and own salespeople<sup>71</sup> <sup>72</sup>.

Therefore the economic efficiency of franchising, and of the vertical restraints included in franchise agreements, should be compared not only to a less integrated structure, but also to the economic efficiency of a different form of integration: internal vertical integration within a single firm. If a vertical restraint is found to be contrary to competition policy, the firm generally has two options. The firm could continue with a franchise organisation, but exclude the offending provision. In this case, the question is, what is the impact on economic efficiency of reducing vertical co-ordination or control, or of achieving such co-ordination with a different contract provision (and presumably one that is inferior from the standpoint of the firms)? The firm may have a second option: replacing franchising with internal vertical integration. If the firm chooses this option, assessment of the impact of the policy on economic efficiency depends on a comparison between internal vertical integration and the franchise agreement<sup>73</sup>.

A full analysis would require a complete theory of the firm, that is, a theory that explains when a single firm acts more efficiently than separate firms, and what is the best internal organisation of a firm. Such an analysis must deal with co-ordination problems, the need for information to monitor and control activities, transactions costs (are they higher or lower within the firm or outside the firm?), as well as "institutional imperfections" such as legal or institutional constraints, capital and labour market imperfections, etc. In the absence of a complete and accepted theory dealing with these issues, we will limit ourselves to listing some arguments usually given to explain the market-place evidence that, for a

considerable number of businesses, franchising is preferred to vertical integration under single ownership as a method of (partial) integration. We distinguish two types of arguments: arguments based on capital constraints, and arguments based on effective vertical control.

## Capital market imperfections

The desire to avoid capital constraints has been identified as a major motivation for firms to favour franchising over internal expansion as a way of extending retail distribution. A firm with a promising but unproven format and with little capital may find it difficult to raise substantial funds on its own. The firm may find that tapping the accumulated capital of potential franchisees or their access to local credit markets is easier, or at any rate less costly, than trying to finance internal expansion<sup>74</sup>. This argument is most convincing for smaller firms beginning to build a distribution network, or perhaps expanding into new markets where the capital markets are uncertain that past success can be repeated. Mature franchisors with established access to national capital markets may be able to borrow on better terms than those available to potential franchisees. On the other hand, franchising may help even larger firms or established franchisors seeking to enter foreign markets, if financing is available at better rates to local potential franchisees.

The ability to use franchising as a way of both overcoming capital constraints and building a co-ordinated distribution system will be particularly important if there are substantial scale economies. In such cases, capital constraints might not simply slow expansion of a venture, they could prevent its success by preventing the system from taking advantage of those scale economies. This phenomenon could be important either for the rapid expansion of a new firm, or for expansion into a new market, perhaps a new national market, that required developing a distribution system with its own scale economies.

#### Vertical control

Vertically integrated firms have their own problems of vertical control. Company-owned outlets and employees, like franchisees, have to be monitored and methods of imposing control and providing incentives have to be found. Internal vertical integration by common ownership is not a panacea. The internal "policing" methods (using this term to capture all aspects of the problem) the vertically integrated firm can use may or may not be superior to those available to control independent franchisees. In at least some situations, the advantage apparently lies with franchising rather than vertical integration<sup>75</sup>.

Comparing internal and external policing is difficult analytically. In theory, all external policing methods can be mimicked in an internal incentive scheme within a vertically integrated firm. For example, in theory the incentives created by using a two-part tariff to make a franchisee the residual claimant could be mimicked by an employment contract that required the outlet manager to pay a

fixed premium annually in return for the right to be employed as manager and the right to receive all the profits of that outlet.

In practice, however, it may not be possible to "sell the technology" to the manager of a company-owned outlet, and therefore give employees the same incentives as independent franchisees<sup>76</sup>. This is consistent with the suspicion often expressed that company-owned outlets provide insufficient effort<sup>77</sup>. On the other hand, direct monitoring and control, which usually involve more information exchange, may be easier to implement in an internal organisation. Both forms of organisation will rely on both direct control and incentives. Which one is a more efficient control mechanism in a particular situation will depend on the value of different mixes of incentives and direct controls.

The incentives possible with franchising are likely to be valuable in businesses where retail effort is particularly important, and/or where it is most difficult to monitor directly. For example, if knowledge of local demand and cost conditions is important, this may make direct control more difficult (since more location-specific information will be needed) and make it more important to provide local managers or franchisees with incentives to adjust to local conditions. Franchising will only be the more efficient organisation, however, if the advantages of incentives are not outweighed by other problems. The independent franchiseeentrepreneur may not be slothful, but, as we have seen, his interests may not coincide with those of the franchisor — unless modified by the provisions of the franchise agreement. Can contract provisions be found to deal with the various problems of vertical co-ordination? If free riding or reputation externalities are important, can they be controlled? If franchisees are risk averse, can contracts be structured to provide them with adequate insurance without doing too much damage to incentives? Can a formula be found to determine franchise fees that tailors the fee to local conditions and satisfies the franchisor that he is receiving an adequate share of the profits, without distorting incentives or risk bearing?

The problem of ensuring adequate retail effort and quality illustrates the complex way factors may interact. It is reasonable to suppose that the free rider problem may be particularly important for mature business format franchisors (as for other firms with well established brand names)78. This creates a problem that must be controlled if franchising is to be efficient. At the same time, the cost of using direct controls to maintain consistent retail quality may be lower for established distribution systems with many outlets. More outlets in a particular area may reduce the costs of monitoring effort and quality, both by reducing the cost of visits to monitor quality and by providing more useful benchmarks of performance. Depending on other circumstances, these lower costs of direct control could complement the efficiency either of franchising or vertical integration. Vertical integration may be favoured if retail effort and quality can be directly controlled at relatively low cost and there are few other dimensions of retail performance that must be controlled (or that are difficult to control directly). If, on the contrary, there are other important aspects of retail performance for which it is important to provide incentives, the relative ease of direct control may make franchising more attractive since it provides a relatively low-cost tool for controlling the free riding that otherwise could be a serious drawback.

Specific analytical conclusions are difficult, but the general point is clear enough. For purposes of improved vertical control, as well as for reasons of access to capital, franchise agreements with vertical restraints in some market circumstances may be a more efficient organisation than either a vertically integrated firm or an unintegrated vertical structure.

# Potential for increasing market competition

The two previous sections have discussed how franchise contract provisions can co-ordinate the behaviour of the upstream franchisor and downstream franchisees. The central focus of this and the next section is market competition; after a discussion of how competition can prevent a franchise system from exercising market power and prevent vertical restraints from reducing efficiency, this section examines ways in which franchising, and the vertical restraints in franchise agreements, might increase the disciplining forces of market competition. The following section discusses how franchise agreement provisions might be used to restrict market competition.

### Competition and the exercise of market power by franchise systems

It follows from the integrating function of franchise contracts that a franchise system should be treated as a single integrated structure in evaluating its position in the market and its ability to exercise market power. In other words, the economic position and role of a franchise system can be seen as close to that of a single integrated entity, rather than as a collection of individual firms, regardless of the legal status of franchisees and franchisors. Whether a franchise system able to act as an integrated entity can exercise market power will depend on the availability to consumers of sufficiently close substitutes for the products or service offered by the franchise system. Where consumers do have sufficient, closely substitutable alternatives for the franchise brand and for purchasing from the franchisees' retail outlets, either from other franchise systems or from suppliers using other distribution methods (either from current suppliers or from entering suppliers), the resulting competitive forces will prevent the franchise from exercising market power.

Since franchise systems involve both upstream producers of inputs, the franchisor, and downstream retailers, the franchisees, there are two dimensions to the competitive alternatives that must be available to prevent the exercise of market power. First, there must be alternative suppliers of upstream inputs. If one thinks of the input supplied by the franchisor and by other upstream producers as establishing the basic brand identity of the product or service, then this can be restated by saying that there must be a sufficient supply of brands that consumers consider close substitutes for the franchise brand. Second, there must be competing retail distributors from which consumers can buy the brands that compete with the franchise brand.

It may not be so important to distinguish competition at these two vertical stages if the brands closely substitutable for the franchise brand also are supplied by integrated systems that each use their own, separate retail outlets — either other franchise systems or producers that own their retail outlets. The number and size distribution of competing suppliers would be essentially the same at both stages. In other cases, however, franchises will compete with brands using less integrated retail distribution; each of these unfranchised, competing retailers may distribute several of the competing brands and competing retailers may carry the same brands. Then it will be important to consider the competitiveness of both stages since market structure at the retail level may be quite different than at the upstream level. A franchise might be able to exercise market power despite a competitive retail market structure if there are only a few other brands that consumers consider close substitutes; limited upstream competition would allow the exercise of market power. Alternatively, a franchise might be able to exercise market power despite the availability of many closely substitutable brands, if these brands are for some reason available from only a limited number of retail distributors (and conditions prevent entry by additional retailers). In this case, limited downstream competition for franchisees from retailers handling other brands could allow the exercise of market power.

Competitive conditions at both vertical stages from other brands and other retailers, whether supplied by franchises or suppliers using other distribution methods, will prevent the franchise system from exercising market power. Competition will also prevent the franchise from exercising the vertical control allowed by vertical restraints to make choices that are inefficient. As seen in the previous sections, vertical restraints may allow the franchise system better control over its targets of pricing, service, quality, and so forth. The franchise will use this control to increase its profits. If the franchise has market power, the choices that increase profits do not necessarily also increase consumer surplus or economic efficiency. Sufficiently strong competition, however, also will constrain the franchise from making choices of, for example, levels of retail service or product quality that reduce consumer surplus and efficiency; choices that reduce consumer surplus and efficiency will no longer be profitable when consumers can turn to alternatives. If markets are really competitive, inefficient franchise systems, those that make inefficient choices, should be pushed out of the market by other, more efficient brands and distribution systems.

Competition involving consumer products and service often is described in terms of interbrand and intrabrand competition. It is worth considering briefly the relationship between the concepts of interbrand and intrabrand competition, and the more general analysis just described of competition in well-defined upstream and downstream product and geographic markets.

Intrabrand competition — competition between different retailers selling the same brand of product (or service) — is a component of competition in retail markets, but not necessarily the only component. Consumers may have more retail alternatives than retailers of a single brand unless consumers consider no other brand to be a close substitute. Since retail markets and competition are often broader than a single brand, intrabrand competition is not a necessity for a retail

market to be competitive. A complete absence of intrabrand competition among franchisees does not mean the franchise system is unconstrained by retail competition, just as a vertically integrated firm that owns all its own retail outlets is not necessarily able to exercise either upstream or downstream market power simply because its outlets do not compete with each other. In each case market power may be denied by competition from other retailers selling other, closely substitutable brands (although of course it is important to determine whether and what other brands are sufficiently substitutable so that their retail supply can prevent the exercise of market power). Intrabrand competition is not synonymous with retail market competition, and its presence or absence cannot be used as the sole indicator of the presence or absence of retail market competition sufficient to prevent the exercise of market power<sup>79</sup>.

Interbrand competition comes closer to the concept of competition described above between a franchise brand and other brands and other retailers. Depending on interpretation, however, the two may not be the same. If interbrand competition is interpreted as referring only to competition between brands whose identity is established by the inputs of upstream suppliers, the concept of interbrand competition encompasses competition between these upstream suppliers, but not the extent to which brands are distributed by competing retailers. On this interpretation the existence of interbrand competition is not sufficient to insure that downstream retailing, as well as upstream supply, is competitive. This is a serious failing as competition at the retail level also is important for promoting efficiency<sup>80</sup>. Interbrand competition can be interpreted more broadly, as competition for the franchise from other brands and from retailers selling other brands. The difficulty is that it can be awkward to describe competition at the retail level as interbrand competition when competing retailers are not identified with particular brands. To avoid confusion and make clear that retail competition also should be considered. this report will generally describe the market competition franchises face as competition from other brands and retailers.

The remainder of this section looks at ways in which franchising, and the vertical restraints in franchise agreements, can increase competition between brands and retailers. As will be seen, these pro-competitive effects are primarily dynamic effects that operate in what economists call the long run: periods long enough for the number of competing upstream producers and downstream retailers to change.

### Entry stimulation

When franchise contracts are used to improve vertical co-ordination and increase profits, they increase the incentives of firms to enter the "vertical chain of production," which includes both upstream and downstream markets. The same products or services might not be profitable if supplied either by a vertically integrated firm or by independent firms prevented from using contracting and vertical restraints to achieve the same degree of vertical co-ordination.

Thus franchising arrangements can encourage entry that increases competition both for upstream producers and for retailers, and consequently promotes economic efficiency. If vertical restraints also improve the efficiency with which a given number of existing franchises operate, these incentives for additional entry and competition add to the ways in which vertical restraints promote efficiency. If instead vertical restraints used by existing franchises add to their profits but reduce efficiency in the short run prior to any entry, in the longer run the potential profitability of franchise systems using vertical restraints may attract entry that increases upstream and downstream competition and results in increased total surplus. The net effect on efficiency over the whole period then may be either positive or negative depending on the relative importance — that is, the magnitude and duration — of the short term reduction in efficiency prior to entry and the longer term improvement in competition and efficiency.

Franchising can encourage several types of entry. A new firm may use the franchise system to enter and compete effectively with already established firms (which may or may not be organised as franchise systems). Or the franchise system may allow an existing small firm to expand and attain an efficient scale of operation, thereby becoming a more effective competitor. In either case, competition may well be increased both for the product represented by the "brand", and in downstream retail markets. In a variation on these cases, franchising may permit a firm already present in one geographic market to enter neighbouring markets; this phenomenon may be particularly important in the European Economic Community, where completion of the internal market in 1992 is aimed at promoting intra-community trade and business.

### Incentives to invest in know-how

The transfer of know-how and the supply of technical skills that is a defining characteristic of business format franchising is very significant for economic analysis. Know-how and technical skills may result from a firm's accumulated experience, from some forms of research and development, from testing different ways of conducting business, or from a particular innovation. In any event, the value of the know-how is created by some sort of investment. A competition policy analysis of contract terms must consider both the benefits of facilitating the transmission of accumulated know-how and skills, and also the preservation of firms' incentives to make such production investments<sup>81</sup>. Firms need to be rewarded by earning returns on investments in know-how.

Franchise agreement provisions can increase the incentives to invest in know-how. First, provisions can protect the franchisor's intellectual property rights by limiting unauthorised use of the know-how for which the franchisor does not receive compensation. This may be particularly important when the franchisor's know-how concerns his experience in conducting business something especially difficult to protect in more standard ways, e.g. by the use of patents or licensing agreements.

Second, the franchise agreement can increase the returns franchisors realise for authorised use. A franchise agreement, together with its various contract provisions and vertical restraints, will increase the total surplus generated by the investment if it is a more efficient way of organising the vertical chain of production than the alternatives. Even if efficiency is not increased, the restrictions of the franchise agreement will be designed to increase the profitability of the vertical structure, which means the agreement will increase the proportion of the surplus generated by the know-how that is captured as profits. (As we have seen, in some situations the restrictions may increase profits at the cost of some reduction in total surplus; the increased profits still represent a potential increase in returns to know-how.) Finally, the terms of the agreement will determine the division of profits between franchisees and franchisors. When a franchisor has a strong bargaining position (as is likely when their particular know-how is valuable), those franchise terms will result in the transfer of a substantial portion of the net revenues to franchisors — thereby allowing the franchisor to realise a larger return on his investment in know-how.

By allowing these larger returns, franchise contract terms encourage investment in the development of know-how that is expected to be productive and profitable. This should have a generally positive effect on economic efficiency in the long run. Encouraging the supply of products and services based on new know-how will increase the competition for existing brands and firms, or will result in new product innovations<sup>82</sup>.

A related point is that franchise contracts may encourage the disclosure and dissemination of information. Most franchise contracts specify that the franchisor must give the franchisees all the relevant information for running the business. Of course, the same information might be given to agents running the franchisor's own outlets, but the franchising contract is generally viewed as generating more information disclosure. This is partly due to the moderate length of franchise contracts (but there are sometimes post-termination provisions which limit the use of the disclosed information) and also to the way franchisees are recruited (since they have to pay to enter the agreement, franchisees need a minimal amount of information before being recruited).

# Potential for reducing market competition

Vertical agreements may increase the profits of franchisors and franchisees by increasing the economic efficiency with which the vertical structure supplies its goods or services. The objective of franchisors and franchisees, however, is to earn profits, and profits also can be increased if it is possible to reduce competition and exercise more market power. The questions are, can vertical restraints in franchise agreements be used to increase or maintain market power, and if so in what circumstances?

### Anti-competitive collusive effects

It is possible for vertical restrictions to promote or maintain horizontal collusion either upstream (franchisor/manufacturer cartels) or downstream (dealer cartels). These are short-run effects in the sense that they involve collusion among existing suppliers. They may or may not be short-lived in duration depending on prospects for entry in the longer run. Only in particular market circumstances, however, will franchisors or franchisees be able to acquire or keep significant market power by using vertical restrictions.

### Franchising and upstream competition

It has been argued that some of the contract provisions discussed above can be used to help competing franchisors sustain collusion. One line of argument is that resale price maintenance can help to sustain high prices by making it easier for franchisors to monitor cheating on a collusive agreement, which in turn reduces the incentives to cheat. First, resale price maintenance eliminates the incentive of franchisors to use secret wholesale price cuts to try to cheat without being detected; according to this argument wholesale price cuts would not increase profits because they could not be passed on without also lowering the more observable controlled retail price<sup>83</sup>. Second, resale price maintenance sharply reduces uncertainty about whether observed changes in retail prices mean that a franchisor is trying to cheat on a collusive agreement, or whether such changes are the result of franchisee initiative, perhaps in response to changes in local retail cost changes<sup>84</sup>.

Another line of argument identifies a possible strategic use of vertical restrictions in franchise agreements<sup>85</sup>. Restrictions that decrease intrabrand competition among franchisees (e.g., by assigning exclusive territories) also may decrease competition at the upstream level by making franchisors' price cuts less attractive. For instance, consider the case of a few manufacturers distributing their products through franchisees with exclusive territories. If one of the franchisors decreases his wholesale price, then his franchisees may pass on only part of the reduction to consumers. Moreover his competitor's franchisees may respond by decreasing their own prices. Both effects lower the increase in demand that can be expected by the franchisor, and thus tend to discourage the franchisor from decreasing his price. In other words, reducing competition among franchisees, e.g. through the use of exclusive territories, tends to make demand less sensitive to changes in wholesale price by the franchisors than if they distributed their products through competitive retailers or if they owned their distribution systems and competed directly with each other at the retail level<sup>86</sup>.

None of these arguments claim that resale price maintenance and territorial restrictions always will allow franchisors to collude. At most these arguments indicate that vertical restraints may facilitate collusion if market conditions otherwise are favourable for the exercise of market power through collusion, which is not always the case.

#### Horizontal cartelization at the downstream level

Some vertical restraints operate directly to eliminate retail, intrabrand competition, and therefore might be used to support a cartel among retailers to fix retail prices, limit output, and divide markets. Retail competition between brands is reduced only to the extent that co-ordinated restrictions are imposed on what would be competing brands in the absence of action by the retailers. Colluding retailers in the same market might be able to raise retail prices if they could set up a "franchise" covering several substitutable products or services whose only purpose was to impose retail restrictions<sup>87</sup>. This seems an unlikely consequence of a business format franchising agreement where there is a legitimate transfer of valuable know-how<sup>88</sup>.

# Market foreclosure and barriers to entry

In some circumstances, provisions in franchise contracts might prevent entry by what would be efficient competitors of the franchisor. One argument is that an incumbent franchisor can foreclose his market and protect himself against the future appearance of more efficient competing franchisors by forcing franchisees to buy from him for a long period of time<sup>89</sup>. Once the franchisees have committed themselves to buying from the initial franchisor, they will be rather "tough" on selling these products, and thus will engage in fierce price or non-price competition if competing products appear. Therefore, if there are barriers to entry by franchisors, then long-term requirements contracts may create barriers to the entry of competing manufacturers. Existing franchisees may be induced to accept such contracts, even though they help the franchisor monopolise the intermediate goods market, if the franchisor allows them part of the extra rent made possible by the long-term contract.

Another argument is that long-term exclusive dealing contracts by a franchisor with a large market share could be used to increase the entry cost of a potential competitor if distribution involves large economies of scope. Suppose, for example, that a manufacturer is distributing his products through franchisees who could also distribute the products of a potential competing manufacturer<sup>90</sup>. If there are synergies from distributing both lines of products, a potential competitor entering the market could have low retailing costs. Exclusive dealing provisions would rule this out. If exclusive dealing provisions force a potential competitor to distribute his products in a less efficient way, for example by setting up his own retail network, the increased distribution costs could deter entry. The loss of scale and scope economies may hurt franchisees if entry does occur, but they can be compensated for this risk by a share of the extra profits generated so long as entry is successfully deterred.

A similar entry barrier might be created if there is a limited supply — including supply of potential entrants — of franchisees, at least of comparable quality, or a scarcity of comparably good retail locations. Then a franchisor with a large market share may be able to tie up the best franchisees or locations using

long-term contracts with exclusive dealing provisions. Again, increased distribution costs could rule out entry from a potential competitor<sup>91</sup>.

The three effects described above clearly are anticompetitive and have socially inefficient consequences, particularly if contracts cover a long period. Also, they may reduce competition not only in the franchisor market, but also in peripheral markets. For example, if a franchisor in the fast-food industry requires his franchisees to distribute only established soft-drink brandnames, this may limit competition among beverages.

It has been argued that other provisions in franchise agreements also may play a role as entry deterrents, particularly in the presence of legal restrictions on predation that are more likely to be applied to large firms than to smaller retailers. For instance, using franchisees with exclusive territories may allow the upstream firm to commit itself to a more aggressive response to geographically limited entry. The argument is that it will be rational for an independent retailer to respond with more aggressive pricing if a competitor enters its territory; when considering how to price in response to entry, the independent retailer will not take into account any loss of profits in other territories due to lower prices.

#### **General lessons**

This analysis shows that the vertical restraints included in franchisee contracts can increase profits in many different ways. Often the restraints will increase economic efficiency as well as franchise profits, but this will not always be the case. What general lessons can be drawn from this analysis to help identify when vertical restraints may reduce rather than improve economic efficiency?

# Effects of vertical restraints depend on context

The first lesson is that the type of the restraint does not itself determine whether it will increase or decrease economic efficiency. A provision may have either beneficial or detrimental effects, depending on the context. For example, resale price maintenance may promote economic efficiency and increase consumer surplus when, by placing a ceiling on retail prices, it eliminates double retail mark-ups. Resale price maintenance that puts a floor under retail prices also may promote economic efficiency when its primary effect is to prevent free riding that undermines the supply of retail services or the development of reputations and uniform quality standards that are valuable to consumers. On the other hand, if the primary effect of resale price maintenance is to facilitate collusion among franchisors, economic efficiency will be reduced. Exclusive territories also may increase economic efficiency if they reduce free rider distortions; unfortunately they have the potential to reduce not only intrabrand competition but also market competition between the franchise brand and other brands and thus to allow increased exercise of market power. Exclusive dealing promotes economic efficiency to the extent that it protects returns to the franchisor's know-how, but reduces efficiency if it allows increased exercise of market power by raising

barriers to the entry of potential competitors or imposes the loss of scale economies on the distribution systems of rivals (and perhaps on itself as well)<sup>92</sup>.

The lesson that context determines the effect of a provision is reinforced by a related finding. Two provisions may be substitute solutions with similar effects on efficiency for one problem; for another they may have opposite effects, one provision improving efficiency and the other reducing it. For example, both resale price maintenance and territorial restrictions may eliminate free rider problems; a double mark-up problem, however, can be solved by resale price maintenance (more precisely, by the price ceilings set by the franchisor), but is made worse by granting the franchisees exclusive territories.

This analysis implies that *per se* illegality (or legality) for particular vertical restraints in franchise agreements cannot be justified solely on the grounds that the provision always will have a negative (or positive) effect on economic efficiency. (It might be, however, that *per se* rules nonetheless are desirable because they save the costs of enforcing rules that rely on a case-by-case analysis of economic effects, or because they fit policy goals other than economic efficiency; these considerations are discussed in more detail in the last sections of Chapter V.) If the policy treatment of a provision is to match its effect on economic efficiency, some analysis of the market context in which the restraint is being used will be necessary to determine its economic effect. Fortunately, the analysis above also provides some general lessons that can serve as guidelines.

# Competition between brands and retailers

Virtually all the arguments given above for how vertical restraints in franchise agreements may reduce economic efficiency depend on the structure and competitiveness of the upstream and downstream markets in which the franchise system operates. Vertical restraints are unlikely to result in reduced competition between different brands and retailers by facilitating collusion or by disadvantaging potential entrants or current suppliers in markets with very competitive structures. Vertical restraints will not result in choices that maximise profits at the expense of consumer surplus and economic efficiency if franchise systems face strong upstream and downstream market competition.

Consider first the possibilities that vertical restraints, such as exclusive territories or resale price maintenance, might be used to reduce competition between brands or retailers. One group of anti-competitive effects depends on vertical restraints making collusion among franchisors easier. The risk that vertical restraints could lead to collusion is very small in markets where there are a relatively large number of closely substitutable, competing brands and of retailers distributing them, or where entry is easy at the level at which collusion is a concern. For example, there seems little risk collusion would be promoted by vertical restraints employed by a small franchisor introducing his products into a market with many existing, competing suppliers<sup>93</sup>. Similarly, there will be little risk that vertical restraints might reduce efficiency by increasing barriers to entry, and thus increase or preserve the exercise of market power, when the franchise system

adopting the restraints faces substantial competition from other brands and retailers in unconcentrated markets or from potential entrants.

Second, consider the possibility that vertical restraints that improve coordination between franchisor and franchisee allow franchise systems to increase profits, but that the choices that increase profits reduce consumer surplus and perhaps also total surplus and economic efficiency. An example is improved coordination in choosing product quality or retail services. Improved co-ordination may lead to increases in both price and product quality or retail services that increase profits but reduce consumer surplus and economic efficiency, but decreased efficiency is unlikely if the franchise faces strong competition from other brands and retailers; consumers who would prefer a different price and quality mix will have alternatives. In general, provisions that allow improved co-ordination within the franchise network, with the possible exception of those to allocate risk, nearly always also will increase economic efficiency (and probably also consumer surplus) when there is strong competition between the franchise network using the restraint and other brands and distribution networks (whether they are franchised or not).

Thus before analysing the detailed effects of particular franchise provisions on economic efficiency, one must first consider how much competition the franchise system faces from other brands and retailers by examining the structure of the supply both of upstream producers and of retail services for brands that are close substitutes for the franchise's brand. This involves answering three questions: what brands and retailers supply sufficiently close substitutes to the product of the franchise to prevent the exercise of market power, what is the structure and competitiveness of upstream supply, and what is the structure and competitiveness of the downstream supply of retail services<sup>94</sup>?

Analysing the structure and competitiveness of upstream and downstream supply involves several steps and issues. Are upstream and downstream supply unconcentrated, and does the franchise system have a small market share? It may not be enough to consider only the franchise's market share. In a concentrated market even the restraints used by a franchise with a small share may contribute importantly to limiting entry if the franchise restraints complement methods used by other suppliers to limit entry. As a somewhat unrealistic but illustrative example, suppose that all but one desirable retail location in each relevant area of the market is controlled (through some unspecified contractual or ownership tie) by the small number of other upstream suppliers in the market; then if the small franchisor is able to control the remaining locations by, say, exclusive dealing provisions, the restraint may prevent a potential entrant from being an effective competitor that limits the exercise of market power, even though this particular franchisor and the restraints he uses affect only a small share of the market. Thus the overall concentration of the market matters, as well as the share of the franchise system.

In addition to static measures of market share and concentration, the analysis also should consider the dynamics of market structure. Is the market expanding rapidly and are new suppliers succeeding, showing evidence of low barriers to entry? The positive effects of franchise contracts are likely to be greatest in such growing markets, and more generally in markets in transition under the influence of

substantial new innovation, turnover of firms and changes in the market position of firms, and rapid economic growth. When static and dynamic market competition between brands and retailers is robust, there is little potential for vertical restrictions to reduce economic efficiency.

# Specific conditions satisfied for reduced economic efficiency

If competition from other brands and retailers is not sufficiently strong to rule out anticompetitive effects, the next question is whether the provisions in a franchise agreement could reduce efficiency in the market conditions in which that franchise system operates. The analysis above helps identify circumstances in which provisions are and are not likely to promote economic efficiency.

For example, arguments that exclusive dealing provisions may reduce economic efficiency by raising entry barriers depend on both limited competition from current suppliers of other brands and on the existence of specific conditions. One argument requires that there be important retail scale and scope economies that an entrant could not take advantage of. Another argument requires that there be a limited number of desirable retail locations or dealers, which is most likely to be plausible only in a mature market with few expansion possibilities.

Similarly, particular market conditions should be examined before concluding that franchise provisions plausibly could lead to collusion among franchisors, even when franchisors operate in relatively concentrated markets. For example, retail price maintenance arguably may facilitate collusion on price in some circumstances. If, however, franchisors could use their wholesale price to control retail price with little variation across outlets, retail price maintenance would add little to the ability to police a collusive agreement. It is more plausible that franchisors might use resale price maintenance to help co-ordinate retail prices where wholesale contracts are complex or where cheating at the wholesale level is difficult to detect<sup>96</sup>. In addition, provisions that might help firms co-ordinate prices may not be enough to support collusive agreements if there is evidence that collusive discipline would be undermined by non-price competition.

# Do restraints increase efficiency?

Where neither general nor specific market conditions rule out the possibility that vertical restraints reduce market competition or economic efficiency, the next issue to consider is the likelihood that the vertical restraints may improve vertical co-ordination in a way that promotes economic efficiency. The analysis above helps identify circumstances in which provisions are and are not likely to promote economic efficiency.

#### Customer services and free rider problems

The analysis above stressed the diverse nature of customer services, as well as the difference in the economic analysis which can be applied to them. Vertical restrictions on intrabrand competition between franchisees, such as exclusive territories or resale price maintenance, can be used to solve free rider problems that otherwise would cause substantial economic inefficiency.

Not all franchisees, however, will face free riding problems that justify such restrictions. First, free riding will be a serious problem only for franchisees providing services whose benefits the franchisee cannot appropriate with a high degree of certainty — as with services that can be consumed separately from purchases or where other franchisees can free ride on a reputation effect. As the earlier analysis stressed, there are limited circumstances in which free riding will be a serious hindrance to the supply of retail service. Second, free riding also may be solved by more direct controls. In market circumstances where the risk is high that resale price maintenance or exclusive territories might reduce market competition and allow the exercise of market power, it is difficult to justify their use to control free riding on services whose supply can be controlled at low cost by direct specification in the franchise agreement or direct oversight by the franchisor<sup>97</sup>. These two conditions should be borne in mind when free rider arguments are advanced.

### The franchisor's know-how

The importance of contract provisions for protecting the franchisor's know-how, which is likely to have real efficiency benefits, should be carefully considered. Know-how generally will be important, and the provisions designed to protect it are likely to involve exclusivity in order to prevent the franchisee from unduly appropriating the benefits of this know-how by using it to distribute competing goods or by engaging, directly or indirectly, in activities similar to those of the franchisor. The provisions that restrict franchisees after the termination of a franchise agreement can serve a similar purpose.

When the effects on the incentives to invest in know-how are considered, provisions that allow the franchisor more completely to capture consumer surplus — for example, by restricting intrabrand competition in order to allow price discrimination — may have social benefits even if they do not increase output and efficiency in the short run. In the longer run, they could lead to a larger supply of productive innovations by present and future franchisors.

Indeed, an argument can be made that even provisions that restrict competition between brands could yield benefits. Strong competition may lead to imitation of innovations that prevents firms from capturing the full benefits of their innovations in product differentiation or methods of retailing. Such a spillover causes socially inefficient underinvestment.

It is doubtful, however, that restrictions expected to reduce such interbrand competition should be allowed for these reasons. Doing so would create an exception within the structure of competition policy that would invite over-use, and that would be extraordinarily difficult to monitor and control. It would be nearly impossible to evaluate the extent of such a spillover and its impact on investment

and welfare, and thus very difficult to quantify any possible efficiency benefits and balance them against the clear efficiency costs of reduced market competition.

# The duration of the contract

Where franchise agreements potentially raise anticompetitive problems, the duration of franchise contracts is an important factor. Long-term contracts can help protect the returns from sunk-cost investments by placing some limits on a wide variety of opportunistic behaviour, but they may also have important anti-competitive effects if they raise barriers to entry. Competition policy should be cautious about long-term contracts where market conditions indicate there is a specific risk that entry barriers could be increased. It then would be important to ask if the contract terms can be justified, for instance by the need to protect important relationship-specific initial investments that cannot be protected in any other way.

Similarly, the period of time covered by post-termination clauses should be considered carefully. A non-competition clause may be justifiable when it applies to a limited period, for example a period of one year, but excessive if applied to a longer period of time.

#### What are the alternatives?

Finally, it should be remembered that franchise agreements are one device for co-ordinating and controlling the decisions made at various stages of the vertical chain of production. Franchise agreements with or without particular vertical restraints ought to be compared not only with each other, but also with the alternatives of more loosely organised distribution and with vertical integration. One's evaluation of vertical restraints in franchise agreements depends importantly on the alternative against which the franchise agreement is compared. For instance, suppose an exclusive dealing provision is included in the franchise contract. Compared with the alternative of a distributor that is an independent firm dealing freely with other manufacturers and competing with other independent distributors, the exclusive dealing provision might, in certain market situations, seem not only to restrict the franchisee but also to raise a barrier to the entry of potential competitors to the franchisor. Such a restriction, however, would certainly be considered quite normal if it applied to a vertically integrated sales outlet of the manufacturer. Much the same is true of exclusive territories or resale price maintenance; neither represents more control or less competition than would be expected if the franchisor owned and operated his own retail outlets.

The evaluation of the impact on economic efficiency of a vertical restraint should consider whether the most likely alternative for a franchisor prevented from using a vertical restraint is a franchise agreement without that restraint, vertical integration, or the inability to find any vertical organisation that can supply that product or service.

### Chapter III

# **Competition Law Applied to Franchising**

This chapter describes the competition law applicable to franchising in OECD Member countries. Also discussed is the related issue of whether franchise agreements are defined for purposes of competition law enforcement. The treatment of particular provisions of franchise agreements in Member countries is discussed in the next chapter. Competition law in OECD Member countries is discussed first, in English alphabetical order, followed by a discussion of the competition law of the European Community. It should be kept in mind that EC competition law, including the EC block exemption Regulation No. 4087/88 for franchise agreements, is enforceable in all EC Member states.

#### Australia

There is no specific law on franchising, apart from the provisions of the Petroleum Retail Marketing Franchise Act 1980. Instead, various laws of more general coverage may be applied to franchise agreements<sup>98</sup>. Franchise agreements may be subject to laws on intellectual property rights or trade marks, if the agreements contain certain restrictions, and they are regulated by the common law of contract. State and Territory fair trading legislation prohibits misleading or deceptive conduct by individuals, including franchisors. Franchise agreements are subject to the consumer protection provisions of Part V of the Trade Practices Act 1974. Finally, the provisions on restrictive business practices in Part IV of the Trade Practices Act may be applied to franchise agreements.

Certain provisions of Part IV of the Act, while not specifically dealing with franchising, may be applied to agreements between franchisor and franchisees containing restrictive clauses such as sole or exclusive territorial appointments, resale price maintenance provisions or non-competition clauses. The relevant provisions are section 45 (contracts, arrangements or understandings that have the purpose of substantially lessening competition); section 45A (price fixing agreements); section 46 (misuse of market power); section 47 (exclusive dealing); section 48 (resale price maintenance); and section 49 (price discrimination). The underlying philosophy of Part IV of the Act is that while anti-competitive agreements and practices are prohibited by the Act, authorisations may be granted in cases where, in the view of the Trade Practice Commission (the TPC), the public benefits of the conduct outweigh the effect on competition. Under the Act, some agreements and practices are illegal *per se*, such as agreements fixing the price of goods; however, while agreements fixing the price of services and collective

boycotts are prohibited irrespective of their effect on competition, such conduct may be authorised by the TPC.

Certain arrangements made as part of or ancillary to franchise agreements also may fall within the common law doctrine of restraint of trade. If the contract is within the scope of the doctrine, it is unenforceable unless the party asserting the benefit of the contract is able to establish that it is reasonable in the interests of the parties and the interests of the public. In determining reasonableness, the geographic area, the scope of activities restrained, and the period of the restraint are always relevant.

In the absence of a coherent system of franchise regulation, it was felt appropriate by the Commonwealth and State Governments in 1986 to propose a set of rules aiming to deal comprehensively with the variety of problems raised by franchising. Accordingly, the Ministerial Council for Companies and Securities released two draft Franchise Agreements Bills for public comment. The first exposure draft contained provisions which proceeded on the basis that various measures of unfairness should be eradicated from franchise agreements irrespective of the parties' view on such agreements. It was criticised for being too onerous on franchisors and as unwarranted interference in the freedom of the contract. The second exposure draft sought to require the disclosure of relevant information to potential franchisees prior to entering into a franchise agreement with the aim of minimising future difficulties in the franchise relationship. This pleased neither franchisors nor franchisees. In addition, neither draft was able to solve the problem of defining franchise agreements to the satisfaction of franchisors and franchisees. The two drafts agreed in making use of trade marks a central feature of franchising, but differed in other aspects of the definition that would have distinguished franchises from other relationships involving use of trade marks. Given the lack of agreement across the broad spectrum of franchisors and franchisees as to what the exact elements of a franchise were, the draft legislation was not proceeded with.

Since September 1987, franchise arrangements have not been subject to the prescribed interest provisions of the Companies Act and Codes and the Securities Act and Codes (replaced on 1 January 1991 by national corporations legislation). These provisions had required franchisor companies to comply with disclosure rules in prospectuses. Franchisors do still have to comply with other relevant Commonwealth and State legislation.

#### **Belgium**

No special law applies to franchise agreements. They are covered by ordinary commercial contract law and by the Act of 27 July 1961 (as amended in 1971) on the unilateral termination of open-ended exclusive sales concessions<sup>99</sup>. The problem of determining a franchising contract and of identifying false franchises is of some importance. Whether or not a contract creates a real franchise relationship will determine, for example, the legality of the entrance fee and entitlement to any compensatory indemnity in case the contract is broken. Most often franchising contracts are treated at the level of unfair competition, labour law or abuse of

confidence. They receive no special treatment in competition law and there is practically no case law in the matter.

#### Canada

No federal legislation specifically governs franchise agreements<sup>100</sup>. At the provincial level, the primary legislation specifically dealing with franchising is that of Alberta (The Franchises Act, Revised Statutes of Alberta) (1980 C.F.-17), which deals with registration and disclosure procedures<sup>101</sup>. In the absence of specific legislation, franchise agreements are subject to various federal acts, and in particular to the Combines Investigation Act, R.S.C. 1985, c.C-34, amended in 1986 by the Competition Act<sup>102</sup>.

Franchise agreements are covered by the provisions of the Competition Act on matters reviewable by the Competition Tribunal (Part VII) and those governing criminal breaches (Part V). Reviewable matters are subject to civil law 103 and the Courts assess their pro- and anti-competitive effects on the market on a case by case approach. For franchise operations, such matters include in particular refusal to deal (Section 75), tied selling, exclusive dealing agreements, market restriction (Section 77) and delivered pricing (Section 81). Provisions of the Act dealing with abuse of dominant position and mergers also may be applied to franchising relationships.

The Competition Act's provisions on abuse of dominant position, which constituted an important part of the 1986 amendments, apply when one or more persons substantially or completely control a class or species of business, have engaged in a practice of anti-competitive acts, and the practice has had or is likely to have the effect of lessening competition substantially (Section 79). As the Courts have considered that these provisions cover companies co-ordinating their activity in such a way as to operate as a single unit, they may also cover franchising operations<sup>104</sup>.

Although less likely to be applied, the merger provisions (Sections 91 to 100) introduced into the Competition Act in 1986 can, because of their wide definition, apply to the granting and reacquisition of a franchise by the franchisor: "merger means the acquisition or establishment, direct or indirect, by one or more persons, whether by purchase or lease of shares or assets, by amalgamation or by combination or otherwise, of control over or significant interest in the whole or a part of a business of a competitor, supplier, customer or other person" 105.

Infringements relating to competition (Part V) may attract criminal penalties. For franchise operations, Section 61, concerning retail price maintenance, is the most relevant provision.

Franchise agreement also could be subject to clauses limiting price discrimination (Section 50) or pyramid selling (Section 55), although this would be less common. Discriminatory selling occurs if a discount, rebate or other advantage is made available to one purchaser when equivalent price advantages are not available to competitors; this does not mean rebates are illegal, but that the same

treatment must be available to any competitor of the beneficiary who is purchasing similar articles in quantity and quality. Franchise operations could be affected by this provision as the combined purchasing of a network of franchisees may be in a position to obtain quantity discounts. Pyramid selling clauses cover selling schemes whereby one person pays a fee to participate in the scheme and receives the right to receive a commission in respect of the recruitment of other persons into the scheme or in respect of sales or leases made by other persons.

#### **Denmark**

Franchise agreements are not subject to any specific legislation in Denmark, but are covered by the Trade Mark Act 1959, the Unfair Marketing Practices Act 1974 and the Competition Act 1989. The Danish Franchisors Association does have its own rules and regulations, including rules on ethics and check lists for its members.

The Competition Act, which is based on a principle of abuse, came into force on 1 January 1990 and is administered by the Competition Council. According to Section 5(1) of the Act, agreements and decisions by which a dominant influence is exerted or may be exerted on a certain market are subject to notification to the Competition Council within 14 days of the conclusion of the agreement or decision concerned. Exceeding the time limit entails invalidation of the agreement.

In November 1991 the Competition Council for the first time applied the Competition Act to franchise agreements. The Council reviewed a set of agreements within the real estate business that connected real estate agents that covered 80 per cent of this market to the three original mortgage-credit institutes. After analyzing the existing agreements on franchising and cooperation in this market, the Council found that three sets of agreements were means for exerting a dominant influence on the real estate and mortgage-credit markets. Each of the three sets of agreements involves one of the mortgage-credit institutes and contains regulations on the conduct of the connected real estate agents. Therefore the Competition Council has decided that 12 of the agreements are subject to notification according to Section 5 of the Competition Act.

#### **Finland**

Finnish competition legislation does not include specific provisions concerning franchising, but it is fully applicable to franchise agreements. Any concerns about restrictive business practices, or other competitive concerns involving franchising, are generally dealt with under the provisions concerning horizontal and vertical agreements. Finnish competition law is mainly based on the abuse principle. The Act on Restrictive Business Practices prohibits only collusive bidding and resale price maintenance.

There are about 100 franchising chains in Finland, about half of which were set up in the 1980s. In a recent survey by the Office of Free Competition, about 70

per cent of the franchise chains surveyed involved product distribution franchise agreements and about 70 per cent of the franchisors with service supply agreements were foreign. There are no significant differences between domestic and foreign franchising chains in Finland in the use of trade names, brand signs, and know-how. Foreign franchisors, however, more frequently offer R&D and marketing research services and accounting and reporting systems to their franchisees. Foreign franchisors also emphasize the use of non-competition clauses, buy-back rights, and provisions such as exclusive distribution contracts, territorial exclusivity and exclusive supply arrangements as important methods to control their franchise networks.

#### France

In addition to the EC rules, franchise agreements in France are subject to general French competition law and to French contract law<sup>106</sup>. Franchises also are subject to the provisions of the Act of 31 December 1989 requiring pre-contract disclosure of particular information by any person making available to any other a commercial name, trade-mark or sign<sup>107</sup>.

Both Titles III and IV of Ordinance No. 86-1243 of 1 December 1986 contain general competition law directly applicable to franchise agreements <sup>108</sup>. Title III prohibits agreements that restrict competition and abuses of dominant position or economic dependence <sup>109</sup>. Title IV of the Ordinance addresses individual restrictive business practices; particularly relevant for franchising are the prohibition of minimum resale price limits (Article 34) and refusals to deal (Article 36-2).

The Competition Council, a quasi-judicial administrative body, is empowered to enforce Title III of the Ordinance<sup>110</sup>. Disputed decisions are referred to the Paris Court of Appeal, whose decisions in turn are reviewable by the Cour de cassation. Decisions on restrictive practices prohibited under Title IV are handled by the civil courts. The Competition Council may deal with practices considered restrictive under Title IV if those practices involve agreements that restrict competition under the meaning of Title III<sup>111</sup>.

Title III of the Ordinance. Article 7 and 8 of Title III identify anticompetitive practices that are prohibited and Article 10 sets standards for exempting behaviour otherwise prohibited under Articles 7 and 8. Article 9 declares void agreements prohibited under Articles 7 and 8.

Article 7 bans concerted actions and agreements "when they are designed for or may have the effect of preventing, restricting or distorting competition in a market". A franchise contract would be an agreement within the meaning of Article 7 and could be prohibited if it was found to prevent, restrict or distort competition. In addition to this general prohibition, Article 7 states that "in particular" agreements shall be prohibited when they tend to a) "limit access to the market or the free exercise of competition by other businesses;" b) "hinder the free setting of prices by competitive forces by artificially promoting increases or decreases"; c) "limit or control production, market outlets, investments, or technical progress"; or

d) "divide up markets or sources of supply". This list makes clear the potential applicability to provisions in franchise agreements of Article 7<sup>112</sup>.

The Competition Council has not had to rule on franchise agreements under Article 7. However, a Council Rapporteur has made the point, in the context of cartels and franchises, that Parliament did not "aim to prevent the development of effective competitive strategies. A firm which acquires, through its commitment to research, development and higher productivity, a strong position on the market will only be at fault if it uses unfair means (refusal to sell, imposed prices, cartels, etc.) to try to prevent its competitors from challenging its new market position"<sup>113</sup>.

The Competition Council has applied Article 7 in the broader context of selective distribution agreements. Such an agreement, it has ruled, does not necessarily contravene Article 7 if it preserves some degree of competition on the market and provided that the criteria for selecting distributors are objective and justified, and that it does not have the intention or effect of excluding one or more specific forms of distribution and is not applied in a discriminatory way. In particular, the Council has ruled that, while a selective distribution network may indeed limit the number of distributors and tend to reduce intrabrand retail price competition, it may also be a source of interbrand competition<sup>114</sup>.

Article 8 prohibits abuses of dominant positions and of economic dependence "by businesses or a group of businesses" when they have or are designed to have the effect of restricting competition<sup>115</sup>. Article 8-1 prohibiting abuse of dominant positions does not define a threshold of dominance, but it includes dominance by the larger firms in a concentrated industry, as well as dominance by a single firm. In practice, no cases of abuse of dominant position by distributive franchising networks have been found; a franchise network would not be in a position of dominance if there were sufficient competition from other distributors.

Article 8-2 prohibits abuse of economic dependence: the unfair exploitation by an enterprise or group of enterprises of "a client or supplier business which is economically dependent upon it and which has no equivalent alternative". Article 8 states that, in particular, refusals to sell, tied sales or discriminatory selling conditions, or the breaking off of established trading relationships on the sole grounds that the other party refuses to submit to unjustifiable trading conditions all may constitute abuses.

Experience in applying the prohibition on the abuse of economic dependence is still limited since it was introduced, on the German model, only in 1986. In particular, there have been no decisions by the Competition Council about any possible abuses of economic dependence in connection with a franchise agreement.

In rulings on other distribution arrangements, the Competition Council has stressed that in establishing that a retailer is dependent upon a supplier, it will take four cumulative factors into consideration: i) the reputation of the supplier's brand for certain products; ii) the size of the market share of the supplier in those products; iii) the share of those products in the retailer's turnover or what share of his purchases is represented by deliveries from the supplier concerned; iv) whether

the distributor can or cannot obtain equivalent products on identical terms from any other suppliers or wholesalers<sup>116</sup>.

However, it is not necessary for all the factors taken into consideration to point in the same direction for dependence to be presumed. The Council will presume dependence if enough of them point in that direction. In its *Seda-JVC* (1987) Decision, the Council found a presumption that Seda was dependent upon JVC's supply of video recorders. JVC seemed to hold only 9 per cent of the video recorder market, but the JVC brand accounted for 75 per cent of Seda's sales. The Council ruled, that in spite of the rather low market share, the JVC brand appeared to have a very high reputation on the market. and Seda did not appear to have any alternative equivalent to deliveries from JVC France, the exclusive importer of JVC products<sup>117</sup>.

Agreements, including franchise agreements, may qualify under Article 10 for exemption from the prohibitions of Articles 7 and 8<sup>118</sup>. The conditions that must be met are similar to the conditions for qualifying for an exemption under Article 85(3) of the Treaty of Rome: practices are not subject to Article 7 and 8 if they can be "justified as furthering economic progress and reserving an equitable share of resulting profits for the users, without enabling the enterprises concerned to eliminate competition for any substantial proportion of the products". The practices may impose restrictions on competition only to the extent that such restrictions are indispensable for the accomplishment of this objective of progress<sup>119</sup>. In assessing the contribution of a practice to economic progress, coherence with the firm's overall strategy and enhancement is considered crucial<sup>120</sup>.

*Title IV of the Ordinance*. Franchise agreements are also subject to Articles 34 to 37 of the 1986 Ordinance that cover individual restrictive practices. Most relevant to franchise contracts are Articles 34 and 36.

Article 34 imposes a fine of 5 000 to 100 000 francs on any person who imposes minimum limits on prices or gross profits.

Article 36 makes a supplier liable for damages to other firms that result from any of three practices: 1) discriminatory prices or terms of sale, 2) refusals to deal, or 3) conditioning or tying the sale of a product or service to the purchase of other products or services or to the purchase of a minimum quantity. Refusals to sell create liability when the requests "are in no way irregular and are made in good faith and the refusal cannot be justified under Article 10".

As mentioned, there is virtually no Competition Council case law directly involving franchising. The courts, however, have built up a case law bearing on franchise agreements. Most of these decisions involved contract law, so it is not surprising that they seem mostly concerned with protecting the contractual balance between parties, and especially the social protection of the franchisee<sup>121</sup>. They contain very little economic analysis of the vertical relations established by these contracts or their effects on prices, competition and economic efficiency. Nonetheless they do shed light on the definition of franchising in French case law and on distinctions drawn between franchise contracts in regard to other distribution agreements. As case law applying competition law to franchising develops, these decisions may well become important, especially given the

similarities between French and EC competition laws, and the similarities in the distinctions among distribution systems made under EC and French law.

The French courts have stressed the importance of know-how and continuing technical assistance as criteria distinguishing franchising from other distribution systems. A 1989 decision by the Versailles Court of Appeal in the *Himbert-Natalys* case clearly defined the elements that characterise franchise agreements<sup>122</sup>: the transfer of original and specific know-how of a technical or commercial kind accompanied by technical assistance to the franchisee throughout the term of his collaboration with the franchisor<sup>123</sup>. Other elements of the agreement did not prove a franchisor/franchisee relationship because they also could be included in agreements for exclusive dealerships: the assignment of a right to use the Natalys trademark in a reciprocally exclusive supply/procurement relationship, an obligation for the franchisee to receive prior training from the franchisor and the franchisor's control over the decoration and fittings of the premises.

In another 1989 case, *Mourat-Natalys*, the Paris Court of Appeal gave a very precise, and quite similar, definition of distribution franchising: a franchising distribution contract through which the franchisor possessing a tradename, experience and know-how granted to the franchisee, an independent trader, in exchange for royalties, the right to use his name and trademark to sell articles from his catalogue, having communicated to the franchisee his know-how and training experience and providing the franchisee with technical, financial and bookkeeping assistance<sup>124</sup>.

The French courts also attach great importance to a balanced contractual vertical relationship between franchisor and franchisee that shelters the franchisee from arbitrary impositions by the franchisor. The courts have held that the franchisor cannot infringe the autonomy of the franchisee without himself challenging the validity of the agreement. While the franchisor is entitled to check up on the use being made of his brand and trademark, and of the know-how he has transferred, that verification must never totally deprive the franchisee of his independence.

One agreement has been annulled for excessive control by the franchisor over the franchisee's choice, imposing styles and prices regardless of the franchisee's preference. In *Société Internationale du Siège (SIS) v. Betin*, 1984<sup>125</sup>, the Paris Court of Appeal found that the franchisor constituted a *de facto* obligatory intermediary, determining both the supplier and the patterns and also imposing prices on the franchisee. The franchisee was required to deal with suppliers approved by the franchisor on the same purchasing terms as a "reference" outlet. He was also required to purchase the whole collection. The contract had the effect of depriving the franchisee of his choice of supplier and of the composition of his stock. The contract was therefore annulled.

# Germany

Franchise agreements are subject to general German competition law. The objectives of the two German competition laws are: i) the suppression of unfair

business practices under the Act against Unfair Competition (Gesetz gegen unlauteren Wettbewerb) (the "AUC"), whose basic aim is the prevention of unethical, excessive or otherwise abusive practices in competition, and ii) the suppression of restrictive business practices under the Act against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen) (the "ARC"), whose basic aim is to maintain competitive market structures; that is, freedom of access to the market for all enterprises<sup>126</sup>.

The AUC presents no features or provisions of particular interest or importance for the application of competition to franchise agreements. The situation is different under the ARC, which applies to the restrictions of competition necessarily accompanying franchise agreements. Franchise agreements are not specifically defined under the ARC. Generally speaking, however, franchise agreements are considered to be those by which a producer or trader (franchisor) grants to one or to several independent enterprises (franchisees) the right to use his firm name and/or his trademark to distribute goods and services within the framework of a marketing concept developed by the franchisor.

Since franchising systems nowadays use many different methods of organisation and contractual provisions, in the view of German competition policy there cannot be one consistent answer to the question of how to deal with their competitive aspects. As a general guideline one can, however, say that the scope given under the ARC broadens for organisations and provisions involving traditional vertical structures and narrows correspondingly for those more oriented toward horizontal organisation. The ARC distinguishes systematically between "horizontal" and "vertical" agreements<sup>127</sup>.

Horizontal agreements. Sections 1 to 8 of the ARC deal with agreements "for a common purpose", that is, agreements between enterprises on the same level of production or distribution, i.e. actual or potential competitors. These are called "horizontal" agreements "agreements of the ARC declares null and void all "horizontal" agreements made for a common purpose which, by restraining competition, are likely to influence production or market conditions (cartel ban of Section 1 ARC)<sup>129</sup>. According to the relevant jurisdictions, an agreement is not regarded as influencing market conditions in the sense of the provision if the parties hold a small market share and business partners may easily obtain the goods and services from other sources <sup>130</sup>.

This cartel ban is principally applicable to all franchise systems co-operatively planned and operated. It can also become relevant for those franchise systems operating with an advisory council or a similar means of co-ordination between the franchisees, provided that they hold more than a small market share.

Sections 2 to 7 of the ARC enumerate the exceptions from the general cartel ban. Amongst these exemptions are, under certain conditions, standardisation and export cartels. Such cartels can be legalised by the Federal Cartel Office (FCO) or, if the conditions of sections 2 to 7 are not satisfied, in exceptional cases by the Minister of Economics (Section 8). Another exemption important for franchising concerns co-operation cartels for small and medium-sized enterprises [Section 5(b)

of the ARC]. The provision is intended to compensate for the structural disadvantages such enterprises have vis-à-vis large enterprises.

Under Section 5(b), co-operation agreements involving market shares not exceeding a total of 15 per cent may be exempted from the cartel ban for a certain period (usually five years), if they serve to rationalise economic processes<sup>131</sup>. (After expiration of this period, permission must be sought for renewal.)

Vertical agreements. Sections 15 to 21 deal with "other" agreements, usually "vertical" agreements between upstream and downstream enterprises <sup>132</sup>. As agreements between the (upstream) franchisor and the (downstream) franchisee typically are vertical agreements in this sense, these provisions are important for vertically structured franchise systems in which franchisees are not involved in decision making concerning the franchise system's product and marketing policy.

Section 15 declares null and void any agreements by which one partner restricts the freedom of the other partner to determine the content of his agreements with third parties, for example, his freedom to determine prices or terms of business in contracts with third parties. This provision applies to agreements about resale price maintenance and to most-favoured-buyer clauses<sup>133</sup>.

Sections 16 and 17 provide for exemptions from Section 15 for books and Sections 20 and 21 for goods produced under a licensed patent, utility model or trade secret as regards resale prices<sup>134</sup>. Exceptions for certain non-binding price recommendations regarding other products are made under Sections 38a and 38(2) 1 ARC.

Section 18 deals with those vertical agreements which do not concern the freedom to determine the content of one partner's agreements with third parties, but his freedom to enter into contracts with third parties: Section 18(1) covers restrictions on the use of goods and services; Section 18(2) covers restrictions on the sale or purchase of goods and services to or from third parties; Section 18(3) covers restrictions on the distribution of supplied goods and Section 18(4) covers tie-in provisions involving unrelated goods or services.

Contrary to Section 15 (and to Section 1), the restrictions covered by Section 18 (1)-(4) are valid until they are declared to be null and void by the cartel authority. The cartel authority will/may do so if the agreement unfairly restricts the competitive ability of a significant number of enterprises bound in this way or the entry into the market by a third party, or if competition is substantially impaired. In other words, the enumerated restrictions are subject only to abuse control.

As the criteria for abuse control are rarely met by small and medium-sized firms, most vertically structured franchise systems will have no restrictions imposed upon them by the Federal Cartel Office in this respect; but restrictions may be imposed if a market dominating enterprise utilises such practices<sup>135</sup>. Even if the criteria for abuse control are met, the FCO will usually not object to specific restrictions if they are necessary to prevent the franchisor's know-how and assistance benefiting rivals or to maintain the identity and reputation of the sales organisation symbolised by the trade name<sup>136</sup>.

#### Greece

There is no specific provision for franchising agreements in the Greek Competition Act No. 703/77, as amended by Act 1934/91. According to the new Article 8a of the Act, the Minister of Commerce after obtaining the concurrent opinion of the Competition Committee can issue decisions that permit the exemption of certain categories of agreements in accordance with Article 1, paragraph 3 of the Act. Besides this possibility of general block exemption, a franchise agreement falling under Article 1 may, if notified in good time according to the provisions of Article 21, be granted an individual exemption by decision of the Competition Committee, if all the conditions set by paragraph 3 of the same Article are satisfied.

The conditions that must be satisfied to qualify for exemption, on the model of the European Community, are: (i) it must contribute to the improvement of production or the distribution of products or the promotion of technical or economic progress, while reserving a reasonable share of the resulting benefits to the consumer; (ii) it must not impose upon the firms concerned any restrictions which are not essential to attain its objectives; and (iii) it must not enable the firms concerned to eliminate competition for a substantial proportion of the products concerned.

#### **Ireland**

On 1 October 1991 the Competition Act 1991 came into force. This Act is based closely on Articles 85 and 86 of the Treaty of Rome. Section 4 of the Act prohibits and renders void all agreements, decisions or concerted practices which have as their object or effect the prevention, restriction or distortion of competition in trade in any goods or services in the State or in any part of the State. Section 4(2) enables the Competition Authority to grant a license exempting agreements from this prohibition; this section in effect is the equivalent of the EC's Article 85(3) and the criteria required to obtain a license are the same as those required by 85(3). It would appear therefore that franchising agreements, and various vertical contract provisions or restraints they might contain, would be caught by Section 4, although as of the end of 1991 the Competition Authority had issued no licenses in respect of any franchise agreements.

# Japan

The main competition laws applicable to franchise agreements are the general Antimonopoly laws: the Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade<sup>137</sup> and Fair Trade Notification No. 15 of 1982 entitled "Unfair Business Practices" (and often referred to as the "General Designation")<sup>138</sup>. Under these Antimonopoly laws, most practices are judged under the rule of reason.

Under these laws, either franchise agreements as a whole, or specific provisions of franchise agreements, can be found to constitute unfair business practices. Unfair business practices are prohibited in general by the Antimonopoly laws, and the General Designation, Notification No. 15, lists 16 practices, many of which involve vertical restraints, that may be considered "unfair". To be considered "unfair", these practices must have a "tendency to impede fair competition"; the degree of impediment that must be found depends on the practice and is specified in the General Designation<sup>139</sup>.

The Fair Trade Commission (FTC) adopted a decree on 20 September 1983 on the application of the Antimonopoly laws to franchise systems. This decree provides guidelines and rules for determining whether, under the Antimonopoly laws, a franchise agreement as a whole is illegal as an unfair business practice, or specific provisions are illegal unfair practices described by the General Designation. (The decree also provides guidelines for the recruitment of franchisees by franchisors<sup>140</sup>.)

Under the decree guidelines, the franchise agreement as a whole must be so balanced as to avoid unreasonable restrictions on the franchisee. Obligations must not be placed only on the franchisee and must be limited in extent to what is necessary to allow the franchisor to manage his business in the face of changing conditions. An agreement that fails to meet this standard could be found in its entirety to be an abuse of a dominant bargaining position (paragraph 14 of the General Designation). Judgements are made in the context of specific agreements. An important general consideration is whether the restrictions in an agreement are necessary to attain the business objectives of the franchise. More specific factors identified by the guidelines include: whether the prices charged for a product whose supplier is designated are excessively high (relative to market prices); whether franchisees are allowed to use alternative sources that can supply similar quality and specifications; whether there are unnecessary controls over the franchised products or over selling-methods; whether the sales targets laid down are compulsory and if so are excessively high; whether the contract contains the right of cancellation of the agreement by the franchisee and the nature of the penalties involved; the period of validity of the contract; and whether it is appropriate to prohibit competition after the end of the contract.

The decree also provides guidelines for determining whether specific provisions of franchise agreements should be considered unfair business practices. Guidelines are provided for determining whether, for example, provisions fall within the scope of Paragraph 10 (tie-in sales, etc.), Paragraph 12 (resale price maintenance), Paragraph 13 (dealing on restrictive terms), or Paragraph 14 (abuse of dominant bargaining position). The considerations to be taken into account vary depending on the nature of the provision, but include: the position of the franchisee, the possible effects on competition among franchisees bound by the provision, the extent of the disadvantage to the franchisee, and a comparison of the disadvantage to the franchisee with the necessity to protect the franchisor's know-how.

The FTC issued new comprehensive guidelines called "the Antimonopoly Act Guidelines Concerning Distribution Systems and Business Practices" on 11 July

1991. Part I of the new Guidelines covers such practices as resale price maintenance, interference in distributors' price maintenance, vertical non-price restraints, interference in distributors' management practices. While these Guidelines do not focus specifically on franchise agreements, provisions that might be included in such agreements are covered in the Guidelines and will be dealt with in accordance with the Antimonopoly Act.

The Antimonopoly laws, as general competition laws, do not apply only to franchise relationships that meet a particular definition. For the Antimonopoly Act to be applicable to the relationship between franchisor and franchisee, however, the franchisee must be independent of the franchisor. In addition, the 1983 decree is intended to provide guidelines for applying the Antimonopoly laws to franchise systems that meet particular criteria: those in which the franchisor furnishes know-how and managerial assistance, where there is a network of stores, and where goods and materials are being supplied.

More generally, in Japan franchising is usually understood as a form of business in which the franchisor licenses specific trademarks and firm names. He also keeps control of the franchise and gives guidance and assistance to the franchisee in a systematic manner; with respect to the operation of the franchise, in particular to sales of the product or offers of services. In applying the Antimonopoly Act, the Japanese competition authorities are particularly concerned with detecting false franchises. Even if the name "franchise" itself is given to an activity, a control is exercised in order to determine whether know-how, technical assistance and managerial guidance are well provided to the franchisee, or whether for example, the term "franchise" has been applied to another type of distribution, such as voluntary distribution chains.

# **New Zealand**

There is no specific legislation on franchising operations in New Zealand, although, as a business practice, franchises are subject to general competition law under Part II of the Commerce Act 1986. The Commerce Act prohibits resale price maintenance; price fixing; and contracts, arrangements and understandings that have the purpose or effect of substantially lessening competition in a market. However, authorisations for restrictive trade practices can be obtained from the Commerce Commission where public benefits outweigh public detriment arising from the lessening of competition.

It is considered that franchising will not affect the competitive process unless market dominance is involved. Section 36 of the Commerce Act prohibits the use of a dominant position in a market for the purpose of restricting the entry of any person into a market, preventing or deterring competitive conduct in any market, or eliminating any person from a market. The enforcement of statutory intellectual property rights is exempted.

#### Norway

Neither price nor competition legislation nor any other Norwegian legislation includes specific provisions concerning franchising. Competition aspects of franchising are dealt with under the general provisions concerning horizontal and vertical agreements. The Norwegian price authorities treat franchises as chains. They consider that the main advantages of co-operation in voluntary chains are often the obtaining of favourable conditions from suppliers and the achievement of more efficient purchase and sale operations. This may lead to lower costs, which again may result in more competitive prices. The authorities judge that competition may be promoted by chains pursuing a common price policy, and being in competition with similar chains or other big suppliers may promote competition. The establishment of new chains will normally mean greater resources and better opportunities to create a more competitive situation than a single enterprise could achieve.

The Norwegian Franchising Association defines "franchising" as follows: "a form of business collaboration between two independent parties. One party, the franchisor, has developed a standardised plan for marketing a commodity or service and running a business with a certain profile. The other party, the franchisees, undertake to run a local business on the basis of a detailed written agreement. The franchisor often supplies goods or equipment to the business; franchising is, however, primarily a concept formula independent of such extensions".

# **Portugal**

Portugal has no specific regulation applicable to franchise agreements. However, the franchise agreement comes under the ordinary rules of private law. The principle of the autonomy of the parties is set out in Article 405 of Portugal's Civil Code. The parties are therefore free to determine the precise content of the contract among themselves.

Franchise agreements also come under the general provisions of competition law. Section 13 of the Competition Act prohibits agreements between firms whose aim or effect is to restrict competition on the national market, while Section 14 prohibits abuses of dominant positions on the national market.

A restrictive practice covered by Sections 13 or 14 may nevertheless be authorised under Section 15 if it would have the effect of improving production or distribution, or of encouraging technical or economic progress, provided that the consumers receive a reasonable share in the resulting benefits, and that the restrictions are essential to obtain those advantages, and would not have the effect of eliminating competition on a substantial proportion of the national market.

# **Spain**

Franchising is a fairly recent development whose vigorous growth from the mid-1980s is expected to intensify with the Single Market in view. In a 1987 Guidebook published by the Internal Trade Directorate for prospective franchisees under the title "Franchising, a formula for the future" it is identified as a system in which one company having some technical or other form of knowledge of its own agrees with one or more other economically independent companies to share that knowledge in return for financial compensation, entering into a set of agreements which can vary in their nature but also include a reciprocal exclusivity clause.

Although a franchising contract must be drafted in compliance with the ordinary Civil Code contract rules, franchising as such is not expressly regulated by any Spanish law<sup>141</sup> but is affected by the provisions of competition law, at both national and EC level<sup>142</sup>.

The Restrictive Practices Act of 20 July 1963 was superseded by the Competition Act 16/1989 of 17 July. The change reflected a desire to apply competition legislation more strictly and in particular, Spain's need to align itself with EC competition regulations. Title 1 of the new Act, "On free competition", includes a part 1 headed "Prohibited practices and authorised practices", which is of special interest to franchising.

Article 1.1 of that part bans any collective agreement, decision, recommendation, concerted practice or collusion having or potentially having the effect of restricting or distorting competition on the Spanish market or any part of that market, especially such practices as:

- a) the direct or indirect setting of prices or other commercial or service conditions;
- b) the limitation or control of production, distribution, technical development or investment;
- c) the sharing out of markets or sources of supply;
- d) the application in commercial or service relationships of unequal conditions for the provision of equivalent goods or services, thereby disadvantaging some competitors over others;
- e) making the conclusion of a contract conditional upon the acceptance of additional goods or services which by their nature or according to the custom of the trade are not related to the subject matter of the contract.

Article 3.1 provides that the practices referred to in Article 1.1 may be authorised when they help to improve production or marketing of goods and services, or encourage technical or economic progress, provided that:

- they allow the consumer or user a reasonable share in the resulting benefits:
- b) they do not impose on the companies concerned any restrictions which are not essential to achieve those aims; and

 they do not enable the companies participating to eliminate competition for a substantial proportion of the contracts or services concerned.

Article 5.1, which is clearly relevant to franchising, provides that the government may issue an exemption regulation, which must always be prepared in consultation with the Competition Tribunal, authorising the categories of agreement (etc.) referred to in Section 3.1, subject to the condition that:

- a) only two companies participate and impose restrictions in the distribution and/or provision of particular products for their sale or resale, or regarding the acquisition or use of industrial or intellectual property rights, or secret industrial or commercial know-how; or
- b) their only aim is the devising and uniform application of standards or patterns, or specialisation in the manufacture of certain specified products, or joint research and development; or
- c) their aim or effect is to increase the rationality and competitiveness of companies, especially small and medium ones.

Since the legislation is so recent, and firms are waiting for some sort of exemption regulations for distribution agreements under article 5.1, the Competition Tribunal has authorised only two franchising agreements under article 3.1. In both cases authorisation has been granted after some modifications were made to the notified agreements.

#### Sweden

No special rules are applied to franchising, but general competition law is fully applicable to franchise agreements. This legislation is based on the abuse principle with two exceptions, vertical price fixing and collusive tendering, which are prohibited *per se* (although maximum prices are allowed). Horizontal price fixing or recommended prices may be prohibited if the parties keep an artificially high price level or obstruct efficient competition, generally or specifically<sup>143</sup>. Actions are taken against practices when, in a particular instance, the Competition Ombudsman (NO) finds that a given restrictive business practice has adverse economic effects. NO then negotiates with the firm involved for removal of these effects and, to that end, may decide to bring the case to the Market Court. If these efforts fail, the Court may void the agreement and impose fines or otherwise order firms to cease and desist from the restrictive practice.

As of 1991, NO had not brought any case concerning franchising to the Market Court. The Competition Ombudsman has conducted an ongoing scrutiny of several franchise agreements and intervened in cases where he found the terms of agreement to be contrary to the Competition Act. The penal provisions of the Competition Act were also applied in cases where resale price maintenance was found to be a restraint of trade. In some cases, NO also negotiated to obtain the removal of certain provisions in franchise agreements.

Legislation specific to franchising has been considered. In 1987, a Commission presented its report containing the draft text of a Franchising Act ("SOU 1987:17 Franchising"). The Commission was entrusted with the task of conducting an open-ended investigation of the forms of franchising occurring in Sweden and of considering the question of specific legislation. It covered a large number of areas such as labour legislation, contract law and intangible rights.

The Commission found that the provisions of the Competition Act were sufficient to deal with restrictive business practices in franchise agreements, but recommended the introduction of new rules in specific areas, such as: one year's notice for cancellation of the agreement and the provision of information to consumers about the fact that the business was being conducted on a franchising basis. The Commission's proposals were criticised by several authorities and have not yet been accepted.

The Commission defined franchising as follows: "A contractual operation between franchisors and franchisees, whereby a franchisor, in return for payment, allows one or more franchisees to carry on a certain business activity using the franchisor's designations, brand names or other distinguishing product characteristics" <sup>144</sup>. The Commission observed that the status of the franchisee in relation to the franchisor must be appraised with reference to the circumstances of each individual case. Ties between them are sometimes so strong that the franchisee should not be regarded as an independent entrepreneur but as an employee or an equal agent in his relation with the franchisor.

From NO's point of view franchising is a vague concept and does not differ very much from other types of vertical agreements and co-operation. As such, restrictive practices in franchise agreements do not seem to present special problems compared with other restrictive business practices. Nevertheless, these agreements typically also include horizontal elements which must be considered. In any case, NO finds inappropriate the adoption of special legislation on franchise agreements.

# **United Kingdom**

The competition legislation applicable to franchise agreements is comprised in four statutes: the Fair Trading Act 1973 (FTA); the Restrictive Trade Practices Act 1976 (RTPA); the Resale Prices Act 1976 and the Competition Act 1980. The Fair Trading Act, which deals with monopoly situations, may apply to franchising if the franchised group falls within the definition of "complex monopoly". In practice this Act has not been used with respect to franchising, in part because certain remedies may not be applied to the agreement caught by the Restrictive Trade Practices Act. If an agreement is registrable under the RTPA, only those restrictions which make it registrable are excluded from the scrutiny of the Monopolies and Merger Commission (MMC).

While the Competition Act may potentially affect franchise agreements, it has so far not been applied to any of them. The Act empowers the Director General to investigate whether any course of business conduct amounts to an anti-competitive practice. If he identifies such a practice, he must state, in a published report of his investigation, whether he considers it appropriate to make a reference to the MMC. He may also accept undertakings from persons having pursued the practice instead of making a reference. Anti-competitive practices are described in the Competition Act in the following terms: "A person engages in an anti-competitive practice if, in the course of business, that person pursues a course of conduct which, of itself or when taken together with a course of conduct pursued by persons associated with him, has or is intended to have or is likely to have the effect of restricting, distorting or preventing competition in connection with the production, supply or acquisition of goods in the United Kingdom or any part of it or the supply or securing of services in the United Kingdom or any part of it".

The Restrictive Trade Practices Act 1976 is the law most concerned with the type of restrictions usually found in franchise agreements. It applies to any agreement between two or more parties who carry on business in the United Kingdom by which more than one party accepts some restriction on his commercial freedom of action. Agreements including restrictions must be registered with the Office of Fair Trading (OFT) prior to their coming into effect. Franchising contracts represent about 20 per cent of all registered agreements<sup>145</sup>.

There is a presumption in the RTPA that restrictions described in the following paragraph are against the public interest. Accordingly, the OFT may refer them to the Restrictive Practices Court (RPC). It is then up to the parties to demonstrate that these restrictions are beneficial. However, under section 21(2) the Director General of the Office of Fair Trading may refrain from submitting an agreement to the Court if the Secretary of State considers the restrictions insignificant. Restrictions may be considered as insignificant if they do not materially affect competition. In some cases and after consultation with the OFT, provisions in these agreements were amended by the parties before registration. Moreover, the OFT may not refer to the Restrictive Practices Court restrictions which are exempted under the EC provisions, but the agreements themselves are still registrable.

The RTPA applies to restrictions accepted in respect of any of the following matters in relation to goods (comparable provisions apply in relation to services): a) the prices to be charged, quoted or paid for goods supplied; b) the prices to be recommended or suggested; c) the terms or conditions subject to which goods are to be supplied or acquired; d) the quantities or descriptions of goods to be produced, supplied or acquired; e) the processes of manufacture to be applied to goods or quantities or descriptions of goods to which the process is to be applied; f) the persons to whom or territories within which goods are to be supplied or processes applied. Chapter IV details the way in which specific vertical restraints are dealt with under these various legal provisions. Generally, the Office of Fair Trading has taken the view that the restrictions in registrable franchise agreements, whether as proposed or after amendment, are insignificant and there exists little or no case law under the Restrictive Trade Practices Act regarding franchising.

It should be realised, however, that many franchise agreements do not in practice fall within the scope of the Restrictive Trade Practices Act, either because

the restrictions (if any) on the franchisor relate only to the grant of any other franchise or license (rather than the supply of goods of services), or because restrictions on the franchisee simply limit rights he would not otherwise have without the agreement. (This latter is called the "open-door" principle.)

#### **United States**

In the United States, the antitrust laws subject all competition questions to the same legal standards and analytic framework, drawing no distinctions between franchising and other distribution systems. The principal provisions of the federal antitrust statutes that may be applied to challenge anticompetitive restrictions in franchising agreements are: Sections 1 and 2 of the Sherman Act, Section 3 of the Clayton Act, and Section 5 of the Federal Trade Commission Act. In addition, many states have enacted antitrust laws that parallel these provisions of the federal statutes.

Section 1 of the Sherman Act generally proscribes any "contract, combination, or conspiracy" that unreasonably restrains the interstate or foreign commerce of the United States. Section 2 of the Sherman Act makes it an offence to monopolise, attempt to monopolise, or combine or conspire to monopolise any part of the nation's interstate or foreign commerce. Section 3 of the Clayton Act prohibits the sale or lease of a "commodity" on the "condition, agreement or understanding" that the purchaser or lessee refrain from dealing with the seller's or lessor's competitors, if the effect may be to "substantially lessen competition or tend to create a monopoly in any line of commerce". Section 5 of the Federal Trade Commission Act broadly declares unlawful "unfair methods of competition" and "unfair or deceptive acts or practices in or affecting commerce".

Most franchising restrictions, other than resale price maintenance and certain tying arrangements, are classified as non-price vertical restrictions and analysed under the *rule of reason*. Resale price maintenance and certain tying arrangements are treated as *per se* violations of the Sherman Act, as are certain horizontal restraints agreed upon by competitors, e.g., price-fixing, collective refusals to deal and division of markets or customers.

The per se rule and the rule of reason have been applied in Sherman Act jurisprudence for over 70 years <sup>146</sup>. In a restatement in *National Society of Professional Engineers v. United States*, 435 U.S. 679,692 (1978) (in the context of violations of Section 1 of the Sherman Act), the Supreme Court stated that agreements are considered *per se* illegal if their "nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality — they are 'illegal *per se*.'" In contrast, the rule of reason should be applied to "agreements whose competitive effect can only be evaluated by analysing the facts peculiar to the business, the history of the restraint, and the reason why it was imposed" <sup>147</sup>. The Court ruled, however, that the rule of reason "does not open the field of antitrust inquiry to any argument in favour of a challenged restraint that may fall within the realm of reason". The basic inquiry under the rule of reason should be whether the restraint in question, "is one that

promotes competition or one that suppresses competition", and the inquiry "is confined to a consideration of the impact on competitive conditions" <sup>148</sup>.

The courts have not developed or applied consistent distinctions between franchising and other distribution systems in rule-of-reason analyses of vertical restraints. In some cases, however, courts have begun to consider the franchising method of doing business as a procompetitive factor in the marketplace and included it in their analysis of whether a particular action unreasonably affects competition<sup>149</sup>. Some courts in their analysis also have considered as a relevant factor the argument that franchisors have a greater stake in the success of their franchisees than does a manufacturer or distributor who imposes restraints on independent dealers<sup>150</sup>.

There are both federal and state regulations or statutes that deal with particular aspects of franchising or with franchising in particular industries. At the federal level, disclosure of information by the franchisor to franchisees is regulated by the Federal Trade Commission's trade regulation rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" which became effective on 21 October 1979. In addition 15 states have enacted laws requiring disclosure and/or registration of a franchise offer. Two industry-specific federal laws — the Automobile Dealers Franchise Act and the Petroleum Marketing Practices Act — regulate relationships between suppliers and distributors of these products, especially the conditions of termination and non-renewal<sup>151</sup>. Eighteen states and the District of Columbia have laws of general applicability to franchising, including, for example, statutory requirements governing termination and non-renewal of the franchise.

Since franchising is not subject to different legal standards or analytic frameworks under U.S. competition policy, there has been no particular incentive to develop specific definitions of franchising for purposes of competition policy that would distinguish it from other similar business arrangements. For other purposes, a variety of definitions or classifications are used.

As discussed in Chapter I, in common parlance in the U.S. almost any commercial relationship that involves the licensing of a brand name or mark may be called a "franchise". Definitions developed for statistical reporting reflect this wide definition. From 1975-1988, the U.S. Department of Commerce issued annual reports titled, "Franchising In The Economy" that provided data on both "product and trade name" franchises and "business format" franchises <sup>152</sup>.

While not drafted directly for the purpose of competition policy, legal definitions of franchising do appear in the federal regulations and laws and state laws governing disclosure and termination and non-renewal of franchises<sup>153</sup>.

The definitions vary among these regulations and statutes, but most definitions in U.S. disclosure laws and regulations target business format franchising and bear a marked similarity to the definition used by the European Community for competition policy<sup>154</sup>. All require the licensing of a trade name, logo or commercial symbol, most commonly in conjunction with the transfer of the franchisor's practical business knowledge and expertise to the franchisee<sup>155</sup>. The requirement that franchisor expertise be transferred is variously expressed as the

imposition of "a significant degree of control" over, or provision of a "significant assistance" in, the franchise's "method of operation"<sup>156</sup>, or the provision of a "marketing plan or system prescribed in substantial part" by the franchisor"<sup>157</sup>.

## **European Community**

Franchise agreements are judged under the general competition rules laid down in Articles 85 and 86 of the Treaty of Rome. These rules have been applied specifically to franchise agreements in a series of decisions by the Court of Justice and by the Commission of the European Communities. These decisions culminated in Commission Regulation No. 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements (hereafter referred to as the "franchise block exemption regulation"). This regulation went into effect on 1 February 1989.

Because the EC has developed a specific and detailed competition policy for franchising, the discussion here is more extensive than in other sections of this chapter. The discussion first reviews general EC competition law and the treatment of vertical distribution agreements. It then discusses decisions of the Court of Justice and the Commission applying competition law to franchise agreements. These decisions and their reasoning in turn provided the basis for the franchise block exemption.

It should be stressed that the EC competition rules, the various decisions, and the Franchise Regulation apply directly in the 12 Member States, although, for obvious practical reasons, their description is not repeated in the sections of this and the next chapter describing competition law and policy applicable to franchising in individual EC Member States. Cases described in those sections, however, show that courts in some Member States that directly enforce the EC competition rules within their jurisdictions already have had occasion to apply EC rules to franchising, and the EC rules may be relied upon by litigants in all national courts in the context of civil proceedings concerning such matters as the enforcement of intellectual property rights or breach of contracts.

# Compatibility of franchise agreements with Article 85<sup>158</sup>

Article 85(1) prohibits "as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market". Under Article 85(2) any such agreement is automatically void.

Article 85(3) provides that agreements, decisions or practices that otherwise would be prohibited by article 85(1) may be exempted if they meet four conditions. First, two positive conditions must be satisfied: an agreement may be exempted if it (i) "contributes to improving the production or distribution of goods or to

promoting technical or economic progress while (ii) allowing consumers a fair share of the resulting benefit". An agreement that satisfies these two conditions can be exempted only if it also (i) does not "impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives" and (ii) does not "afford such undertakings the possibility of eliminating competition with respect to a substantial part of the products in question" Exemptions are allowed either by decisions on individual agreements found to meet these conditions, or by a block exemption regulation ruling that a particular class of agreements meet these conditions and qualify for an exemption 160.

A franchise agreement, like any other agreement, will not be liable to prohibition under Article 85(1) in two circumstances. The first is if it does not affect trade between Member States. This condition is in fact met quite often; franchise agreements for the many franchises that do not operate simultaneously in more than one EC country are not likely to affect trade between EC Member states. The second circumstance is if the scale of operations is sufficiently small that the agreement exerts no appreciable effect on market conditions. An agreement is considered not to have an appreciable effect on market conditions if the market shares of the firms involved do not exceed 5 per cent and if their combined annual turnover within the EC does not exceed 200 million ECU<sup>161</sup>.

The objectives of Community competition policy are shaped by the fundamental purposes of the Treaty of Rome. As suggested by the language of Article 85(1), Community competition policy has as objectives both promoting the integration of the various national markets into a single market, and establishing and protecting freedom of competition throughout this single market. Furthermore, competition policy is just one component of an overall Community economic policy, and therefore policies such as trade policy and industrial policy also must be considered in forming competition policy, and in particular in decisions taken within the limits of Article 85(3).

# Policies toward systems of vertical distribution

The Court of Justice and the Commission did not rule on the application of Article 85 to franchise agreements before 1986. By then, the treatment of other types of vertical distribution agreements under Article 85 was well established, and the general principles developed in evaluating other types of vertical distribution agreements were applied in the rulings on franchise agreements.

The general approach of the Court and the Commission has been to identify different categories or types of distribution arrangements, and to establish a specific treatment for each. EC competition law and policy distinguishes seven types of distribution arrangements or agreements; in descending order of integration these are:

- distribution by affiliate (full integration)
- agency contracts
- franchise agreements

- exclusive distribution agreements
- exclusive purchase agreements
- selective distribution agreements
- agreements between an enterprise and an independent distributor.

Application of EC competition rules to these distribution agreements is guided by two principles. First, the greater the degree of integration between producer and distributor, the less rigorously the rules protecting competition have to be applied. Thus, in the case of distribution by affiliate, competition rules are in principle not applicable to assignments of tasks within a single company or between a parent company and its affiliates (so long as the affiliate does not enjoy real autonomy). Likewise, Article 85(1) is not considered applicable where an economic agent sells or deals as an intermediary on behalf of only one principal in a product market. On the other hand, when a commercial agent does not act exclusively for a single producer in a product market, he will be assumed to be acting as an independent dealer, and as such will be subject to the provisions of Article 85(1).

The second principle is that whether a type of distribution system is lawful under EC competition rules depends on the object of the contract and distribution system. If the type of distribution system is lawful, then accessory provisions or provisions necessary for the operation of the lawful system are themselves considered lawful, either because they are not subject to Article 85(1) or because they qualify for exemption under Article 85(3). Since the objects of the contracts vary with the type of distribution system, the provisions that are lawful because they are necessary and accessory also vary from type of distribution system to another. For example, non-competition provisions (of limited duration) in a franchise agreement are not considered to infringe Article 85(1) because they are necessary to protect the know-how of the franchisor, the use of which is the purpose of franchise agreements. On the other hand, the same non-competition provision is not exempted under either the exclusive distribution or exclusive purchase regulations.

Following these principles, the Court and the Commission have developed separate treatment under EC competition law for each of these distribution systems. The discussion examines in greatest detail the treatment of franchise agreements. It is useful, however, to look first at the treatment of exclusive distribution and purchasing agreements, and of selective distribution agreements. Policies established earlier for these distribution systems underlie the treatment developed for franchise systems. Furthermore, outside the EC such distribution systems sometimes are classified as franchises under the broader definition of franchising. Numerous decisions of the Court and the Commission have dealt with the treatment of each of these types of distribution system and of particular provisions in each type of distribution system. Only a few of these decisions are mentioned here.

The 1966 judgment of the Court of Justice in the *Grundig-Consten* case established the basic legal position of exclusive dealing contracts under Article 85. The decision confirmed the essential points of a 1964 ruling by the Commission on this agreement<sup>162</sup>. The decision helped establish the general proposition that vertical

agreements, and not only horizontal agreements, were covered by Article 85(1)<sup>163</sup>. The decision also confirmed that, while exclusive dealing agreements could be acceptable under Article 85, territorial restrictions that prevented parallel imports and could prevent integration of national markets into the Common market were restrictions of competition that could not be exempted under Article 85(3) from prohibition<sup>164</sup>. Many subsequent decisions on various provisions affecting territorial restrictions, including basic decisions on franchise agreements, have relied on the Grundig decision.

Relying on its experience from decisions on particular agreements and on Grundig and other court judgments, the Commission has issued block exemption regulations for exclusive distribution and exclusive purchase agreements. These identify contract provisions that are acceptable in these types of distribution systems under Article 85(1) or are exempted under Article 85(3) by the regulation, provisions that are neither acceptable under Article 85(1) nor exempted under Article 85(3), and define the agreements to which the regulation and its exemptions apply. The first block exemption for exclusive dealing agreements, Regulation No. 67/67, was issued in 1967; upon its expiration it was replaced by separate block exemptions regulations for exclusive distribution and exclusive purchasing agreements, Regulation Nos. 1983/83 and 1984/83 respectively. 165

Broadly speaking, the principle of the *Grundig* decision, and subsequently of the block exemptions, is that exclusive distribution and purchasing agreements may be acceptable. Dealers may be assigned exclusive territories, and dealers may sign agreements to purchase exclusively from a particular supplier. Various obligations may be required of dealers, such as that they may not actively seek customers in the territories of other dealers, must carry full lines of products, or must undertake particular advertising or marketing efforts. Such agreements are acceptable, however, only if they do not prevent parallel imports. The agreements also must not be horizontal; for example, one manufacturer may not assign as his exclusive dealer a manufacturer of a competing product as exclusive dealer.

Court judgments also have reviewed selective distribution systems. For example, the two Metro cases reviewed Commission decisions on selective distribution systems. 166 No block exemption has been issued for selective distribution agreements, but the Commission has developed general positions or principles on the issues and problems of selective distribution systems <sup>167</sup>. (A block exemption, Regulation No. 123/85, was adopted in 1984 for motor vehicle distribution and servicing agreements.) The Commission and Court have accepted that "the essential feature of selective distribution, namely the setting of objective criteria for the professional qualification of dealers, does not fall within Article 85(1)"168. More specifically, the Court has ruled that selective distribution systems constitute "an aspect of competition which accords with Article 85(1), provided that resellers are chosen on the basis of objective criteria of a qualitative nature relating to the technical qualifications of the reseller and his staff and the suitability of his trading premises and that such conditions are laid down uniformly and are not applied in a discriminatory fashion" 169. Use of other sorts of qualitative criteria, additional requirements, for example, on promotional activities may be considered restrictions of competition in the meaning of Article 85(1). Exemptions may be granted under Article 85(3) for such additional requirements, but the evaluation must consider competitive conditions in the sector concerned. Thus exemptions were granted for SABA's distribution system, and the exemptions were upheld by the Court in the two *Metro* decisions, in part because of the competitiveness of the consumer electronics sector. Quantitative limitations on the number of dealers generally are considered restrictions of competition under Article 85(1), and exemptions are granted only in "exceptional circumstances" and where necessary to maintain a satisfactory distribution system. Finally, distribution agreements will not be acceptable under Article 85 if qualified dealers are excluded from a network in order to maintain high prices or the selective distribution system is used to prevent intra-Community trade<sup>171</sup>.

# Development of a policy toward franchising

The EC's policy toward franchising developed in the context of these existing policies on other vertical distribution systems. Prior to the first rulings of the Court and the Commission on franchise agreements, three issues were subject to uncertainty. First, did franchise agreements, or any provisions commonly found in franchise agreements, constitute restrictions of competition within the meaning of Article 85(1)? If so, did franchise agreements qualify for a block exemption under Article 85(3) that already had been granted, and in particular for the block exemption for exclusive distribution contracts? Franchisors generally considered that their agreements were acceptable, because either they did not restrict competition or qualified for an existing exemption, but this had not been established. Finally, if franchise agreements did restrict competition and did not qualify for an existing exemption, did they meet the conditions set out by Article 85(3) for an exemption?

The 1986 *Pronuptia* case was the first franchising case submitted to the EC Court of Justice<sup>172</sup>. In its ruling, the Court provided clear answers to the first two of these issues. First, the Court of Justice ruled that many provisions in the Pronuptia franchise agreement, essential to the working of the franchise system, did not restrict competition. Other provisions, notably those that shared markets or limited price competition, were found to restrict competition. Second, the ruling made it clear that existing exemptions for other methods of distribution could not be applied to franchising contracts and any provisions in them that did restrict competition.

The Court of Justice ruled that "The compatibility of franchise agreements with Article 85(1) depends on the provisions contained therein and on their economic context" The Court of Justice found that franchise agreements should be distinguished from other distribution agreements. "Rather than a method of distribution, it is a way for an undertaking to derive financial benefit from its expertise, without investing its own capital...(and) gives traders who do not have the necessary experience access to methods which they could not have learned without considerable effort and allows them to benefit from the reputation of the franchisor's name ... Such a system, which allows the franchisor to profit from his success, does not in itself restrict competition" According to the Court, for a

franchising system to work i) "the franchisor must be able to communicate his know-how to the franchisees and provide them with the necessary assistance in order to enable them to apply his methods without running the risk that know-how and assistance might benefit competitors, even indirectly" and ii) "the franchisor must be able to take the measures necessary for maintaining the identity and reputation of the network bearing his business name or symbol" 176.

Based on these findings on the importance to franchising of protecting know-how and the identity and reputation of their network, the Court held that i) "Provisions which are strictly necessary in order to ensure the know-how and assistance provided by the franchisor do not benefit competitors"; and ii) Provisions which establish the control strictly necessary for maintaining the identity and reputation of the network identified by the common name or symbol...do not constitute restrictions of competition for the purposes of Article 85(1)"177. The Court was clear that only provisions "strictly necessary" for these purposes qualified under these findings, and not necessarily any provisions that might have the objectives of protecting know-how or the reputation of the network.

Other provisions could not be justified on the same grounds:

"It must be emphasized on the other hand that, far from being necessary for the protection of the know-how provided or the maintenance of the network's identify and reputation, certain provisions restrict competition between the members of the network. That is true of provisions which share markets between the franchisor and franchisees or between franchisees or prevent franchisees from engaging in price competition with each other" 178.

Provisions that shared markets, such as the grant of exclusive territories in the Pronuptia franchise agreement, were restrictions of competition under Article 85(1)<sup>179</sup>. The Court noted that the granting of an exclusive territory might be an important factor in convincing a potential franchisee to invest in a franchise, but argued that this "consideration, however, is relevant only to an examination of the agreement in light of the conditions laid down in Article 85(3)" for an exemption <sup>180</sup>. The Court also found that, while competition would be restricted by provisions that prevented price competition between franchisees, "the fact that the franchisor makes price recommendations to the franchisee does not constitute a restriction of competition, so long as there is no concerted practice between the franchisor and the franchisee or between the franchisees themselves for the application of such prices" <sup>181</sup>.

The finding that some provisions in the agreement did restrict competition made it relevant for the Court to address the second question: did franchise agreements qualify for the block exemption granted exclusive dealing under Article 85(3)? The EC Court of Justice found that franchise agreements did not<sup>182</sup>.

After the Court decision, the Commission approved an exemption under Article 85(3) for a Pronuptia franchise agreement. Following closely the reasoning of the Court of Justice, the Commission found that clauses other than those involving market sharing — exclusive territories — were not restrictions under Article 85(1). These last provisions were granted an exemption under the Article 85(3) following findings that they met the four necessary conditions. First, the

Commission argued that the franchise agreement would improve the production and distribution of products by allowing the franchisor to extend his distribution network. Second, consumers would benefit from the quality of service provided by franchisees and because of the extent of interbrand competition in the market. Third, "the clauses ... which restrict competition by giving the franchisee territorial exclusivity, can be considered, in the circumstances, to be indispensable in that prospective franchisees would probably be unwilling to undertake the necessary investment and to pay a substantial initial fee to enter the franchise system if they were not provided with some protection against competition from other franchisees and from the franchisor in the allotted territory". Finally, the agreement would not eliminate competition in the products in question — bridal wear and accessories<sup>183</sup>. In its decision, the Commission noted that Pronuptia held about a 30 per cent share of the bridal wear market in France and smaller shares in other Member states, and that there were "many other manufacturers of bridal fashions in France and other EEC countries" 184.

Between 1986 and 1988 the Commission issued decisions approving the franchise agreements of Yves Rocher, Computerland, ServiceMaster and Charles Jourdan, and granting exemptions under Article 85(3) where necessary 185. As with the Pronuptia franchise network, the Commission found in each case that the franchise faced considerable competition. Yves Rocher was found to hold 7.5 per cent of the French market for cosmetics and 5 to 6 per cent of the market in other Member States. In 1985 Computerland stores accounted for less than 3.3 per cent of retail sales of microcomputer products in the Community as whole, while in 1986 the largest market share in any Member States was approximately 4 per cent (considerably lower than its 20 per cent share in the United States at the time). ServiceMaster had a 6 per cent share in the United Kingdom and projected a EEC market share of 5 per cent or somewhat more in the near future. The Commission noted that interbrand competition for cleaning and maintenance was strong with low barriers to entry<sup>186</sup>. In the case of *Charles Jourdan*, the Commission noted a wide range and number of competitors in both the production and retailing of footwear and handbags<sup>187</sup>.

Regulation No. 4087/88 of 30 November 1988, providing a block exemption for franchise agreements, in a sense codified the case law that had built up.

# The Regulation exempting franchise agreements

Regulation No. 4087/88 contains nine articles<sup>188</sup> preceded by a 17 paragraph preamble. The preamble describes generally the types of franchises covered by the agreement and how franchises satisfy the conditions of Articles 85(1) and 85(3). The nine articles that follow give more detailed definitions of the terms and coverage of the regulation, and set out the precise extent and terms of the exemption.

General principles. The preamble gives a generally favourable picture of franchising. The discussion roughly follows the four conditions set out in Article 85(3). First, the preamble states that franchise agreements "normally improve the

distribution of goods and services as they give franchisors the possibility of establishing a uniform network with limited investments, which may assist the entry of new competitors on the market ... thus increasing interbrand competition. They also allow independent traders to set up outlets more rapidly and with higher chance of success than if they had to do so without the franchisor's experience and assistance" 189.

Second, the preamble finds: "As a rule, franchise agreements also allow consumers and other end users a fair share of the resulting benefits, as they combine the advantages of a uniform network with the existence of traders personally interested in the efficient operation of their business....The favourable effect of franchising on interbrand competition and the fact that consumers are free to deal with any franchisee in the network guarantees that a reasonable part of the resulting benefits will be passed on to the consumers" <sup>190</sup>.

Third, the preamble considers "obligations restrictive of competition which may be included in franchise agreements", in particular exclusive territories and exclusive dealing, and finds that they "do not impose restrictions which are not necessary.... In particular, the limited territorial protection granted to the franchisees is indispensable to protect their investment"<sup>191</sup>.

Fourth, the preamble states that "To guarantee that competition is not eliminated for a substantial part of the goods which are the subject of the franchise, it is necessary that parallel imports remain possible". The preamble also notes that the exemption may be withdrawn by the Commission if the agreement has effects inconsistent with Article 85(3); "This applies in particular where competition is significantly restricted because of the structure of the relevant market" 192.

Scope of application. The preamble states that the regulation covers only franchise agreements "for the retailing of goods or the provision of services to end users", i.e. retailing distribution and master franchises 193. Industrial and wholesale franchises are not exempted by the Regulation 194, although, as the preamble notes, industrial franchise agreements may qualify for other exemptions, especially those provided by Regulations for patent licensing agreements or for know-how agreements 195.

Article 1 of the Regulation provides more precise definitions of a franchise and of the franchise agreements covered by the Regulation. In the absence of a legal definition in any particular Member State, the Commission carefully and precisely defines franchising in the Regulation as consisting of: "a package of industrial or intellectual property rights relating to trademarks, trade names, shop signs, utility models, designs, copyrights, know-how or patents which can be exploited for the resale of goods or the provision of services to end users" <sup>196</sup>.

Article 1 defines a franchise agreement covered by the Regulation as: "An agreement whereby one undertaking, the franchisor, grants the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified types of goods and/or services" 197. It further requires that, to be covered by Regulation No. 4087/88, a franchise agreement must include each of three obligations (i) "the use of a common name or shop sign and a uniform presentation of contract premises and/or

means of transport"; (ii) "the communication by the franchisor to the franchisee of know-how" and (iii) "the continuing provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement<sup>198</sup>".

The transfer of know-how is a defining characteristic for franchise agreements covered by the Regulation, and the Regulation gives a precise and fairly narrow definition of know-how: "A package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified" 199. The concepts of secret, substantial and identified are defined as well<sup>200</sup>. The Regulation prescribes that know-how must be "described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality". The effect is to define the relevant know-how primarily as commercial rather than technical information, which therefore could not easily be covered by the Regulation on know-how agreements.

In practice, the importance of the know-how and technical assistance provided varies from one franchise agreement to another. They often have included training sessions on the organisation and running of the retail outlet, assistance in choosing a retail location, advice and assistance on stocking, and regular training of staff<sup>201</sup>.

Treatment of agreement provisions. In addition to providing definitions, Article 1 declares that, pursuant to Article 85(3), franchise agreements shall be exempt from the provisions of Article 85(1) (so long as they meet the conditions set out in the Regulation). Remaining articles state the treatment of various contract provisions as exempted, prohibited, or permissible subject to limitations. The treatment of particular provisions is examined in more detail in the next chapter of this report.

Article 2 defines obligations which, although identified as restrictions of competition, nevertheless are exempted and therefore permissible because they are considered necessary to maintain the network. The obligations listed involve the establishment of exclusive territories or exclusive dealing. These are the exempt clauses.

Article 3 contains what are called the "white" clauses, clauses which are not normally considered by the Commission as restricting competition. The white clauses are divided into two groups. First, Article 3-1 lists obligations that are no obstacle to exemption provided that they are "necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network".

Second, Article 3-2, lists obligations the franchisor might use to maintain control over the use of his know-how and trademark and over the operation and reputation of the network. These provisions are unconditionally allowed to appear in agreements because they do not restrict competition in the meaning of Article 85-1<sup>202</sup>. (Article 8e, however, provides that the benefit of exemption may be withdrawn from the franchisor if he is using the various (exempt) methods of controlling the franchisee "for reasons other than protecting the franchisor's industrial or intellectual property rights, maintaining the common identity and

reputation of the network or verifying that the franchisee abides by its obligations under the agreement").

The clauses exempted in Article 3-2 are as follows: not to disclose know-how to third parties; to communicate to the franchisor any experience gained in exploiting the franchise and to grant him a non-exclusive licence for the know-how resulting from that experience; to inform the franchisor of infringements of his rights; not to use know-how for purposes other than the exploitation of the franchise (the franchisee may be held to this obligation after termination of the agreement); to attend training courses; to apply the commercial methods devised by the franchisor, including any subsequent modification thereof; to comply with the franchisor's standards for the equipment and presentation of the contract premises; to allow checks by the franchisor of the premises and of the goods, inventory and accounts of the franchisee; not to change the location of the premises without the franchisor's consent; not to assign the rights and obligations under the franchise agreement without the franchisor's consent<sup>203</sup>.

Article 4 lays down three conditions with which franchise agreements must comply to qualify for exemption. First, the franchisee must be "free to obtain the goods that are the subject-matter of the franchise from other franchisees ... or authorised distributors<sup>204</sup>". Agreements may not prevent parallel imports or impose absolute territorial protection. Second, a franchisee obligated "to honour guarantees for the franchisor's goods" must honour similar guarantees of any such goods regardless of whether they were supplied from another retail outlet in the common market<sup>205</sup>. Third, to enable the consumers to better benefit from the franchise, the franchisee must "indicate his status as an independent undertaking" so that they can identify him as the owner with liability<sup>206</sup>.

Article 5 contains the "black" list of seven provisions. The exemption does not apply to agreements containing any of these provisions<sup>207</sup>. The obligations contained in these provisions or the situations they reflect are assumed never to have positive effects.

Article 6 establishes the procedure by which the Commission may extend the exemption to franchise agreements that include provisions "restrictive of competition" that are neither expressly authorised (in Articles 2 or 3) nor prohibited (in Article 5)<sup>208</sup>. The Commission must be notified of agreements that include such "grey" clauses, and then has six months in which to oppose them. (Agreements that normally are automatically exempt need not be notified.)<sup>209</sup> Article 7 guarantees the secrecy of information acquired pursuant to the Regulation.

Under Article 8, the Commission may withdraw an agreement's exemption in particular cases where the agreement would have effects "incompatible with the conditions of Article 85(3)". More specifically, Article 8 authorises the Commission to withdraw an exemption "in particular where territorial protection is awarded to the franchisee" and one of several other conditions also exists (i) "parallel networks of similar agreements by competing manufacturers or distributors" significantly restrict "access to the relevant market or competition therein"; (ii) lack of "effective competition in a substantial part of the common market" for the franchise's goods or services; (iii) parties attempt to isolate markets

within the common market; or (iv) "franchisees engaged in concerted practices relating to the sale prices of the goods or services concerned" 210.

Lastly, *Article 9* provides that the Regulation enters into force on 1 February 1989, is to remain in force until 31 December 1999, and is binding in its entirety and directly applicable in all Member States.

Paragraph 17 of the preamble to the franchise block exemption further clarifies the relationship between the block exemptions for various types of distribution agreements: "Agreements may benefit from the provisions either of this Regulation or of another Regulation, according to their particular nature and provided that they fulfil the necessary conditions of application. They may not benefit from a combination of the provisions of this Regulation with those of another block exemption Regulation." Franchise agreements contain specific technical restrictions that are not covered by the other regulations. Consequently, an exclusive distribution agreement will need, first of all, to be amended to qualify under the franchising Regulation; at that point, it will no longer be able to claim exemptions applicable under exclusive distribution. Similarly, distribution agreements in the motor vehicle, service station and beer outlet sectors will be unable to qualify for the application of Regulation No. 4087/88 unless they give up the special provisions governing them under the Regulation on exclusive purchasing agreements<sup>211</sup>. However, a supplier may, for any one product, simultaneously but separately, have both an exclusive distribution network and a franchising system. This faculty offered by EC legislation aims to stimulate competition between networks and/or adapt distribution patterns more closely to local needs.

# Chapter IV

# Competition Policy on Individual Vertical Restraints in Franchise Agreements

This chapter discusses the competition policy in OECD Member countries towards the provisions, or vertical restraints, most commonly met with in franchise contracts. These sections are as follows: A. Resale price maintenance (or vertical price restrictions); B. Territorial or customer restrictions (or exclusive territories); C. Exclusive dealing obligations; D. Refusals to deal; E. Tie-ins; F. Obligations not to compete; G. Minimum requirements; and H. Advertising restrictions. Each section summarises the relevant legal provisions and current jurisprudence in individual Member countries in English alphabetical order, followed by a discussion of treatment under EC competition law and the franchise block exemption regulation.

# A. Resale price maintenance (or vertical price restrictions)

## Australia

Section 48 of the Trade Practices Act prohibits resale price maintenance (RPM) *per se*, i.e. it is unnecessary to show any restrictive effect on competition. Section 96 sets out specific acts constituting RPM. Infringements are heavily penalised. In 1990 penalties of \$A195 000 were imposed on Commodore Business Machines Pty Limited and \$A250 000 on Sony (Australia) Pty Limited for breaches of the resale price maintenance provisions<sup>212</sup>. In July 1990, the TPC agreed not to take legal action against Toshiba (Australia) Pty Ltd for alleged resale price maintenance in computer hardware, in exchange for a formal undertaking by the company to set up long term compliance training for its staff. It is generally permissible for a supplier or franchisor to stipulate maximum prices or to recommend prices in so far as the franchisor makes it clear that prices are recommended only.

Horizontal price fixing, between or amongst franchisees, is deemed by section 45A to substantially lessen competition, and is prohibited by section 45(2). While the franchisor may not stipulate prices in respect of goods he supplies (RPM), he may stipulate the prices at which goods supplied by a third party may be sold, without infringing section 48 or section 45(2), if he is not in competition with the franchisees. If each franchisee charges these prices in accordance with the franchisor's instructions, such a practice will be considered a vertical arrangement,

and not a horizontal price fixing contract, arrangement or understanding between or among the franchisees<sup>213</sup>.

## Canada

The provisions of the Competition Act concerning price maintenance cover franchise schemes insofar as Section 61 applies to whomever is engaged in the business of producing or supplying a product and also to whomever has the exclusive rights and privileges conferred by a patent, trade mark, copyright or registered industrial design.

Subsection 61(1)(a) provides that these persons shall not by agreement, threat, promise or any like means, attempt to influence upward, or to discourage the reduction of, the price at which any other person engaged in business in Canada supplies or offers to supply or advertises a product within Canada. Canadian courts have provided useful clarifications of this provision:

- a) To establish an offence, it is not necessary to prove that the supplier effectively influenced the price upward; it suffices to demonstrate that he attempted to do so;
- b) The terms "agreement, threat, promise or any like means" may be broadly applied to situations in which there has been an attempt to influence prices as, for example:
  - i) Co-operative advertising schemes where the supplier makes his participation dependent on not advertising for discount prices (*R* v A & M Records of Canada Ltd. (1980), 51 C.P.R. (2d) 225 (Ont.Co.Ct))<sup>214</sup>;
  - *ii)* Sales price reductions, that are made at manufacturers' suggested list prices<sup>215</sup>:
  - *iii*) Incentives to respect the suggested prices (proposal to supply a desired product, or to compel other retailers to respect the suggested prices)<sup>216</sup>;
  - iv) Cancellation or threatened cancellation of specific benefits if a retailer considers or implements price cuts (*R.v Sunoco Inc.* (1986), 11 C.P.R.(3d) 557 (Ont. Dist. Ct.))<sup>217</sup>.

Subsection 61(1)(b) defines as a separate offence the refusal by any person to supply a product to (...) any other person engaged in business in Canada because of the low pricing policy of that other person. According to the nature of the case, the person is convicted either under this or the previous Subsection.

Subsection 61(6) further provides that no person shall, by threat, promise or any like means, attempt to induce a supplier, whether within or without Canada, as a condition of doing business with the supplier, to refuse to supply a product to a particular person or class of persons because of the low pricing policy of that person or class of persons. Thus it dissuades any attempt by dealers to induce their supplier not to supply other dealers applying lower prices.

Breaches of these two Subsections — 61(1) and 61(6) — have given rise to an abundant jurisprudence mostly concerning cases of classically vertical distribution but no doubt transposable to franchise agreements<sup>218</sup>. In the event of conviction, the offence is punishable by a fine determined by the Court or five years' imprisonment, or both<sup>219</sup>.

There are nevertheless a number of exceptions of particular interest in respect of product distribution systems. Subsection 61(2) states that Subsection 61(1) does not apply where the person attempting to influence the conduct of another person and that other person are affiliated companies or directors, agents, officers or employees of: (i) the same company, partnership or sole proprietorship, or (ii) companies, partnerships or sole proprietorships that are affiliated, or (iii) where the person attempting to influence the conduct of another person and that other person are principal and agent.

Subsections 61(3)(4) and (5) deal with suggested resale prices. The first states that producers or suppliers who suggest a resale price must, in order not to be liable under the price maintenance provisions of the Act, make it clear to the person to whom the suggestion is made that he is under no obligation to accept the suggestion; in the absence of proof to the contrary, the fact of suggesting a resale price is considered as proof of an attempt to influence. Subsection 61(4) clarifies the terms under which a supplier, other than a retailer, may publish an advertisement mentioning a resale price for a product; it must be made clear that the product may be sold at a lower price<sup>220</sup>.

Subsection 61(9) exonerates from the provisions of Subsection 61(1)(b) any person who believes that the person he refuses to supply is using his products as loss-leaders, not for the purpose of a making a profit thereon but for the purposes of advertising and attracting customers in the hope of selling them other products, or is engaging in misleading advertising in respect of those products, or is not providing the level of servicing which purchasers might reasonably expect.

These exceptions apply only to what would otherwise be the offence of refusing to supply to a retailer setting low prices; they do not apply to the offences described in Subsections 61(1)(a) and 61(6).

#### **Finland**

The Act on Restrictive Business Practices prohibits resale price maintenance. In 1989, for example, the Office of Free Competition investigated vertical price maintenance in two franchising agreements in the clothing and furniture businesses. After negotiations with the parties, the franchisors in each case had to remove their price fixing requirements. Franchisees are not entitled to set prices that differ from those given or recommended by the franchisors.

# France

Resale price maintenance may be caught under either Article 34 of Title IV or under Articles 7 or 8 of Title III of the 1986 Ordinance. The treatment of minimum and maximum price restriction differs somewhat. Minimum price restrictions are prohibited *per se* by Article 34 and fines are imposed for violations; no examination of market effect is required. Article 34 does not apply to maximum price restrictions.

Resale price maintenance provisions also could be considered an agreement restricting competition under Article 7, especially since the article includes "preventing the free effect of competition on prices" as one of the listed effects of agreements that shall cause prohibition. A finding that Article 7 had been violated would involve some evaluation that competition had been restricted under the meaning of Article 7. In principle Article 7 could be applied to either minimum or maximum price restrictions, although the necessary finding of a restriction of competition is perhaps more likely in the case of a franchisor setting minimum price restrictions. Provisions imposing resale prices also might be considered an abuse of economic dependence under Article 8.

While resale price maintenance, and especially minimum resale price maintenance, is not acceptable, recommended prices, so long as they are not strictly enforced, are acceptable. In a 1983 ruling on selective distribution contracts in the perfumery trade<sup>221</sup>, the Competition Commission (1983) was willing to consider arguments by manufacturers that sales at low prices could harm their image: "Manufacturers sometimes justify their action vis-à-vis their dealers by the need to protect their brand image. Such concerns warrant consideration"<sup>222</sup>. The Commission nevertheless held that manufacturers should not go beyond a system of recommended prices, and that contract provisions forbidding advertising outside of the shop merely because it mentioned prices below the recommended ones should be deleted.

The Competition Council ruled on minimum price restrictions in a 1989 case involving the distribution of sports shoes of Adidas and other large manufacturers<sup>223</sup>. This case primarily involved selective distribution, although some manufacturers used wholesale franchisees, but there was little indication the Council would follow a different line of reasoning for franchises on pricing issues. These manufacturers of higher quality sport shoes had refused to sell to large super or hypermarkets who would not respect minimum recommended mark-ups on wholesale prices. The manufacturers argued that this refusal was explained by the existing distribution contracts with dealers who did respect the recommended prices. The Council considered both the general question of whether the manufacturers could distribute their product through selected outlets, and the specific issue of minimum price restrictions.

On the first question, the Council observed that, "provided selective distribution schemes preserve a degree of market competition, they are in compliance with the provisions of Article 7 of the 1986 Ordinance and Article 85 of the Treaty of Rome if the criteria for selection are objective, are necessary for an

adequate distribution of the product at issue, do not have the objective or effect of excluding by their nature a particular form of distribution, and are not applied discriminatorily"<sup>224</sup>. The Council argued that selective distribution contracts should be evaluated in the context of their effect on competition in the market. The Council concluded that selective distribution systems, if based on acceptable criteria, were not incompatible with competition in this market. In support, the Council emphasized the extent of interbrand competition: the influence of fashion in shifting demand among brands, and the demonstrated possibility of successful entry<sup>225</sup>.

This ruling represented a new approach to the validity of selective distribution schemes. The previously prevailing ruling, according to one commentator, had been that "these systems of themselves lead to a certain restriction of competition" <sup>226</sup>. The Council instead stressed that vertical contracts should be evaluated after considering their overall economic effect, and suggested in particular that it was important to consider the extent of interbrand competition.

At the same time, the Council ruled that the manufacturers had violated Article 7 of the 1986 Ordinance by making tacit acceptance of minimum recommended mark-ups a condition for being a reseller<sup>227</sup>. The Council found that it was not appropriate for the manufacturers to limit price competition among the distributors of their shoes. In choosing their resellers, the manufacturers had not limited themselves to the use of objective criteria. Instead the manufacturers had used recommended mark-ups to maintain high profit margins and prices among their retailers and had prevented large distributors from selling high- and medium-class sports shoes<sup>228</sup>.

The civil courts generally have held that resale price maintenance indicates excessive interference by the franchisor in the business of the franchisee. In Lypobar v. La Croissanterie (1989), the Paris Court of Appeal found that a franchisor, by a variety of actions including resale price maintenance, had treated his franchisees as mere "concessionaires" and had abused their economic dependence. The Court affirmed that a franchisee must be free to set his resale prices, and that "by imposing supply and resale prices, the franchisor destroyed the franchisee's freedom to manage his business and acted as the de facto owner of the business, without the franchisee's consent and in contradiction with the basic obligations stemming from the franchise contract." At the same time, the Court acknowledged that a provision allowing the franchisor to communicate a list of indicative prices to the franchisee was lawful, but only if the franchisee remained free to set his own resale prices and was not obliged in practice to apply the prices communicated by the franchisor<sup>229</sup>.

## Germany

The franchisee's freedom of pricing is particularly important under the provisions of the ARC. As a rule, the franchisor may not influence the franchisee's freedom of pricing in any way whatsoever. Section 15 prohibits agreements fixing resale prices — including both maximum and minimum resale prices — in

vertically structured franchise systems. In horizontally structured systems, resale price maintenance is prohibited under Section 1, or possibly under Section 25(1) of the ARC. Furthermore, the franchisor must not, by threatening or causing harm, induce the franchisee to set specific sales prices [Section 25(2) in conjunction with Section 15 ARC]. These provisions have been applied in several cases involving franchise systems.

In the case of *Wienerwald GmbH*, the franchisor provided the franchisees with the know-how necessary to operate a restaurant under that name. Franchise agreements originally included a resale price maintenance provision, but both this provision and price recommendations in the company's internal "operating manual" were eliminated following objections of the FCO. Wienerwald now issues menus with a uniform appearance but that show the franchisees' own prices.

In the case of *McDonald's Corporation*, the terms of the franchise agreements allowed the franchisor to prescribe binding prices at which the franchisees could sell food and beverages, although specific retail prices had not yet been determined. The FCO objected and the agreements were changed accordingly.

Another case involved prices advertised by McDonald's. In addition to a national advertising company, the McDonald's franchisees and the outlets owned by McDonald's in a particular area use a common regional advertising agency. In connection with two advertising campaigns for new products that were carried out by one national and eight such regional advertising companies, uniform prices had been agreed upon. It was pointed out to McDonald's by the FCO that decisions on prices taken within the advertising companies also infringe the law.

McDonald's was further informed that price recommendations issued by the advertising companies' advisory councils also were illegal. Interpreted as small-firm recommendations, the FCO stated that they were illegal because the recommendations also were directed at McDonald's, a large firm, and therefore were not covered by the exemption provision of Section 38(2) No. 1 of the ARC. Interpreted as non-binding price recommendations they were also illegal because the advisory councils of the advertising companies could not ensure a consistent level of quality of the food and drink offered in the franchised restaurant which could therefore not be regarded as branded goods within the meaning of Section 38a (2) of the ARC. The FCO stated, however, that it would tolerate advertising with non-binding price recommendations if, and only as long as, new products are being introduced.

On the other hand, a franchisor's influence on pricing by determining transfer prices was not objected to by the FCO in another case (*Pinguin-Frischfracht-System*) on the grounds that, although the system in question was largely co-operative in nature and considered to infringe Section 1 ARC, it had been legalised under Section 5(b) ARC.

Resale price maintenance may be permitted only if franchisees are actually acting in a way similar to commercial agents who do not act for their own account. The Federal Supreme Court has confirmed in its *Telefunken* case that resale price maintenance imposed in a commercial agent relationship does not infringe Section 15 ARC<sup>230</sup>.

#### Japan

Resale price maintenance "without good reason" is one of 16 practices designated as unfair business practices by FTC Notification No. 15 of 1982<sup>231</sup>. Resale price maintenance also may be dealt with under another unfair business practice listed by the Notification: dealing under restrictive terms. The Antimonopoly Act prohibits unfair trade practices under Article 19. The FTC has issued numerous cease and desist orders against resale price maintenance.

In *Wakodo K.K. v. FTC* (1975)<sup>232</sup> and *Meiji Shoji K.K. v. FTC* (1975)<sup>233</sup>, the Supreme Court held that there are few, if any justifications for resale price maintenance, except for two specific situations. First, resale price maintenance has been allowed for products designated by the FTC that have uniform quality — only certain categories of drugs and cosmetics have been so designated. There were also exemptions for copyrighted works. In addition, the Guidelines issued in July 1991 indicate two specific situations in which resale price maintenance shall be allowed: genuine consignment sales and de facto direct transactions between a manufacturer and customers.

Recommended resale prices, however, are allowed when they are considered necessary to maintain the uniformity of the network and to facilitate the choice of consumers. According to the FTC's 1983 Decree on the Application of Antimonopoly Laws to Franchise Systems, the franchisee must be free to adapt his pricing policy to take account of the particularities of the market. According to the new Guidelines issued in July 1991, however, in cases where any artificial measures have been taken to cause distributors to sell at a supplier's indicated price, such conduct shall be deemed as resale price maintenance and therefore illegal.

# New Zealand

Resale price maintenance (RPM) is prohibited under section 37 of the Commerce Act 1986. However, the recent review of the Commerce Act found that while RPM is generally inconsistent with a competitive market, it can, in some circumstances, have beneficial effects and in these instances it may be desirable<sup>234</sup>. It was accepted that the only arguments for outright prohibition are to minimise administration and compliance costs<sup>235</sup>. The Commerce Amendment Act 1990 retains the prohibition on RPM but allows authorisation by the Commerce Commission in those cases where it can be shown that the benefits to the public outweigh the anticompetitive effects of the practice. This brings the treatment of this particular form of practice into line with the treatment of other practices under the Commerce Act.

Third-party RPM is prohibited under section 38. This could affect franchisors who do not supply goods to the franchisee but threaten to interfere with the supply of goods to franchisees from other sources unless the set price is adhered to. It also forbids conduct which brings about this result without any threat actually being made. Section 37 and 38 do not apply to service-only franchises, but vertical price fixing for services may be caught under section 27 if an anticompetitive effect or

intent is proved<sup>236</sup>. Genuine price recommendations are allowed where this fact is clearly stated.

Price fixing is prohibited by section 30. It covers controlling or maintaining prices indirectly as well as fixing them overtly, and extends to attempts to regulate discounts, allowances, credits or rebates as well as prices proper. It applies to horizontal arrangements between franchisees. Joint venture pricing and joint buying arrangements are outside the scope of section 30. However, such arrangements can still fall foul of the general prohibitions appearing in other sections of the Act if there is proof of the necessary anticompetitive effect or intent<sup>237</sup>.

## Norway

Resale price maintenance and agreements concerning recommended resale prices are prohibited under the provisions of 18 October 1957. Price fixing agreements are prohibited under the provisions of 1 July 1960. In principle, the prohibition also applies to chains. As mentioned in the previous chapter, the Price Directorate is, however, of the opinion that in some cases such co-operation may promote competition. Each application for exemption is considered on its merits and exemptions from the provisions are granted for individual chains.

The possibility that a voluntary chain may contribute to real price competition in a market is of major importance when considering the possibility of giving an exemption. The number of participating enterprises is also taken into account. Another relevant element is whether the participants have the same marketing profile and level of costs.

A condition for granting an exemption is that prices are only recommended. The individual shops must be free to stipulate their own prices. The Price Directorate does not expect much price competition between members of a chain. Consequently, price recommendations within a chain have a stronger normative effect than allowing a single supplier to issue recommended resale prices. Resale price maintenance has been allowed in some cases.

# Spain

Price restrictions are banned by the Competition Act. Article 1.1 a) of Chapter I of Title 1 "On free competition" prohibits any agreement, concerted decision or practice whose effect is directly or indirectly to set prices or other commercial or service conditions.

A franchise agreement might, however, evade the rigour of that rule since price restrictions otherwise banned by Article 1.1 might be authorised under Article 3.1 and/or benefit from an exemption provided under Article 5.1 of this Chapter, if the franchise agreement satisfied the conditions required by those two articles.

Recommended price lists have been permitted, given interbrand competition in the relevant market and the existence of parallel networks of authorized dealers. Fixed, or minimum or maximum prices have been considered "unessential restrictions" and thus unlawful.

#### Sweden

In Sweden, any vertical restraint in franchise agreements may be judged as unduly restricting competition if it affects free competition substantially. It will, however, be judged under the abuse principle with the exception of resale price maintenance which is prohibited. In cases dealt with by NO, franchisors circulated price lists to their franchisees who were required to give notice if they were going to diverge from the franchisor's list. NO found that this practice had too heavy an influence on franchisees but accepted price recommendations.

# United Kingdom

In the United Kingdom and apart from the applicable competition rules already identified in Chapter III, common law rules exist relating to restraints of trade<sup>238</sup>. These restraints are void unless the party seeking to enforce the provision can show that the restraint is reasonably necessary to protect his legitimate interest.

Under the Resale Prices Act 1976 it is unlawful for suppliers of goods to impose minimum resale price on dealers, or to compel them to charge those prices by threatening withdrawal of supplies or by imposing some other sanctions. The Act does not prohibit the establishment of maximum resale prices nor does it control prices of services. In cases where minimum prices are recommended, the Office of Fair Trading takes care to ensure that the franchisee is free to charge less than the recommended price<sup>239</sup>.

# **United States**

Resale price maintenance, or vertical price fixing, has been considered a *per se* violation under Section 1 of the Sherman Act since the U.S. Supreme Court first enunciated this rule in 1911 in *Dr. Miles Medical Co. v. John D. Park & Sons*<sup>240</sup>. Recent decisions suggest the treatment of resale price maintenance is undergoing a transition as courts are clarifying and narrowing the types of conduct encompassed within the reach of the *per se* rule. Particularly important are recent decisions on the scope of *per se* illegality that were motivated in large part by the need to distinguish vertical price restraints from vertical non-price restraints created by the Court's decision in *Continental TV Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977). Vertical price restraints remain *per se* illegal, while the *GTE Sylvania* decision established that vertical non-price restraint are to be judged under the rule of reason. (The *GTE Sylvania* decision is discussed in detail in the following section on territorial restrictions.)

In Monsanto Co. v. Spray-Rite Co., 465 U.S. 752 (1984), the Supreme Court held that evidence that a dealer was terminated following the receipt of complaints from other dealers concerning the price-cutting practices of the terminated dealer was not sufficient evidence to establish existence of an agreement to vertically fix prices that is per se illegal under Section 1 of the Sherman Act. The Court said that "the correct standard is that there must be evidence that tends to exclude the possibility of independent action by the manufacturer and distributor." The evidence must "reasonably tend to prove the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful objective." The Court explained that more was needed for such a showing than evidence that a distributor had conformed to suggested prices; some evidence of communication between distributor and manufacturer was needed showing that agreement to such prices was sought by the manufacturer and acquiesced in by the distributor<sup>241</sup>. Evidence of agreement is necessary since a manufacturer generally has the right to act independently to refuse to deal with a distributor, including distributors who fail to comply with resale prices announced in advance by the manufacturer<sup>242</sup>.

Monsanto, a manufacturer of grain crop herbicides, had not renewed the contract of Spray-Rite, one of its dealers, one year after Monsanto began a new marketing plan of appointing distributors for one-year terms based on new criteria for judging the sales activity of the dealers and the training of its salesmen. Monsanto at that time supplied about 15 per cent of corn (maize) crop herbicides and about 3 per cent of soy crop herbicides, although its share of corn herbicides subsequently increased. Spray-Rite was the 10th largest of approximately 100 distributors of Monsanto's primary corn herbicide. Dealers did not have exclusive territories. Following termination, Spray-Rite continued to sell herbicides until 1972 and purchased some of Monsanto's products from other dealers, although it was unable to purchase either the volumes it desired or to secure supplies as early in the season as it wished. Spray-Rite sued, alleging a conspiracy between Monsanto and some of its dealers to fix the resale prices of Monsanto's herbicides, and that Monsanto terminated Spray-Rite's dealership, followed various shipping and compensation policies, and encouraged other dealers to boycott Spray-Rite in furtherance of this conspiracy. The District Court instructed the jury that Monsanto's conduct was per se unlawful if it was taken to further a conspiracy between Monsanto and some dealers to fix resale prices; the jury found that the termination of Spray-Rite (and the other conduct), was taken to further such a conspiracy. The Court of Appeal affirmed the decision holding that there was sufficient evidence to satisfy Spray-Rite's burden of proving a conspiracy to set resale prices, and specifically that "proof of termination following competitor complaints is sufficient to support an inference of concerted action." This standard conflicted with statements by Courts of Appeal in other Circuits, and the Supreme Court accepted the case to resolve the conflict<sup>243</sup>.

The Supreme Court rejected the standard of the Court of Appeal of the Seventh Circuit (although it affirmed the judgment against *Monsanto* on the grounds that there was other evidence sufficient to support the finding of conspiracy). In its decision the Court noted the difficulty in practice of drawing a

distinction between concerted action to set resale prices, *per se* illegal under *Dr. Miles* (see below), and non-price vertical restraints, which the *Sylvania* decision found was to be judged under the rule of reason.

"In *Sylvania* we emphasized that the legality of arguably anticompetitive conduct should be judged primarily by its "market impact." But the economic effect of all of the conduct described above — unilateral and concerted vertical price setting, agreements on price and non-price restrictions — is in many, but not all, cases similar or identical....(I)t is precisely in cases in which the manufacturer attempts to further a particular marketing strategy by means of agreements on often costly non-price restrictions that it will have the most interest in the distributors' resale prices. The manufacturers often will want to ensure that its distributors earn sufficient profit to pay for programs such as hiring and training additional salesmen or demonstrating the technical features of the product, and will want to see that "freeriders" do not interfere"<sup>2244</sup>.

The Court stated that if the burden of proving a price-fixing agreement that was per se illegal could be satisfied by "highly ambiguous evidence, there is considerable danger that the doctrines enunciated in Sylvania and Colgate (establishing the legality of independent refusal to deal by manufacturers) will be seriously eroded". The Court found the standard of the Court of Appeal flawed because it ignored this danger. Complaints by dealers that other dealers were cutting prices, the Court argued, were normal and were particularly likely "where the manufacturer has imposed a costly set of non-price restrictions". Furthermore, it was part of assuring an "efficient distribution system" for manufacturers and distributors to co-ordinate their behavior and for manufacturers to rely on distributors as important sources of information about the retail pricing of their products<sup>245</sup>. Thus the Court insisted that more than complaints about price cutting should be necessary to infer a vertical agreement to fix prices that would be per se illegal. To accept the Court of Appeal's standard "could penalize perfectly legitimate conduct" and would undermine the Sylvania ruling that non-price vertical restrictions were not per se illegal and should be judged by their economic impact under the rule of reason<sup>246</sup>.

The Supreme Court returned to the distinction between vertical price and non-price restrictions in a second important case, *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988). In this case, the Court held that a vertical restraint is not *per se* illegal under Section 1 of the Sherman Act unless it includes some agreement about price or price level.

Like *Monsanto*, this case also involved dealer termination. The petitioner and Hartwell were dealers for Sharp electronic calculators in the same metropolitan area. Sharp published a list of suggested minimum prices, but its written dealership agreements contained no requirement that these or any other retail prices be charged. Business Electronics' retail prices generally were below both the recommended prices and the retail prices of Hartwell, which also sometimes charged less than the recommended prices. Hartwell complained several times to Sharp about the low retail prices of Business Electronics and finally told Sharp it

would cease to be a dealer for Sharp's calculators unless Sharp terminated Business Electronic's dealership within 30 days; Sharp terminated Business Electronics as a dealer the next month. Business Electronics sued.

In its decision, the Supreme Court focused on the distinction between the *per se* illegality of vertical price restrictions and the treatment of vertical non-price restrictions under the rule of reason:

Although vertical agreements on resale prices have been illegal since *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, we have recognized that the scope of *per se* illegality should be narrow in the context of vertical restraints. In Continental T.V. v. GTE Sylvania, Inc., we refused to extend *per se* illegality to vertical non-price restraints.

It refused to do so because the economic effect of vertical non-price restraints had not been shown to have the generally harmful effect on competition necessary to justify *per se* illegality. The Court then went on, citing *Monsanto*, to say, "We have been solicitous to assure that the market-freeing effect of our decision in *GTE Sylvania* is not frustrated by related market rules<sup>247</sup>."

The Court stated that its approach was "guided by the premises of GTE Sylvania and Monsanto: that there is a presumption in favor of a rule-of-reason standard; that departure from that standard must be justified by demonstrable economic effect...and that rules in this area should be formulated with a view towards protecting the doctrine of GTE Sylvania." The Court found that the economic effects of the vertical restraint in this case did not justify per se treatment: "There has been no showing here than an agreement between a manufacturer and dealer to terminate a 'price cutter', without a further agreement on the price or price levels to be charged by remaining dealers, almost always tends to restrict competition and reduce output." Furthermore, a rule that included such a restraint within the scope of per se illegality "would threaten to dismantle the doctrine of GTE Sylvania. Any agreement between a manufacturer and a dealer to terminate another dealer who happens to have charged lower prices can be alleged to have been directed against the terminated dealer's 'price cutting.'" The effect on the GTE Sylvania doctrine would be widespread since "vertical non-price restraints only accomplish the benefits identified in GTE Sylvania because they reduce intrabrand price competition to the point where the dealer's profit margin permits provision of the desired services". Thus the Court refused to include within the scope of per se illegality agreements to terminate a price cutter where there was no further express or implied agreement on the prices or price levels to be set. This ruling affects the scope of the principle that vertical price restraints or agreements are per se illegal, but did not overrule the principle itself<sup>248</sup>. In addition, this ruling, like Monsanto, does not prevent restraints or agreements that to some extent involve pricing from being judged under the rule of reason when they fall outside the scope of agreements that are per se illegal.

Both *Monsanto* and *Business Electronics* involved minimum resale price agreements. Another recent case, *Atlantic Richfield Co. v. USA Petroleum Co.*<sup>249</sup>, involved maximum resale price agreements. In *Albrecht v. Herald Co.*, 390 US 145 (1968), the Supreme Court held that vertical maximum price fixing agreements

were *per se* illegal. The issue presented to the court in *Atlantic Richfield* ("ARCO") involved standing to sue, and its ruling does not alter the substantive finding of *Albrecht* that the *per se* standard applies. Nonetheless, the decision is interesting.

Dealers of USA Petroleum Company competed with ARCO retail dealers and set relatively low prices. When ARCO began offering incentives to its dealers to set similarly low prices, USA Petroleum Co. sued, alleging a conspiracy of ARCO with its dealers to set a maximum retail price. Another claim that ARCO's prices were predatory was withdrawn. Private plaintiffs must show they have suffered "antitrust injury" to have standing to sue under §4 of the Clayton Act. The Court ruled that as a competitor, USA Petroleum Company could not show antitrust injury if a vertical, nonpredatory maximum resale price agreement results in lower prices, and therefore did not have standing to sue: "when a firm ... lowers prices but maintaining them above predatory levels, the business lost by rivals cannot be viewed as an "anti-competitive" consequence of the claimed violation... Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition, hence, they cannot give rise to antitrust injury"<sup>250</sup>.

# European Community

Resale price maintenance is prohibited as a restriction of competition under Article 85(1), and exemptions are not given under Article 85(3). Recommendations for minimum and maximum prices, however, are acceptable provided they do not go beyond simple advice. This position is taken both in the block exemption Regulation No. 4087/87 for franchise agreements, and in earlier court and Commission decisions.

One example of the early decisions setting out the policy toward resale price maintenance is the 1973 *Deutsche-Phillips* decision of the Commission<sup>251</sup>. The Commission found unacceptable agreements that required the German dealers of Phillips' products to charge prices fixed by Deutsche Phillips, the German distributor, regardless of whether the sales were to customers in Germany or elsewhere in the Community. Resale price maintenance was at the time legal in Germany and the provisions protected this system. Nonetheless the Commission found the provisions unjustified because they obstructed the sale of imported products at prices below those fixed, and thus could maintain national markets within the Community, which was incompatible with the competition rules of the Community.<sup>252</sup>

In distribution agreements submitted to it that do not involve franchising, the Commission also has regularly required that price maintenance clauses be struck out before granting exemptions under Article 85(3). Moreover, Regulation No. 1983/83 does not allow the exemption of exclusive distribution agreements containing retail price maintenance clauses<sup>253</sup>. A request for individual exemption may, on occasion, be made but the chances of its being approved are very small<sup>254</sup>.

Resale price maintenance is on the "black list" of the franchise block exemption Regulation. Article 5e says the exemption will not apply where:

"the franchisee is restricted by the franchisor, directly or indirectly, in the determination of sale prices for the goods or services which are the subject-matter of the franchise, without prejudice to the possibility for the franchisor of recommending sales prices".

The initial paragraphs of the Regulation are even clearer about the permissibility of recommended prices: "the franchisor should be free to recommend prices to the franchisees, where it is not prohibited by national laws and to the extent that it does not lead to concerted practices for the effective application of these prices"<sup>255</sup>.

This is consistent with the position taken by the Court of Justice in its *Pronuptia* decision. The Court found resale price maintenance a restriction of competition because of its effect on intrabrand competition: "certain provisions restrict competition between the members of the network. That is true of provisions...which prevent franchisees from engaging in price competition with each other." The Court went on, however, to find that price guidelines do not restrict competition "so long as there is no concerted practice...for the actual application of such prices" 256.

In considering individual exemptions for franchise agreements before the block exemption was granted, the Commission consistently ruled that resale price maintenance was prohibited under Article 85(1) and was not eligible for exemption<sup>257</sup>. Before exempting the Pronuptia franchise agreement, the Commission caused to be abolished the clause that required the franchisee not to harm the brand image of the franchisor by his pricing level<sup>258</sup>. On the other hand, it considered that Article 85(1) was not contravened by the clause concerning indicative prices on promotional material nor by that which recommended the franchisee not exceed the maximum prices quoted by the franchisor in its advertising and promotions<sup>259</sup>.

Minimum price clauses formed part of the first contracts notified to the Commission by *Yves Rocher* and concluded when the firm's network was originally being set up. As a result of observations made by the Commission, Yves Rocher expressly deleted resale price maintenance provisions in these contracts — which were not applied in practice — before the Commission granted an exemption<sup>260</sup>. The Commission ruled that "the resale price maintenance clauses and the prohibition on cross supplies between franchisees prevented the machinery for correcting price differences within the network from operating." The Commission did, however, authorise the Laboratoires de Cosmétologie Yves Rocher to issue a catalogue of recommended resale prices to its franchisees since franchisees remained "free to set their retail selling prices at a lower or higher level, it being understood that it was recommended to them not to sell at a higher price than given in the catalogue"<sup>261</sup>.

#### B. Territorial or customer restrictions (or territorial exclusivity)

#### Australia

Territorial exclusivity is not prohibited except if it has the purpose or has or is likely to have the effect of substantially lessening competition. So long as the restraint of competition has a public benefit the TPC may even grant an authorisation. In 1979, the TPC authorised a system of territorial zoning for the distribution of newspapers and magazines (*John Fairfax and Sons and Ors*)<sup>262</sup>. The TPC may also decide to take no action when receiving a notification which includes territorial restraints. The Commission so decided in the *Coca-Cola* decision<sup>263</sup>.

The Coca-Cola case involved an exclusive dealing agreement including territorial exclusivity arrangements. Franchisees agreed to limit their sales to a defined territory. The TPC noted that a monopoly was granted to each franchisee in his territory which removed the possibility of intrabrand competition. However, the Commission found that the restrictions involved were outweighed by the pro-competitive effects resulting from the franchise. The TPC, among other elements, took into account the fact that there was no complaint to the Commission by competitors and that significant inter-brand competition existed.

Territorial exclusivity, however, must be limited to a reasonable period, generally not exceeding five years. In addition to prohibitions on territorial exclusivity established by the Trade Practices Act, certain territorial restrictions may be prohibited by the common law restraint of trade doctrine.

### Canada

Territorial restriction, or market restriction as it is known, is governed by Section 77 of the Competition Act, as are tie-in and exclusive dealing provisions. Market restriction is defined by the Act as any practice whereby a supplier of a product, as a condition of supplying the product to a client, requires that client to supply any product only in a defined market, or exacts a penalty of some kind from the customer if he does not respect that obligation.

Like tying and exclusive dealing, market restriction will be subject to a Competition Tribunal order only if it meets certain criteria. Subsection 77(3) provides, in particular, that where the Tribunal finds that market restriction, because it is engaged in by a major supplier of a product or because it is widespread in relation to a product, is likely to substantially lessen competition in relation to the product, the Tribunal may prohibit all or any of the suppliers from continuing to engage in market restriction and may order any other measure that, in its opinion, is necessary to restore or stimulate competition.

Subsection 77(4) provides for exceptions to be made to the above where market restriction (and exclusive dealing) is or will be engaged in only for a reasonable period of time to facilitate entry of a new supplier or product into a market [Subsection 77(4)(a)], and in the case of companies, partnerships and sole proprietorships that are affiliated. Beyond the latter provision, which applies also to

tied selling and exclusive dealing, Subsection 77(6) provides that, as regards market restriction, where there is an agreement whereby one person supplies or causes to be supplied to another person an ingredient that the second person processes by the addition of labour and material into an article of food or drink that he then sells with a trade mark that the first person owns or in respect of which the first person is a registered user, the first and the second person are deemed to be affiliated. This is the so-called "soft drink" exemption, which may also be applied to other franchise schemes.

#### France

Territorial exclusivity provisions imply that a franchisor refuses to sell to third parties in a sales territory already assigned to a franchisee. Refusal of the franchisor to satisfy the demand of non-franchisees appears to be inherent in the very principle of franchising. So in a franchising network, refusal may be "justifiable," and/or in certain circumstances qualify for a decree of exemption under the last paragraph of Article 10. Before the 1986 Ordinance, refusal to sell was a penal offence in itself<sup>264</sup>. However, the case law of distribution agreements had gradually been identifying criteria to justify exemption from the principle that refusal to sell was an offence (legal unavailability of the products, abnormal character of demand etc.).

In the *Interrent* case<sup>265</sup>, an Interrent franchised car rentor with the exclusive right to exploit this trade-mark for the Aubagne-La Ciotat area complained that he had been deprived of his franchise before the expiry of his contract. The franchisor had revoked the contract, claiming that the franchisee had violated the clause in the contract forbidding him to actively seek customers. In 1989, the Cour de cassation upheld the decision of the Court of Appeal: a clause prohibiting the franchisee from seeking customers actively was lawful and could lawfully prevent the franchisee from agreeing to a car-rental request from a regular and important customer where delivery of the vehicle had to be made in the territory of another franchisee and such delivery was of a repeated nature. In this case, the franchisee had apparently engaged in "active" competition by delivering rental vehicles on several occasions to Marignane airport, in a sector held by another Interrent franchisee. Neither Court adopted an economic line of reasoning; the Cour de cassation observed merely that the Court of Appeal verdict was based on contract law.

At the same time there are limits to acceptable territorial restrictions. As provided by Community law, the franchisor may lawfully determine sales areas provided this does not result in absolute sharing of the market and prohibition of competition between franchisees. In the *sports shoe* case, for example, the Competition Council noted that the firm Adidas, by refusing to export its products to other countries in the European Community, had contravened Article 85 of the Treaty of Rome. It is lawful to prohibit "active" competition only; "passive" competition — that is, at the customer's request — must always remain possible. Clauses prohibiting the search for customers in the territory of a competing franchisee are therefore lawful.

A territorial exclusivity clause also must not overstep the required objectives and must improve customer service. The Competition Council, in its *sports shoe* decision, ruled on the exclusivity clauses in the wholesale franchise contracts of Adidas. Under this clause, the franchisee undertook not to do business directly or indirectly outside a given territory. The Council ruled that "the obvious purpose of this clause is to prohibit all possibility of competition between franchisees. It goes beyond what is necessary for reaching the goal of wholesale franchise contracts, which is to improve service to dealers." The franchisee also undertook not to sell to clubs, public bodies, groups, associations, supermarkets, bulk buyers and chain stores. The Council was unable to establish that "this clause, given that the distribution circuits in question could obtain supplies directly from the manufacturer, had by itself, for goal or effect their exclusion from the Adidas franchise distribution network and hence the distortion of competition." The Competition Council enjoined the firm Adidas to amend the provisions contained in its contracts and which were liable to restrict all competition between dealers and limit market entry to shoe retailers.

## Germany

In vertically structured franchise systems, territorial protection clauses are subject only to abuse control under the ARC (Section 18). The FCO will not object to the allocation of an exclusive territory if it is essential to the establishment of a franchise system or if it is required for its smooth operation because, in that case, the clause is not considered unfair. This applies to all territorial arrangements granting the franchisees territorial protection from would-be franchisees and the franchisor's own network of outlets (external protection). In the absence of external protection, it would be most difficult to find franchisees willing to pay the high initial entry fee and the equipment cost for the franchised outlet. Where a franchisee is restricted in the sale of contract goods outside the allocated territory, for example in outlets to be set up in the future (internal protection), such territorial protection may be objectionable and has to be examined separately in each case. Such an obligation may unfairly prevent the mostly small or medium-sized franchisee's internal growth in a particular case and rule out competition among franchisees<sup>266</sup>.

## Japan

Territorial restrictions may be prohibited as unduly restricting the transactions between a franchisee and his customers, unless there is justification for the restrictions<sup>267</sup>. Territorial restrictions have been considered justifiable if they promote interbrand competition. Territorial restrictions also normally are considered acceptable if they help new or weak franchisees until they become fully competitive. If, however, the market of the franchised product is highly concentrated, territorial restrictions would be in violation of the Antimonopoly laws.

Three criteria are generally used to determine whether a practice is justifiable and not unduly restrictive. First, how strict is the restraint and its enforcement: is the franchisee completely prohibited from selling outside its territory or only required to concentrate its selling efforts within its territory while remaining free to sell to customers outside? Second, how competitive is the structure of the market of the franchised product? Third, what is the market share of the franchisor?

According to the new Guidelines issued in July 1991, territorial restrictions are deemed illegal in cases where such a restriction is imposed by an influential franchisor in a market, and if the price level of the product covered by the restriction is likely to be maintained. Whether a franchisor is considered influential in a market is judged by his market share of the franchisor, that is by whether the franchisor has a market share of 10 per cent or more and is one of the four largest suppliers in the market as measured by its share. Such restrictions are usually legal if the franchisor is a new entrant or has a share smaller than 10 per cent and is not one of the four largest in the market.

#### New Zealand

Territorial restrictions are covered by the general provisions on anticompetitive behaviour. Whether franchise operations are at risk as a result of such restraints would depend on market power, whether customers can or will cross territorial boundaries, and whether there are competing non-franchised products or services available within the territory<sup>268</sup>.

# Spain

Territorial and customer restrictions are banned by Article 1.1 b) and c) of Chapter I of Title I of the Competition Act, which prohibits the limiting or controlling of production, distribution, technical development or investment, as well as the dividing up of markets and sources of supply. The ban may, however, be lifted and the restrictions authorised when the conditions set out in Article 3.1 and 5.2 are fulfilled. In the Toshiba case the Tribunal ruled that clauses obliging the franchisee to exploit the franchise only from the contract premises combined with a degree of territorial exclusivity are, in principle, restrictive of competition, but may qualify for an authorization.

### Sweden

Territorial restraints have been considered acceptable by NO in some cases where the franchisee was allowed to sell "passively", i.e. to accept orders from a customer outside his territory. Too few cases have been considered, however, to establish a general principle that passive exclusive territories are acceptable.

#### United Kingdom

Franchise agreements granting exclusive territories may be caught under either section 6 of the Restrictive Trade Practices Act (RPTA) dealing with goods or section 11 dealing with services. If, however, the territorial restriction grants the right to carry on an activity in a specified territory where no such right existed previously, this may not be considered a restriction, by virtue of the "open door" principle. Alternatively, a territorial restriction (as opposed to the granting of a limited right) may relate solely to goods or services supplied under the agreement and therefore be disregarded (i.e. treated as not "relevant") under section 9(3) or section 18(2) of the Act. Restrictions granting exclusive territories, however, may be "relevant" under the RTPA and can lead to an agreement becoming registrable. Some authorities are of the opinion that for this reason many UK franchisors do not grant exclusive territories<sup>269</sup>.

#### **United States**

Since the landmark case of *Continental TV Inc.v. GTE Sylvania Inc.*, 433 U.S. 36 (1977), the rule of reason has been applied to vertical territorial restrictions. In deciding *GTE Sylvania* the Supreme Court expressly overruled its 1967 decision in *United States v. Arnold Schwinn & Co.*, 388 U.S. 365 (1967), in which territorial restrictions were found to be a *per se* violation of the Sherman Act<sup>270</sup>.

The *GTE Sylvania* case grew out of a dispute between Sylvania and one of its dealers. In 1962 Sylvania, following a period in which the market share of its television sets had fallen, began to distribute its sets through a limited number of franchised dealers<sup>271</sup>, and each was allowed to sell Sylvania televisions only from specified locations. In 1965, over Continental's objection, Sylvania franchised a new dealer close to one of Continental TV's stores in San Francisco, and also refused Continental's request that its new store in another California city, Sacramento, be a Sylvania TV dealer. In the ensuing dispute, Sylvania cancelled Continental TV's franchises, and Continental sued GTE Sylvania claiming the territorial restrictions violated Section 1 of the Sherman Act. At the time, GTE Sylvania had a 5 per cent share of television sales nationwide, up from about 2 per cent in 1962, and a 15 per cent share in Sacramento<sup>272</sup>.

The Supreme Court's decision is significant for its reasoning as well as for the application of the rule of reason. The Court argued that the purpose and economic effect of non-price vertical restraints should be considered. The Court's analysis distinguished between intrabrand and interbrand competition, considered efficiency arguments for vertical restraints, and argued that the potentially beneficial effects of non-price vertical restraints on interbrand competition should be taken into account:

"The market impact of vertical restrictions is complex because of their potential for a simultaneous reduction of intrabrand competition and stimulation of inter-brand competition....Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular

product competing for the business of a given group of buyers. Location restrictions have this effect....Although intrabrand competition may be reduced, the ability of retailers to exploit the resulting market may be limited both by the number of consumers able to travel to other franchised locations and, perhaps more importantly, to purchase the competing products of other manufacturers....Vertical restrictions promote inter-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products....Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers....For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labour that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products....Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation...."

The Court also noted that "per se rules in this area may work to the ultimate detriment of the small businessmen who operate as franchisees. To the extent that a per se rule prevents a firm from using the franchise system to achieve efficiencies that it perceives as important to its successful operation, the rule creates an incentive for vertical integration into the distributive system, thereby eliminating to that extent the role of independent businessmen."

At the same time, the Court in *GTE Sylvania* reaffirmed the *per se* illegality of territorial restrictions that are horizontal agreements: "There may be occasional problems in differentiating vertical restrictions from restrictions originating in agreements among retailers. There is no doubt that restrictions in the latter category would be illegal *per se*."

The court's treatment of territorial or customer restrictions has been more variable in dual distribution systems where the manufacturer is both a retailer and a wholesaler distributing through other franchised retailers. Some courts, especially prior to *GTE Sylvania* have viewed territorial restrictions in dual distribution systems as horizontal restrictions that are illegal. Other courts, especially more recently, have been willing to apply a rule of reason where examination of the facts shows the restrictions do not involve horizontal agreement<sup>273</sup>.

## European Community

Territorial restrictions in franchise agreements are acceptable under the franchise block exemption regulation so long as they are limited and do not prevent franchisees from supplying particular consumers based on their place of residence. This position was taken in the original ruling by the Court of Justice in *Pronuptia* and the first Commission decisions on exemptions for franchise agreements. These decisions themselves relied on an established position of Community competition

policy and law on vertical distribution agreements that territorial restrictions may be acceptable if they do not prevent parallel imports.

The position may be traced back to the Commission and Court decisions in the mid-1960s on the *Grundig-Consten* agreement, in which absolute territorial restrictions were found unacceptable.<sup>274</sup> Under the agreement, Consten was the exclusive distributor of various Grundig consumer electronics products in France. Grundig agreed not to supply these products, either directly or indirectly, to any person in the territory under contract to Consten. Every purchaser from Grundig was required in their agreements neither to export or re-export Grundig products. Consten itself was forbidden to deliver products either directly or indirectly from its territory to other countries. Nonetheless, other distributors in fact were acquiring parallel imports of Grundig products into France and selling them in competition with those distributed by Consten, which led to the actions decided by the Commission and Court.

The Commission in 1964 decided, first, that the agreement was a restriction of competition in the meaning of Article 85(1). The Commission noted that it had been argued that "competition plays such a large part in the production stage that any distortion of competition resulting from the nomination of a sole representative is excluded." The Commission rejected this argument on two grounds. First, "it is sufficient, for there to be a restriction of competition in the sense of Article 85 paragraph 1, that competition be restricted or restrained at one stage only." Second, the Commission stressed the importance not only of competition among distributors, but of intra-brand competition:

"For trademarked articles such as those in question here, the products of different manufacturers display different exterior and, in part, also, technical characteristics. For these products the purchasers can generally only rely upon a comparison of offers and prices laid down by suppliers in respect of those articles bearing the same mark....This is why competition at the distribution stage, and in particular between wholesalers distributing articles with the same trade mark, assumes particular importance."

The Commission did not support this argument by a direct appeal to evidence on the extent of competition from other brands or on the relevant market to which these products were supplied. In its recitation of relevant facts, the Commission did discuss evidence that the same Grundig products were sold at higher prices in France than in other countries in the Community, but the conclusion about the importance of intrabrand competition at the wholesale level does not explicitly rely on this evidence.

Finally, the Commission concluded the agreement violated Article 85(1) because it was capable of affecting trade between member states since it prevented re-exports by Consten and "As a consequence, the integration of national markets into a Common Market is hindered, if not prevented."

The Commission next considered whether the agreement qualified for an exemption under Article 85(3). The Commission "accepted...as an hypothesis" that the assigning of exclusive territories in the agreement could improve production and distribution for one or more reasons, including: assigning a sole distributor

allows that distributor to provide the manufacturer with better information from downstream markets, if there are several importers none will have an adequate incentive to provide guaranty and after-sales service which are important for marketing such products, and parallel importers are able to offer lower prices because they can benefit from the efforts of the primary distributor in the areas of publicity and service. Based on the evidence on differences in price, the Commission questioned whether, as required for an exemption, consumers received a fair share of the benefit generated by the agreement.

More importantly, however, the Commission concluded that the agreement failed to qualify for exemption because, while arguably the agreement might improve production and distribution, absolute territorial restrictions were not indispensable for those benefits. The Commission examined each of the claimed benefits, arguing that each would be achievable with more limited territorial exclusivity that did not prevent parallel imports. Hence absolute territorial protection was not indispensable and not eligible for exemption under Article 85(3). For example, it was not necessary to ban parallel imports to prevent free riding (although the Commission did not use this term) and to allow the provision of guaranty and after sales services; after sales service could be charged for directly and supplied regardless of where the product was purchased, and the claim that such services would not be supplied was contradicted by the fact that parallel importers into France had organized such services. Consequently, the Commission refused to exempt the agreement that provided strict territorial exclusivity.

The Court of Justice upheld the basic position that absolute territorial restrictions that prevented parallel imports were restrictions of competition and were not eligible for exemption under Article 85(3). In its decision, the Court underlined and tended to generalise about both the potential of absolute territorial restrictions to preserve national markets and the importance of intrabrand competition. On the first point, in finding that Article 85(1) applied to vertical as well as horizontal agreements, the Court stressed that "an agreement between producer and distributor which might tend to restore the national divisions in trade between Member States might be such as to frustrate the most fundamental objectives of the Community."<sup>275</sup> On the second point, the Court rejected claims that the Commission's decision was flawed because it failed to evaluate the effects of the agreement on competition between different brands:

"The principle of freedom of competition concerns the various stages and manifestations of competition. Although competition between producers is generally more noticeable than that between distributors of products of the same make, it does not thereby follow that an agreement tending to restrict the latter kind of competition should escape prohibition of Article 85(1) merely because it might increase the former."

The Court went on from this view of competition to find that the Commission was correct in concluding that the agreement restricted competition in the meaning of Article 85(1):

"Since the agreement thus aims at isolating the French market for Grundig products and maintaining artificially, for products of a very well-known brand, separate national markets within the Community it is therefore such as to distort competition in the Common Market.

It was therefore proper for the contested decision to hold that the Court found that the agreement constitutes an infringement of Article 85(1). No further considerations, whether of economic data (price differences between France and Germany, representative character of the type of appliance considered, levels of overhead borne by Consten)... and no possible favourable effects of the agreement in other respects, can in any way lead, in the face of above mentioned restrictions, to a different solution under Article 85(1)".<sup>277</sup>

In the final part of its decision, the Court upheld the Commission decision denying exemption under Article 85(3). The Court found adequate the Commission's evaluation of whether the criteria for exemption were met.

When the Court examined territorial restrictions in franchise agreements in its *Pronuptia* decision, it cited the *Grundig* decision as making clear that "a restriction of that kind constitutes a limitation of competition for the purposes of Article 85(1) if it concerns a business name or symbol which is already well-known." Following a suggestion of the Court, the Commission found that the Pronuptia agreement, and specifically the territorial restrictions, qualified for an exemption under Article 85(-3) so long as parallel imports remained possible. Similarly, the other franchise agreements considered by the Commission for individual exemptions — *Yves Rocher, Computerland, ServiceMaster*, and *Charles Jourdan* — all contained limited territorial restrictions. In each case the Commission found the restrictions qualified for exemptions under Article 85(-3).

The franchise block exemption Regulation No. 4087/88 continues this treatment. Article 2 specifically exempts several aspects of territorial restriction that are identified as "restrictions of competition": territorial protection granted by the franchisor to the franchisee (Article 2(a)); location clauses obliging "the franchisee to exploit the franchise only from the contract premises" (Article 2(c)); and requirements that the franchisee "refrain, outside the contract territory, from seeking customers for the goods or services which are the subject matter of the franchise (Article 2(e))<sup>278</sup>.

In granting both the individual and block exemptions, the Commission has found that territorial restrictions in franchise agreements satisfy the conditions of Article 85(3). In particular, the Commission has argued that franchising improves the distribution of goods and offers consumers a fair share of the resulting benefits, and that territorial restrictions are indispensable if these benefits are to be realised. Following an argument originally suggested by the Court in *Pronuptia* and repeated by the Commission in granting individual exemptions, the Preamble to the franchise block exemption regulation states: "the limited territorial protection granted to the franchisees is indispensable to protect their investment" 279.

As this suggests, however, only limited territorial restrictions qualify for exemption under the block exemption regulation. The preamble states that the

Regulation must specify "conditions which must be satisfied for the exemption to apply", and that "to guarantee that competition is not eliminated for a substantial part of the goods which are the subject of the franchise, it is necessary that parallel imports remain possible." Article 5(g) states an agreement shall not be exempt if "franchises are obligated not to supply within the common market the goods or services which are the subject-matter of the franchise to end-users because of their place of residence." In addition, an exemption may be withdrawn by the Commission, under the terms of Article 8(c) of the Regulation, if users are prevented, because of their place of residence, from obtaining franchised goods, or markets in different Member States are isolated by using differences in specifications.

## C. Exclusive dealing obligations

#### Australia

In principle, Section 47(1) prohibits clauses imposing the requirement not to deal in competing products. Section 47 lists detailed practices by both supplier and acquirer which are considered exclusive dealing. They would be prohibited only after an examination of the market conditions as to whether they substantially lessened competition. In *Chrysler Australia* (1975), the TPC cleared agreements where the distributor refrained from selling competing products (air conditioners)<sup>281</sup>.

Exclusive dealing conduct other than third line forcing may be notified. Once conduct is notified to the TPC, it is immune from the Act until such time as it is revoked by the TPC on the grounds that it substantially lessens competition and that the effect on competition is not outweighed by public benefits flowing from that conduct. The conferred statutory immunity may be withdrawn by notice of the Commission. Among the elements taken into account by the Commission in assessing public benefit are the length of the restraint and the possibility of access to the market.

Exclusive dealing may be permitted in the context of franchising if it is necessary to protect the reputation of the trade mark and/or the network. However, franchisees should not be deprived of their freedom to purchase goods from third parties in so far as these goods are of an adequate quality.

### Canada

Exclusive agreements, like tied sales, are covered by Section 77 of the Competition Act, which defines them as any practice whereby a supplier of a product, as a condition of supplying the product to a customer, requires that customer to deal only or primarily in products supplied by or designated by the supplier or his nominee, or refrain from dealing in a competing product.

As noted below in the section on tied selling, an order may be made when the elements of subsection 77(2) are met. The exceptions under Sub-section 77(4) concerning companies, partnerships and sole proprietorships that are affiliated equally apply to exclusive agreements. This subsection also states that the Tribunal shall not make an order where, in its opinion, exclusive dealing is or will be engaged in only for a reasonable period of time to facilitate entry of a new supplier of a product into a market or of a new product into a market.

As in the case of tied sales, a study of this practice involves analysing its advantages and drawbacks with respect to competition, with particular emphasis on appraising the extent to which this form of restriction on intrabrand competition could have the effect of promoting interbrand competition.

The Restrictive Trade Practices Commission evaluated exclusive dealing obligations in the *Bombardier* case. The Director of Investigation and Research had applied to the Commission for an Order directed against the company to prohibit it from requiring its distributors of snowmobiles with whom it had concluded franchise agreements to sell no other brand and also to resupply those distributors whose deliveries had been halted because they were selling competing brands.

In its decision of October 1980, the Commission clarified some provisions of Section 77 of the Act applying not only to exclusive dealing but also to tied selling and market restriction. On the concept of major supplier it specified that

"a major or important supplier is one whose actions are taken to have an appreciable or significant impact on the markets in which it sells. Where available, a firm's market share is a good indication of its importance since its ability to gain market share summarises its capabilities in a number of dimensions. Other characteristics of a supplier which might also be used in assessing its importance in an industry are its financial strength and its record as an innovator."

The Commission also analysed the trend in market shares, the availability of current and potential distributors and competitors' capability of making sufficient sales to produce at reasonable costs. The Commission noted that two other suppliers had been able to recruit new distributors and that their sales were such as to allow them to have adequate distribution systems. While it was difficult to find retail distributors in some regions, there did not seem to be a large number of locations where only the Bombardier brand was available. There was no evidence that Bombardier distributors were suffering from their inability to sell other brands. The Commission concluded that the evidence in its possession "does not show a substantial lessening or reduction of competition nor a likelihood thereof. Moreover, there is no evidence that competition at the manufacturing level was substantially affected by Bombardier's exclusive dealing in the markets covered."

In Canada, exclusivity clauses may also be dealt with under section 79 of the Competition Act, a general provision relating to abuse of a dominant position. The application to such clauses of both sections 77 and 79 was recently considered by the Competition Tribunal in its decision in the NutraSweet matter. The contractual terms considered in this case included exclusive supply and use clauses as well as a special allowance to customers for displaying the NutraSweet logo. The Order

issued by the Tribunal in this case prohibits NutraSweet from entering into or enforcing these contractual terms.

In its decision, the Tribunal recognised that exclusivity can often be the outcome of competitive bargaining processes. In this case, however, the Tribunal concluded that NutraSweet's contractual terms were intended to and did have the effect of impeding entry into the market for aspartame. The Tribunal rejected arguments that the various exclusivity clauses were necessary to prevent free riding and to enable the company to recoup the costs incurred in obtaining regulatory approvals and developing the market. The Tribunal's decision is presently under appeal.

#### France

In *Mourat-Natalys* (1989), the franchisee was obligated to purchase from the franchisor by a tacitly renewable 3-year exclusivity clause. The franchisee had to purchase from the franchisor a volume of goods equal to at least 70 per cent of the previous year's turnover. The Paris Court of Appeal was not called upon to rule on the lawfulness itself of the terms of the contract but on their compatibility with the Treaty of Rome provisions on parallel imports in the European Community.

The Court ruled that given the nature of the franchise contract, which implied use of the franchisor's trademark, logo and know-how, any sale by one franchisee to another was considered to have been made by the franchisor who was the source of supply for all members of its network. The franchisee claimed that the exclusive purchasing clause prevented her from obtaining supplies or fulfilling orders from another member of the network, so impeding parallel imports. The Court did not accept this argument. Referring to the *Pronuptia* decision<sup>282</sup>, the Paris Court of Appeal noted that a clause of this kind had been recognised as compatible with EC rules on the grounds that it was essential to preserve the network. This clause indeed did not prevent the franchisee from purchasing from or selling to other franchisees.

In Société Internationale du Siège v. Betin, the Paris Court of Appeal ruled the exclusive purchasing clause and the standard form contract of which it was an essential element to be null and void, since the exclusive purchasing clause did not specify the subject of subsequent sales. While the subject of the contract was clearly stated (namely leather furniture), the proportions were not: the franchisee undertook to present the full collection which could vary "en fonction des nécessités commerciales appréciées par le seul fournisseur" (depending on business needs of which the supplier was sole judge). This system of purchasing did not allow the franchisee to stock up according to local customer demand and swelled the number of unsold goods which could amount to up to 50 per cent of the stock. The franchisee was also obliged to engage in an advertising campaign mismatched to local needs. As a result he ran the risk of bankruptcy. The Cour de cassation (the final Court of Appeal) implicitly recognised the cogency of the analysis of the Paris Court of Appeal in dismissing the appeal lodged by the franchisor.

The exclusive purchasing clause is not considered by the courts to be decisive evidence of the existence of a genuine franchise contract. In *Himbert-Natalys* (1989), the Versailles Court of Appeal observed that exclusive purchase and distribution arrangements, with mutual exclusivity, were features common to both trading ("concession") and franchise agreements. On these grounds, the Court deemed the franchise contract to be tantamount to an exclusive supplier contract. This case has had many legal developments<sup>283</sup>. The franchisor, Natalys, sells mainly through its franchisees — items for mothers-to-be and small children. In the case in point, the franchisee was required to purchase and sell exclusively articles bearing the franchisor's trademark. It was not obliged to purchase the whole range of articles and no purchasing quotas were imposed<sup>284</sup>. The franchisee had repeatedly violated this exclusivity clause<sup>285</sup> but refused to recognise that it had done so and demanded that the contract in its entirety be declared null and void on grounds of failure, from the franchisor's side, to state prices. The contract was annulled by the Versailles Court of Appeal (1989), after the case was sent back to it by the Cour de cassation, for a new hearing on these grounds.

## Germany

Imposing exclusive sales obligations on the franchisee is not considered to be unfair where, in view of the franchise system, the franchisee must concentrate all his efforts on the franchise business.

### Japan

Exclusive dealing may be unlawful if it unduly restricts fair competition under Article 11 of the Notification<sup>286</sup>. If the franchisor is operating in a competitive market, justifications may be accepted. Exclusive dealing could be considered as unduly restrictive in some circumstances, such as: the franchisor has a large market share; the practice is linked to another illegal practice such as resale price maintenance; it is difficult for competitors to find alternative distribution; or the exclusive dealing obligation will remain in effect for a long term.

According to the new Guidelines of July 1991, exclusive dealing is deemed illegal if the restriction is imposed by a franchisor that is considered influential in the market and if the restriction may result in making it more difficult for new entrants or competitors to easily secure alternative distribution channels. Whether a franchisor is considered influential depends on its market share and position in the market. Exclusive dealing restrictions usually are legal if the franchisor is a new entrant or has a market share that is less than 10 per cent and does not place it among the four largest suppliers in the market.

#### New Zealand

Exclusive dealing is not specifically prohibited because the view is that some exclusive dealing arrangements may have a neutral or even a positive impact on competition, particularly where the arrangement enables new products or new entrants to penetrate markets<sup>287</sup>. There has been only one case to date regarding exclusive dealing and this was brought by a new entrant against an established firm. In *Simpson Appliances (NZ) Ltd v Fisher & Paykel Ltd (1990)* the High Court reversed the earlier Commerce Commission decision and found that F&P's exclusive dealing clause did not substantially lessen competition even though F&P's market shares were well in excess of 50 per cent. Important factors taken into consideration were that the exclusive dealing clause could be terminated without penalty on 90 days notice; that F&P's market power was significantly constrained by competition from other firms and imports; and that retail space had not been foreclosed.

Exclusionary provisions are prohibited by section 29 of the Commerce Act. Effect is irrelevant but anticompetitive purpose must be proved. This section could apply to arrangements between franchisees or contained in an agreement which allows the franchisor to compete directly with the franchisee. It could also apply where a franchisor consults franchisees before making changes to the system or its membership. Such consultation may be held to give rise to an exclusionary provision if the franchisees confer with each other<sup>288</sup>.

## Spain

Exclusivity agreements are treated in the Competition Safeguards Act in the same way as territorial and customer restrictions. In franchising agreements exclusive purchasing clauses can be authorized for the "core" products or services in the contract, but not for other products or services. Some alternative source of supply must be allowed for these other products or services. In the *Candy* case, the Tribunal did not accept a full supply restriction, requiring the possibility of supply from other franchisees in addition to supply from the franchisor. In the *Toshiba* case, the Tribunal did not accept the exclusive supply clause for accessories or spare parts after the expiration of the warranty period for equipment sold by the franchisee.

## United Kingdom

Supply restrictions in a franchise contract can be relevant for the purposes of the RTPA and would be analysed for anti-competitive effect in any registrable agreement along with all other relevant restrictions. A non-registrable franchise agreement with supply restrictions could be examined under the Competition Act where the terms for its application were met. These restrictions may also be void if they are considered to be an unreasonable restraint of trade under common law. The

Courts have decided that a restraint of trade may be justified by the special circumstances of a particular case.

### **United States**

Exclusive dealing and requirements contracts may be challenged under Section 3 of the Clayton Act, where the standard is whether "the effect may be to substantially lessen competition or tend to create a monopoly"<sup>289</sup>. They also may be challenged under Section 5 of the Federal Trade Commission Act as an "unfair method of competition", or under Section 1 of the Sherman Act as a restraint of trade. Exclusive dealing also may be challenged under Section 2 of the Sherman Act. These practices are not *per se* illegal, but have always been judged under the rule of reason. Recent decisions have shown a broadening of the factors considered most important, with less emphasis solely on the volume of commerce affected, measured either in absolute or market share terms<sup>290</sup>.

Early cases in the 1920s had found that Section 3 of the Clayton Act was violated by an exclusive dealing contract that affected 40 per cent of sales [paper dress patterns; Standard Fashion Co. v. Magrane-Houston Co., 258 U.S. 346 (1922)], but had not been violated by an exclusive dealing contract involving about 1 per cent of the market [margarine: Pearsall Butter Company v. Federal Trade Commission, 292 F. 720 (7th Cir. 1923)]. The Supreme Court considered this area again in a major decision in Standard Oil Co. of California v. United States, 337 U.S. 293 (1949). Standard Oil of California, a supplier with a 23 per cent share of sales in its region, had signed exclusive supply or requirements contracts with independent dealers. The contracts were signed with 16 per cent of service stations and involved about 7 per cent of gasoline sales (and 14 per cent of retail sales not counting wholesale sales to industrial buyers). The Supreme Court held that "the qualifying clause of Section 3 (of the Clayton Act) is satisfied by proof that competition has been foreclosed in a substantial share of the line of commerce affected. Standard's use of the contracts creates just such a potential clog on competition, as it was the purpose of Section 3 to remove wherever, were it to become actual, it would impede a substantial amount of competitive activity...." In the decision the Court expressly acknowledged that such contracts could serve legitimate business purposes. The Court argued, however, that it was not in a good position to attempt to balance such legitimate effects against possible anticompetitive effects, and that therefore it should decide based primarily on a quantitative structural test<sup>291</sup>.

This *Standard Station* decision could be interpreted as setting a relatively low threshold at which exclusive dealing or requirements contracts were illegal<sup>292</sup>. The Supreme Court's decision in *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961), reviewed its earlier decisions and rejected such strict interpretations. The Supreme Court held that

"to determine substantiality...it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein. It follows that a mere showing that the contract itself involves a substantial number of dollars is ordinarily of little consequence"<sup>293</sup>.

Thus, the Court used a standard involving a broader analysis of market conditions and of the effect of exclusive dealing than it had in the earlier standard decision. The Court, however, provided little practical guidance for how such an analysis should be carried out and noted that the 0.77 per cent of the market affected by the contracts in questions was not sufficient to be deemed to violate competition legislation<sup>294</sup>.

Cases on exclusive dealing brought under Section 5 of the FTC Act have at times been decided on somewhat different standards than cases (such as those discussed above) brought under the Clayton Act. In one early decision in 1953, the FTC indicated it would consider a wide range of factors and carry out an economic analysis to determine if the anticompetitive effect prohibited under Section 5 was present, something of a contrast to the approach in the Standard Stations case of a few years earlier<sup>295</sup>. Ten years later, however, in *Brown Shoe Co.*, the Commission held Section 5 of the FTC Act prohibited any exclusive dealing arrangement that foreclosed competitors from a "significant number" of outlets; the decision found unlawful an agreement in which 650 retail shoe outlets agreed to purchase shoes "primarily" from *Brown Shoe Co.* and not to purchase any "conflicting" shoes<sup>296</sup>. The Supreme Court upheld the FTC decision in 1966 (five years after Tampa *Electric*), ruling that the FTC had not exceeded its broad powers under the FTC Act, although the decision would not appear to have followed the approach of the Court in Tampa Electric for Clayton Act cases, namely using a broad analysis of market conditions and the effects of the contract on effective competition.

In Beltone Electronics Corp., Trade Reg. (CCH) (1982), however, the Federal Trade Commission did use a broad market analysis, similar to that employed in Tampa Electric and consistent with the approach developed by the Supreme Court in GTE Sylvania toward non-price vertical restraints, to analyze an exclusive dealing agreement between a hearing aid manufacturer and its retailers<sup>297</sup>. The Commission stated that "a proper analysis of exclusive dealing arrangements should take into account market definition, the amount of foreclosure in the relevant market, the duration of the contracts, the extent to which entry is deferred, and the reasonable justifications, if any, for the exclusivity"298. The agreement in question did not violate antitrust law since it affected only 7-8 per cent of hearing-aid dealers in the market in question (the domestic market), the manufacturer's share of sales had plummeted in recent years, and it was obvious that its competitors had no problem in finding distributors to sell their products. The Commission also cited Beltone's efforts to promote its brand on the market by encouraging the promotional efforts of its dealers and ensuring that its own marketing strategy was effective. FTC ruled that given the absence of evidence of any lessening of interbrand competition, Beltone's distribution practices did not unreasonably restrict competition.

The broad market analysis standard set forth in Tampa Electric and further developed in *Beltone* has been applied by the courts in subsequent decisions. In Ryko Mfg Co. v. Eden Servs. and Chuck's Feed and Seed Co. v. Ralston Purina Co. the courts rejected a purely quantitative test and applied a test "which takes into account not only the market share of the firm but the dynamic nature of the market in which the foreclosure occurs" 299. The four-justice concurring opinion in Jefferson Parish Hospital No. 2 v. Hyde, 466 U.S. 2 44-46 (1984), stressed that the key factor in assessing the legality of an exclusive dealing arrangement is whether it restrains horizontal competition by allowing suppliers to freeze out other suppliers or buyers to freeze out other buyers. In Roland Machinery Co. v. Dresser Industries, Inc., 749 F.2d 380, 394 (7th Cir. 1984), the court held that a plaintiff in an exclusive dealing case must prove that the exclusion is "likely to keep at least one significant competitor of the defendant from doing business in a relevant market", and that "the probable (not certain) effect of the exclusion will be to raise prices above (and therefore reduce output below) the competitive level or otherwise injure competition".

## European Community

The franchise block exemption regulation (No. 4087/88) allows exclusive dealing obligations and requirements contracts subject to certain conditions and limitations. It should be noted, however, that Article 8 authorises the Commission to withdraw the benefits of exemption under Regulation 4087/88 if, as a result of exclusive dealing provisions (or other circumstances) the agreement has effects incompatible with Article 85(3). In particular, exemption could be withdrawn if competition were significantly restricted by the cumulative effect of exclusive dealing provisions in similar agreements of competing manufacturers, or if the goods or services supplied by the franchise did not face effective competition in a substantial part of the common market.

The treatment of extensive dealing provisions is covered in a series of clauses that must be studied in conjunction (i.e. 2-e, 3-1-a, 3-1-b, 4-a, 5-b and 5-c). As in other areas, the regulation distinguishes obligations that are restrictions of competition under Article 85(1) but are exempted under Article 85(3) (Article 2), obligations that are allowable and are not normally restrictions of competition under Article 85(1) (Article 3), and obligations that are not acceptable and for which no exemption is granted (Article 5 together with limitations stated in Article 4).

Exclusive dealing or requirements contracts are allowable for goods produced by the franchisor that are the "subject-matter of the franchise." Article 2-e exempts agreements that include "obligations on the franchisee not to manufacture, sell or use...goods competing with the franchisor's goods which are the subject-matter of the franchise...." The article, however, distinguishes the case of spare parts or accessories; the same obligation may them not be imposed for them. (Obligations involving spare parts are treated in the same way as in the block exemption Regulation for automobile distribution.)

Article 3-1 places more limitations on other obligations involving the use or sale of goods. First, such obligations are allowable only "in so far as they are necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network." Second, if this standard is met, and also if "it is impracticable...to apply objective quality specifications," the franchisee may be required "to sell, or use...goods which are manufactured only by the franchisor or by third parties designated" by the franchisor (Article 3-1-b). If minimum quality specifications can be established, then the exemption is extended only to the setting of these specifications (Article 3-1-a). For the Commission, an exclusive purchasing obligation is not indispensable to the network's operation if goods of equivalent quality are available; in that case, the obligation amounts to a tie-in that restricts competition by preventing other producers from selling through the franchised network<sup>300</sup>.

Articles 4 and 5 further limit or clarify when exclusivity clauses are allowed. First, Article 4 insures that exclusivity obligations may not prevent parallel imports; under Article 4-a franchisees must be "free to obtain goods that are the subject-matter of the franchise from other franchisees" <sup>301</sup>. If the franchised network exists alongside a selective distribution system, the franchisee also must be free to obtain the goods from those dealers. Article 5 clarifies that the exemptions under Articles 2-e, and 3-1-b are strictly limited. Article 5-b says that an exempted agreement must not prevent a franchisee from obtaining "supplies of goods of a quality equivalent to that offered by the franchisor" except as allowed under Article 2-e for goods that are the subject-matter of the franchise and compete with goods produced by the franchisor or as allowed under Article 3-1-b where objective quality standards cannot be specified. Article 5-c says the franchisor may not refuse to specify third party suppliers unless the refusal is justified by the need to protect the identity and reputation of the network or the franchisor's intellectual property or is allowed under the terms of Article 2-e.

The conditions adopted in the Regulations follow earlier decisions, particularly those involving the Pronuptia and Yves Rocher franchise networks. Before the *Pronuptia* case, in cases involving other distribution systems, exclusive purchasing clauses were deemed restrictions of competition, but often benefited from exemptions under Article 85-3. In *Pronuptia*, the Court of Justice recognised the franchisor's right to control the goods offered by franchisees, in order to ensure that the public could find goods of the same quality from each franchisee<sup>302</sup>. The Court ruled that in this franchise agreement such a clause should not be considered as restraining competition within the meaning of Article 85(1). The Court further recognised that, in such circumstances, a provision requiring the franchisee to sell only products supplied by the franchisor or by suppliers selected by him, may be considered necessary for the protection of the network's reputation<sup>303</sup>.

These ruling were carefully limited. The Court of Justice specified that these rulings depended on both the nature of the goods and the large number of franchisees. Since the Pronuptia franchise concerned fashion articles, it might be impractical to lay down objective quality specifications. Moreover, it might be too expensive to ensure that such specifications are observed because of the large number of franchisees. The Court noted, however, that franchisees must remain

free to obtain products from other franchisees. In granting an exemption for the Pronuptia franchise agreement, the Commission also was careful to set limits on exclusivity provisions; the Commission ordered Pronuptia's standard form agreement to be amended to put into writing that franchisees were free to purchase and sell the products from other franchisees, and that they could purchase goods "not connected with the essential object of the franchise business" from other suppliers subject to approval of their quality<sup>304</sup>.

The Pronuptia franchise was considered to be an "open" franchise since a third of the goods could be obtained from outside suppliers. The *Yves Rocher* franchise, on the other hand, was deemed to be a "closed" franchise since franchisees were not entitled to obtain goods that were the subject-matter of the franchise from other suppliers. However, the Commission recognised that even in a "closed" franchise, "the obligation on the franchisee to sell only products bearing the Yves Rocher trademark..." was "inherent in the very nature of the Yves Rocher distribution formula.... The retailing of products bearing trademarks other than that of the franchisor exposes Yves Rocher to the risk of the use of their know-how for the benefit of competing producers and would detract from the identity of the network which is symbolised by the Yves Rocher sign. This implies that the franchisee may obtain supplies only from Yves Rocher or from other franchisees." However, under the terms of the contract, franchisees remained free to sell accessories bearing trademarks other than that of Yves Rocher provided these were previously approved by the franchisor<sup>305</sup>.

Fewer limitations are placed on exclusivity provisions in some other distribution systems. In Commission Regulation No. 1983/83 on exclusive distribution agreements, the exclusive purchase clause is the subject of an exemption by categories: the supplier is entitled to require that the exclusive distributor obtain the contract goods for resale from no other source<sup>306</sup>. Regulation No. 1984/83 is directed at exclusive purchasing agreements for the purpose of the resale of goods which are evidently exempt. In this Regulation the Commission states that exclusive purchase agreements of limited duration "lead in general to an improvement in distribution;" it enables the supplier to concentrate its sales activities; he does not need to maintain numerous business relations with a larger number of dealers; he is also able, by dealing with only one dealer, to overcome more easily distribution difficulties in international trade<sup>307</sup>.

### D. Refusals to deal

### Australia

The Trade Practices Act does not specifically proscribe refusals to deal, recognising that franchisors are generally free to choose the franchisees with whom they wish to do business. Refusals to deal may, depending on the facts, constitute a contravention of several provisions of the Act. A refusal to deal by a corporation with a substantial degree of market power may constitute a contravention of section 46 (misuse of market power). Similarly, a refusal to deal may be evidence of an

exclusive practice. Collective refusals to deal between competitors (be they franchisees or franchisors) constitute, for the purposes of section 45 (contracts, arrangements and understandings), "exclusionary provisions" (or primary boycotts) as defined by section 4D. Such boycotts are not subject to a competition test, but may be authorised by the TPC on public benefit grounds.

#### Canada

Refusal to deal is governed by Section 75 of the Competition Act, which is applicable in the following circumstances: i) a person is substantially affected in his business or is precluded from carrying on business due to his inability to obtain adequate supplies of a product anywhere in a market on usual trade terms; ii) the person referred to in paragraph (i) is unable to obtain adequate supplies of the product because of insufficient competition among suppliers of the product in the market; iii) the person referred to in paragraph (i) is willing and able to meet the usual trade terms of the supplier or suppliers of the product; iv) the product is in ample supply.

The Tribunal may therefore order that one or more suppliers of the product in the market accept the person as a customer within a specified time on usual trade terms unless, within the specified time, any customs duties on the article are removed, reduced or remitted and the effect (of so doing) is to place the person on an equal footing with other persons who are able to obtain adequate supplies of the article in Canada.

Sub-section 75(2) establishes a distinction important in the application of the Section to franchise operations: it states that an article is not a separate product in a market only because it is differentiated from other articles in its class by a trade mark, proprietary name or the like. To be differentiated, an article must have such a dominant position in that market as to substantially affect the ability of the franchisee to carry on business in that class of articles, if he does not have access to that article. In the case of a franchise relationship, it is therefore important to establish whether the market dominance of the product bearing the franchisor's trade mark is such that the franchisee's ability to carry on business in that class of article might be significantly affected unless he has access to it. In case of doubt the Tribunal could not find competition to be insufficient solely on the grounds that the franchisor supplies the article bearing his trade mark.

The application of section 75 of the Competition Act to the practice of refusal to deal was considered by the Competition Tribunal in the 1989 *Chrysler Auto Parts* case. The actions that formed the basis for this case included refusals by Chrysler to supply a Canadian exporter, Brunet, with brand-name Chrysler parts for export to overseas markets. Brunet previously had been able to obtain parts for export from Chrysler Canada on terms similar to those for authorised Canadian distributors of these products.

In this case, the Tribunal issued a remedial order requiring Chrysler to recommence supplying parts to Brunet. This decision was based on the impact of the refusal to supply on Brunet's business and the nature of his previous relationship with Chrysler. In its decision, the Tribunal indicated that it is not compelled under section 75 to order the supply of products in every case where the elements of the section are met. Rather, the Tribunal stated that it might refuse to issue an order to supply in such cases if there are legitimate economic and business interests to protect. This decision is presently under appeal.

Section 81 of the Competition Act on delivered pricing may be applied to franchise dealership; it refers to the practice of refusing a customer, or someone seeking to become one, delivery of an article at any place where the supplier engages in a practice of making delivery to other customers on the same trade terms that would be available to that customer if his place of business were located there.

The Act stipulates that when the Competition Tribunal finds that delivered pricing is engaged in by a major supplier of an article in a market or is widespread in a market, with the result that a customer is denied an advantage that would otherwise be available to him, it may make an order prohibiting such practice and requiring the supplier to supply a customer in a locality where he is already delivering to other customers.

In two cases, however, the Tribunal may not issue an order; these exceptions are of particular relevance to franchise operations: first, when the Tribunal finds that the supplier could not accommodate any additional customers at a locality without making significant capital investment there; and second, when the supplier refuses to supply a product to a customer that the latter sells in association with the supplier's trade mark or in respect of which he is a registered user, and when, furthermore, the Tribunal feels this practice to be necessary to maintain the quality standard of the product in question.

### France

Under Article 36 of the 1986 Ordinance, a supplier refusing to sell is liable for damages caused, provided that the "requests are in no way abnormal and are made in good faith" and are not justified by the provisions of Article 10 (which provides for exemptions on conditions similar to those in Article 85(3) of the Treaty of Rome)<sup>308</sup>. Refusal may be considered unlawful if it results from a cartel or is a sign of a position of dominance or abuse of economic dependence. Refusal of a franchisor to satisfy demands from non-franchisees appears to be inherent in franchising, and so may be "justifiable" and qualify for an exemption under Article 10.

The Competition Council has not yet handed down any decisions with respect to franchises. However, reference may be made to the analyses it has made of other vertical contracts. The Council has in its possession a considerable body of case law pertaining to refusals to deal in the context of market relations, inter alia the decisions relating to the distribution of hi-fi and video equipment<sup>309</sup>.

Refusals to deal may also be involved in the initial selection of distributors. In the *sports shoes* case, the Council enjoined a number of manufacturers to change their criteria for selecting dealers for their network, so that these would be based on only objective and qualitative considerations<sup>310</sup>.

Termination or non-renewal of a franchise agreement also could raise issues of a refusal to deal. The Competition Council has issued no jurisprudence on the right to renew a franchise. The 1986 Ordinance on abuse of a situation of economic dependence provided a means for controlling abusive conduct by franchisors vis-à-vis their franchisees when the latter are in a situation of economic dependence. A franchisee, "who does not have an equivalent solution" (Article 8.2) and who might therefore be impelled on expiry of his contract to apply to have it renewed on the grounds that he had no equivalent substitute solution, could find himself in this situation<sup>311</sup>. It is too early to judge whether Article 8.2 could be used to establish certain rights with respect to the renewal of franchise contracts.

The approach taken could be along the lines adopted in a case concerning selective distribution, *Kenner Parker Tonka* (1989)<sup>312</sup>. The Competition Council considered that some distributors previously admitted to the network could be excluded from it without competition being thereby restricted. The Council recognised that a supplier may, in order to improve the distribution of his product, decide to alter the structure of his network by introducing selection criteria, without his previous dealers benefiting from any acquired rights with respect to their status quo. The Council did, however, ascertain that the new network set up preserved intrabrand competition<sup>313</sup>.

For civil courts, the franchisee has a hybrid status. Labour law applies in his relations with the franchisor and business law in his conflicts with third parties<sup>314</sup>. Termination of contract has the effect of depriving the franchisee of his customers who abandon his point of sale for the new franchisee's store. The courts generally take the franchisee's high degree of dependence on his franchisor into account and the fact that he is not well placed to renegotiate a new contract<sup>315</sup>.

## Japan

Under Notification No. 15, refusals to deal may be dealt with in two different ways. A concerted refusal to deal is defined under Article 1 of the Notification as a concerted action between two entrepreneurs: (i) aiming to refuse to deal with a third party or to restrict the quantity or substance of a product to be delivered to him; (ii) causing another entrepreneur to take action which comes under (i). Without proper justification, concerted refusals to deal are likely to be declared unlawful. In addition, a concerted refusal to deal shall be deemed an unreasonable restraint of trade that is prohibited under Article 3 of the Antimonopoly Act if the conduct results in a substantial restraint of competition in a market.

Other refusals to deal are also covered by Article 2. They are more unlikely to be declared unlawful. It will depend on their reasonableness. They will be generally declared unlawful if they coexist with another violation of the Antimonopoly Act such as resale price maintenance. They may also be prohibited when they are operated by entrepreneurs having a dominant position on the market.

#### New Zealand

A refusal to supply may be subject to a sanction where the refusal occurs because the resupplier is a discounter, or because of an arrangement between suppliers as to whom they will supply, or where a refusal to resupply arises in response to coercion by another resupplier. Section 36 of the Commerce Act would apply where a dominant firm can be shown to be seeking to deter competitive conduct<sup>316</sup>.

Termination of a franchise is not a breach of the Act unless termination, or the threat of it, is used as a means of driving a franchisee out of the market, or to force the franchisee into accepting an anticompetitive practice. Where a franchisor wishes to take over the franchise itself or substitute one existing franchisee for another, there may be sufficient anticompetitive motive to invoke section 36, as the anticompetitive purpose need not be in the same market as the market in which the franchisor is dominant. A franchisor is not obligated to replace a franchisee and can leave a franchise vacant indefinitely<sup>317</sup>.

## Spain

Refusal to sell to non-authorized dealers is a prohibited practice under Article 1.1, but may be authorized under Article 3.1. In the *Toshiba* case, it was authorized by the Tribunal "because of the need for the franchisor to protect the reputation of its products, its networks and its distinctive signs".

## **United States**

Issues of a refusal to deal generally arise when a manufacturer, here a franchisor, refuses to enter into a relationship with a distributor or franchisee in the first instance, or where the franchisor either terminates an existing distributor/ franchisee or intervenes in the sale or assignment of a franchise<sup>318</sup>. Sections 1 and 2 of the Sherman Act may be applicable to refusals to deal. Terminations of vertical relationships also are subject to the provisions in federal statutes (specifically the Petroleum Marketing Practices Act and the Automobile Dealers Day in Court Act) and in state laws discussed in the previous chapter.

Section 1 of the Sherman Act may be violated where : 1) the refusal to deal is pursuant to a horizontal agreement either between suppliers, or between dealers who induce the supplier to terminate another dealer; or 2) the refusal to deal is used by the supplier to enforce another illegal, vertical restraint. In the latter case, refusals to deal are subject to the same standard as the underlying restriction to be enforced; i.e. vertical refusals to deal to enforce resale price maintenance have been found *per se* illegal (as in *Monsanto*) while those used to enforce, for example, territorial restrictions are judged under the rule of reason (as established in *GTE Sylvania*). Section 2 of the Sherman Act may be violated where the supplier's

refusal to deal is in furtherance of an attempt to obtain or maintain monopoly power; e.g. *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951)<sup>319</sup>.

Franchise agreements have benefited from the traditional concept of freedom of choice that has prevailed since the *United States v. Colgate Co.*, 250 U.S. 300 (1919). This decision established the doctrine that a seller (here a franchisor) may, in the absence of any intent to create or maintain a monopoly, unilaterally select the person (or persons) with whom he chooses to deal. In various decisions over the years, the courts have acknowledged that the franchisor has a legitimate interest in ensuring that his franchise is in the hands of competent persons able to maintain the quality of the goods and services that are the subject of the franchise. They have generally admitted a franchisor's refusal to consent to a primary sale or assignment of the franchise and his desire to terminate or not renew a franchise agreement when such action is the result of a unilateral decision and constitutes a reasonable step to preserve his legitimate interests in the franchise system.

In Seligson v. Plum Tree, Inc., 362 F Supp 748, 753 (ED PA 1973), a gift store franchisor, Plum Tree, was sued by the Seligson family, who claimed to represent Plum Tree's franchisees. It was alleged, inter alia, that under the franchise agreement, franchise rights were not assignable without Plum Tree's written prior consent. The Court settled this matter, stating: "There is certainly nothing unreasonable in requiring the consent of the franchisor to the assignment of the franchise. A franchisor has a perfect right to consider the character, stability, reputation, business ability, etc. of those to whom it will entrust its own good name, its mark and its products. We see nothing invidious in a franchisor taking precautions against the indiscriminate use of its own reputation and the intrusion of perhaps unsavoury strangers".

The Courts also have accepted that franchisors may block a proposed assignment of the franchise to competent managers when the refusal is for legitimate, procompetitive reasons. In Kestenbaum v. Falstaff Brewing Corp., 575 F2d 574 (5th Cir 1978), cert. denied, 440 U.S. 909 (1979), a beer distributor, Kestenbaum, sued his supplier, the Falstaff brewery, to which he had been bound since 1967 (although they had dealt with each other before that date) by a franchise agreement renewable yearly. Among the issues was the legality of a clause requiring the franchisee to obtain the franchisor's approval of "the assignee's sales management and financial ability to perform as a Falstaff distributor". Kestenbaum, after running into business problems, had found a buyer for two franchises he held. While not calling into question the buyer's management ability or his financial soundness, the franchisor refused to agree to the proposed assignment. Falstaff preferred that the franchises be assigned to existing distributors and suggested that Kestenbaum should receive only \$25 000 for the sale. The franchisee pointed out that his franchisor's requirements (in particular, the prior consent requirement) affected the goodwill value of his business.

The Fifth Circuit overruled the decision of the district court, which had found that this restraint was unlawful *per se*, and found that the rule of reason should apply. It accepted the justification given by the franchisor for refusing assignment

to the candidate proposed by Kestenbaum, namely that the territory was too small and that it was preferable to add it to that of one of his franchisees already operating in the vicinity. The Circuit concluded that "that is a good business reason, and evidences a procompetitive intent which is probative of a lack of anticompetitive effect." Kestenbaum was required to produce further proof of his allegations regarding the coercion he had been subjected to, the impact this had had on the value of his business, and the unlawful restrictions imposed on the buyers. Kestenbaum having failed to satisfy the Court on these counts, the Court found that it was not unreasonable for the franchisor to exercise power of approval.

Similarly the courts recognised the validity of the position of a franchisor which refused to assign a franchise to one of its franchisees whose performance was considered to be wanting; in *Hamro v. Shell Oil Co.*, 674 F2d 784 (9th Circuit 1982), the Ninth Circuit confirmed the district court's judgment that Shell had not employed wrongful means and that it had acted not to punish Hamro or force it to purchase larger quantities of tyres, batteries and automotive accessories but simply to protect its own interests.

In contrast, the courts have found that various forms of refusal to deal, in particular terminations and non-renewals, do constitute offences when they impede competition and when the link between the allegedly unlawful non-renewal and the complaints is proven, i.e. when the existence of a combination or conspiracy in violation of the Sherman Act can be demonstrated<sup>320</sup>.

In American Motor Inns Inc. v. Holiday Inns, 521 F2d 1230 (3rd Cir 1975), Holiday Inns had refused an application by one of its main franchisees, American Motor Inns, to open a new hotel near Newark airport. The franchisor had sent a letter beforehand to franchisees already operating in the vicinity to apprise them of the application; some of them, who themselves were interested in expansion, objected. Holiday Inns Franchises Committee was unable in these circumstances to grant the franchise to American Motor<sup>321</sup>. The Third Circuit held that in allowing its existing franchisees to decide whether a potential competitor could be authorised to enter the market in question (i.e. the airport zone), Holiday Inn had allowed them to carve up the market among themselves "thus precluding further intrabrand competition. Such conduct constitutes a horizontal market allocation that is a violation of the Sherman Act". The Supreme Court recently applied a similar analysis in *Palmer v. BRG of Georgia, Inc.*, 111 S. Ct. 401 (1990).

The requirement since the *Colgate* case to show conspiracy remains a delicate issue. This is particularly true in franchise relationships. Franchisor and the franchisee are *ipso facto* in constant contact, and the franchisees are tied to each other by their common trading identity and by all the formal and informal contacts they establish among themselves, often with the active encouragement of the franchisor<sup>322</sup>. The related Supreme Court rulings, first in *Monsanto Co. v. Spray Rite Serv. Corp.*, 465 US 752 (1984) and then in *Business Electronics Corp. v. Sharp Electronics Corp.*, 108 S.Ct. 1515 (1988), illustrate the complex and controversial nature of the issues. These cases involved allegations that the desire to maintain minimum prices lay behind refusals to renew a dealership (in *Monsanto*)

or termination of a dealership (*Sharp*). The *Monsanto* and *Sharp* cases are discussed above in the section on resale price maintenance.

In *Arnold Pontiac-GMC, Inc. v. Bud Baer, Inc.*, 282 F.2d 1335 (3rd Cir. 1987), the Court followed *Monsanto* in determining the evidence necessary to find a Section 1 violation. Arnold Pontiac, an automobile dealer with Buick and GMC trunk franchises, alleged that four Buick dealers had conspired together and with GMC to prevent it from receiving a Buick franchise. The Court ruled that Arnold Pontiac had produced the type of evidence required by Monsanto — a written memorandum by a GMC representative to a Buick zone manager — to show the existence of a combination among Buick dealer defendants. Furthermore, the Court stressed there was "a plausible motive" for such a combination — the elimination of one competitor in a limited market — and combined action of the dealers in the area was rational since it would be more effective than complaints by an individual dealer. The 3rd Circuit reversed the district court's grant of summary judgement to defendants on Arnold Pontiac's Section 1 Sherman Act claim against them.

# European Community

As a general matter, the franchisor is free to choose his franchisees and to deal only with them. No specific rules govern the choice of franchisees. The Commission, in granting an individual exemption for the *Pronuptia* agreement, observed:

"In effect, the characteristics of such a (franchise) system are such that the franchisor grants to the franchisee the exclusive right to use his brand marks and his commercial know-how in a defined territory, and that the franchisor is free to choose his franchisees. The exclusion of any other dealer from the territory allotted to the franchisee is therefore a consequence which is inherent in the very system of franchising." 323

Other decisions of the Commission, and of the Court, also have allowed franchisors to choose franchisees and to limit the number of franchisees<sup>324</sup>.

Article 2(a) of Regulation 4087/88 permits the franchisor to agree with a franchisee that within a contract service area it will not grant rights to exploit the franchise to third parties, will not itself market the goods or services, and will not supply its goods to third parties. Article 3-2(j) authorises provisions that require the franchisor's consent to an assignment of the rights and obligations under the franchise agreement. If, however, the selection of franchisees were used to enforce a concerted practice by franchisees involving pricing, the benefits of the block exemption regulation could be withdrawn by the Commission under the terms of Article 8.

The choice of dealers, and hence refusals to deal, are treated quite differently in selective distribution systems. As noted in Chapter III, the guidelines for selective distribution require that distributors be chosen on the basis of objective qualitative criteria, applied without discrimination. Quantitative limitations of dealers who meet the qualitative criteria are not acceptable. In addition, the

Commission has made clear that otherwise qualified dealers must not be excluded to maintain high prices.<sup>325</sup>

## E. Tie-ins

#### Australia

"Third-line forcing" is prohibited *per se* under Section 47(6) and (7). It consists in the franchisor conditioning the supply of goods or services on the purchase by the franchisee of goods from a third party. It may also be a refusal to sell for the reason that goods have not been acquired by a third party. As a consequence, the franchisee's freedom to choose sources of supply is limited.

The requirement by the franchisor that the franchisee purchases his goods or services as a condition for granting the franchise is an exclusive dealing practice which is not unlawful *per se*.

### Canada

In Canada, tie-ins are governed by Section 77 of the Competition Act and may be of three kinds: (i) a supplier, as a condition of supplying a product, requires a customer to acquire another product from the supplier or his nominee; (ii) a supplier requires that a customer refrain from using or distributing with the tying product another product that is not of a brand or manufacture designated by the supplier or his nominee; and (iii) a supplier induces a customer to meet one of the above conditions by offering to supply the tying product to him on more favourable terms if the customer agrees to meet the said conditions.

According to Subsection 77(2), a Competition Court order can be obtained only where it is established that tied selling engaged in by a major supplier of a product in a market, or widespread in a market, is likely to (i) impede entry into or expansion of a firm in the market, (ii) impede introduction of a product into or expansion of sales of a product in the market, or (iii) have any other exclusionary effect in the market, with the result that competition is or is likely to be lessened substantially. The order may prohibit the continuation of tied selling and contain any other requirement that, in the Court's opinion, is necessary to overcome the effects thereof or to restore or stimulate competition.

Section 77(4) deals with exceptions, some of which particularly concern franchising. Subsection 77(4)(b) provides that the Court will not make an order where the tied selling is reasonable in regard to the technological relationship between or among the products to which it applies, that is, where a product's repute would be affected by the acquirer's use of a product other than the tying product. Subsection 77(4) also states that no order will be made in the case of tied selling between affiliated companies as defined in Subsection 77(5)<sup>326</sup>. Subsection 77(5) adds that a company is affiliated where one party grants the other the right to use a trade mark or trade name to identify the business of the grantee, but this provision

applies only if the business is related to the sale or distribution (pursuant to a marketing plan prescribed substantially by the grantor) of a multiplicity of products obtained from competing sources of supply and a multiplicity of suppliers and if no one product dominates the business. This is the so-called "Canadian Tire exemption", which could no doubt be applied to other franchise schemes<sup>327</sup>.

Even where a franchise agreement falls within the scope of Section 77, the conditions listed in the various Subsections ensure that tied sales connected with franchising are accorded a case-by-case treatment enabling the pro- and anticompetitive features of the agreement to be weighed.

One case to date, involving a vertical distribution system, deserves mention: *BBM Bureau of Measurement*, in which the Restrictive Trade Practices Commission, upon application from the Director of Investigation and Research, issued a remedial order on 18 December 1981<sup>328</sup>. BBM covered all the Canadian provinces and, since 1963, regularly supplied radio and TV audience measurements to advertisers, advertising agencies and radio and TV stations. The only other firm supplying regular nationwide TV audience measurements was the Media Research Division of AC Nielsen Company of Canada Ltd., the subsidiary of a major American company specialising in this field and operating in several countries. Nielsen Canada had been winding down its measurement of radio audience ratings begun in 1959, but continued with TV audience measurement as part of its services. In providing these rating figures, of capital importance to advertisers and advertising agencies, each company employed different but equally acceptable methods. In other words, their product was generally interchangeable.

The Director claimed before the Commission that, in 1979, BBM had induced advertising agencies and representatives of major stations to buy TV audience measurements by offering them radio audience measurements on more favourable terms if they also bought the TV ratings, that is, it offered them a discount. The advertisers had no choice — BBM obliged them to buy TV audience measurements as a condition of buying the radio audience figures. The Director pleaded that BBM, a major supplier, was guilty of tied selling which appreciably weakened or was likely to weaken competition as it created barriers to entry for newcomers in the market, and impeded the expansion of its main rival in Canada. BBM countered that no sale had been made, since it was a users' association which received the measurements in exchange for an annual subscription.

The Commission rejected this argument, considering that if BBM were indeed organised as an association, its members were in fact also customers to whom BBM supplied products like any other commercial company. BBM attempted to use Section 77(4)(b), under which no order may be made where a tied sale is reasonable in regard to the technological relationship between the products concerned. The Commission rejected this argument as well, declaring:

"Undoubtedly, cost efficiencies and useful technological exchange can be expected to flow from producing two similar products under one roof. However, Section 77(4)(b) applies to the reasonable requirement of the sale of two products together for technological reasons, not to their production. In effect, the Section provides a defence or justification of a tied sale on the

basis that the reputation of the tying product might be injured or destroyed if the supplier cannot insist on a purchaser using only the tied product in conjunction with it. In the present instance, there is no suggestion that the reputation or goodwill of either of BBM's reporting services would be damaged by the purchaser not using the other service. Section 77(4)(b) has no application."

#### France

Contract provisions conditioning or tying the sale of one product or service to the sale of another are subject to Articles 7 and 8 of Title III of the 1986 Ordinance prohibiting restrictions of competition or abuses of dominance or dependence. Tying agreements would be prohibited under these articles only if found to restrict or restrain competition or found to be an abuse. These provisions do not recognise tied sales or purchases as a separate legal category. Article 36-2 of Title IV makes a seller liable in Civil Court for damages caused another firm by conditioning (or tying) the sale of a product or service on the requirement of the purchase of another product or service<sup>329</sup>. More generally, tying agreements may be interpreted under French law as imposing unfair sales conditions, taking such forms as customer loyalty discounts and bonuses, mutual purchases, supplier-imposed requirements on use of materials, etc.

There is to date no jurisprudence on tying arrangements by franchises. Decisions have been made, however, in cases where distributors were tied to their suppliers by sub-clauses in their contract (cafés obliged to use coffee machines provided by the coffee supplier or various articles involved in serving beer). Such sub-clauses can force a distributor into investing so heavily that he does not dare to cancel his contract when it expires.

The general argument developed by the Competition Council in its *petroleum tanks* decision gives some idea of what its approach might be in a franchise case<sup>330</sup>. In 1987, the Competition Council condemned the obligation imposed on filling station operators to return the fuel-holding tanks themselves which had been lent to them by the oil companies during the term of their distribution agreement. The Council considered that, in the event of a contract being terminated, the effect of the return in kind clause was to increase, without any business compensation, the costs involved in changing a supplier; and that it would therefore restrict the fluidity of the dealers' market with respect to suppliers. The Council rejected the claim of the oil companies that the clause was indispensable in an exclusive contract for a supplier to protect itself from unfair competition in the case of expiry or termination of a distribution contract. The Council found that, if the contract contained a repurchasing option for the dealers, the risk of unfair competition disappeared.

The Paris Court of Appeal examined the appeal lodged by the oil companies<sup>331</sup>. It by and large upheld the Council's decision. In particular, it noted that, "Total was wrong in claiming that it could lawfully prevent a rival from benefiting without charge from Total's investment. The repurchase price would reimburse it for the undepreciated portion of its investment (in petroleum tanks). A

new supplier would then find itself vis-à-vis the dealer in the same situation as with a newcomer who owned his own holding tanks and could therefore obtain financial terms less favourable to the supplier. The latter would thus not enjoy a competitive advantage."

## Germany

Tie-ins are subject only to abuse control under Section 18 ARC. The FCO consequently will not object to tie-in clauses that are necessary to maintain the identity and reputation of the sales organisation symbolised by the trade name.

Therefore, requiring the franchisee to purchase all his supplies exclusively from suppliers authorised by the franchisor is not considered to be unfair and abusive, if the restriction clearly serves to safeguard the level of quality of the franchised products. In that case, the tying of supplies at the same time promotes the reputation of the franchise system and secures the proper functioning of the system in the interest of the mostly small and medium-sized franchise holders. Similarly, requiring the franchisee to purchase all his supplies exclusively from the franchisor is not considered to be unfair, provided that the franchisor is the manufacturer of the contract goods and the tying of supplies serves to maintain the level of quality. However, where the franchisor purchases the contract goods from third parties, such tying of supplies is not considered a prerequisite for the proper functioning of the franchise system<sup>332</sup>.

The FCO has, in the case of *McDonalds*, found unobjectionable an agreement which requires the franchisees to purchase all their supplies from McDonalds-licensed firms. In the *Photo Phorst* case, the agreement contained an exclusive purchasing restriction for processing services and a definition of the additional assortment by the franchisor. As regards the latter, the franchisees may also purchase from other suppliers if they can supply identical products at lower prices. The FCO found this, too, to be unobjectionable.

### Japan

In principle, tie-ins which unduly restrict the freedom of a franchisee to purchase other products than the principal product are prohibited under Article 10 of the Notification when they are unjustified<sup>333</sup>. Such a clause imposed without justification (such as the need for uniformity of image, protection of the brand or quality) would generally be considered illegal. A tie-in would be considered justified, however, if the tied product supplements the principal product or if the former is so related to the principal that the tie-in makes both more beneficial.

The following factors must be considered in order to decide if a clause falls within Article 10 of the Notification on tie-in sales: the position of the franchisor, the scope of practices, the number and size of franchisees and the degree of restriction.

#### New Zealand

Although both full line and third line forcing were prohibited under earlier legislation, these are not offences under the Commerce Act 1986 unless anticompetitive effect or intent can be shown. Third line forcing can be linked to quality control, but full line forcing is harder to defend. Product forcing by franchisors who dominate the product market may be attacked under Section 36<sup>334</sup>.

# Spain

Tie-ins are prohibited under Article 1.1(e), Chapter 1, Title I of the Competition Act, which governs the linking of contracts to acceptance of additional services which, by their nature or according to trade practice, are unrelated to the object of the contract. They are permitted, however, where — as may be the case with a franchise agreement — the conditions set out in Articles 3.1 and 5.1 are fulfilled.

# United Kingdom

Product ties have been the subject of references to the MMC many times but not in the context of franchise agreements. Tied selling agreements involving petrol filling stations were, in most cases, considered acceptable for a period not exceeding five years<sup>335</sup>. With regard to the selective supply of beer, steps were taken in 1989 to give effect to the Government's decisions in response to the MMC's recommendations that the tied house system should be substantially modified. Orders were made which will in particular require all brewers owning more than 2,000 licensed premises (the six largest national brewers) to release from all product ties, by 1 November 1992, that number of their houses amounting to half the excess over 2000. Since 1 May 1990, the brewers have been required to end all ties on wines, spirits and other beverages and to allow their tied tenants to choose at least one cask-conditioned beer from another supplier<sup>336</sup>. If tie-in sales in franchise agreements are considered abusive, they may fall within the scope of the Competition Act.

## **United States**

Tie-ins have been challenged under Section 1 of the Sherman Act, Section 3 of the Clayton Act, Section 5 of the Federal Trade Commission Act, and as conduct that supported finding a violation of Section 2 of the Sherman Act. A number of tie-in cases have involved franchise agreements, although these are usually brought as Section 1 Sherman Act cases rather than under Section 3 of the Clayton Act; Section 3 applies only to ties involving two tangible goods, and franchise tying cases often involve allegations that sale of a product is tied to the trademark license. Tie-ins involving intangibles may be challenged under Section 5 of the Federal

Trade Commission Act as well as Section 1 of the Sherman Act. Certain tie-ins have been judged to harm competition by extending monopoly power from one market to another (the "leverage theory")<sup>337,338</sup> and by erecting barriers to entry in the market for the tied products. The Supreme Court in *Northern Pacific Railway v. United States*, 365 U.S. 1 (1958) found that

"Tying arrangements deny competitors free access to the market for the tied product, not because the party imposing the tying requirements has a better product or lower price but because of his power or leverage in another market. At the same time buyers are forced to forego their free choice between competing products" 339.

In *Standard Oil Co.v. United States*, 337 U.S. (1949), the Supreme Court held: "Tying arrangements serve hardly any purpose beyond the suppression of competition.(...)The existence of market control for the tying device, therefore, affords a strong foundation for the presumption that it has been or probably will be used to limit competition in the tied product also." The Supreme Court has found tie-ins *per se* unlawful under both Section 1 of the Sherman Act and Section 3 of the Clayton Act<sup>340</sup>. The courts generally require that several conditions must be satisfied for a tie-in to be *per se* illegal: (1) two separate products must be involved, (2) the sale or lease, or agreement to sell or lease one product (the tied product) depends on the purchase of another product (the tying product), (3) there is sufficient economic power to force the buyer to accept the arrangement, and (4) a not insubstantial amount of interstate commerce is affected<sup>341</sup>, <sup>342</sup>. Even when these conditions are met, the courts have allowed a defence-of-business justification for the tie-in in some cases.

Determining whether the conditions for a *per se* violation have been established or whether there is a business justification defence frequently involves analyses of market conditions and effects. As a result, applications of the per se rule against tie-ins are in some ways similar to rule of reason evaluations. In addition, if they do not satisfy the conditions for *per se* illegality, tie-ins still may be considered under the rule of reason as a Sherman Act Section 1 violation<sup>343</sup>. The decision of the Supreme Court in *Jefferson Parish Hospital District No. 2 v. Hyde*, 466 U.S. 2 (1984), continued to treat tie-ins as *per se* illegal, but the Court's review of the conditions that must be established for a *per se* violation increases the emphasis on market analysis.

### The two separate products test<sup>344</sup>

In a number of cases<sup>345</sup>, the Supreme Court and lower courts have considered the general question of when agreements involve two separate products. The issue has been important for franchises because tying violations in franchise agreements became much more likely following court decisions that, in some circumstances, a trademark license could be a separate tying product.

The first case in which a trademark license was held to be a separate tying product was *Susser v. Carvel Corp.*, 332 F2d 505 (2d Cir 1964), cert dismissed, 381 US 125 (1965). The franchisor, Carvel, obliged its franchisees to purchase from it

ingredients and other articles used in preparing the ice-cream that they sold. The Second Circuit agreed with the Southern District Court of New York that, for purposes of judging an alleged tie-in, the franchise trademark and the ingredients were separate products<sup>346</sup>.

Subsequent lower court cases attempted to distinguish the circumstances under which the trademark constituted a product separate from products or services the franchisee was obligated to purchase. In Siegel v. Chicken Delight Inc., 448 F2d 43, 47 (9th Cir 1971), cert denied, 405 U.S. 955 (1972), the Ninth Circuit drew a distinction based on the function of trademarks. When the trademark was the emblem of the source of a product it was not a separate product. In other cases, as often in the (then) recent development of franchising, the trademark was a representation of product quality, of the way it had been made, stored, distributed, etc. In the Chicken Delight case, the Court found that the trademark certified that the end-product had been prepared, produced and distributed in line with the franchisor's standards, specifications and methods, reflecting its reputation for quality. The goodwill of Chicken Delight was not a matter of what was used in making the end-product "but how it is used and what results have given the system and its end-product their entitlement to trademark protection." The Court concluded from this functional analysis that the trademark, representing quality, and the ingredients were two separate items and that the franchisees' complaint was therefore justified.

In two important cases in 1982, the Ninth Circuit developed this trademark function argument by distinguishing business format and distribution franchise systems. In Krehl v. Baskin-Robbins Ice Cream Co., 664 F2d 1348 (9th\Cir\1982), the defendant, Baskin-Robbins, franchisor of the country's largest chain of ice cream stores, was accused by some of its franchisees of tying the sale of the Baskin-Robbins trademark to the purchase of Baskin-Robbins ice cream<sup>347</sup>. In a business format franchise, the Court argued, the franchisor provides the trademark and perhaps some supplies while the franchisee is responsible for producing and preparing the end-product according to a method specified by the franchisor. In such a system there is "generally only a remote connection between the trademark and the products the franchisees are compelled to purchase...because consumers have no reason to associate with the trademark, those component goods used either in the operation of the franchised store or in the manufacture of the end product"<sup>348</sup>. Therefore the trademark could be a separate product. In a distribution franchise, however, such as that of Baskin-Robbins, the franchise is the "conduit" for distributing the trademarked goods...manufactured by the franchisor or...by its licensees according to detailed specification<sup>349</sup>. In such a situation, the Court ruled: "The desirability of the trademark is therefore utterly dependent upon the perceived quality of the product it represents. They are both so inextricably related in the mind of the consumer as to preclude any finding that the trademark is a separate item for tie-in purposes." The Court also pointed to the secret nature of the manufacturing formulae and the impossibility of communicating production specifications as justifying, out of a concern for maintaining quality, the link between the franchise trademark and the end-product. In the light of these considerations, the 9th Circuit Court upheld the decision of the District Court for the Central District of California and ruled that "the Baskin-Robbins trademark lacked sufficient independent existence apart from the ice cream products allegedly tied to its sale, to justify a finding of an unlawful tying arrangement."

The Ninth Circuit followed the same reasoning in another 1982 case, *Hamro v. Shell Oil Co.*, 674 F2d 784 (9th Circuit 1982). The Court found that in this distribution franchise the Shell trademark and Shell gasoline should be considered a single product, and therefore there could be no tie between them.

A Fourth Circuit case, Principe v. McDonald's Corp., 631 F2d 303 (4th Circ 1980), cert denied, 451 US 970 (1981), considered whether the McDonald's franchised name was a separate product<sup>350</sup>. The Court held that "a modern franchisor like McDonald's offers its franchisees a complete method of doing business....Its regime pervades all facets of the business, from the design of the menu board to the amount of ketchup on the hamburgers...the modern franchisee pays not only for the right to use a trademark but for the right to become part of a system whose business methods virtually guarantee his success." The proper question therefore was whether the allegedly tied products were integral components of the business method being franchised: "Where the challenged aggregation is an essential ingredient of the franchised system's formula for success, there is but a single product and no tie-in exists as a matter of law." The Court, after listing the benefits to both parties of the restaurant leasing system, concluded in the present case that, "All of these factors contribute significantly to the overall success of the McDonald's system....To characterise the franchise as an unnecessary aggregation of separate products tied to the McDonald's name is to miss the point entirely....We decline to find that it is an illegal tie-in." This decision can be viewed as a departure from the Ninth Circuit decisions since separate products were not found, even though a business format franchise was involved and the alleged tied product could not be considered to be the central, distributed product bearing the franchisor's identity; alternatively it can be interpreted as a similar decision for its focus on the extent to which the trademark and the alleged tied product were inseparable elements of the aggregation of products or services essential to the franchise operation<sup>351</sup>.

The Court in *Jefferson Parish* considered the question of whether anesthesiology services constituted a product separate from the other services provided by the hospital. *Jefferson Parish* did not involve either franchising or the question of whether a trademark was a separate product. The principles that the court stated should be followed in determining whether there are separate products that can, however, be applied to the question of whether a trademark constitutes a separate product. The Court rejected tests based "on the functional relationships of the products" and on whether the products constituted a "functionally integrated package of services"<sup>352</sup>. Instead, the Court said the criterion should be whether there are two distinct product markets based on the character of demand for the two products: "no tying arrangement can exist unless there is sufficient demand for the purchase of (the tied product) separate from (the tying product) to identify a distinct product market in which it is efficient to offer (the tied product) separately from (the tying product)"<sup>353</sup>. The Court maintained that the need for determining that two distinguishable product markets exist is linked to the underlying rationale for the

rule against tying: "The answer to the question whether petitioners have utilised a tying arrangement must be based on whether there is a possibility that the economic effect of the arrangement is that condemned by the rule against tying — that petitioners have foreclosed competition on the merits in a product market distinct from the market for the tying item" 354.

Jefferson Parish may make it difficult to find that a trademark and the product marketed under the trademark constitute separate markets when no market exists for the trademark without the product. An example is Smith v. Mobil Oil Corp., 667 F. Supp. 1314 (W.D. Mo. 1987), where the court found that the Mobil trademark and Mobil gasoline were not separate products.

# Determining market power

The second element necessary for a tying arrangement to be *per se* illegal is some degree of economic power in the tying market. Varying standards have been used, however, to judge the extent of power necessary<sup>355</sup>. In early cases in which the seller had a patent on the tied product sufficient economic power was found<sup>356</sup>. In *Times Picayune* the Supreme Court found that monopoly power over the tying product was necessary, but later in *Northern Pacific* found monopoly or dominance was not necessary, but that what was required was "sufficient economic power to appreciably restrain free competition in the market for the tied product"<sup>357</sup>. In *United States v. Loew's, Inc.* the Supreme Court found sufficient economic power in the tying product's "desirability to consumers" and "uniqueness" of attributes; the Court found the required economic power could be presumed in the case of a copyrighted film<sup>358</sup>. In a later case, *Fortner II*, the Supreme Court found that in order to "have the kind of uniqueness considered relevant" the seller had to have "some advantage not shared by his competitors in the market for the tying product"<sup>359</sup>.

Some lower courts, particularly in cases decided before *Fortner II*, found that a patent or copyright over the tying product was sufficient to confer the required economic power. An important question in franchise cases was whether sufficient economic power also could be inferred from the franchisor's trademark. In *Siegel v. Chicken Delight*, decided before *Fortner II*, the Ninth Circuit found the Chicken Delight trademark did confer sufficient economic power to make the tying arrangement *per se* illegal<sup>360</sup>. Other courts disagreed. The Second Circuit in *Carvel* overturned a lower court decision that the Carvel trademark conferred sufficient economic power. The Second Circuit decided that the trademark was not sufficient evidence, and that the petitioners had failed to demonstrate that Carvel had "sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product" or that "a not insubstantial amount of commerce (was) affected" <sup>361</sup>.

The Supreme Court in *Jefferson Parish* suggests a standard of market power. The Court reviewed earlier decisions<sup>362</sup> and concluded, "The essential characteristic of an invalid tying arrangement lies in the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer

either did not want at all, or might have preferred to purchase elsewhere on different terms. When such `forcing' is present, competition on the merits in the market for the tied item is restrained and the Sherman Act is violated"<sup>363</sup>. The Court ruled that Jefferson Hospital's market share of 30 per cent was not sufficient to demonstrate market power; the fact that 70 per cent of patients living in Jefferson Parish obtained treatment in other hospitals indicated the defendant did not have sufficient market domination<sup>364</sup>.

In the wake of *Jefferson Parish*, Judge Posner, in *J. Walters and Sons Building Inc.*, 737 F2d 698, 705 (7th Cir 1984), noted that "...the emphasis in the Supreme Court's recent decision in Jefferson Parish on the importance of proving that the owner of the tying product has real market power may doom the franchise trademark cases, as they mostly involve highly competitive retail industries, such as the fast food business...". Subsequent decisions have borne out this prediction<sup>365</sup>. The courts have focused on whether franchisors have power in the market for new franchises; absent such power, they have not found sufficient economic power for tying to be *per se* illegal because existing franchisees are to some extent "locked-in."

In Will v. Comprehensive Accounting Corp., 776 F2d 665 (7th Cir 1985), cert denied, 106 S Ct 1659 (1986), the Seventh Circuit dismissed the plaintiff's claim, concluding that he "did not show or try to show that Comprehensive (had) a cost advantage over rivals and potential rivals, that there (was) a barrier to entry into the business of franchising. They did not show or try to show that rivals could not produce a similar package for a similar cost; without such a showing, they must lose." Without such a showing, the plaintiff could not establish the necessary market power.

In Mozart Co.v. Mercedes-Benz of N.A. Inc., 833 F2d 1342, 1346-47 and n.4 (9th Cir 1987), the Ninth Circuit considered the legality of a clause requiring use of genuine Mercedes-Benz parts or parts approved by Mercedes-Benz. The Court agreed that two separate products were involved, but concluded the tying product, Mercedes-Benz automobiles, did not possess sufficient market power. It rejected the argument that a prestigious trademark was itself persuasive evidence of economic power; unlike a patent or copyright which was designed to protect the uniqueness of the product itself a trademark protected only the name or symbol of the product. Market power, if any, was derived from the product, not from the name or symbol as such<sup>366</sup>. The Court also doubted whether market power could be proved from the uniqueness of the Mercedes automobile to the consumer; individual purchasers might regard a Mercedes as unique, but the critical issue was "whether MBNA possess(ed) the market power to force dealers to purchase the tied product rather than acquire the franchise to sell a different automobile. Obviously, there (were) costs in surrendering one franchise and acquiring another, but these (were) costs unrelated to the market power of a unique automobile. These costs (would) enable the car maker to extract concessions from the dealer, but this power (was) related to the franchise method of doing business, not to the possible uniqueness of the car....The District Court...fail(ed) to anticipate adequately the basic fact that the market at issue is the market for dealership franchises."

## Business justifications

While treatment of tie-ins as a *per se* violation (under certain conditions) would appear to preclude consideration of a business justification defence, the courts, relying on Supreme Court precedents<sup>367</sup>, have accepted such a defence in a limited number of cases. A business justification defence also can be offered when the conditions for a *per se* violation are not established and a tying arrangement is considered under the rule of reason.

The arguments most frequently used by defendants are:

- The need to help the franchisor and the franchisee to break into the market. In *Siegel v. Chicken Delight*, the franchisor, quoting the Supreme Court decision in *United States v. Jerrold Elecs. Corp.* (see below), claimed that when it had first ventured into the fast food business in 1952, this was a new line of business;
- The need to protect a trade secret. In *Krehl v. Baskin-Robbins Ice Cream*, the Ninth Circuit invoked this argument when examining the relation between the trademark and the product allegedly tied to its sale: "Where, as here, the alleged tied product is manufactured pursuant to secret formulae, the specification alternative is not available." In *Siegel v. Chicken Delight*, the Ninth Circuit rejected the three justifications put forward but acknowledged that "there may of course be cases where some extraordinary condition forecloses specifications, e.g., where it would divulge a trade secret.";
- The need to preserve the quality of the product and the goodwill of the trademark. In *Siegel v. Chicken Delight*, the franchisor pleaded "marketing identity' purpose, the franchisor's preservation of the distinctiveness, uniformity and quality of its product". In Susser v. Carvel, the same argument was used (see below).

The courts have rarely, however, accepted these arguments, and have been particularly careful to insist on the requirement that this defence is admissible for tying only where no less restrictive alternative is available. The Ninth Circuit decision accepting defendant's business justifications in the Mozart case (see below) is an exception with few precedents.

One of the few cases in which a business justification defence was accepted (although it did not concern a franchise agreement) was *United States v. Jerrold Elecs. Corp.*, 187 F.Supp. 545 (E.D.Pa. 1960), aff'd 365 U.S. 567 (1961). The court allowed Jerrold Electronics' plea that, in order to ensure the efficient operation of a new business, it required that buyers of its TV system also buy the installation and maintenance service that went with it so that Jerrold's goodwill might be safeguarded. This justification of the tie was accepted only for a new business, however<sup>368</sup>.

In Susser v. Carvel Corp., 332 F2d 505 (2nd Cir 1964), cert denied, 381 US 125 (1965) (where the conditions for a per se violation were not established), the majority<sup>369</sup> considered that tying the right to use the trademark to the purchase of ice

cream was lawful since it would have been difficult to describe in writing "the desired texture and taste of an ice cream cone or sundae", and, even if this had been possible, "(it) does not show that administration could be confided to 400 dealers." This being so, the majority felt there was no reason for questioning the District Court judge's opinion that, "To require Carvel to limit itself to advance specifications of standards for all the various types of accessory products used in connection with the mix would impose an impractical and unreasonable burden of formulation...".

More recently, two circuits evaluated quite differently a business justification defence for the requirement by Mercedes-Benz that its dealers use genuine Mercedes-Benz or approved parts. The Ninth Circuit, in Mozart Co.v. Mercedes-Benz of North America Inc., 833 F2d 1342, 1346 (9th Cir 1987), prefaced its decision by remarking, "It has been suggested that the quality control defence be viewed with less scepticism than it usually has been accorded. It has been argued that tying arrangements are more effective and less costly than alternative methods for ensuring franchisee compliance with quality specifications." The Court cited the need for franchisors like MBNA, whose specific concern it was, to resist the tendency of certain franchisees to "cut corners" for financial reasons; and agreed that policing compliance with the specifications was extremely costly. The Court therefore allowed that "...efficiency loss from alternative methods of quality control (might) outweigh any potentially anticompetitive effects of a tying arrangement." The Court approved the findings of the District Court jury, namely that there was no less restrictive alternative, that the restraint was not more onerous than was necessary to achieve a legitimate goal and that the tying arrangement was necessary to protect the quality and safety of the vehicles. It concluded, "There is substantial evidence to support the jury's finding that the only feasible method for maintaining quality control (was) the use of the tying arrangement. Therefore we affirm the judgment for MBNA on the Sherman Act §1 tying claim."

This holding contrasts sharply with a prior decision by the Fourth Circuit. In *Metrix Warehouse Inc. v. Daimler Benz Aktiengesellschaft*, 828 F2d 1033, 1040-42 (4th Cir 1987), the Fourth Circuit rejected arguments advanced as a business justification defence, including maintaining quality control, in light of evidence that the various objectives cited could have been achieved through a less restrictive means than tying, including the prior issuance of product design specifications. It remains to be seen whether other decisions will follow the Fourth Circuit decision, which also is in line with earlier holdings, or whether other courts will follow the approach of the Ninth Circuit<sup>370</sup>.

### Approved suppliers

Franchisors generally have been able to specify approved suppliers in order to control quality without it being considered a tying violation<sup>371</sup>. In the case of *Kentucky Fried Chicken Corp.* v. *Diversified Packaging Corp.*, 549 F.2d 368, 375 (1977) the Fifth Circuit decided that "Although in the archetypal case...tying

arrangements serve hardly any purpose beyond the suppression of competition..., in the franchising context ties may well serve legitimate purposes." The approved source program of Kentucky Fried Chicken was found not to be a *per se* tying violation, and also was not illegal under the rule of reason. In a more recent case, the court rejected a claim by franchisees that *McDonald's* requirements that Coca-Cola be the only cola drink that could be sold was an illegal tie. The court agreed that McDonald's had a legitimate interest in a standard menu across franchisees<sup>372</sup>.

## European Community

There are no developments in Community competition law dealing with "tying" provisions as such. The treatments of various types of vertical distribution agreements do, however, cover similar issues by indicating whether downstream purchasers may or may not be obligated to purchase various types of goods or services from the upstream party to the agreement. The rules applicable to franchising already have been covered in the earlier section discussing the treatment under EC competition law of exclusive dealing provisions in franchise agreements. Provisions in the block exemption Regulation No 84/83 for exclusive purchasing agreements also limit allowable purchase obligations, or "tying". Article 3(c) specifies that the block exemption shall not apply where "the exclusive purchase obligation is agreed for more than one type of goods where these are neither by their nature nor according to commercial usage connected to each other."

# F. Obligations not to compete

#### Australia

Such obligations are often dealt with under the common law of restraints of trade. They may be void if their duration is unreasonable or if they are against public policy interests. Under section 45 of the Trade Practices Act, covenants not to compete are also considered to be restrictive practices and are prohibited, if they have the effect of substantially lessening competition. They may, however, be authorised by the TPC on public benefit grounds. The Trade Practices Commission has made it clear that covenants not to compete after termination of the franchise were anti-competitive restraints which should be deleted from the agreement.

If the TPC denies authorisation of a clause not to compete, the Courts may be called upon to determine whether the agreement may substantially lessen competition. For the Courts, post-termination restraints on franchisees must be reasonable in terms of both the distances and the time involved. In 1983, in *Austra Tanks*<sup>373</sup>, fewer than 82 152 different combinations of possibilities in relation to distance and time were contained in the agreement. The Court invalidated that restraint. A provision containing 120 combinations was also invalidated in *Lloyds Ships v Davross*, in 1987<sup>374</sup>. In this case, the Court also decided that these restraints should also be limited to the field of activity of the franchisee. The franchise

concerned the building of certain classes of ships and the Court held that the non-competition provision at the end of the agreement should not contain a restraint against "the business of shipbuilding of any description".

#### France

Non-competition clauses must comply with three sets of legal conditions. Under contract law, they must respect the contractual balance between parties. Under competition law and in pursuance of Article 10, they must be ancillary to the main contract and limited in sphere of activity, time and space<sup>375</sup>. Last, under EC law, the clauses must be essential to performance of the contract and strictly limited to what is indispensable; this is similar to the requirements under EEC law.

French commentators disagree as to the validity of the non-competition clause in franchise contracts. Some consider the clause to be unlawful since customers are exclusively bound to the business of the trader who has developed a special relationship with them in his day-to-day dealings. Other commentators consider that, in the modern distribution system of a franchise, customers are more attached to the franchisor's brand and reputation than to the retailer. In the view of these commentators, admitting that the customers are the franchisee's would allow any network to gain unduly from another network's customer base<sup>376</sup>. The Cour de cassation, for its part, deems non-competition clauses to be valid.

In *Himbert-Natalys*, the Paris Court of Appeal ruled in favour of the franchisee<sup>377</sup>. It pronounced null and void the clause inserted in the contract which stated that, upon its expiry, the franchisee would refrain from competing with Natalys within a given territory for two years. The reason for the annulment was that the franchisee and proprietor of her outlet would lose all her customers and could not continue trading. The court dealing with the substance of the case did not deem it useful to pursue a line of reasoning based on more modern competition considerations; this ruling conflicted with earlier judgments which had ruled that the non-competition clause was valid if it was limited in time and space, as to its sector of activity and the legitimate interest of the person benefiting from the clause in question<sup>378</sup>.

Not surprisingly, the Cour de cassation reversed, in 1989, the Court of Appeal judgment. The Cour de cassation held that the Court of Appeal had violated legal rulings on the freedom of trade and industry in so far as the challenged clause was limited in time and space and as to its sector of activity. It is striking to note that the Cour de cassation referred to 1791 legal provisions to motivate its decision<sup>379</sup>.

Subsequently, in *Mourat-Natalys*, the Paris Court of Appeal, referring to the EC Decision in the *Pronuptia* case, deemed that the non-competition clause in a franchise contract was valid provided the non-reestablishment clause was limited territorially (here within a radius of 1 km of the store) and reasonable in duration (in this case two years after expiry of the contract) and that it did not prevent the franchisee from setting up a similar business immediately. Thus when the franchise concerns clothes for mothers-to-be and for small children under the age of six, nothing prevents the franchisee from selling ladies' fashion wear and clothes for

children over the age of six. The Court judged, moreover, that the non-competition clause was justifiable since it provided the network with necessary protection, without imposing undue constraints<sup>380</sup>. Last, the Court pointed out that the non-competition clause benefited the consumer, in virtue of both its reasonably limited character and the advantage it brought in terms of economic development, namely more effective distribution at the best price.

# Germany

Non-competition clauses requiring franchisees, during the term of the agreement or for a reasonable period after its termination, not to engage in any similar business which would compete with the franchise system are, as a rule, not considered "unfair". Provided that the duration of the non-competition clauses does not exceed a reasonable period, such clauses serve to protect the legitimate interests of the franchise system and are not regarded as abusive under Section 18 ARC<sup>381</sup>.

The non-competition clauses contained in *McDonalds* franchise agreements (franchisees may only acquire participations under 2 per cent in other catering concerns and must not compete within a 30 mile zone for a period of one year after termination of the agreement) were not objected to by the FCO. Likewise, the FCO did not object to a clause in the *Photo Phorst* agreements which ruled that if Phorst terminated the agreement without notice, the franchisee was subject to a 12-month prohibition on competing from the same premises.

However, any clauses restraining competition between franchisees and the franchisor's own outlets principally fall under the cartel ban of Section 1 ARC as they constitute agreements restraining competition at a horizontal level. In cases like these, the FCO places great importance on the assertion that there will be no co-ordination between the franchisors' own outlets and franchisees<sup>382</sup>.

# Japan

The lawfulness of the prohibition on competition after the termination of the contract must be judged in the light of the franchisor's need to protect his activity and know-how. The period and the scope of the restriction must be reasonably limited. If the prohibition goes beyond what is necessary, it may fall under Article 14 (abuse of a dominant bargaining position) or under some other provisions.

# Spain

A covenant not to compete is considered to fall in the category of prohibited practices of Article 1, but may be justified and eligible for authorisation under Article 3. The decision in the *Toshiba* case considered whether a covenant for the franchisee not to compete for one year following the termination of the franchise agreement was or was not essential to avoid the use by competitors of know-how

and of customer lists. The Tribunal considers that a covenant not to compete for a period of one year is necessary to protect the investments made by other franchisees when a new network is being built up, as long as intrabrand competition is assured in each area by the existence of a parallel network of authorised dealers.

#### Sweden

Covenants not to compete are acceptable during the term of the agreement. At the end of the agreement, such covenants must be of a reasonable duration, and not too long. The Ombudsman has found in this context that several aspects must be considered. A non-competition clause could present major difficulties for a franchisee trying to sell his enterprise. On the other hand, one has to give due consideration to the interests of the franchisor in safeguarding his know-how, which also merits protection from a public interest point of view.

## United Kingdom

These obligations must be reasonable. A provision not to compete during the term of the contract does not appear to have been challenged in the Courts. Post-termination restraints not to compete in the territory or near any other franchisee are carefully scrutinised. In the view of the Office of Fair Trading, restrictions often tend to be wider than strictly necessary, for example covering the whole of the United Kingdom. The restrictions must be limited to what is strictly needed for the protection of the franchisor and other franchisees<sup>383</sup>. For example, in the case of a temporary employment agency, a restriction for one year within a seven miles radius in an urban area was considered acceptable. Periods of between six months and two years have also been approved by the Courts<sup>384</sup>.

### **United States**

The enforceability of covenants not to compete that are entered into ancillary to another legal agreement is evaluated under the rule of reason<sup>385</sup>. A covenant not to compete generally is considered reasonable if it meets the following requirements: (a) the restraint is ancillary to the main purpose of a lawful contract; (b) the party imposing the restraint does not have monopoly power and the restraint does not foster a monopoly; (c) the restraint is partial in nature and no broader than reasonably necessary in terms of time and scope (i.e., territory, product line); and (d) the restraint is no broader than necessary to afford fair protection to the parties and not so extensive as to interfere with the public interest<sup>386</sup>.

The validity of covenants not to compete is also subject to state laws. In most states, covenants not to compete may be enforced both during the term of the franchise agreement and after termination of the franchise. However, many courts tend to treat post-term noncompetition convenants more skeptically than in-term covenants.

#### European Community

The franchise block exemption regulation, No. 4087/88, exempts the clause in which the franchisee undertakes "not to engage, directly or indirectly, in any similar business in a territory where it would compete with a member of the franchised network, including the franchisor"<sup>387</sup>. The franchisee may be held to this obligation after termination of the agreement, only "for a reasonable period which may not exceed one year"<sup>388</sup>. This exemption, however, applies only in so far as it is necessary to protect the franchisor's rights or to maintain the common identity and reputation of the network.

As in other areas, the block exemption regulation is consistent with individual exemptions granted by the Commission to franchise agreements. In its Pronuptia exemption decision, the Commission explained that the ban on competition during the period of the contract was necessary to protect the know-how and other assistance supplied, while the period of one year after the ending of the contract could be regarded as reasonable<sup>389</sup>. Similarly in Yves Rocher, the Commission judged that the provision under which the franchisee agrees not to carry on competing activities for the duration of the contract was indispensable to protect the know-how and assistance provided by the franchisor. By their nature, the know-how and assistance provided were of a kind which could be used for the benefit of other beauty products or services which would, even if only indirectly, enable competitors to benefit from the trading methods employed. The Commission further judged the same to be true of the clause forbidding former Yves Rocher franchisees from carrying on a retail cosmetics business in their former exclusive territories for one year after the contract's termination. The Commission justified this clause on the grounds that this was simply intended to prevent Yves Rocher's competitors from benefiting from the know-how which had been communicated by Yves Rocher to the former franchisee and from the clientele acquired as a result of that know-how and Yves Rocher's identifying marks.

# G. Minimum requirements

#### New Zealand

A requirement that a franchisee purchase a minimum quantity of goods from the franchisor is not in itself a breach of the Commerce Act, even if the quota is set at a level which precludes recourse to competitors. It is unlikely that such a quota, which is in effect a single brand franchise, would be considered to be a contract with the purpose of substantially lessening competition<sup>390</sup>.

## **United States**

Requirements by a manufacturer that a dealer offer for sale the manufacturer's complete line of products commonly is referred to as "full line forcing." Full line forcing agreements typically do not require that the dealer sell the manufacturer's products exclusively, only that the dealer stock the full line. A key issue is whether full line forcing forecloses competition in a substantial amount of commerce. In the absence of evidence that the dealer is contractually restricted from handling competitive products, full line forcing generally has been upheld under the rule of reason because, as a practical matter, of the plaintiff's difficulty of establishing the amount of competition foreclosed by the requirement, or indeed whether there was any foreclosure at all<sup>391</sup>.

Full line forcing may be unlawful if coupled with quantity purchase or inventory requirements that effectively preclude the distributor from handling competing lines. In *Miller Motors, Inc. v. Ford Motor Co.*, 252 F.2d 441 (4th Cir. 1958), the requirement that the dealer maintain a stock of Ford-manufactured parts and accessories was coupled with the requirements that the inventory maintained be "reasonably comparable to the current demand." The court construed the inventory requirement as referring to current demand for Ford-manufactured products. While upholding the contractual provision as interpreted, the court noted that if the inventory requirement meant current demand for all parts, it would raise serious anticompetitive questions because it would interfere with the dealer's ability to stock rival replacement parts<sup>392</sup>.

A full line forcing requirement also may be found to be a disguised, illegal tie-in where the products subject to a full line forcing agreement are not related to each other or are not part of the same line and the other elements of an unlawful tie-in are established. In such cases, the full line forcing requirement could not be justified as necessary to meet a reasonable customer expectation that such products would be available<sup>393</sup>.

## European Community

The franchise block exemption regulation No. 4087/88 exempts obligations on the franchisee "to offer for sale a minimum range of goods, achieve a minimum turnover, plan its orders in advance, (and) keep minimum stocks" but only to the extent necessary to protect the franchisor's property rights or maintain the identify and reputation of the network<sup>394</sup>. Such obligations are generally not considered restrictions of competition under Article 85(1), but are specifically exempted in case they would be restrictive under special circumstances. However, according to established case law that can probably be applied to the franchise system, quantitative restrictions should be confined to what is necessary and there should be no discrimination in their application<sup>395</sup>.

In its *Pronuptia* exemption Decision, the Commission considered that the obligations to pay a minimum amount of royalties each year, to order in advance a per centage of estimated sales based on those of the previous year and to hold stocks did not constitute restrictions of competition in a franchise system<sup>396</sup>. In particular, the provision requiring the franchisee to hold a minimum stock of goods was deemed to be a guarantee assuring the consumer of the continuity of supplies. It is largely admitted in EC case law on franchising.

On the question of quantitative restrictions the Commission was at pains to emphasize in its *Pronuptia* decision that "in a selective distribution system, such obligations could be regarded as restricting competition when they exclude from the network firms that fulfilled the uniform qualitative selection criteria but were unwilling to accept such further obligations, and when their effect was that distributors would be forced to push certain products to the detriment of other items"<sup>397</sup>. Nonetheless, some quantitative restrictions may be exempted under Article 85(3) if they apply indiscriminately to all retailers. Moreover, in the Regulation on Exclusive Distribution Agreements, the obligation on the exclusive dealer to purchase complete ranges of goods or minimum quantities does not preclude exemption<sup>398</sup>.

# H. Advertising restrictions

## **United States**

Where a manufacturer has denied co-operative advertising reimbursements to dealers because the advertised prices did not conform to the manufacturer's suggested resale prices, such practice has been subject to challenge as an illegal vertical restraint. Initially, lower federal courts held that co-operative advertising programmes that condition reimbursement on use of the manufacturer's suggested resale prices were within the established rule of per se illegality for resale price maintenance<sup>399</sup>. Subsequently, the Fifth Circuit in *Nissan* declined to apply the *per* se rule of illegality and upheld a co-operative advertising programme under which a distributor received partial reimbursement only if the distributor advertised the supplier's suggested resale price or no price at all<sup>400</sup>. The court noted that suggesting resale prices was not per se illegal and that the co-operative advertising programme had no demonstrable economic effect on price. The evidence showed that dealers sold Datsuns at whatever price they chose and were free to advertise at their own expense new cars at prices other than the suggested resale price<sup>401</sup>. The Supreme Court decision in Business Electronics v. Sharp Electronics, 108 S.Ct. 1515 (1988), contains a dictum on this issue that is consistent with the approach taken in *Nissan*. In *Sharp*, the court suggested that a restraint on dealer advertising of prices below the manufacturer's suggested resale price is not by itself illegal per se unless it is part and parcel of some agreement to fix the resale price<sup>402</sup>.

The Department of Justice and the Federal Trade Commission have taken the enforcement position that, under certain circumstances, where co-operative advertising programmes limit a retailer's pricing freedom, they may constitute unlawful vertical price fixing<sup>403</sup>. The Federal Trade Commission, until recently, maintained an enforcement policy to treat as *per se* unlawful co-operative advertising programmes that conditioned reimbursement on use of the manufacturer's suggested resale price. In 1987 the Commission announced a new enforcement policy that co-operative advertising programmes would be judged under the rule of reason<sup>404</sup>. Consistent with this change in enforcement policy, the Commission, in March 1990, modified a 1971 order against the Magnavox

Company, deleting order provisions that prohibited price-restrictive co-operative advertising programmes<sup>405</sup>.

# European Community

Article 3-1-g of the franchise block exemption regulation, No. 4087/88, exempts obligations that the franchisee pay the franchisor for advertising and that the franchisee itself advertise and get approval from the franchisor for the nature of the advertising. As with other provisions of this Article, these obligations generally are not considered restrictions of competition, but an exemption is granted only to the extent necessary to protect the franchisor's property rights of the identity and reputation of the network. However, the franchisor is not authorised to impose his own pricing policy in such circumstances.

The allowed advertising practices, however, clearly do not extend to any practice that would allow the franchisor to impose retail prices. The Commission in its decision granting an exemption for the *Pronuptia* franchise agreement found that the franchisor could recommend to the franchisee that it not exceed recommended prices the franchisor had advertised, so long as the franchisor did not go beyond that to restrict the franchisee's freedom to set prices<sup>406</sup>. It also is clear that the franchisor's rights to approve franchisee advertising extend only to the "nature" of the advertising; the Commission in its Pronuptia exemption decision clarified this phrase by stressing that the franchisor only had the right to "control...the nature of the advertisements with the object of ensuring conformity with the Pronuptia chain's brand image" the block exemption, attempts to control the franchisee's advertised price surely would be interpreted as going beyond what was necessary to protect the franchisor's property rights or the network's identity and reputation [as well as being an "indirect" restriction of resale price prohibited by Article 5(e)].

In the case of exclusive distribution systems, the Commission has recognised that the exclusive distributor should take account in his local campaigns of national advertising by the supplier<sup>408</sup>. It has also endorsed the obligation on the distributor to submit his advertising material to the supplier for approval, except when it concerns prices and terms of sale<sup>409</sup>. Last, the Regulation on Exclusive Distribution Agreements exempts the obligation on the distributor to take measures for promotion of sales, in particular to advertise<sup>410</sup>.

# Chapter V

# **Economic Assessment of Competition Law Provisions Applicable to Franchising**

Designing a competition policy towards franchising which has economic efficiency as an important objective involves balancing several factors: the congruence between the legal treatment of provisions and their effect on economic efficiency, the effect of alternative policy rules on enforcement costs and legal certainty, and the degree to which policies also serve objectives other than economic efficiency. Each is discussed in this chapter. The first section discusses the extent to which the competition policies of Member countries and the EC towards particular vertical restraints in franchise agreements match the effects on economic efficiency of those provisions. The second section analyses how the choice of competition policy rules is affected by the recognition that greater reliance of competition policy on detailed analysis imposes enforcement costs. The final section considers briefly how objectives other than economic efficiency may affect competition policies.

## An analysis of the applications of competition policy

The treatment of various provisions by the competition policy of Member countries and of the EC will be compared, first of all, with the effect of these provisions on economic efficiency that is predicted by the economic analysis of Chapter II. Like chapter IV, this section is organised provision by provision.

## Territorial restrictions

Broadly speaking, territorial restrictions are often (but not always) acceptable under the competition policies of Member countries and the EC, although such provisions tend to reduce intrabrand competition when part of a franchise agreement. There are several differences, however: in the extent to which competition authorities are concerned with intrabrand competition between franchisees, and with the degree of market competition between brands and retailers carrying various brands, and also in the strictness of the territorial restrictions that are allowed.

The general acceptance of territorial restrictions is illustrated by the position of the Australian TPC, which stressed that although Coca-Cola granted each

franchisee a monopoly position in each territory, the franchise agreement had pro-competitive effects as well. It is interesting to note that the TPC insisted that territorial exclusivity must be limited to a "reasonable" period, generally not exceeding five years. Among the evidence cited by the Commission was the lack of complaints by competitors. As a general observation, such evidence should be interpreted with caution, since territorial restrictions could be used to decrease inter-brand competition with other suppliers as well as intrabrand competition within the franchise system.

In the United States, the Supreme Court's reasoning in *Continental TV v. GTE Sylvania* explicitly applied not only to territorial restrictions but more generally to non-price vertical restrictions. The Court stressed the efficiency justifications for and the pro-competitive effects of territorial restrictions in particular and non-price vertical restrictions in general. Since vertical non-price restrictions could not be presumed to have anticompetitive effects, the Court found that they should be judged under the rule of reason, rather than be *per se* illegal as in the earlier *Schwinn* case<sup>411</sup>. The Supreme Court also stressed the adverse effects that a *per se* rule may have on small and independent business.

In many respects, the reasoning in the decision is consistent with the analysis of the efficiency effects of vertical restraints presented in Chapter II. Two partial qualifications are worth making, however. (A third issue, the sharp distinction drawn between price and non-price vertical restraints, is discussed below).

First, the language of the decision indicates that restrictions on intrabrand competition are justified because they may result in increased inter-brand competition. Vertical restraints certainly often can lead to increased competition between suppliers of different brands. It is not true, however, that vertical restrictions that reduce intrabrand competition can be justified on efficiency grounds only if entry is encouraged and inter-brand competition thereby increased 112. Even without encouraging entry, vertical restraints can promote economic efficiency and benefit consumers by improving the efficiency with which existing competitors supply their products or services, particularly if overall market conditions ensure that inter-brand competition remains robust. Since it is difficult to say in such situations that inter-brand competition has been increased in any measurable fashion, evidence of actual or likely increases in inter-brand competition should not be considered necessary to prove the efficiency benefits of vertical restraints.

Second, the *GTE Sylvania* decision gives considerable prominence to the free-rider effect as an efficiency justification for non-price vertical restrictions. There is less attention, however, to the particular circumstances in which free-riding provides an efficiency justification for vertical restrictions<sup>413</sup>. This is understandable in context; the Court was not itself conducting or evaluating a rule of reason analysis, but was determining whether a rule of reason approach, rather than *per se* illegality, was appropriate. To support its decision, the Court only needed to show that non-price vertical restrictions need not be anticompetitive<sup>414</sup>. For other courts applying the rule of reason, and the general analysis of

GTE Sylvania, however, it is important to recall what conditions are necessary for free-riding to pose a substantial threat to efficiency.

A concurring opinion by Justice White in *Sylvania*, although it differs at several points from the main opinion by Justice Powell, raises two issues of general importance: the role of inter-brand competition and market structure, and the effect of more or less strict territorial restrictions on intrabrand competition. Each issue, Justic White argued, provided grounds for distinguishing the *GTE Sylvania* case from *Schwinn*<sup>415</sup>. First, Justice White pointed to differences in market share: "Sylvania, unlike Schwinn, had an insignificant market share at the time it adopted its challenged distribution practice and enjoyed no consumer preference that would allow its retailers to charge a premium over the other brands"<sup>416</sup>. Schwinn was "the leading bicycle producer in the Nation", with a national market share of 22.5 per cent<sup>417</sup>, whereas Sylvania was a "faltering, if not failing" producer of television sets, with a relatively insignificant (1 per cent to 2 per cent) share of the national market in which the dominant manufacturer had a 60 per cent to 70 per cent share<sup>418</sup>.

The underlying general point about the significance of market competition between brands is important and well-taken, and certainly should be relevant to a rule of reason determination. However, the evaluation of this inter-brand competition, and of the effect of territorial restrictions on inter-brand competition, should go well beyond simple consideration of market share. One such additional consideration, changes in market structure over time, undermines a claim that lack of inter-brand, market competition supported a finding that the Schwinn agreement was anticompetitive. A source of much criticism of the *Schwinn* decision was that while Schwinn's market share was 22.5 per cent in 1951, its share had fallen to 12.8 per cent by 1961<sup>419</sup>.

Justice White also argued that a distinction should be drawn between *Schwinn* and *Sylvania* because of differences in the strictness of the territorial restrictions involved<sup>420</sup>. He recalled that under Schwinn's customer restrictions, the franchised dealers were not allowed to sell to discounters or other non-franchised dealers. Sylvania's location restrictions, on the other hand, though they "inhibited to some degree the freedom of the retailers to dispose of the purchased products by requiring the retailer to sell from one particular place of business (they left the retailer) still free to sell to any type of customer — including discounters and other non-franchised dealers — from any area"<sup>421</sup>. Therefore, the restrictions employed by Sylvania were supposed to reduce intrabrand competition less than those employed by Schwinn.

This argument is only in part convincing. A provision not to sell to customers in other territories does have a bigger impact on intrabrand competition than a simple location restriction. The argument about the possibility of selling to non-franchised dealers is dubious however. In fact, even if reselling is allowed, there may well be an implicit general understanding that franchisees should not engage in such a practice (e.g., such as selling to discounters who are present in another franchise's territory), since this would result in indirect competition and

would eventually decrease every franchise's profits. (Justice White actually did not mention whether there was substantial competitive pressure for Sylvania products from discounters, integrated outlets or other types of non-franchised dealers).

More important are two closely related general issues. First, to what extent do efficiency effects justify competition policy distinctions between more and less strict territorial restrictions? Second, to what extent and in what circumstances should competition policy be concerned specifically with preserving intrabrand retail competition as well as with the competitiveness of upstream and downstream markets, which may include suppliers and retailers of several brands? This second issue is central to evaluating not only territorial restrictions, but also other vertical restraints that limit intrabrand competition.

The distinction between "absolute" and "limited" or "passive" exclusive territories suggested by Justice White's opinion (but not by the main Court opinion) is a central part of the competition policy of the EC toward territorial restrictions (a franchisee is allowed to sell "passively" if he is allowed to accept orders from outside his territory). In its *Pronuptia* exemption decision, for example, the Commission stressed that the location restriction it was exempting did not prevent customers from choosing where to buy the goods (it also mentioned that the franchisees were free to sell to each other)<sup>422</sup>. This distinction between "absolute" and "limited" territorial protection has been recalled in all successive franchise cases (*Yves Rocher, Computerland, ServiceMaster, Charles Jourdan, ...*) and constitutes one of the building blocks of the franchise exemption regulation. The reasons given for limited territorial restrictions being acceptable and for strict territorial restrictions being unacceptable, however, are not completely convincing in justifying the distinction from the standpoint of economic efficiency.

The Commission lists a number of reasons why limited location provisions were important — indeed "indispensable" — for franchise distribution, which means of distribution in turn offered substantial benefits. These reasons included the need to give some assurance to franchisees that their initial investments could be recovered, and to give them incentives to exert important efforts. These reasons, however, also would justify stronger provisions that protected franchisees more completely from intrabrand competition<sup>423</sup>.

The Commission, however, argues that stricter territorial restrictions would not qualify for exemption under Article 85(3), in part because they would more completely eliminate intrabrand competition. The preliminary considerations of the franchise block exemption regulation state in particular that, "To guarantee that competition cannot be eliminated for a substantial part of the goods which are the subject of the franchise, it is necessary that parallel imports remain possible..."424, and Article 5-g asserts that agreements cannot be exempted under which "the franchisees are obliged not to supply within the Common Market the goods or services which are the subject-matter of the franchise to end users because of their place of residence". Therefore, although the Commission recognises that reducing intrabrand competition may in some contexts increase inter-brand competition, it nevertheless insists on maintaining a "substantial amount of intrabrand competition". This calls for three remarks.

First, there may be some circumstances where there is relatively little difference in the extent to which "absolute" and "limited" territorial protection reduce intrabrand competition. The franchise exemption regulation allows the franchiser to commit himself not to compete with his franchisees, either directly or indirectly<sup>425</sup>, and it also allows him to require that his franchisees should not compete "actively" in other franchisees' territories<sup>426</sup>. Since there are no limitations imposed on the size of the territories, a franchisor may indeed use such provisions to grant his franchisees a quite high level of intrabrand protection. This also suggests that the level of intrabrand competition preserved by having only limited territorial protection will vary considerably from one franchise to another.

Second, as stressed above, there is no obvious reason in terms of economic efficiency for establishing an "automatic", *per se*-like borderline. Higher degrees of protection from intrabrand competition may be desirable in periods of transition when a franchisor seeks to enter a new market, whereas even limited protection should be ruled out when it is used by long-established, dominant firms in order to facilitate collusion. Even if this limited exemption rule is the best compromise to be found among possible *per se* rules, it is not clear that such an automatic rule should be favoured over a more contingent one, based on pre-specified characteristics of the market. In particular, designing or allowing more permissive rules for small firms may decrease the delays and the costs associated with administrative or judicial procedures — both being especially important for small firms.

Third, the importance of allowing only limited territorial restrictions in order to maintain some intrabrand competition is expressed in terms of one of the conditions that must be met for an exemption under Article 85(3): to guarantee that competition is not eliminated for a substantial part of the products in question<sup>427</sup>. The extent to which intrabrand competition must be preserved to satisfy this condition turns on the interpretation of a phrase and the objective of the condition. First, what are the products in question? If the products in question are those of the particular franchise system, then by definition eliminating intrabrand competition eliminates competition between the products in question. Another approach, however, is to ask, what is the objective that underlies the concern that competition not be eliminated? To the extent that concern is economic efficiency, then what matters is competition in the relevant product and geographic markets for competition policy analysis. The products in question — that is, the products relevant for evaluating whether efficiency will be harmed by the elimination of some or all intrabrand competition — are not necessarily only the products of the particular franchise system, but what often will be the broader set of products or brands in the relevant market. On this interpretation it is the preservation of overall competition in the relevant market, and not specifically of intrabrand competition, that would be necessary to satisfy this condition of Article 85(3).

These comments consider only the immediate impact on economic efficiency of more or less strict territorial restrictions. It seems likely, however, that the distinction by the Commission is based at least in part on considerations and objectives other than direct effects on economic efficiency. In particular, one should recall that one of the main aims of the Treaty of Rome was to improve internal trade and business among Member countries of the Community, which

helps explain why any exclusive practice which might restrict trade between states has been treated with suspicion. This issue is discussed in the last section of this chapter.

# Exclusive dealing arrangements

Exclusive dealing can be socially as well as privately beneficial when it serves to ensure a minimum level of services at the franchisees' level or when it protects the franchisor's rights in a specific investment in a form of know-how which has to be transmitted to the franchisees for the good operation of the franchise business. On the other hand it can reduce market competition with other brands or retailers when a franchisor uses exclusive contracts to foreclose his market, or to pre-empt interesting outlet locations or prominent franchisees. This latter feature is likely to be most harmful when used by well-established franchisors, and when there is a shortage, at least a transitory one, of possible franchisees — because of the lack of space, for example, or of the absence of skilled franchisees. It is thus particularly relevant here to distinguish the situation of experienced franchisors long established in a market from the situation of new franchisors or the situation of franchisors attempting to enter new markets. Moreover, since other means exist to ensure a provision of services by the franchisees without risking market foreclosure that raises entry barriers, arguments in favour of exclusive dealing should concentrate on the protection of the franchisor's specific investment.

Several Member countries do aim at distinguishing between whether franchisors are well-established in their markets ("major suppliers") or are new entrants, and apparently are succeeding in doing so. In Canada, the *Bombardier* case is particularly interesting. Article 77.4.a of the Competition Act allows the competition authorities to exempt exclusive dealing provisions, for a reasonable period, when these provisions mainly serve to facilitate the entry of a new firm or of a new product. In its *Bombardier* decision the Restrictive Trade Practices Commission clarified the application of this article of the Competition Act and developed an interesting analytical framework for the evaluation of the relative importance of Bombardier in its market (including Bombardier's market share, financial strength and record of innovation, the evolution of relative market shares, the availability of other distributors for competing manufacturers, the choice offered to consumers in remote locations ...)<sup>428</sup>.

In the United States, the decision of the Supreme Court in *Tampa Electric v. Nashville Coal* pointed toward evaluating the internal efficiency and market effects of exclusivity provisions, rather than looking more mechanically only at market shares. The decision, however, provided little guidance about how this analysis should be carried out (recall that the Court simply asserted that affecting 0.77 per cent of the coal market was not significant enough to be considered as a violation of competition regulations). Subsequent decisions have applied such an approach. In the *Beltone Electronics* case, the Federal Trade Commission applied a general analysis of the economic effects in finding acceptable the exclusive dealing

provisions of a manufacturer with a 7 to 8 per cent market share. The Commission reached a decision on the grounds that this manufacturer's sales were declining (so that the exclusive dealing arrangement could be interpreted as a way of placing the firm in a good position for a new start), that other distributors were available to competing manufacturers, and that the arrangement aimed to stimulate the distributors' efforts to promote Beltone's products. The Commission, however, did not discuss the possibility that exclusive dealing protected the franchisor's investments except for citing the franchisor's need to protect its "investments" in clients that it referred to its franchisees.

The standards set in the later 7th Circuit decision in Roland Machinery Co. v. Dresser Industries, Inc., 749 F.2d. 380, 384 (7th Cir. 1984), for determining whether exclusive dealing is anticompetitive also suggest a willingness to use economic reasoning to analyse the competitive effect of exclusive dealing. Judge Posner said that a plaintiff in an exclusive dealing case must prove that the exclusion is "likely to keep at least one significant competitor of the defendant from doing business in a relevant market" and that "the probable (not certain) effect of the exclusion will be to raise prices above (and therefore reduce output below) the competitive level or otherwise injure competition." The second condition, determining whether exclusive dealing is likely to affect prices, involves looking directly at whether exclusive dealing allows increased exercise of market power. The first condition, determining whether a competitor is kept from doing business, is more problematic. Keeping a competitor from doing business is one means by which exclusive dealing might harm competition, particularly if "competitor" is interpreted to include potential entrants as well as firms that have supplied or are supplying the market. Exclusive dealing, however, also could harm competition without preventing either existing suppliers or entrants from doing business; if exclusive dealing provisions raise the costs of some rival suppliers or entrants they may be unable to prevent the increased exercise of market power even though they continue to do business.

The European Economic Community case is slightly more complex. The franchise block exemption regulation allows exclusive dealing provisions, but only in some situations. First, the Commission draws a distinction between those products which are at the core of the franchise agreement, and more secondary products such as accessories or spare parts; exclusive agreements cannot be employed for these secondary products. The Commission also allows exclusivity requirements for other goods or services purchased by the franchisee, provided certain conditions are satisfied; in particular, the exclusivity clause must be necessary for the protection of the franchisor's rights, and it must be impossible to achieve similar goals in different ways, such as by specifying objective quality standards. The exemption regulation therefore does not apply when the franchisee can buy from other suppliers items which could meet reasonable and explicit quality requirements (except, of course, if the goal of the franchise consists exactly in distributing the franchisor's products). In the same spirit, even if the aim of the franchise is the distribution of the franchisor's products, the franchisor cannot prevent his franchisees from buying the franchisor's products from other franchisees or retail outlets (cf. the previous discussion on territorial restrictions).

The European Commission's emphasis in its list of acceptable franchise provisions on the necessity of the exclusive arrangement for the protection of the franchisor's rights is significant. The difference between core products and secondary ones is interesting; in many cases quality and other efficiency arguments will be stronger for products that are the subject-matter of the franchise. It is less clear how consistently this distinction will draw a line between exclusivity arrangements that do and do not increase efficiency<sup>429</sup>. In particular, where there is little prospect of any effect on market power, exclusivity arrangements could be allowed for a broader range of products without much risk of harming economic efficiency. Similarly, the exclusivity requirements for spare parts or accessories could be interpreted as a tie-in, and could be analysed and accepted as such in some circumstances rather than being automatically ruled out<sup>430</sup>. Also, the effect on economic efficiency of another limitation in the block exemption restriction — the prohibition on preventing a franchisee from buying the franchisor's products from other franchisees — is not clear. For example, this prohibition could be used by the franchisor to sustain a non-linear tariff — such as progressive rebates for large quantities — in order to give franchisees incentives to promote the franchisor's products, a purpose that could be completely consistent with economic efficiency. It could also be used to improve protection of the franchisor's rights. On the other hand, allowing franchisees to buy from each other does not seem to create substantial risks of reduced inter-brand competition or market foreclosure.

#### Price restrictions

Price restrictions succeed in generating a broad consensus among the different countries, although particular countries' practices do differ somewhat. All countries are very suspicious of restrictions that aim to limit the franchisees' freedom to choose their own price, and it is difficult to find another topic where there is such unanimity. Resale price maintenance is virtually always unlawful<sup>431</sup>. Only more limited restrictions — such as the use of recommended prices — are tolerated and even then sometimes only in exceptional circumstances such as promotional campaigns for the introduction of new products.

The French position is one example of a strong stand against restrictions aimed at controlling prices. It is based in part on a desire to assure the liberty of prices at the retail level following the elimination of price controls in 1986, as well as a desire to ensure the freedom of legally independent enterprises to set their own prices and to pass on any cost savings they might generate. Further, there is the desire to eliminate the possibility of collusive conduct by upstream firms, based on concern that cartel conduct, widespread in the past, remains a significant problem. Nonetheless, the French authorities permit recommended prices, recognising their role in communicating to consumers and downstream firms the level of price and associated "image" of the product or service.

The Canadian position is another example of a tough position. The Canadian Competition Act proscribes not only resale price maintenance, but also any attempt or intention to fix resale prices. This prohibition of course applies to direct tools of

price control, but also to indirect tools, such as financial or non-financial incentives schemes, refusals to deal with price-cutters, etc.<sup>432</sup>. "Attempt" or "intention" to control resale prices is to be understood broadly, so that franchisors have to be cautious about any related provision, like recommended prices. Other countries are more permissive toward recommended prices, or apply different treatment to the use of price floors and price ceilings.

Here these policies are analysed in terms of the effect of vertical price restrictions on economic efficiency. The focus is on three issues: first, the sharp distinction frequently drawn by competition policy between price and non-price vertical restraints and the use of *per se* rules of illegality for resale price maintenance; second, distinctions between minimum and maximum price restrictions; and third, policy toward recommended prices. It is important to re-emphasize, however, that while the analysis of this report focuses on issues of economic efficiency, rules against vertical price restrictions may be justified by other policy goals or by consideration of the enforcement costs of alternative policies.

## Price versus non-price vertical restraints

What is most striking from the economic point of view is that the strong contrast between the unanimity against vertical price restraints and the more or less sympathetic attitude towards non-price vertical restrictions (such as exclusive territories) is not matched by a corresponding contrast in the effects of price and non-price vertical restraints on economic efficiency. It is difficult to find a marked contrast between the economic effects of "necessarily bad" price restrictions and those of "possibly good" non-price restrictions. Either type of restriction may either improve or harm economic efficiency. Indeed price and non-price vertical restrictions often are alternative ways for the franchise to achieve the same objective and, in particular, either may be used to allow increases in retail prices and services (that may or may not benefit consumers on balance). Many arguments used in recent American cases in which non-price vertical restrictions were finally allowed could be used equally well in support of price restrictions. To develop the point, this report follows the arguments of the U.S. Supreme Court in GTE Sylvania and subsequent cases in support of the proposition that non-price vertical restraints can be beneficial and should be judged by the rule of reason, while vertical price restraints should continue to be per se illegal.

The Court has focused on three ways in which vertical restraints can affect economic efficiency: (a) non-price vertical restraints prevent externalities that reduce the efficiency with which products or services are supplied; (b) non-price vertical restraints promote inter-brand competition; and (c) vertical price restraints are much more likely to reduce inter-brand competition. In each area the economic effects of resale price maintenance (concentrating on minimum price restrictions) and of non-price vertical restraints (concentrating on exclusive territories) will be briefly reviewed and compared.

# Efficiency of supply

Arguments that non-price vertical restraints can improve the efficiency with which products and services are supplied have often been based on the possibility of free riding. For services not definable in the contract and whose benefits are non-appropriable, free-riding may lead to their under-provision, not only from the firms' points of view, but also from that of total economic welfare. Then both private and social objectives agree that practices that reduce or eliminate the problem should be encouraged. This clearly applies to the use of exclusive territories since they prevent the franchisees, at least partially<sup>433</sup>, from free-riding on each other's efforts. The argument also applies to resale price maintenance, specially to the imposition of minimum resale prices. By eliminating intrabrand price competition and guaranteeing a minimum mark-up to franchisees, the franchisor can promote intrabrand non-price competition and induce a higher provision of services on behalf of the franchisees<sup>434</sup>.

The Supreme Court of the United States summarised the argument to support its *Sylvania* decision that non-price vertical restrictions, in particular exclusive territories, should be evaluated under a rule of reason:

"Established manufacturers can use (vertical restrictions) to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free-rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did" one did" and the services than if none did" and the services that the servic

From the discussion above, one can see that these arguments could be used, with the very same words, to show that resale price maintenance also can be beneficial.

Free riding is not the only reason that franchises might use either price or non-price vertical restraints to reduce intrabrand competition. Vertical restraints could also be used to allow greater control of the supply of retail services or pricing. Either price or non-price restrictions could be used by a franchisor to reduce intrabrand competition, however, and either might improve efficiency, but also might raise profits at the expense of consumer surplus and total welfare.

Another argument involving the efficiency of supply is sometimes made against price restrictions. It is argued that resale price maintenance imposed by the manufacturer, or franchisor, necessarily will lead to inefficiencies because it will prevent differences in the retail costs of various distributors from being passed on as differences in retail prices. Retail prices that do not reflect differences in retail cost are a source of inefficiency, but there are several observations that can be made about this argument. First, it assumes that the franchisor imposes a uniform resale price. In principle the franchisor could recognise differences in retail costs and set different prices for franchisees with different levels of costs<sup>436</sup>. Second, the franchisor in general will want retail prices to vary when retail costs vary in order to

maximise profits. If retail costs do vary significantly, the franchisor will have an incentive to set different retail prices. If this is not possible, the franchisor will have a reason to use a vertical restraint other than resale price maintenance that does not force uniform retail prices with the resulting loss of such profits. Third, one may question to what extent retail costs will vary among franchisees in a business format franchise; the uniformity of the business format should go a long way toward reducing such variations.

Fourth, retail price maintenance could also cause inefficiencies by preventing retail prices from reflecting retail cost differences due not to differences in the costs of doing business efficiently at different locations, but to differences in the efficiency with which various retailers operate. Franchise systems, however, have a profit incentive to avoid using retail price maintenance provisions if they prevent the franchise's retail operations from being efficient; retail inefficiencies reduce the joint profitability of the franchise system as well as reducing economic efficiency. Rather than rely on price competition to enforce such efficiency, however, the franchise may choose to use other tools, such as direct control of franchisee operations and requiring the franchisee to use the standard business methods. Indeed, the uniform retail business methods that often form a large part of a franchise system may go far to establish the efficiency of its retail operations.

Finally while resale price maintenance will have some efficiency costs if it prevents retail prices from varying with retail costs, non-price vertical restraints can have analogous efficiency costs. Exclusive territories may be made larger than would be most efficient in order to reduce intrabrand competition; such an efficiency cost is likely to be greater if only passive territorial restrictions are allowed. Thus while this argument does identify a possible efficiency cost of vertical price restrictions, it is not clear either that the loss will be substantial, or that such considerations provide a basis for distinguishing between price and non-price vertical restrictions.

# Promotion of inter-brand competition

In arguing that non-price vertical restrictions may be beneficial, the Supreme Court in *Sylvania* also stressed their potential for promoting entry and increased inter-brand competition in the long run:

"Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers....

Vertical restrictions promote inter-brand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These "redeeming virtues" are implicit in every decision sustaining vertical restrictions under the rule of reason. Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers. For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the

kind of investment of capital and labor that is often required in the distribution of products unknown to the consumers"<sup>437</sup>.

The Supreme Court clearly recognises that vertical restrictions (location restrictions, in that particular case) may have negative effects on intrabrand competition, and yet advocates a rule of reason because of the possible "redeeming virtues" of these restrictions on inter-brand competition.

Economic analysis does support the proposition that non-price vertical restraints can encourage entry and promote inter-brand competition. Such procompetitive arguments partly rely on the fact that, by allowing greater efficiency to be achieved or even by merely facilitating rising profits in the short-run, franchise arrangements can attract more entrants, particularly when important investments need to be made to enter the market. The arguments, however, should not be limited to non-price vertical restrictions. Price restrictions also can promote entry and inter-brand competition by increasing the profitability, and perhaps also the efficiency, of the franchise.

## Restriction of inter-brand competition

The Supreme Court has recognised that non-price vertical restraints will have an effect on price, which comes close to acknowledging that price and non-price vertical restraints can have very similar economic effects. In *Monsanto v. Spray Rite*, the Court noted:

"It is precisely in cases in which the manufacturer attempts to further a particular marketing strategy by means of agreements on often costly non-price restrictions that it will have the most interest in the distributors' resale prices. The manufacturer often will want to ensure that its distributors earn sufficient profit to pay for programs such as hiring and training additional salesmen or demonstrating the technical features of the products, and will want to see that "free-riders" do not interfere" 438.

Because price and non-price vertical restraints both can have similar effects on price (albeit one directly and the other indirectly), distinguishing the two can be difficult. In *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988) the Court grappled with the difficulties of drawing a line between *per se* illegal price vertical restraints and non-price vertical restraints to be judged under the rule of reason, given that both affected retail prices:

"The District Court's rule on the scope of *per se* illegality for vertical restraints would threaten to dismantle the doctrine of *GTE Sylvania*. Any agreement between a manufacturer and a dealer to terminate another dealer who happens to have charged lower prices can be alleged to have been directed against the terminated dealer for 'price cutting.' In the vast majority of cases it will be extremely difficult to convince a jury that its motivation was to ensure adequate services, since price cutting and some measure of service cutting usually go hand in hand....Moreover, even vertical restraints that do not result in dealer termination, such as the initial granting of an

exclusive territory or the requirement that certain services be provided, can be attacked as designed to allow existing dealers to charge higher prices....We cannot avoid this difficulty by invalidating as illegal *per se* only those agreements imposing vertical restraints that contain the word 'price', or that affect the 'prices' charged by dealers....All vertical restraints, including the exclusive territory agreement held not to be *per se* illegal in *GTE Sylvania*, have the potential to allow dealers to increase "prices" and can be characterised as intended to achieve just that"<sup>439</sup>.

While the Court recognised that upstream producers using non-price restrictions will be concerned with retail prices, and non-price restrictions often will have the effect of increasing retail prices, the Court was anxious both to protect the doctrine of *GTE Sylvania* that non-price restrictions be judged under the rule of reason and to retain the rule of *per se* illegality for vertical price restrictions. Thus it was necessary to establish what was a vertical price restriction that was *per se* illegal, and what was a vertical non-price restriction (that perhaps affected prices) to be judged under the rule of reason. The *Monsanto* and *Sharp* decisions both addressed this question; the *per se* rule applies only if there is clear evidence of agreement between manufacturer and distributor which "tends to exclude the possibility of independent action" by the two (*Monsanto*), 440 and there is agreement about the price or price levels (*Sharp*), and not only an agreement (e.g. on a non-price restriction) that might affect price but did not establish that price. 441

In retaining the rule of *per se* illegality for vertical price restraints, the Court insisted there is a substantial distinction to be drawn. In *Business Electronics Corp.* v. *Sharp Electronics Corp.*, 485 U.S. 717 (1988), the Court reviewed *GTE Sylvania* and reiterated that price and non-price restraints should be distinguished:

"Our opinion in *GTE Sylvania* noted a significant distinction between vertical non-price and vertical price restraints. That is, there was support for the proposition that vertical price restraints reduce inter-brand price competition because they "facilitate cartelizing".... The authorities cited by the Court suggested how vertical price agreements might assist horizontal price fixing at the manufacturer level (by reducing the manufacturer's incentive to cheat on a cartel, since its retailers could not pass on lower prices to consumers) or might be used to organise cartels at the retailer level. Similar support for the cartel-facilitating effect of vertical non-price restraints was and remains lacking"<sup>442</sup>.

With this claim in mind, it is possible to review the analysis of Chapter II on the potential for price and non-price restraints to reduce market competition. The review will begin with possible effects on the ability of existing suppliers to collude.

Resale price maintenance or the fixing of minimum prices in a franchise agreement clearly may reduce competition and efficiency if the provisions serve merely to sustain a downstream cartel arrangement among franchisees (and perhaps other retail dealers) selling substitutable products or services that is designed to maintain high prices, limit output and divide markets. Two remarks are in order. First, such "fake" franchise agreements could also use the assignment of exclusive

territories to achieve similar negative effects. Second, such horizontal cartel agreements are more generally undesirable as such, and clearly deserve specific treatment.

The Court (in the passage quoted above) cites the argument that "vertical price agreements" can facilitate collusion by reducing the incentive of a franchisor to cheat on a cartel by lowering wholesale price<sup>443</sup>. This argument is made in the economics literature<sup>444</sup>. The argument, however, has not been formalised and still lacks convincing empirical evidence. The argument implicitly relies on the assumption that the franchisor can undertake not to modify the retail price set by the franchisee — that, for example, franchise contract terms make it impossible to renegotiate the retail price, or that retail prices are made more difficult or costly to renegotiate or reset than wholesale prices. If this were not the case, a franchisor could "cheat" on the cartel agreement, despite resale price maintenance, by modifying both the retail price and the wholesale price at the same time. Furthermore, even if one accepts the argument as given, resale price maintenance is not claimed to do more than facilitate collusion; collusion still could be effective and persist only under familiar, identifiable conditions, which include the existence of barriers to entry, high market concentration, and so forth.

The economic literature, however, also outlines ways in which vertical non-price restrictions may reduce interbrand competition between upstream producers. One possibility discussed in Chapter II is that franchisors in a concentrated market may be able to reduce the strength of competition by delegating retail pricing responsibility to franchisees while reducing intrabrand competition with territorial restrictions. By delegating retail pricing and reducing intrabrand competition, the franchisors reduce their incentives to lower wholesale prices because franchisees, in the absence of vigorous retail competition, will pass on only part of any reduction in the wholesale price.

Other arguments in the literature outline how vertical non-price restraints may limit market competition between brands by deterring otherwise efficient entry. Exclusive dealing provisions could raise entry barriers. Territorial restrictions might help deter entry by allowing retail franchisees with pricing freedom to make credible threats that they would respond to geographically limited entry with price wars. Provisions establishing resale price maintenance would not affect pricing behaviour incentives in the same way. If nonetheless franchisors used price restrictions to set low retail prices that forced exit of an efficient rival or prevented entry by efficient suppliers, competition policy rules could be enforced against the pricing itself (rather than against the pricing provisions).

In sum, it is hard to support the Supreme Court's claim that a clear distinction can be made in the danger to inter-brand competition posed by price and non-price competition. In particular, it is hard to support the Court's assertion that "similar support for the cartel-facilitating effect of vertical non-price restraints was and remains lacking"; there certainly does exist support in the analytical literature for the proposition that non-price vertical restraints also may restrict inter-brand competition.

# Per se illegality versus a rule of reason

This review does not argue for a sharp distinction in the legal treatment of price versus non-price restrictions based on their effect on economic efficiency. If the emphasis is placed on the possibility of undesirable effects, both should be *per se* unlawful. Both may be used to reduce market competition in some circumstances. If, on the contrary, attention is paid to the possibility of intrabrand efficiency-enhancing effects or of desirable long-run effects on inter-brand competition, then a rule of reason could be applied to both. Vertical price restrictions, as well as vertical non-price restrictions may promote economic efficiency, although neither necessarily will do so. However, a *per se* rule also could be chosen to reduce enforcement costs or to serve objectives other than economic efficiency as discussed later in this chapter.

# The difference between minimum and maximum prices

There does appear to be a difference in the economic impact of price floors or minimum resale prices, and the effects of price ceilings or maximum resale prices. Here, however, the contrast in economic effects sometimes is greater than the contrast in competition policy toward the two practices.

The effects on economic efficiency of price ceilings, on the one hand, and those of minimum resale price maintenance, on the other hand are quite different. Price ceilings can be used to eliminate double mark-up problems, which increases economic efficiency, while price floors cannot. Price ceilings cannot be used to limit intrabrand competition, while price floors can. Price ceilings are unlikely to facilitate collusion, while price floors might in some circumstances be used to sustain a cartel arrangement, at least at the retail level. The primary way in which they might reduce competition would be if franchisors set maximum prices at low levels to force the exit of efficient rivals or to prevent efficient entry; to deal with such cases competition policy could enforce rules against price ceilings being set at "predatory" levels, rather than against provisions allowing maximum prices to be set at all. Price ceilings also could reduce economic efficiency if, in the absence of strong competition from other brands and retailers, the franchise system used this tool to indirectly limit the level of retail services and the most profitable level of services was lower than the most efficient level.445 Of course, with a different pattern of consumer preferences for services, price floors may reduce economic efficiency in the same way; price floors may be used to encourage an increased supply of retail services which is profitable, but greater than what would be most efficient.

There is thus a considerable difference between the economic effects of imposing minimum and maximum prices. A number of countries, however, treat maximum price fixing schemes like any other kind of price restriction. In *United States v. Socony-Vacuum Oil Co.*, for example, the Supreme Court of the United States recalled that "under the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilising the price of

a commodity in interstate or foreign commerce is illegal *per se*"446. Other cases in which price ceilings were treated as *per se* illegal in the United States are *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.*<sup>447</sup>, *Albrecht v. Herald Co.*<sup>448</sup>, and *Arizona v. Maricopa County Medical Society*<sup>449</sup>.

The arguments given to sustain this position are sometimes dubious. Consider the decision of the U.S. Supreme Court in *Albrecht v. Herald Co.*, 390 U.S. 145 (1968). First, the Court points to the possibility that maximum prices may limit the supply of services:

"Maximum prices may be fixed too low for the dealer to furnish services essential to the value which goods have for the consumer or to furnish services and conveniences which consumers desire and for which they are willing to pay"450.

Maximum prices might be used to limit the supply of services, but the Court's argument is incomplete since it fails to explain why the upstream supplier (the franchisor in this case) would wish to limit the supply of services that "are essential to the value which goods have for the consumer ... and for which they are willing to pay". Limiting the supply of services for which consumers are willing to pay would not in general be profitable; it is profitable only when (a) the suppliers have some market power, and (b) consumers willing to pay the additional cost will purchase even if the additional services are not provided (although they suffer a loss of consumer surplus), while other consumers, who would not be willing to pay the cost of additional services will stop buying (or reduce their purchases) if the services are supplied.

The Court also supports finding maximum price agreements illegal by arguing that maximum prices may harm competition and increase prices in the market. In *Albrecht v. Herald Co.* the Court argues that:

"schemes to fix maximum prices, by substituting the perhaps erroneous judgement of a seller for the forces of the competitive market, may severely intrude upon the ability of buyers to compete and survive in that market" 451.

It is doubtful that a franchisor and his franchisees would agree on aprice fixing scheme, however, if it were to lead to such inefficiencies; both are interested in the franchisees being able to survive in the market-place. Also, in the same decision, the Supreme Court quite wrongly asserted that:

"if the actual price charged under a maximum price scheme is nearly always the maximum price, which is increasingly likely as the maximum price approaches the actual cost of a dealer, the scheme tends to acquire all the attributes of an arrangement fixing minimum prices" 452.

Although maximum price fixing schemes potentially can "fix" prices, the impact on efficiency is the opposite of that of minimum price fixing agreements (excepting the imposition of predatory prices). The situation the Court identified as that in which maximum prices are most likely to be the price set in the market — the situation in which the maximum price just covers the cost of the dealer — would be a situation in which the "agreed" price would be the same as the price set by dealers in a competitive retail market.

Some countries, however, have adopted a more permissive position towards the use of maximum prices. For example, Australia generally allows a supplier to stipulate maximum prices. In Canada, competition law only prohibits restrictions that prevent reductions in prices or influence prices upward. In the United Kingdom, the Resale Prices Act makes it unlawful for suppliers of goods to impose minimum resale prices on dealers, but does not prohibit the setting of maximum resale prices. In New Zealand, the showing that the benefits of a price restriction outweigh anticompetitive costs, which is required under the Commerce Amendment Act 1990 for authorisation, may prove easier for maximum than minimum price restrictions. Also, in a recent decision, USA Petroleum Co. v. Atlantic Richfield Co., the United States Court of Appeal for the Ninth Circuit recognised that: "Maximum and minimum price fixing may have different consequences in many situations"<sup>453</sup>. While the Supreme Court in this case reaffirmed the per se illegality of such agreements, it also asserted that "actions per se unlawful may nonetheless have some procompetitive effects"454 and found that the plaintiff, a competitor, did not have standing because he had not shown any antitrust injury.

## Suggested prices

Lastly, a *per se* rule against price restrictions may lead firms to find alternative, but related, ways to formally circumvent this rule, such as the use of strongly "suggested" or "recommended" prices. Moreover, it can lead unconvinced Courts or other antitrust authorities to "close their eyes" to such practices even in circumstances in which recommended prices do become the prevailing retail price, and thus have economic effects nearly indistinguishable from minimum price restrictions. In general it will be difficult to distinguish recommended prices from imposed price restrictions so that the resulting groups of practices have clearly different economic effects. Doing so would depend on difficult determinations of the extent to which recommended prices are followed, and in fact result in prices different from what they would be in the absence of the practice.

Some of these difficult problems are illustrated in the U.S. case, *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988). Business Electronics (BE in the following) and another retailer, Hartwell, were authorised by Sharp to sell its electronics calculators in a given area. In response to Hartwell's complaints about BE's prices, Sharp terminated BE's dealership. Although there was some non-negligible indirect evidence suggesting the existence of a "price conspiracy" between the respondent and the other retailer<sup>455</sup>, the United States Court of Appeal for the Fifth Circuit and later the Supreme Court refused to apply the *per se* rule because of the lack of agreement on specific prices or price levels, and argued in part that despite the recommended price and the apparent effort to enforce adherence, it could not be presumed that retail prices would be controlled as they would be by a direct agreement<sup>456</sup>.

Finally, recall that in some countries, such as France, suggested prices are acceptable on the grounds that such price recommendations can communicate

information to consumers and franchisees about the general price level of the product or services and its associated "image".

## Tie-ins

Like all other vertical restraints, tie-ins may be either harmful or beneficial, depending on context. This is reflected in the laws of the various countries, which generally apply a flexible rule of reason. The United States has been one exception, with tying arrangements being considered *per se* illegal. This is somewhat misleading, however, because a number of conditions must be satisfied before the *per se* rule is applied, and under the current standard these conditions involve considerable market analysis. We begin with the definition of a tying arrangement, then comment on the application of the rule of reason.

# The definition of the tying product

Since tying arrangements require two products, an important legal question, particularly in the United States, has been whether two products were involved in an agreement. This question became particularly important following several decisions, notably *Susser v. Carvel* and *Siegel v. Chicken Delight*, suggesting that the franchisor's brand or trade mark could be a separate tying product. That in turn potentially made any obligation to purchase a product or service from the franchisor a "tied" product. Under some decisions, the selling of an "XYZ" shoe might have been found to be a tying arrangement, since it required buying simultaneously the shoe and its "XYZ" trademark.

The United States courts struggled with this issue for some years. The Supreme Court's decision in *Jefferson Parish*, however, has provided a new test for separate products, the two-market test, that has been widely followed. A considerable virtue of the *Jefferson Parish* approach is that it focuses on tests involving the market consequences of agreements, rather than on drawing distinctions using criteria that may have no close relationship to market outcomes. This test does seem to prevent a finding of separate products and tying arrangements in many situations in which the alleged tie clearly could have no adverse affect on market competition. Under *Jefferson Parish* a product and its trademark could not be two products. On the other hand, the two-market test would seem to make it possible to find that a franchisor's tradename or brand was a product separate from a product or service that could be used by the franchisee without changing the basic nature of the product or service sold under the trademark, a circumstance in which it might be possible for a tying arrangement to reduce competition by raising entry barriers.

In the case of a business-format franchise, the "way-of-doing-business" can be identified as a distinct product. The Court of Appeal in *Principle v. McDonald's Corp.*, was correct to observe that "McDonald's offers its franchisees a complete method of doing business from the design of the menu board to the amount of catsup on the hamburgers". This "complete method" identifies a product that is both

demanded and offered: potential franchisees are interested in acquiring the rights to operate any of several "fast food" franchises, and there are a variety of suppliers including both some bigger competitors (Burger King, etc.) and a competitive fringe. This does not mean, however, that all "ingredients" should necessarily be considered intrinsic parts of the "product". Some products sold by a franchisee, such as soft drinks and hamburgers, may be in separate product markets; if so, requiring a franchisee, for example, to distribute only some specific brand of drinks — putting aside quality considerations — clearly looks like a tying arrangement.

Finally, it is interesting that the *Jefferson Parish* two-market test brings U.S. jurisprudence on tying closer to the position of the EC franchise block exemption regulation on the types of products that franchisees may be obligated to purchase from the franchisor. Under the EC regulation, an obligation is permissible that prevents the franchisee from buying elsewhere products or services that compete with those of the franchisor and are the subject-matter of the franchise<sup>457</sup>. Such a product or service and the franchisor's trademark would be unlikely to pass the two-market test. The EC block exemption is much more restrictive about requiring franchisees to buy other goods or services, which in some instances at least would also be more likely to be found separate from the franchise trademark under the two-market test.

# Evaluating the effects of a tying arrangement

One of the main arguments against tie-ins involves the possibility that the franchisor has "sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product" Tying can indeed leverage market power and be harmful when: (i) the franchisor has some market power in the market of the tying product; and (ii) the franchisor forecloses a non-negligible share of the market for the tied product thereby making entry more difficult.

The first condition on the franchisor's market power for the tying product has been interpreted in various ways, sometimes with a very loose standard. In the United States, a variety of standards were used to determine if there was sufficient economic power over the tying product; some decisions were willing to accept use of a brandname as sufficient evidence of economic power. These standards properly have been replaced, especially in Jefferson Parish, with standards based on the franchisor's market power in the market for the tying product, rather than on only the less well-defined concept of economic power. The threshold level of market power seems however to have been relatively high. In *Jefferson Parish*, for example, the Supreme Court considered that a 30 per cent market share was "insufficient as a basis to infer market power", even though it recognised at the same time that there existed "market imperfections" that allowed the hospital to charge non-competitive prices; it is immediately added in the decision of the Court that "while these factors may generate 'market power' in some abstract sense, they do not generate the kind of market power that justifies condemnation of tying" 459.

The second condition, which relates to the structure of the market for the tied product, is often missing in the application of the rule of reason to tie-ins. It is very significant, however, for the economic impact of a tying arrangement. Even if the franchisor succeeds in using a significant market power in one market to force his franchisees to buy other goods as well, this may have little impact on competition in the other markets if his franchisees represent only a negligible share of the customers of the other products. Chicken Delight's requirement to buy packing items, for example, may have had only negligible consequences on the competition in the packing industry. In the U.S., application of the per se rule against tying does require a showing that a "not insubstantial" amount of commerce is foreclosed in the market for the tied product. Courts, however, often have found the necessary showing satisfied by evidence on the total dollar amount of commerce foreclosed to competitors by the tie, rather than by evidence on the proportion of the market for the tied product or on the economic effect the tie has in the market for the tied product. Several circuits, however, have also required a showing that tying resulted in the actual foreclosure of competition in the market for the tied product, or that there was a substantial danger that the tie would allow the seller to acquire market power in the tied product market<sup>460</sup>.

In addition, tie-ins can have efficiency-enhancing effects. One way a tie can enhance efficiency is by preventing inefficient input substitution. This argument, however, does not seem to be much accepted in competition policy jurisprudence as a basis for allowing use of tying provisions.

In the United States, *Siegel v. Chicken Delight, Inc.* provides for another possible efficiency-enhancing use of tie-ins. Rather than requiring any franchise fee or royalties, Chicken Delight used the packing items needed in the franchised business operation as a "counting device" to recover a return proportional to the volume of sales. This counting device worked well for the franchisee: it was simple and avoided requiring franchisees to report sales accurately. The Court of Appeal, however, rejected this argument and, although Chicken Delight's franchisees represented a relatively small share of customers for similar packing, condemned the tying requirement; without franchise fees and royalties, the franchisor did not survive very long after the decision.

Other possible efficiency-enhancing uses of arrangements involve preservation of the franchisor's goodwill and quality reputation. There has been some willingness to consider such uses of ties in both the United States and the EC. In the U.S. in *Mozart v. Mercedes Benz*, a tying arrangement involving parts was found legal, largely on the grounds that it was justified by the benefits of quality control. The EC franchise block exemption allows franchisors to obligate franchisees to purchase from specified sources where necessary to protect the identity and reputation of the network (but only if quality standards cannot be specified).

Whether a tying agreement is in fact necessary to protect quality or otherwise enhance efficiency should be checked carefully in circumstances in which competition might be threatened. The distinction drawn by the Canadian Restrictive Trade Practices Commission between efficiency effects in the joint production of the tying and tied products, on the one hand, and quality arguments used to justify tying arrangements for inputs, on the other hand, seems particularly relevant. It should also be checked that alternative methods do not exist with similar efficiency-enhancing effects, if the market circumstances described above indicate a risk of harm to competition. The EC block exemption allows the designation of suppliers to protect quality only if it is "impracticable" to set objective quality specifications<sup>461</sup>. In another U.S. case, *Metrix v. Daimler Benz*, the same tying arrangement for parts considered in *Mozart* (but applied to a different distributor) was not allowed on the grounds that there were alternative methods available to ensure quality.

## Refusal to deal

In most cases would-be franchisees must meet certain skills or ability requirements, or must have a minimal financial strength for the success of the franchise. As long as these requirements can be precisely formulated and are clearly necessary, franchisors must certainly be allowed to refuse any candidate who would fail to meet these requirements — and franchisors are actually allowed to do so.

The case is less clear when relevant requirements cannot be made explicit or are based on features difficult to verify. It should be stressed, however, that the right to refuse a potential franchisee is a necessary counterpart to most of the other restrictions discussed above. Suppose for example that a franchisor decides to grant his franchisees exclusive territories. This is possible only if he can guarantee a franchisee that no other franchised outlet will appear in the given territory, which in turn implicitly requires the ability to refuse to deal with any potential franchisee in this territory.

It is difficult to define a relevant jurisprudence for refusals to deal independently from the positions adopted in favour of or against other types of restrictions. When a high initial fee is involved, however, a distinction could be drawn between a refusal to deal with a would-be franchisee and the unilateral termination of an existing franchise agreement. A similar distinction may be relevant when the franchise operation requires important specific investments on the franchisees' side.

## Non-competition provisions

Franchise contracts often include a provision preventing the franchisee from engaging in direct or indirect competition with the franchisor, either during the duration of the contract, or for some period after its termination, or both. When it applies to the period covered by the contract, such a restriction usually constitutes a corollary to other restrictions, such as territorial restraints or exclusive dealing arrangements, and must be judged along the same line as the restriction of which it is the counterpart.

On the other hand, limits on the franchisee's right to compete after the franchise agreement is terminated have their own justifications. The most convincing involves the protection of the franchisor's specific investment in the franchise business, particularly when the franchisor transfers some know-how and technical skills to his franchisees. Such post-termination restrictions, however, also may have non-negligible consequences for inter-brand competition and for the franchisor's rights — which in turn affects competition in the long-run. The beneficial effect of encouraging efficient investments therefore has to be appropriately weighed against possible *ex post* negative effects. Many countries have decided to allow such a post-termination restriction for a period of at most one year, which seems a reasonable compromise.

# The role of simple rules

To this point, the analysis has focused only on the extent to which competition policies match the legal treatment of vertical provisions in franchise agreements with their effect on economic efficiency — allowing provisions when they are likely to increase economic efficiency and prohibiting them when they are likely to reduce efficiency. The closer a policy comes to matching legal treatment of practices to their effect on efficiency, the lower the costs of lost efficiency it imposes on the economy by prohibiting practices that would have increased efficiency or allowing practices that reduce efficiency. (For want of a better short label, these will be referred to as costs of "wrong decisions" — recognising that such decisions would be "wrong" only by the standard of economic efficiency, and also that, as will become clear, even the most efficient rule is likely to impose some such costs.)

When the objective is economic efficiency, however, the design of competition policy rules should consider not only the costs of "wrong decisions" that will result from various rules, but also the costs of enforcing the rules. Enforcing a competition policy rule imposes costs of analysis and litigation on both competition policy authorities and businesses. In addition, when businesses cannot be certain in advance what practices will be ruled acceptable, this will alter their behaviour and impose costs; in other words, reduced legal predictability and certainty imposes costs.

Competition policy that follows the objective of economic efficiency should try to design policy rules that minimise the sum of enforcement costs and costs of "wrong decisions". This is easy if a simple rule with low enforcement costs also matches policy treatment to the effects of the practice on efficiency. This often will not be the case with the provisions in franchise agreements. Instead, the choice of a policy rule will have to consider a tradeoff between enforcement costs and costs of "wrong decisions". Enforcement costs generally will be higher when legal treatment depends on detailed case-by-case analysis of economic effects than when it depends on a simple rule — either a *per se* rule with no inquiry into the effect of a restraint or a simple contingent rule that treatment of a provision depends on simple indicators rather than on a complete analysis. The costs of "wrong decisions",

however, will be higher with the simple rule if it does a less good job of matching the legal treatment of practices to their effect on economic efficiency.

This balance of benefits and costs for *per se* or other simple rules may differ across jurisdictions. In particular the enforcement costs of following more general rules may depend on the underlying structure of competition law. This makes it harder to generalise across different jurisdictions on the tradeoffs involved in choosing a competition policy rule. The EC provides an example. Since the Court of Justice in *Pronuptia* found that provisions establishing exclusive territories infringed Article 85(1), any franchise agreement assigning exclusive territories requires an exemption under Article 85(3)<sup>462</sup>. Enforcement costs would be high for a policy of individual exemptions based on case-by-case analysis since formal, affirmative approval would be needed for all franchise agreements in the EC granting territorial exclusivity. These high enforcement costs make a simple rule, such as the block exemption, more attractive. The balance of costs and benefits of simple rules could be quite different in other jurisdictions where a policy of case-by-case analysis does not imply the necessity of formal examination and approval of all provision for exclusive territories.

This section reconsiders the analysis of competition policy towards vertical restraints in franchise agreements, taking into account enforcement costs as well as whether the rule matches legal treatment to economic effect. It first considers designing specific competition policy rules for franchise agreements, next reconsiders rules of *per se* illegality for resale price maintenance, and last discusses the use of simple contingent rules based on market structure. This analysis continues to assume that the underlying objective of competition policy is economic efficiency, although the objective is enlarged to include costs of enforcement. The concluding section of this chapter considers briefly how the choice of policy may be affected by objectives other than economic efficiency.

#### Specific rules for franchise agreements

Almost all countries have developed a competition jurisprudence for each particular type of provision found in franchise contracts. The issue is thus whether there is a need for a specific competition regulation, not for each separate provision, but for franchising considered as a distinctive way of conducting business.

The fact that a group of business relationships with a consistent set of characteristics may be identified — such as franchise agreements — does not by itself necessarily imply a need for competition policy regulations or rules designed to apply specifically to them. Competition policy could apply existing general legislation or rules based on the characteristics themselves. If enforcement costs were not increased by a policy of analysing each vertical arrangement's effect on economic efficiency, there would be little reason to design specific rules for groups of vertical arrangements. Policy treatment could rely on case-by-case analyses that considered any characteristics that might be used to define franchising or other categories of distribution arrangements.

Case-by-case analysis is costly, however, and therefore simple rules may lower enforcement costs, including simple rules designed specifically for franchise agreements. Simple rules designed with the characteristics of franchise agreements in mind may have lower costs of "wrong" decisions than rules with comparably low enforcement costs applied to a wider range of distribution arrangements. On the other hand, even if costs of "wrong decisions" are reduced, they are not necessarily eliminated. In addition, designing specific regulations for defined groups of agreements also has potential costs and disadvantages. Businesses' choices of distribution arrangements may be based not only on efficiency but on the competition policy treatment for which each category of distribution arrangement qualifies. The strict definitions of types of arrangements that are necessary may discourage business partners from innovating new relationships<sup>463</sup>. New relationships that do not fit any existing definitions may receive less favourable, or at any rate less certain, treatment under competition policy. Specific rules may proliferate to adapt to variations in vertical arrangements to the point where it is difficult to set specific rules for each arrangement that consistently apply the general rules and objectives that underlie competition policy. In sum, the decision to apply simple rules to a defined group of agreements still involves a comparison of benefits and costs with other rules, both those based on more general analysis and those applying simple rules to a wider range of agreements.

The European Economic Community provides an important example of specific competition regulations designed for different types of distribution agreements, including franchising, as an alternative to considering these agreements as part of case-by-case analyses. Several provisions receive different treatment in the franchise regulations than in regulations for other distribution arrangements, in part to allow protection of the know-how that is a defining characteristic of franchising in the EC.

The EC franchise Regulation, however, also illustrates the continued tradeoff between costs of "wrong decisions" and enforcement costs, even when simple rules are applied to agreements with shared characteristics. Before adoption of the franchise regulation, the European Commission exempted several individual franchise agreements after individual analysis. In each case — Pronuptia, Yves Rocher, Computerland, ServiceMaster, and Charles Jourdan — the Commission found that the franchise system faced considerable inter-brand competition and gave this as one reason for concluding that an exemption was justified under Article 85(3)<sup>464</sup>. The block exemption regulation also refers to inter-brand competition playing a rule in insuring that the conditions of Article 85(3) are satisfied<sup>465</sup>. Consistent with the approach of setting easily enforced rules, however, it does not condition the acceptability of any provision on a prior determination of the extent of inter-brand or market competition. Instead, the block exemption regulation specifies that the benefits of the block exemption may be withdrawn if inter-brand competition is restricted, but franchise agreements that qualify for the exemption do not have to be submitted to the Commission for review<sup>466</sup>. The lack of competition and consequent harm may, however, be brought to the Commission's attention by another firm. In some circumstances other firms might be harmed by the provisions and therefore likely to complain; a complaint is less likely in a market with structural conditions such that vertical provisions allow the exercise of greater market power by all incumbent firms in a market.

Many Member countries have not found it advisable to design specific regulations or policies for any defined group of franchise agreements. Whether for purposes of designing specific regulations or for applying more general regulations, however, it is useful to review how common characteristics of franchise agreements are relevant for competition policy. We do this first for franchising broadly defined, and then for the more limited set of agreements fitting the EC definition of franchising.

## Franchising in the broad sense

There is a broad consensus among Member countries and the EC that the extensive, licensed use of trade-marks is a defining characteristic of a franchise, although in many Member countries and the EC this alone is not sufficient to distinguish franchising from all other distribution arrangements. From an economic point of view, this use of trade-marks or brand-names is significant: most of the usual arguments that vertical restraints are efficiency-enhancing are valid mainly when the manufacturer's (or franchisor's) brand-name is involved. For example, the free-rider problem only exists when there is something on which to free-ride. Arguments that restraints are efficient because they allow the preservation of the franchisor's "image" or reputation will be valid only if there is an extensive use of the franchisor's name. Similarly, supporters of the view that restraints typically are efficiency-enhancing often base arguments on the importance of protecting the goodwill associated with the franchisor's name, which can only be important if the franchisor's name is used extensively. Potential benefits from franchise agreements and restrictions enhancing inter-brand competition in the long run also depend directly on the extensive use of brand-names. Such benefits will be realised only if franchising permits a new brand to enter a market.

Given this economic significance, it certainly seems reasonable to indicate how existing rules should be applied, or adapted where necessary, to distribution systems that meet these broad criteria, namely: a close relationship between two parties in which one party (the franchisee) makes abundant use of distinctive characteristics (such as trademarks, brand-names, and signs) of the other (the franchisor). Of course, many other characteristics and market conditions will play a role in determining the effects of provisions on economic efficiency.

## Franchising with the transfer of know-how

The issue of a specific rule is more complicated if franchising is understood in a narrower sense, i.e. if in addition it requires some transfer of know-how. On the one hand, the transfer of know-how is important for analysing the effects of vertical restraints on economic efficiency, as emphasized in Chapter II. On the other hand, one might take account of the significance of know-how by applying more general rules on intellectual property rights.

For example, the definition of know-how adopted by the European Commission in the block exemption regulation for franchising is almost identical to the definition they adopted in the block exemption for know-how licensing agreements<sup>467</sup>. Both definitions emphasize the notions of "secret", "substantial" and "identified". Likewise, some of the same United State jurisprudence discussed in this report, such as the *GTE Sylania*, *Monsanto v. Spray-Rite*, and *Jefferson Parish Hospital*, is relevant for the treatment of intellectual property rights and industrial licensing agreements in the U.S. <sup>468</sup>.

The *Maize Seed* decision of the European Court of Justice<sup>469</sup> provides an example of how general rules governing the protection of intellectual property rights could be applied in the franchise context. In that case, exclusive arrangements for the reproduction and the distribution of a new hybrid maize seed were challenged by the European Commission. The appellants, supported by the British and German Governments and by the French plant licensing authorities, argued that exclusivity was necessary to introduce the new seeds and thereby to promote competition between those and other seeds — an argument reminiscent of those employed to ease the development of franchise networks. The Court refused to distinguish breeders' rights from any other kind of intellectual property rights:

"Many products capable of forming the subject-matter of a trademark or a patent, in particular certain food or pharmaceutical products, are in a similar situation. Although the reasons put forward by the applicants are based on correct findings of fact, they are not sufficient to justify a special system for breeders' rights in relation to other industrial or commercial property rights" <sup>470</sup>.

The Court thus refused to develop a specific rule in this case, advocating general rules applicable both to industrial property rights and to commercial property rights.

There are reasons, however, why specific rules might be valuable for franchising where substantial know-how is transferred. The know-how transferred within a franchise often is more difficult to describe explicitly than the intellectual property to which general rules are usually applied. In the case of maize seeds, for example, one can describe with sufficient precision how to reproduce these seeds and their expected characteristics. Things may be much more complicated with a form of know-how which relates to a particular way of conducting a business. Such know-how is usually not communicated only via written documents which can be identified from the beginning, but rather through appropriate training, on-going technical assistance and the like.

Consequently, while the EC's solution for protecting the kind of intellectual property rights involved in the *Maize Seed* decision — set out in the 1984 patent licensing block exemption regulation<sup>471</sup> and the 1989 know-how block exemption regulations<sup>472</sup> — may well be appropriate for such rights, the same provisions may be less well-suited for the kind of knowledge and know-how involved in franchising. Moreover, the kind of relationship usually established by franchise agreements potentially enables the contracting parties to specify any of a variety of alternative ways of remunerating the franchisor's know-how — for example,

franchisees' contributions to advertising, paying royalties to the franchisor, or agreements to distribute franchisor's products other than those directly concerned by the franchise agreements. This is a much wider range of potential methods of remuneration than will be available in many patent or know-how licensing agreements outside of franchising. For both reasons, franchise contracts may deserve distinctive treatment.

At the same time, the difficulty of specifying the know-how may make the rule quite fragile. It is difficult to specify when to apply a rule that is appropriate when know-how has been transferred if we cannot precisely define what constitutes such know-how and when it has been transferred. For instance, in the *Charles Jourdan* case, the franchisor sold shoes not only through company-owned outlets as well as traditional independent retailers, but also through franchised retailers and through so-called "approved" retailers. The situation of the approved retailers was somewhat in-between the situation of franchised retailers and that of completely independent retailers. Approved dealers received a limited amount of information about fashion trends, whereas franchisees would also get advice on management, decoration, advertising, etc. Although the know-how involved in "approved dealership" arrangements seemed much more limited than in franchise agreements, some have argued that the block exemption for franchising should also apply to such arrangements.

The role of know-how in insuring use of a common business format within the franchise system also has implications. To the extent that franchisees use a common business format, there is likely to be less variation among them in services and quality they provide; indeed one economic function of franchising that can be of value to consumers may be this uniformity which allows the licensed brand name to convey information about quality. The common business format also usually means reduced variation among franchisees in retailing costs, both because of uniformity in retailing services and quality and because the common format often extends to the methods of doing business. Consequently, the uniformity of business format means less of a role for intrabrand competition among franchisees in giving consumers choices among different price-quality bundles and in having retail prices signal the costs and efficiency of different methods of retailing.

# Per se rules for price and non-price vertical restraints

This report has argued that each type of vertical restraint may either enhance or reduce efficiency depending on the market environment in which the franchise operates and the function of the provision in the context of the entire franchise agreement. This implies that an economic analysis of individual franchise agreements, sometimes a detailed analysis, would be necessary to determine the effect of provisions on efficiency. Conversely, it also implies that *per se* treatment of particular vertical restraints — either general acceptance or prohibition — either sometimes will prevent franchises from using the provision when it would enhance efficiency (in the case of per se illegality) or allow its use when it reduces efficiency (in the case of *per se* legality). These are important points, but they do

not establish that *per se* rules necessarily are inefficient. They do imply, first, that the case for *per se* rules being efficient must rest not on a claim that a vertical restraint always is efficient or inefficient, but on a tradeoff of sometimes prohibiting inefficient practices or allowing efficient practices in exchange for lower enforcement costs and greater legal security; and second, that *per se* rules should be measured both against a policy of general analysis and against other simple rules to determine which rules achieve the most efficient tradeoff of enforcement costs and policy results.

It is now possible to consider whether enforcement costs help explain the pattern of rules in many Member states whereby vertical price restraints are *per se* illegal, while allowing or prohibiting most non-price vertical restraints based on an analysis of their effects. This pattern of rules might be efficient because of some combination of higher enforcement costs for applying a rule of reason to vertical price and lower costs of "wrong decisions" for a *per se* rule for vertical price. The discussion turns to the factors that would affect these costs, although it is difficult to reach definitive conclusions about their magnitudes<sup>475</sup>.

## Difficulty of case-by-case analysis

Enforcement costs vary with the difficulty of the analysis, which affects the direct costs of the analysis, the uncertainty of the outcome, and the likelihood of errors. Enforcement costs also could vary with the difficulty of collecting relevant information. The economic analyses of price and non-price vertical restraints seem comparably complex, however; indeed often the analyses are very similar. It seems hard to say much more than that *per se* rules (of either illegality or legality) for both price and non-price vertical restraints offer benefits (increased legal certainty and security) for business and reduced costs (enforcement and litigation) for both competition policy authorities and business. It is difficult either to say that the savings from using a simple rule would be greater for one type of restraint than for the other, or to categorically reject the possibility.

## Availability of alternatives

The cost of "wrong decisions" imposed by a rule of *per se* illegality will be lower or higher as businesses have better or worse alternatives for improving efficiency when a *per se* rule prevents use of a practice that would increase efficiency. The analytical evidence again is mixed and empirical evidence largely lacking on whether franchises have better alternatives for prohibited vertical price restrictions than they would for prohibited non-price restrictions. Vertical price controls and territorial exclusivity are alternative tools to restrict intrabrand competition and free riding; if one but not both is prohibited the other is a possible alternative. Each has its advantages either because it is a more efficient tool for controlling free riding or because of other functions it serves. Prohibition of either therefore may have costs both for the franchise and for efficiency. Each has also inconveniences and undesirable effects. For example, resale price maintenance can

control both free riding and double mark-up problems, while exclusive territories would exacerbate double mark-up problems. On the other hand, exclusive territories also may do more than control free riding problems. An exclusive territory is a promise that the franchisor will not undercut the franchise's future revenues by signing up another nearby franchisee. Such a promise can help make the franchisee more willing to commit sunk investments and agree to pay higher franchise fees.

This use of exclusive territories to encourage franchisees to sink investments deserves particular attention since the European Commission stressed it in arguing that (limited) territorial exclusivity was indispensable for franchising. An absence of good alternatives for a valuable function, indispensability, would greatly increase the costs of a rule prohibiting limited territorial exclusivity.

Economic analysis confirms that exclusive territories may increase the willingness of franchisees to sink investments, but also raises doubt about whether such provisions are indispensable for the viability of franchise. Other provisions can address the problem; for example, structuring payments to the franchisor as a royalty rather than a franchisee fee is at least a partial alternative since it gives the franchisor a stake in the net revenues of existing franchisees. Even without specific provisions, such opportunistic behaviour will be limited by its effect on the recruitment of new franchisees and on the size of the franchise fees they will pay. These alternatives may be less satisfactory from the standpoint of either profitability or economic efficiency, however, and analysis does not tell us how good or inferior these alternatives will be in practice for how many franchises. Nor does empirical data settle the question, although in the United Kingdom at least many franchise agreements do not involve formal guarantees of exclusive territories, and therefore apparently find alternative solutions<sup>476</sup>. None of this denies that exclusive territories may promote efficiency by making franchisees more willing to sink investments. It suggests that their function is not qualitatively different from other functions of both non-price and price vertical restraints in franchise agreements that promote efficiency and should be considered in designing competition policy<sup>477</sup>. Finally, even if the value of this function helps establish that a rule of reason or of general acceptability is preferable to per se illegality for some territorial exclusivity, it leaves open the question of the best rule for vertical price restraints.

In Member countries in which vertical price controls are prohibited, but recommended prices are not, the latter may reduce the costs of the *per se* prohibition of strict vertical price restrictions. It is less clear whether on balance *per se* illegality of strict price controls is more attractive because the alternative of recommended prices is allowed. Recommended prices are a weaker form of vertical price control, and as such potentially can be used for either efficiency-enhancing or efficiency-reducing, anticompetitive purposes. Allowing recommended prices does reduce the costs imposed by a rule preventing use of strict retail price maintenance in circumstances where it would improve efficiency, but similarly reduces the benefits of the *per se* rule by allowing an alternative that sometimes may be nearly as effective for serving anticompetitive purposes.

### Evidence on efficient uses of vertical price restraints

A per se rule for vertical price restraints would impose lower costs of "wrong decisions" than would a per se rule for non-price vertical restraints if price restrictions were used less frequently (or less effectively) to improve efficiency (were they legal) than non-price vertical restraints. Economic analysis says vertical price restraints may be used for a variety of purposes and are capable of either increasing or decreasing efficiency. Economic analysis also identifies circumstances in which each result is most likely. The analysis, however, does not predict clearly how frequently franchises will need to (or wish to) adopt any tool to serve each type of purpose — be it avoiding free riding or trying to erect barriers to entry. Nor does analysis predict how often franchises would choose a price rather than a non-price restraint for each purpose when the two are alternative tools<sup>478</sup>. The analysis suggests no clear reason why franchises would not use price restraints to improve efficiency, but the extent remains in part an empirical question.

Studies of retail price controls provide some guidance, but they have limitations for our purposes. First, they generally do not focus on the use of retail price controls by franchises, and therefore cannot tell us specifically how franchises use price restraints or if they use them differently than other types of distribution arrangements. Second, the studies often do not provide enough information to discriminate between efficiency-enhancing and efficiency-reducing explanations for vertical price controls. To give one important example, many studies have looked at whether price restraints increase retail prices. Increases in retail prices, however, are consistent with the explanation either that the restraints prevent free riding and increase the supply of retail services valued by consumers, or that they encourage collusion. More detailed evidence beyond the simple effect on price is needed to discriminate between these hypotheses, but often is not provided by price studies<sup>479</sup>.

One valuable review and evaluation of empirical evidence on retail price maintenance is a study by Overstreet (1983). He examines both empirical studies from the general literature and data from Federal Trade Commission retail price maintenance cases between 1965 and 1982. He also unusually, reviews briefly some studies of price restraints in other countries. Many of his studies are particularly valuable because they look at retail price maintenance during a period before 1975 when it was broadly legal in much of the United States under state and federal fair trade laws.

Overstreet draws several conclusions from his empirical studies. First, price surveys find that resale price maintenance (RPM) usually increases retail prices, but these studies typically do not contain enough information to conclude either whether consumers benefited or lost, or whether overall economic efficiency was increased. Second, studies from the period when RPM was legal show it being used by small as well as large firms and in all types of market structures, suggesting many instances where it was unlikely that RPM was facilitating effective collusion. At the same time, RPM may have been facilitating effective collusion in some cases. Also consistent with the view that RPM served different purposes in different industries is a third finding that there was considerable variability in the proportion

of firms in an industry using RPM. Fourth, during the fair trade era RPM was used by many small firms temporarily, and their unilateral abandonment of RPM makes it doubtful that RPM was being used to support a dealer cartel. Fifth, while some case studies conclude that RPM has been used to reinforce collusion or hinder the development of more efficient distribution systems, these studies also report some procompetitive uses of RPM, and studies of other cases find that RPM was used to promote efficiency. Overstreet's general conclusion is that "the empirical evidence on the effects of RPM validates the implications of current economic theory. Theory suggests that RPM can have diverse effects, and the empirical evidence suggests that, in fact, RPM has been used in the U.S. and elsewhere in both socially desirable and undesirable ways" 480.

Not all analysts have reached the same conclusion. Some of the individual studies reviewed by Overstreet found that RPM was primarily used in ways that reduce competition or efficiency. A study of RPM in Germany carried out before RPM was prohibited in 1978 (and not reviewed by Overstreet) was critical of its efficiency effects and found that it strengthened manufacturer and retailer collusion<sup>481</sup>.

The empirical evidence thus is mixed. At a minimum, however, it seems fair to say that the weight of the evidence does not unambiguously suggests that vertical price restraints generally are used to reduce competition or harm consumers, and only rarely to promote efficiency. A stronger conclusion, supported by Overstreet's review, is that when RPM is legal, it often is used in circumstances where it seems unlikely to reduce competition. In either case, the available empirical evidence does not show clearly that vertical price restraints can be generally prohibited without preventing their use in a non-negligible number of cases in which they would enhance efficiency. Nor does the empirical evidence support making vertical price controls generally acceptable, since the evidence is that they are used in some cases to limit competition.

### A simple contingent rule

*Per se* rules and detailed case-by-case analysis are not the only rules available for competition policy. One intermediate alternative is a simple contingent rule that makes policy treatment depend on a simple indicator of a provision's likely economic effect rather than detailed analysis<sup>482</sup>. Such a rule will be attractive where criteria can be identified that allow easy, low-cost identification of cases where particular practices can be generally expected to be either efficient or inefficient. If such criteria can be found, both the enforcement costs of identifying these cases and the costs of making "wrong decisions" about them will be low.

The economic analysis of vertical restraints provides a nominee for such a simple contingent rule for policy towards franchise agreements. Neither price nor non-price vertical restraints are likely to be anticompetitive or reduce economic efficiency when the franchise system faces substantial upstream and downstream competition. A simple rule allowing franchises to use either price or non-price vertical restraints in situations where the franchise faces strong market competition

and collusion is unlikely to be successful should rarely allow practices that reduce economic efficiency.

At least some of the instances in which franchises face strong inter-brand competition should be identifiable by clear criteria, making the rule enforceable without high costs of analysis or litigation and without creating great uncertainty. Various indicators of competitive conditions in the relevant markets could be used; among the most promising are some fairly low critical value for the market shares of the franchise in upstream and downstream markets, a critical value for concentration in these markets, and evidence of dynamic market competition such as recent entry of the franchise in question, recent entry and growth of other upstream suppliers, retailers or franchises providing substitutable products, and substantial fluctuations in market shares.

This contingent rule could be implemented in ways depending on judgements about specific designs. Different choices of criteria could be made, depending on the desired simplicity of their application and the desire to extend the safe harbour created by the rule to a larger or smaller proportion of the cases in which vertical restraints would be likely to increase efficiency. That choice will depend on judgements about the effects of somewhat more complicated but inclusive criteria on enforcement costs and on the potential costs of "wrong decisions". These judgements in turn will be affected by the treatment of cases that fall outside this safe harbour. If a provision is always or usually prohibited when the safe harbour criteria are not met, the overall costs of "wrong decisions" may seem lower when more inclusive criteria are set for the safe harbour.

The more difficult cases that fall outside the safe harbour could be handled in various ways depending on the balancing of costs of enforcement and "wrong decisions". These cases are more difficult precisely because there is no clear presumption from economic analysis either that price and non-price vertical restraints will enhance efficiency or reduce it. The absence of strong market competition from other brands and retailers removes the presumption that efficiency will not be reduced. The contrary presumption that the provision always will be inefficient or anticompetitive is not justified because vertical restraints may enhance the efficiency of supply even by a monopolist. All such cases could be analysed, or enforcement practices could be concentrated on cases meeting a second, less strict set of criteria to identify other cases in which practices are efficient. Alternatively, rules of *per se* illegality, or of a rebuttable presumption of illegality, could be used in some set of less competitive market situations if reduced enforcement costs were judged to justify the costs of prohibiting restraints in the portion of these cases where they would be efficient.

In several instances such a rule does form part of competition policy in Member countries towards franchises. Rule of reason treatment of non-price vertical restraints often requires some showing of market power before a vertical restraint is prohibited. For example, policy in the U.S. toward non-price vertical restraints has moved in this direction as courts and competition policy authorities increasingly have looked to fairly well-defined guidelines and criteria marking off

minimum market structure conditions that must be exceeded before there is a risk that vertical non-price restraints would be harmful<sup>483</sup>.

Given the widespread prohibition of resale price maintenance, there are far fewer examples applying such a contingent rule to vertical price restraints. In the EC, however, there in effect is a safe harbour protecting agreements from being found by the Commission to infringe Article 85(1) that applies to vertical price provisions as well as other provisions. The Commission judges that agreements will not have an appreciable effect on market conditions, and therefore will not be found to fall within the scope of Article 85(1), when the market share of the firms involved does not exceed 5 per cent and their combined annual turnover does not exceed 200 million ECU<sup>484</sup>. (This position, however, binds only the Commission, and does not prevent Courts from finding that an agreement violates Article 85(1). In addition, while some small franchise may thus have a safe harbour against the Commission's taking action under EC competition law, resale price maintenance often is still not acceptable under the competition policy of individual EC member states.) The low market share criteria should identify cases where vertical restraints are unlikely to reduce efficiency. Franchises satisfying the market share criteria, but not the additional criterion of small absolute size, however, also could be granted wide freedom to use vertical restraints without threatening efficiency; the economic effects of vertical restraints depend more on size relative to the relevant market than on absolute size. There is a general problem, however, with designing criteria to identify cases where vertical restraints can be presumed to promote efficiency. At present, the same criteria determine whether all agreements, both vertical or horizontal, are subject to Article 85(1); the same criteria will not be appropriate for determining when horizontal and vertical agreements threaten competition.

# Other policy goals

Economic efficiency, the focus of this report, is not always the sole goal considered in forming competition policy<sup>485</sup>. There will not always be a conflict between policies that promote economic efficiency and policies that promote other goals, but when there is, setting policy involves a process of minimising the conflicts and balancing the conflicting objectives. This section briefly considers how goals other than economic efficiency may point to different policies. The discussion illustrates the kinds of issues involved in considering other objectives, but makes no attempt either to review all goals of competition policy in Member countries, or to cover adequately all implications for policy choices or all nuances of the goals discussed.

Two possible goals of competition policy — legal security and consumer surplus — can be thought of as related to economic efficiency, but can be considered separate goals. Each has been discussed already.

Legal security has been discussed as one component of enforcement costs. Whether legal security is thought of as a separate goal or an aspect of it economic efficiency, more or less weight can be given to in setting policy depending on what costs are thought to be imposed when competition policy rules make policy

treatment less predictable and certain. As lack of legal security is considered more costly and given more weight, competition policy can be expected to rely more on *per se* rules or other simple rules, even though they sometimes may prohibit practices that in themselves would increase efficiency or may allow practices that reduce efficiency.

The goal of consumer surplus is closely related to that of economic efficiency, since it is part of the total surplus whose maximisation is the goal of economic efficiency. There is no conflict between their goals so long as practices increase both. A conflict arises only when a practice is expected to increase producer surplus at the expense of consumer surplus, but on net increases the total surplus. In these cases, competition policy may place greater weight on consumer surplus because it disapproves of the redistribution of wealth involved or because of the difficulties of measuring the net effect when consumer and producer surplus move in opposite directions<sup>486</sup>.

Chapter II provides a basis for considering the effects of this goal since it analysed the effects of vertical restraints on consumer surplus as well as on total surplus. According to this analysis, any given vertical restraint may increase consumer surplus in some circumstances, and decrease it in others: the same qualitative conclusion is reached for the effect of vertical restraints on total surplus<sup>487</sup>. Vertical restraints that prevent double mark-ups will increase consumer surplus as well as producer profits and should be encouraged under either goal. Vertical restraints that reduce market competition and allow increased exercise of market power generally will reduce both consumer surplus and total surplus. Vertical restraints that overcome vertical or horizontal externalities that reduce the supply of product quality or retail services may or may not increase consumer surplus, and therefore may or may not increase total surplus (although the likelihood they will increase total surplus is greater than the likelihood they will increase consumer surplus). The goals of consumer surplus and total surplus also suggest somewhat different views of these vertical restraints that would allow the franchisor to earn a larger return on the intellectual property of know-how by capturing a greater portion of total surplus. In the short run, it is the nature of such practices to reduce consumer surplus and increase profits; total surplus may increase or decrease (although again any decrease will be smaller than the decrease in consumer surplus). In the long run, the net effect of such practices on total efficiency often will be positive because of the increased incentive for investing in productive intellectual property; the effect on consumer surplus also may be positive in the long run, but the effect is more complicated and less clear.

Thus an objective of consumer surplus rather than total surplus may lead to differences in the treatment of particular cases and in the balance of costs and benefits of policy rules. There is not, however, a sharp qualitative difference in the policies implied by the two objectives. If its objective is maximising consumer surplus, competition policy still must deal with the difficulty that individual provisions may either increase or decrease consumer surplus depending on market and other circumstances.

A stated objective of competition policy in the European Community is to assist in the breaking down of existing barriers between markets to create a common market and to prevent "divisions of markets resulting from restrictive business practices...."488. Establishing a common market is, of course, a fundamental objective of the Treaty of Rome. Furthermore, the objective of establishing a common market is embedded in Article 85(1) itself as the underlying purpose for prohibiting certain agreements; Article 85(1) begins by stating that the agreements to be specified "shall be prohibited as incompatible with the common market". The nature of the agreements to be prohibited under Article 85(1) suggests the close relationship between the objectives of establishing a common market and of insuring the process of competition: it is agreements "which have as their object or effect the prevention, restriction or distortion of competition within the common market" that are to be prohibited as "incompatible with the common market". The weight given the objective of establishing a common market also is clear in the enforcement of competition policy. In its "First Report on Competition Policy" in 1978 the European Commission pointed out that "(r)estrictions on competition and practices which jeopardise the unity of the Common Market are proceeded against with special vigour" by the Commission and the Court.

The relationship between the objectives of establishing a common market and of promoting economic efficiency will depend in part on interpretation. Certainly the goals need not be inconsistent; barriers between markets can reduce efficiency. Interpreted strictly, however, the goal of eliminating obstacles to trade within the common market can be a distinct goal. Provisions capable of being used to divide economically meaningful markets and reduce competition and efficiency, may in other cases be used in ways that do not harm efficiency<sup>489</sup>. The nearly per se prohibition by EC competition policy of strict vertical price controls and strict territorial exclusivity appears in both cases to be based at least in part on the goal of eliminating market divisions. Strict territorial exclusivity is prohibited because it could prevent parallel imports that would threaten market divisions. Similarly, strict vertical price controls could be used to establish different retail prices by different franchisees in different areas, although this is not a necessary consequence of vertical price controls. As we have seen, each provision may be used to reduce intrabrand competition, and in this sense to divide the markets or groups of customers served by a particular supplier. When those customers are served by other competing suppliers providing close substitutes and barriers or restrictions do not divide the market for these suppliers along the same lines, there need not be any reduction in competition or efficiency, or any effective division of the overall market.

Another goal considered by competition policy in some Member countries is that of economic independence for legally independent businesses. A somewhat similar goal is the prevention of one business's taking advantage of another economically dependent on it, as a retailer judged to be without alternatives might be considered dependent on a supplier. For example, competition policy in Germany and France appears to consider such goals as well as that of economic efficiency. To the extent that the legal right of the independent retailer to set his own prices is considered an essential component of his freedom, it follows directly

that strict control of retail prices by another, the franchisor, must be prohibited. The distinction between retail price control by the franchisor and recommended prices also seems clearer in terms of this goal of independence than of economic efficiency. As noted earlier it is difficult to draw a consistent distinction between the economic effects of recommended and controlled prices; the degree of price control effected by recommended prices may vary considerably, in some cases being nearly as great as with formal retail price maintenance. The goal of independence seems to focus more on economic effects than on the legal and contractual freedom of a retailer to set his prices, and in these terms there is a clear distinction between the recommended prices and retail price maintenance.

## Chapter VI

# **Conclusions**

This report has reviewed the application of competition policy to franchising, a relatively new form of distribution that has spread rapidly across the OECD in recent decades. Franchising offers increased possibilities for new entry and for the expansion of existing firms. Competition authorities should appreciate this potential of franchising for promoting competition as well as the risks that vertical restraints in franchise agreements may have anticompetitive effects. The spread of franchising, as well as substantial changes in competition law and policy and the development of better analytical tools in the area of vertical restraints, both call for and allow a thorough assessment of franchise agreements with a balanced assessment of both possible pro- and anticompetitive effects.

Franchising is not uniquely defined, and this is reflected in the present report. In some Member countries a producer-dealer agreement must involve not only a trademark or brandname, but also the transmission of know-how or technical skills to qualify as a franchise contract. Other Member countries include a wider range of relationships in the category of franchising. Many employ no specific definition in applying competition policy. The report primarily addresses competition policy issues that are specific to franchising as narrowly defined above, but also reaches more general issues relevant for analysing other vertical relationships. The report, however, does not cover exhaustively all producer-dealer relationships, such as exclusive or selective distribution, encompassed by broader definitions of franchising.

The report juxtaposes the existing treatment of franchising agreements under competition law with an economic analysis of the positive and negative effects of franchise agreements, leading to a critique of certain policy approaches. The economic analysis and critique are intended to be both general and forward-looking; they therefore do not take into account existing statutory restrictions and countervailing policy considerations. It must be stressed that some of the provisions discussed below, such as those aiming at the control of resale prices, are generally prohibited in several and sometimes in most Member countries. The analysis presented here thus serves as a framework for possible future policy developments.

The analysis of competition policy in this report focuses on how franchise contract provisions may promote or reduce efficiency and market competition. The underlying assumption is that promoting economic efficiency is an important objective of competition policy, and therefore that its implications will be important even if final policy decisions consider other objectives. Two additional remarks are in order:

- First, the report does not analyse in detail how policy choices might be affected by other possible objectives of competition policy: for example, social or distributive considerations, the elimination of the legacy of price controls, the preservation of economic independence for legally independent downstream firms (including the ability of those firms to set prices freely), the willingness to protect specific (e.g., traditional) forms of business, and the integration of the Common Market under the Treaty of Rome.
- Second, the measure of economic efficiency used is the sum of the surpluses of all economic agents: the sum of both consumer surplus and producer surplus (or producer profits). By this measure, redistributions from consumers to profits have no effect on economic efficiency so long as they do not affect the sum of the surpluses.<sup>490</sup> Competition policy may only consider or emphasize effects on consumer surplus, rather than on the sum of consumer and producer surplus; the report's analysis is also relevant in these cases since it generally considers the effect of provisions in franchise agreements on consumer surplus as well as on total surplus.

The report's review of existing laws and legal statutes for franchising reveals diverse attitudes towards this form of distribution. In some jurisdictions, there is established competition policy for each of the types of provisions found in franchise agreements, but the policy does not depend directly on whether the agreement in which the provision is included fits a defined category of franchise agreements (although the nature of the agreement may affect the analysis of the provision's effect and its acceptability). In other jurisdictions, specific regulations have been designed for franchise agreements as such, as for other forms of distribution. The law sometimes specifies "black" and "white" lists of provisions that generally are unacceptable or acceptable respectively, and it sometimes accounts for the structure of the markets in which franchisors and franchisees operate.

The approach taken by this report is driven by an economic assessment of the pro- and anticompetitive effects of franchise contracts. The analysis finds that these effects depend upon the structure of the markets and, often, cannot be related to a specific provision without considering other contract provisions. This analysis leads to three broad conclusions.

First, each type of provision found in franchise agreements may have pro- or anti-competitive economic effects, depending on its function within the package of provisions that forms the franchise contract, and depending on the constraining power of competition in the market. No provision can be presumed always to have either a negative or a positive effect on economic efficiency. Exclusive dealing, for example, promotes efficiency when it protects the franchisor's know-how but not when used to deter the entry of potential competitors; territorial restrictions can eliminate free-rider problems, but also may reduce market competition. The relevant context encompasses not only the degree of upstream and downstream competition, the maturity of the market, the existence of barriers to entry and the possible transmission of know-how, but also the informational environment and

risk-sharing issues. For example, territorial restrictions, by reducing intrabrand competition, give franchisees more freedom to determine their prices and thus enable the franchisor to delegate pricing decisions to the franchisees; this may be useful when the franchisees have better information about local demand conditions, but it also makes the franchisees bear more risk.

Second, the state of competition plays a crucial role in determining the economic effects of provisions in franchise agreements. This point itself has three related aspects:

Market structure must be taken into account when evaluating the impact of franchise agreements on competition. Many potential anticompetitive effects ascribed to franchise contracts are caused by pre-existing market imperfections: where competition from other brands and retailers is vigorous, the potential negative effects do not arise.

For example, franchise agreements can be used strategically to decrease upstream competition, but only if competition is initially highly imperfect, with a limited number of large producers serving an important share of the market; such a strategy would be ineffective when the franchisor is a fringe firm using a franchise system to enter a market or to better compete with large incumbent firms.

Similarly, franchise agreements may raise barriers to entry, but only when imperfections are already present, for example, when there is a scarcity of convenient outlet locations. Therefore, when there are no or minimal barriers to entry or to exit, or when the franchisor and the franchisees have no significant market power, the franchise contract is unlikely to have significant anticompetitive effects.

- Competition policy should focus more on the strength of competition between a franchise system and other upstream producers and retailers supplying closely substitutable products or services, rather than on intrabrand competition. The ability of market competition to prevent the exercise of market power is not necessarily weakened when an upstream producer prevents retail outlets he owns or controls from competing with each other. Likewise, when a franchisor and franchisee agree on some particular provisions, which may indeed decrease intrabrand competition between franchisees, one should ask whether this has a positive or a negative effect on market competition. By reducing intrabrand competition, the franchisor may, for example, eliminate free-rider problems and induce the franchisees to provide higher or better services to consumers; in such a case, reducing intrabrand competition may help the producer to better compete with his rivals, thus benefiting consumers.
- For an assessment of the market share and market power of a franchise, relevant product and geographic product markets should be defined using the same criteria as for other competition policy purposes. This is consistent with focusing on the strength of competition between

suppliers in markets, rather than only on intrabrand competition. Frequently the franchise system will face competition from other brands and other retailers supplying close substitutes, in which case an absence of competition between particular retailers — the franchisees — does not necessarily imply a lack of market competition. Of course it is crucial to determine whether and which other brands and retailers offer consumers closely substitutable alternatives. Market definitions also should not depend on the particular form of distribution or production supplying a product or service; the market may include not only the brands and franchisees of other competing franchise systems, but also products or services delivered by other distribution systems. For example, the franchisees of a given franchise distribution system may be competing with their franchisor's own outlets, with competing franchisors' franchised and directly-owned outlets, and with independent retail outlets distributing their and other franchisors' products as well as other manufacturers' goods, etc. In some cases, competitors may also include mail-order systems or other forms of direct sales from producers.

The third broad conclusion is that provisions in franchise contracts may have both static and dynamic effects on efficiency and competition, which may go in opposite directions. Even if a franchise contract might reduce competition among a static group of established suppliers, it nevertheless may increase competition over a longer period of time when dynamic effects on entry and new investment in know-how are considered. Expectations of higher profits due to franchise contracts increase incentives for entry and for investment in intellectual property. On the other hand, static anticompetitive effects may be quite long-lived if entry is delayed or blocked. Positive dynamic effects on competition are particularly likely to be important in the longer run when the franchise contract helps a producer to recover the benefits from an innovation, i.e. when some transfer of know-how is involved. In such cases, the possible initial decrease in intra- and inter-brand competition among existing supplies may be a necessary counterpart to ensuring adequate motivations for the research and the development of desirable innovations.<sup>491</sup>

These conclusions are based on an economic analysis of how provisions in franchise contracts can affect economic efficiency. The analysis focuses first on the functions of vertical restraints in franchise contracts and on how different types of provisions can serve these functions, rather than on the effects of individual provisions. These functions are grouped into two categories: vertical co-ordination and modifying inter-brand competition.

**Vertical co-ordination** of prices, services, quantities and qualities is not always easy to achieve. When for example a franchisee chooses the retail pricing for a product, he does not necessarily take into account the impact of his pricing decision on the franchisor's profits or reputation. Similarly, spillovers between the efforts provided by neighbouring franchisees may induce the franchisees to free-ride on each other, resulting in levels of effort or retail services that are too low from the franchisor's point of view.

Franchise contracts, by including provisions that give franchisors and franchisees better control of the relevant decisions, improve co-ordination and thus increase profits. Improved vertical co-ordination usually also benefits consumers because it tends to lower prices or to promote better levels of service. Undesirable effects on the level of service are difficult to detect directly since they rely upon conditions — on the information context, the consumers' willingness to pay for increased services, etc. — not readily observed, but those undesirable effects are unlikely unless the franchisor has some substantial market power.

Inter-brand competition also can be affected by franchise agreements. These effects can be grouped into effects on static competition among existing suppliers in the market — effects most likely to be negative — and dynamic effects on the possibilities for new entry and on incentives for new investment in know-how and product diversity — effects that may be either positive or negative.

- Negative effects on competition among existing suppliers are generated if the franchise agreement increases the risk of cartelisation, either among franchisors or among franchisees. Downstream cartels may, for example, set up sham franchise agreements to help sustain collusion. Competing franchisors may also design their franchise contracts in such a way as to strategically decrease upstream competition.
- Negative effects on dynamic competition are generated if the franchise agreement helps raise potential entry barriers. Long-term franchise contracts may enable franchisors to commit themselves or their franchisees to respond in a given way to the entry of a newcomer. For example, long-term buying contracts may prevent franchisees from dealing with potential rivals, which may effectively foreclose the market to future entrants if the number of possible outlets is restricted. Territorial restrictions, by dividing the market among franchisees, may permit a tougher response in the case of geographically limited entry.
- Finally, positive dynamic effects on inter-brand competition may be generated if franchisee agreements increase expected profits either by improving vertical co-ordination or by increasing the franchisor's ability to capture the returns to his innovations and investments in know-how in the form of profits; the increase in expected profits can encourage increased innovation and entry.

This review of functions provides the basis for understanding the impact of individual provisions on economic efficiency, which typically may be either positive or negative. In part this is because a franchise often has a choice among various provisions that would accomplish similar functions, and in part because the effect on consumer surplus and overall efficiency may depend on the extent to which competition from other brands and retailers constrains the franchise.

**Territorial restrictions**, which tend to divide more or less effectively the market between franchisees, and thus to reduce intrabrand competition, also may reduce market competition when used strategically by franchisors to lessen upstream competition.<sup>492</sup> This may occur, however, only if there is a small number

of large upstream firms or, more generally, if upstream competition is already weak. Territorial restrictions also may deter entry by increasing the intensity of price competition in the case of geographically limited entry; independent outlets with more flexible pricing decisions may indeed be willing to respond in a tougher way to the arrival of a new entrant.

But territorial restrictions also may reduce free-rider problems in the provision of, for example, advice to consumers. More generally, by reducing intrabrand competition, these restrictions can give franchisees more adequate incentives to provide desired levels of service, at least from a profit-maximising point of view; if moreover there is enough competition from other brands and retailers, either from competing franchises or from non-franchised rivals, franchisees will have incentives to provide the best possible bundle of prices and services. Providing the proper incentives for retail service may be particularly important for business format franchises, for which franchisees' efforts or services are a crucial element.

Finally, by limiting intrabrand competition and, accordingly, by increasing franchisees' expected profits, territorial restrictions can give would-be franchisees greater incentives to invest in specific skills and effectively enter a market.

Territorial restrictions can have these desirable effects only if they reduce intrabrand competition sufficiently. From this point of view, the most restrictive forms of territorial restrictions may be the most desirable: the stricter the restriction, the more intrabrand competition is reduced, increasing both the incentives to exert effort and the efficiency gains obtained.

Vertical price restrictions are often suspected of being anticompetitive as well as undesirable for limiting the freedom of franchisees to set prices. However, leaving aside policies aimed at protecting such freedom at the franchisee level, such price restrictions may generate the same benefits as territorial restraints, although unlike territorial restrictions they may not allow franchisors to reduce inter-brand competition.

One concern behind the prevailing prohibition on vertical price restraints may be their possible use by a dealer cartel to sustain collusion. This seems less of a risk in the context of franchising, and especially business format franchising, than with more loosely organised distribution arrangements. In the case of franchisees, price restrictions applied only to franchisees following relatively uniform methods of retailing are unlikely to block the development of new retailing methods and most likely will reduce intrabrand rather than inter-brand competition.

Arguments also have been made that resale price maintenance may make it easier to monitor and enforce upstream collusion. This possibility is of substantial concern in some Member countries where cartel conduct has been widespread in the recent past. Still, greater control by franchisors over retail prices does not necessarily increase the likelihood of such collusion. The inter-brand competition-reducing effects of territorial restrictions described above depend on delegating price decisions to franchisees, rather than limiting franchisees' freedom to set prices. In any case, firms are unlikely to be able to sustain collusion in

markets that are unconcentrated or easy to enter, even with any help price restrictions could give.

Like territorial restrictions, price restrictions may promote efficiency by improving vertical co-ordination between franchisor and franchisees. When both franchisor and franchisee have some pricing discretion, a price ceiling may be used to eliminate double mark-up problems<sup>493</sup>. Price restrictions also can be an alternative to territorial restrictions for encouraging franchisees to provide adequate efforts and services -- an alternative that does not generate double mark-up problems. Price restrictions also might be the preferred tool to control the supply of retail effort and service if only less strict territorial restrictions setting franchisee locations are feasible and a suboptimal number or location of franchisees would be necessary to have the desired effect on intrabrand competition. In any case, the better the alternatives available to consumers from other brands and retailers, the less likely that franchise control over services will increase profits but reduce consumer surplus.

As with territorial restrictions, price restraints can serve desirable functions most effectively when prices are well controlled. This supports sometimes permitting not only "suggested" or "recommended" prices, accepted by some competition authorities for their usefulness in communicating information to consumers and franchisees, but also true price restrictions. Also, it should be noted that one possible anticompetitive use of price control often cited — sustaining a dealer cartel — is in fact a type of horizontal agreement and in principle could still be controlled as such even if the *per se* ban on vertical price restrictions were lifted.

**Exclusive dealing** arrangements can have undesirable market foreclosure effects, and yet may help protect the franchisor's investment in know-how and technical skills, and may give franchisees the right incentives to provide effort and services.

Market foreclosure effects are potentially very harmful and therefore deserve special attention. They can appear, however, only if market rigidities exist — such as the lack of interesting outlet locations or of would-be franchisees, large credit market imperfections, etc. — which make pre-empting strategies successful.

Where the risk of them is great, exclusive dealing arrangements should only be allowed when necessary, that is, when other and less harmful instruments would not be effective. This suggests that exclusive dealing arrangements designed to give franchisees the right incentives to invest in effort and services should be disallowed when these incentives can be given via other provisions, such as territorial or price restrictions. But exclusive dealing arrangements should be looked at more favourably when know-how is involved, and particularly in the case of business format franchising. Also, a possible solution to the anticompetitive effects is the imposing of upper bounds on the duration of franchise contracts in light of the market imperfections set out above.

**Tying** arrangements also may be either harmful or beneficial, depending on context. Again, harmful effects are associated with the existence of some market power in the tying product market. They can only appear when the franchisor tries to exercise in other markets the market power he has in the market for the tied

product, or when the franchisor tries to entrench its position of power in the market for the tying product. On the other hand, tie-ins may be efficiency-enhancing when used to avoid free-riding on quality or inefficient input substitution or as an accounting device that implements a partial substitute for royalty payments by franchisees that saves on transactions and enforcement costs. As with exclusive dealing arrangements, the possible negative effects of tie-ins on inter-brand competition deserve particular attention and suggest that inquiries should be made about the existence of alternative ways to get the same efficiency benefits.

This analysis implies that treating a type of provision used in franchise contracts as acceptable or unacceptable in all circumstances will not always match its effect on economic efficiency. A rule that a provision is always acceptable sometimes will allow it to reduce market competition or economic efficiency. A rule that a provision is always prohibited sometimes will prevent its use where it would increase economic efficiency. To match treatment of provisions to their effects, each type would have to be treated differently depending on its likely economic effect in the particular circumstance. Where different provisions can be expected to have the same effect, they would have to receive the same treatment, although in other circumstances their effects and treatment would differ.

The effect of provisions on economic efficiency is not, however, the only issue. Other costs of enforcing different policy rules also are relevant. Policy based on more extensive analysis and more complicated rules may mean higher costs of litigation and enforcement, both for competition policy authorities and business, and greater uncertainty for businesses about the legality of various provisions.

The policy of uniform prohibition or acceptance of types of provisions illustrates the tradeoffs involved in balancing these two types of costs. A *per se* rule has low enforcement costs; relatively little analysis or litigation is needed and businesses will have considerable certainty about whether the practice is acceptable. At the same time, a *per se* rule will impose costs of lost efficiency when it prohibits efficient practices (for which firms do not have equally good alternatives) or allows inefficient practices. Judged only by the objective of economic efficiency, whether *per se* rules will be preferred to rules basing the treatment of provisions on some analysis of their effects depends on whether the saving in enforcement costs is greater than the loss in efficiency from uniform treatment of the provision.

*Per se* rules also illustrate the point that economic efficiency may not be the only objective of competition policy. If its other objectives are best served by the uniform prohibition or acceptance of a provision, competition policy must weigh this against the effect on economic efficiency to determine whether *per se* rules are optimal.

Returning to the focus of this report — economic efficiency — a competition policy in which treatment of a provision is contingent on its expected effect will be made more attractive if enforcement costs can be reduced, as where competition policy authorities prepare enforcement guidelines clarifying the criteria used to judge the effects of franchise contract provisions. Such guidelines can increase the

predictability of the results of reviews and make the review itself less costly and more consistent by specifying a uniform "flowchart" for the analysis.

These guidelines should concentrate on answering the following questions:

- 1. Are identifiable conditions present that make negative effects on market competition likely, and what are the negative effects? As discussed below, this stage of analysis can identify cases in which more analysis may be needed.
- 2. Do conditions indicate that the vertical restraints are likely to increase efficiency?
- 3. If there are risks of reduced market competition, are there other ways to achieve the same efficiencies without the same risks?

Guidelines also should cover the treatment of intellectual property when franchise systems involve know-how transfers and the transmission of technical skills or new ways of conducting business. There does not appear to be any reason to treat franchise agreements more restrictively than agreements involving protected intellectual property. Furthermore, the difficulties associated with know-how protection suggest more favourable treatment of those agreements that may reduce intra- or inter-brand competition in the short-run, at least for a limited period of time, when those agreements help protect returns to know-how on ways of conducting business. This may provide some basis for the establishment of speedy review procedures.

The consistent influence of market structure on the effects of vertical restraints provides a unifying basis for policy analysis and, most importantly, a way to control the enforcement costs of a policy that tailors treatment of provisions to their likely economic effect. The extent of analysis necessary to identify the economic effects of provisions varies with the level of market competition, and competition policy can take advantage of this to design a policy in which treatment is contingent on market structure. The report proposes distinguishing three market situations:

Franchisors with small market shares in unconcentrated upstream aand downstream markets and new franchisors or established franchisors attempting to enter a new market could be given great freedom in crafting their agreements. Here, none of the possible anticompetitive effects are likely to arise — all these potential undesirable effects depend on the franchisor's possessing market power in an appropriately defined market. Only efficiency-enhancing effects, corresponding to a better co-ordination between the franchisor and his franchisees, are likely to result from the use of vertical restraints by franchises that do not have market power. Moreover, giving more freedom to firms in such situations will give greater incentives to invest in new ways of doing business or other kinds of know-how, and will therefore have desirable pro-competitive effects in the long-run. These firms could be granted quasi-automatic permission to include vertical restraints, including price as well non-price restrictions. In jurisdictions requiring notifications, these franchises could benefit from speedy review procedures, mainly aimed at checking that pre-specified thresholds are met, if they cannot be exempted from any such procedures. Countries that do not use notification procedures could publicise the existence of such "safe harbours" from eventual enforcement actions. Since the franchise's maturity and market share are likely to evolve over time, however, the availability of a safe harbour might eventually disappear; such permission or exemption might have to be periodically reconfirmed.

b) Franchise systems that are non-negligible and well-established in their respective markets require more analysis to determine the effects of provisions. First, an inquiry would be needed to assess the competitiveness of the markets in which the franchise agreement takes place. This inquiry should evaluate the importance of possible barriers to entry or exit and look for other potential market rigidities, such as credit market imperfections, the scarcity of interesting outlet locations, etc.

If it appears from the structure of the market, particularly ease of entry and exit, that the franchisor is unlikely to have market power, as in the first case restraints should be efficiency enhancing, and both price and non-price restrictions could be allowed.

If there are significant entry barriers or other substantial market imperfections, so that the franchisor and possibly a limited number of other upstream firms or retailers can exercise significant market power, then a more extensive review would be needed. Further inquiries should make explicit the efficiency-enhancing effects, evaluate their significance, check they could not be obtained in other ways without the same potential negative impacts on competition and, lastly, determine whether significant transfers of know-how and technical skills are involved. Then the possible anticompetitive effects have to be traded-off against the efficiency-enhancing effects — provided they could not be achieved at less cost to market competition — and, if relevant, against higher incentives given to firms to invest in know-how and the like.

When the franchisor has a dominant position in his market, the risks of a strategic use of vertical restraints are clearly higher and before allowing them a review should scrutinise even more carefully the alleged efficiency-enhancing effects and look cautiously at the potential negative effects on inter-brand competition, particularly from a long-run perspective. For example, competition authorities may consider alternative means exist to get the same efficiency gains even if these involve higher costs from the franchisor's point of view; exclusive dealing and tying arrangements, provisions likely to impede inter-brand competition in the long-run, should be treated particularly

cautiously. The pre-eminence given to long-term competition suggest that vertical restraints are most likely to be beneficial when relationships involve important transfers of know-how; some other cases, involving for example large free-rider problems, may however also provide a justification.

A range of specific policies can be built on this framework while retaining the underlying principle that policy treatment be contingent on market conditions in general and on the strength of competitive forces in particular.

In the first market category, where franchise systems face substantial competition from other brands and retailers, there is a strong argument for establishing clear market structure criteria under which franchises qualify for a safe harbour within which both non-price and vertical price restraints may be included in franchise agreements. This policy would pose little risk for economic efficiency so long as the criteria were carefully set to insure competitive market conditions. Enforcement costs should be low because many instances where competition is substantial can be identified easily and predictably by simple structural measures. The market structure criteria bounding the safe harbour could be varied to be more or less inclusive and easily determined. The specific choice of market structure indicators and their critical values could be tailored to judgements in different jurisdictions about the effects of these choices on enforcement costs and on the risks of approving provisions that will reduce economic efficiency.

The tradeoffs between enforcement costs and matching policy to economic effect are more difficult for franchises in the remaining two market categories. Broadly speaking, as we proceed from the first to the second to the third category, more extensive analysis is needed to determine the economic effect of provisions, but the likelihood that a provision will reduce economic efficiency or market inter-brand competition rises. Still, vertical restraints can be efficient and competition policy should consider attempting to identify circumstances in which provisions are most and least likely to promote efficiency. The enforcement costs of such a rule of reason approach can be reduced by developing clear, even if more complicated, criteria, to determine likely economic effects. Where it is judged that enforcement costs are not worth their pay-off, there are a variety of alternatives. If the safe harbour criteria are relatively restrictive, secondary criteria might identify some cases for additional market structure analysis to determine if the franchise faces substantial competition so that vertical restriction would be generally acceptable. Where simple rules are to be substituted for more general analysis, rules of rebuttable presumption could be considered. A rebuttable presumption of illegality would allow the firms involved to argue for acceptance if they felt the rule imposed sufficiently high costs to justify attempting to overturn the presumption.

Clearly there is a wide range of possibilities, and no single set of detailed recommendations may be appropriate for all Member countries and jurisdictions. The report also recognises that objectives other than economic efficiency sometimes will be weighed in forming competition policy. While acknowledging these influences, the report makes three basic recommendations of increasing

specificity to guide competition policy towards franchising where economic efficiency is an important objective.

- First, competition policy should recognise the range of different purposes, some enhancing and some reducing efficiency, that may be served by vertical provisions in franchise agreements.
- Second, serious consideration should be given to establishing policies toward franchise agreements that make the acceptability of provisions contingent on indicators of market competition.
- Third, serious consideration should be given to developing market structure criteria for a safe harbour within which franchise agreements would be allowed to include both price and non-price vertical restraints.

# **Notes**

- 1. Retail franchising is thus distinguished from upstream licensing, e.g., the licensing of an industrial process.
- 2. Advocate General's opinion in Pronuptia v. Schillgalis, (1986) ECR 353 at para 2.1.
- 3. Reported in Mendelsohn (1985, p. 14).
- 4. Economic efficiency is defined and analysed in more detail in the next chapter.
- 5. The constitutional basis in the Treaty of Rome for this goal is discussed in Chapter III of the report.
- 6. A very similar approach was taken in the recent report: OECD (1989); see in particular p. 19.
- 7. In addition to retail distribution franchising, there also are industrial franchise agreements where the industrial franchisor licenses another undertaking, the franchisee, to manufacture products and assigns know-how and use of the brand-name to the franchisee. This type of franchising is regulated by the laws on patent and know-how licensing; see OECD (1989).
- 8. See a similar list of basic characteristics in Mendelsohn (1985, pp. 1-2).
- 9. On the difference between franchising and other distribution systems, see the Acts of the International Seminar on Exclusive Distribution held in Strasbourg in 1983 under the aegis of the French DGCCRF and the Commission of the European Communities, in *Revue de la concurrence et de la consommation*, *Supplément au No. 25*, technical note by the DGCC, "Eléments de réflexion sur la distribution sélective", July 1983.
- 10. The last obligation is known as exclusive dealing. In the countries where distinctions are made between exclusive and selective distribution, the definitions of these forms of distribution and whether exclusive dealing also is included varie. In the German and EC concepts, the difference between an exclusive distributor and a selective distributor is that the former is assigned an exclusive territory whereas the latter is not. In France, there are two differences: the exclusive distributor has an exclusive territory and, what is more, undertakes to sell no products other than those manufactured by the franchisor. Thus in France the emphasis on the trademark is stronger than in other countries. In the United Kingdom, assignment of an exclusive territory, even to an exclusive distributor, is quite rare.
- 11. EC competition policy for these seven forms of distribution is discussed further in Chapter III.
- 12. Commission Regulation No. 4087/88. This regulation is discussed in detail in Chapter III.
- 13. "Franchising in the Economy," US Department of Commerce, issued from 1975-1988.
- 14. Quoted in Mendelsohn (1985, pp. 5-6).

- 15. See the discussion in Chapter III for details.
- 16. It is important to keep in mind that EC regulations, and in particular the franchise block exemption regulation, are directly applicable and binding in all EC Member states. In addition, it should be realised that the EC regulation on franchising is grounded in the accumulated case-by-case experience of the European Commission and the Court of Justice in dealing with a range of various types of vertical arrangements and their effects.
- 17. For a recent discussion of the concept of economic efficiency in industrial organisation analysis, see Tirole (1988, pp. 6-12).
- 18. To give a simple example, increased price discrimination can increase total surplus and economic efficiency if it results in an increase in total output, even though consumer surplus is reduced and producer profits increased.
- 19. In some situations producers may spend amounts that otherwise would be profits in efforts to retain or increase net revenues without generating corresponding increases in consumer benefits; for example, firms might seek legal or political decisions that would help protect them from competition by other suppliers. Such a "rent-seeking behaviour" as it is called by economists converts profits that otherwise would be part of the total surplus into a cost; it therefore reduces the total surplus and represents a reduction of economic efficiency.
- 20. In principle, it would be possible to make all consumers better off by redistributing wealth after any change that increases economic efficiency, but of course in practice such redistributions may not occur.
- In France, for example, the competition authorities distinguish four types of franchises including arrangements where the franchisor (1) manufactures a product,
   (2) distributes products manufactured by others, (3) organises the provision of services or (4) provides a mixture of products and services.
- 22. The EC does see franchise distribution as involving an intermediate degree of vertical integration between the greater vertical integration of distribution by affiliate or agent, and the lesser vertical integration of, for example, systems of exclusive or selective distribution or of contracts between producers and independent distributors. See Chapter III for further discussion.
- 23. For more extensive reviews of the economic analysis of vertical relationships and restraints and for extensive references to the economic literature, see Tirole (1988, in Chapter 4); and Katz (1989).
- 24. More general analyses often assume that dealers, or franchisees in this context, act to maximise their utility. Utility depends both on profits and on nonpecuniary arguments such as effort expended. To simplify, the analysis here describes both franchisors and franchisees as being motivated only by profits.
- 25. Some analysts do not include provisions that specify pricing arrangements franchisee fees or royalties in the category of vertical restraints.
- 26. This classification and the section which follows build on the first part of Rey and Tirole (1986).
- 27. The amount of the fee due may be fixed or may depend on factors outside the control of the franchisee: for example, population within some specified distance of the franchisee's location. The fee may be a one-time charge or due periodically, e.g. annually. Of course if the franchise fee does depend on some such outside factor, the factor chosen must be objectively verifiable to minimise disputes.

- 28. The price per unit for the intermediate input could be set at zero, in which case the franchisee pays only the fixed franchisee fee. This might happen if the only intermediate input purchased from the franchisor were know-how and the franchisee paid only a fee whose amount was independent of any measure of the know-how transferred. In such case, other provisions likely would in some way specify the amount of assistance the franchisor was obligated to provide.
- 29. If the franchisor proposes progressive rebates (i.e., the average price per unit decreases with the quantity bought) then as with franchise fees, one of the franchisees could buy the whole quantity in order to resell it to the other franchisees. In this case, only the price associated with the total quantity matters. Suppose now that the average price increases with the quantity bought, and that there are two distributors, a "big" one and a "small" one. In the absence of arbitrage, the small one enjoys a lower (average) price. If arbitrage is possible, however, the small distributor can buy more than what he needs (thus paying an average price which is somewhere between the two initial average prices), in order to resell his excess quantity to the big distributor. The best attitude for the distributors is to buy exactly the same quantity and then to trade at some internal and intermediate price. The franchisor would then be better off using this unique intermediate price.
- 30. A possible way to trace consumers is to use warranty cards or discount coupons that must be sent back to the manufacturer with the customer's address written in.
- 31. A franchisee could for instance make use of "forced" advertising spillovers to attract "innocently" the rival's consumers into his own territory.
- 32. Williamson (1985, pp. 181-182) points out that where the profits of the franchise system are reduced by lack of co-ordinated behaviour, one can imagine a scenario in which the franchisees "hire" the franchisor to impose more co-ordinated behaviour on all franchisees because doing so increases profits.
- 33. Of course actual bargaining outcomes will depend on the relative strengths of bargaining positions. Bargaining positions will be affected by the alternatives available to each party; for example, for the franchisor how good is the alternative of owned retail outlets, and for the potential franchisee are there competing franchise systems or how good is the alternative of retailing outside a franchise system? Also in practice franchisors often use standard contract forms, at least as a starting point for negotiations in part for reasons of bargaining strategy. Such bargaining issues are important for determining actual contract terms and the division of net revenues, but do not change the point that the use of vertical restraints or controls can be understood without assuming any coercion.
- 34. Use of a tie for either purpose will work much better if the input has to be used in fixed proportions. For example, a tie-in requiring use of packaging materials supplied by the franchisor might be used to monitor sales.
- 35. This externality was identified and analysed by Spengler (1950).
- 36. In the economic literature this is often referred to as a problem of "double marginalisation" (double mark-up).
- 37. Leaving aside complications introduced by uncertainty and risk, the franchisor generally collects only net revenues in excess of the amount necessary for the franchisee to earn a normal return on his investments.
- 38. The profit-maximising retail price will vary with shifts in demand and will pass through only part of changes in retail costs. The franchisor would have to vary the

- wholesale price to induce the retail price to respond to demand and changes in a way that maximised aggregate profit.
- 39. In theory, the fee could be made contingent on future market conditions (outside the control of the franchisee) that determine future profits. In practice, it is very difficult to write or enforce such a provision.
- 40. See Katz (1989, pp. 667-670).
- 41. Territorial restrictions could allow price discrimination either because the restrictions divide customers along the lines of the desired price discrimination so that the discrimination is implemented by different retail prices set by different franchisees, or because individual franchisees choose to discriminate among the customers they serve.
- 42. See for example the discussions in Mathewson and Winter (1984) and Tirole (1988, chapter 4).
- 43. The consumers' surplus relates to the average quantity bought (or the "average consumer's utility"), whereas consumer's demand relates to the marginal quantity bought (i.e. the utility of the "marginal consumer" who, at the margin, is indifferent between buying or not); see for instance Spence (1975), and Sheshinski (1976).
- 44. In some cases it will not be appropriate to consider by itself the impact on social welfare of a more co-ordinated choice of retail services. Essentially the same vertical externality affects both the choice of retail services and the choice of retail price. Some provisions, notably those that make franchisees residual claimants of marginal profit, simultaneously reduce the double mark-up of retail price and allow the vertical franchise structure better control of retail services. The question then arises, what is the net impact on social welfare of both changes? Eliminating the double mark-up pushes down retail price, so the overall effect may be both a lower retail price and increased retail services. If so, consumers clearly benefit and efficiency is improved. Even if on balance retail prices rise, eliminating the double mark-up moderates the increase and makes it more likely that the net effect on welfare is positive. The net effect of vertical controls that improve the franchisor's control of retail services, may depend on whether the same contract provisions also reduce the vertical externality that affects the choice of retail price.
- 45. Remember that this discussion of the vertical externality assumes there are no horizontal externalities between retailers; by assumption consumers cannot consume retail services supplied by one retailer and purchase the product from another. For detailed analyses of the vertical externality discussed here see Comanor(1985), and Caillaud and Rey (1986).
- 46. This incentive is very similar to the incentive that might lead franchisors and franchisees to suppress intrabrand competition in order to allow price discrimination that increases profits but is inconsistent with retail competition.
- 47. On the other hand if retail price increases with the increased control, consumer surplus will fall and the total surplus (consumer surplus plus profit) may fall.
- 48. Initially emphasised by Telser (1960), this problem has been more recently analysed by, among others, Mathewson and Winter (1982 and 1985).
- 49. This assumes that the advertising message applies at least in part to general characteristics of the product, rather than applying only to the individual retailer.
- 50. Suppose for instance that two franchisees distribute the franchisor's good in two distinct parts of a city, and that advertising can only be made through a local

- newspaper covering the whole city: a retailer will then receive only half of the benefits associated with his advertising expenses, and benefit from the other franchisee's effort. Each of them will invest less than what would be efficient, and partly rely on the other's effort.
- 51. Even if free riding limits supply of service by retailers, welfare losses will be reduced to the extent a substitute service is provided by a supplier other than the retailer. Customers may have alternative sources of information, such as consumer information or speciality magazines.
- 52. This reputation effect is discussed by Mathewson and Winter (1986) and Katz (1989).
- 53. A variation on this condition would be that consumers find it so difficult to distinguish between quality due to franchisor effort and that due to franchisee effort that they are slow to associate low quality with a particular franchisee. Katz (1989) notes that either consumers must spread their purchases among more than one retailer, or customers of one retailer must be influenced by the experiences of those who buy from other retailers.
- 54. See for instance Klein and Saft (1985).
- 55. Another type of horizontal externality cited in the literature, quality certification, is unlikely to apply to business format franchising. The idea is that certain dealers establish a reputation for carrying only quality items. The effort necessary to gain such a reputation, however, is costly. Other dealers, who do not make this effort, may benefit from the certification of quality, and if they are allowed to sell the same product at a lower price, the supply of certification services may be undercut. Where franchising imposes a common business format, it is hard to see how some franchisees might be able to free ride on certification services provided by other franchisees.
- 56. Klein and Murphy (1988) argue that it frequently will be efficient to use direct controls together with either resale price maintenance or exclusive territories to provide the franchisee with a rent stream. That in turn makes the direct quality controls enforceable, because the franchisee loses these profits if he violates the contract and fails to provide the specified level of quality. It is doubtful, however, that RPM or exclusive territories would be needed in many business format franchises for this purpose. Such franchisees are likely to make relationship-specific investments that are sunk. Returns on these investments, which need not be more than a competitive return in the long run, could constitute a sufficient stream of rents to make a contract enforceable. Williamson (1985, p. 181) points out that franchisors indeed may require franchisees to make relationship-specific investments, so that the returns on those investments become "hostages" that would be forfeited if the franchise relationship is terminated because the franchisee fails to live up to his obligations under the contract.
- 57. This possibility is stressed by Klein and Murphy (1988); also see Katz (1989, p. 684).
- 58. A free riding argument has for instance been used for the beer industry, the service consisting in ensuring the distribution of only fresh beer. By this argument, the guarantee of beer freshness is a public good on which retailers can free ride. In this case, however, the service could become appropriable by indicating the date of manufacture on the labels; consumers could then choose to buy from retailers distributing only fresh beer.

- 59. Absent repeated contracting with franchisees (so that there are no reputation effects), the franchisor sells his technology for a fixed franchise fee and prices other inputs at marginal cost, his profit does not depend on the level of sales (at least if his marginal cost is approximately constant); he could thus sell the technology at a high price, promising some level of sales, and then make no effort to guarantee this level of sales. If there were multiple franchisees, then the franchisor's franchise fees will depend on his reputation for expending effort. Hence, the franchisor would have incentives to make the efforts.
- 60. The problem may be somewhat reduced to the extent that franchisors earn returns on investments in quality or promotional effort in the form of profits from additional franchisees who sign up in the future, or from renewed franchise agreements.
- 61. It is possible to make both parties residual claimants through the use of a third party (such as an intermediate distributor, for instance), as illustrated by Holmstrom (1982). Such an incentive device is however subject to collusion (i.e., the franchisor and the franchisees could collude in order to free ride at the expense of the mediator).
- See section above on the choice of retail pricing and section below on allocation of risk.
- 63. Another restraint also would be needed to deal with the reduced incentive to supply promotional effort or quality since the franchisee would not be a residual claimant on marginal profit.
- 64. A tie or royalty may be a particularly valuable restraint when there is considerable retail competition. If there is perfect competition at the retail level, the franchisor will be unable to use a franchise fee to extract profits. Perfect competition forces retailers to price at marginal cost. With perfect competition at the retail level and no possibility of input substitution, the franchisor could extract all profits by a mark-up of his wholesale price. This will not be true if input substitution is possible. And since a franchise fee is unavailable, the franchisor may need to use ties or a royalty.
- 65. A further complication is the question of whether any distortions other than the input distortions are solved at the same time. If there is market power at the retail level as well as the franchisor level, there will be a double mark-up problem as well as an input efficiency, absent any vertical restraints or integration. Welfare is more likely to increase if the vertical restraint or package of vertical restraints solves both problems (e.g. by a tie alone); See Waterson (1982, pp. 129-144) and other references and discussions in Perry (1989, esp. pp. 191-192).
- 66. Franchisees are not made better off by the larger proportion of net revenue they may obtain since this only offsets the utility they lose by having to bear the additional risk.
- 67. Other vertical restraints also allocate risk to franchisees. With resale price maintenance, the franchisee will be insured against demand fluctuations but will bear the whole risk of changes in retail costs. With quantity fixing, the franchisee again bears the whole risk from both cost and demand fluctuations (since he can sell the same quantity at a higher price when demand is higher). In all cases, if the retailer is risk averse, the optimal franchise contract involves a tradeoff of insurance and efficiency motives. See Rey and Tirole (1986).
- 68. Williamson (1985) and (1989) have extensive discussions of the general implications of relationship-specific investments.
- 69. The problem is exacerbated for the franchisor if other manufacturers can benefit from the franchisor's promotional effort and brand image. Franchisees then might

use the franchisor's name to attract customers and then divert them to competitive brands, which can be priced lower to the extent that these competing goods can avoid incurring the same promotional expenses. See Marvel (1982), for more on this. In France, a case opposed the Carrefour retail chain and Rossignol, the ski manufacturer. Carrefour was accused of using Rossignol's brand name to falsely attract consumers. (Substantial rebates were announced on Rossignol skis, but only a few of them were available, so that consumers, once they had gone to the Carrefour store, had to leave or choose another brand.)

- 70. Even long-term contracting may not be sufficient to induce efficient levels of investments, particularly if it is difficult or prohibitively costly to specify all possible relevant contingencies. For an analysis of incentives to under-invest in the absence of complete long-term contracts, see for instance Grout (1984), Rogerson (1984), Hart and Moore (1988), and Aghion, Dewatripont and Rey (1989).
- 71. Williamson (1984, p. 155) has pointed out this organisation continuum: "...unified governance (firms) and autonomous contracting (discrete markets) are only two possibilities, indeed polar extremes, on a governance spectrum that includes joint ventures, franchising, and a variety of complex contracting forms".
- 72. As pointed out above, and discussed in Chapter III, EC competition policy does view franchising as a form of distribution involving an intermediate degree of vertical integration between franchisor and retail franchisee.
- 73. When territorial restrictions in its contracts with wholesale distributors were found illegal in 1967 in a prominent case in the United States, Arnold, Schwinn & Co. terminated the contracts and formed a vertically integrated wholesaling subsidiary. Scherer and Ross (1990, p. 563).
- 74. If the credit available to the firm were rationed and not simply more costly, as perhaps might happen during times of tight money, then access to the accumulated capital of potential franchisees would be particularly valuable.
- 75. Williamson (1985, esp. Chap. 4 6) has an extensive discussion of these issues.
- 76. There are a number of possible explanations for this. One involves another aspect of capital market imperfections: it is usually easier for an existing firm to raise funds than it is for a private individual. (Even if the individual has access to a capital market, he may face higher interest rates than a firm.) Second, the impossibility for a firm to enter into materially binding long-term contracts with an employee makes it difficult for an internal compensation scheme to duplicate the incentives associated with running his own business. Third, employment laws may make it impossible to write employment contracts that could leave employees with the negative net wages that might be earned if the outlet did badly. For further discussion see Williamson (1985, Chapter 6).
- 77. See for instance Mathewson and Winter (1985).
- 78. The importance of reputation will also depend on the nature of the product sold. Reputation should be particularly important where it is difficult or costly for consumers to confirm quality prior to purchase.
- 79. While intrabrand competition is not a necessary condition for retail competition, that does not mean that intrabrand competition may not contribute to retail competition and efficiency. First, in the absence of competing retailers carrying other brands or of other competing brands, retail competition may not be robust without intrabrand competition. Second, as suggested earlier, franchise systems sometimes may use a

- degree of intrabrand competition as one tool of vertical control to discipline franchise behaviour.
- 80. In an example of this use of the term, see Steiner (1991).
- 81. As is well known, there can be conflict between the short-run objective of maximising the allocative and productive efficiency of the use of existing intellectual property and the long-run benefits of ensuring a private return to investments in intellectual property that ensures future supply. See, for example, chapter 2 of the OECD report on Competition Policy and Intellectual Property Rights (1989). Franchise contracts may in fact reduce this conflict. As we have seen, it often will be desirable to use two-part tariffs so that intermediate inputs supplied by the franchisor can be priced closer to marginal cost. Franchisors will have an incentive to set low prices for the know-how they transfer in order to avoid inefficiently discouraging the use of this know-how by franchisees. This will encourage the efficient spreading of information, at least within the franchise structure.
- 82. Surely such investment is efficient overall and should be encouraged. Nonetheless a completely unequivocal conclusion is inconsistent with the literature that shows that under either monopoly or monopolistic competition it is possible that there can be an incentive to provide too much (or too little) product variety. See the discussion and references in Katz (1989).
- 83. Whether retail prices in fact are more easily observable than wholesale price, and thus the extent to which resale price maintenance would reduce the costs of monitoring price agreements, may be disputed and may differ depending on the nature of the product or service being sold. Effective retail prices may vary because of secret cuts in retail prices that are sanctioned by the franchisor, or perhaps more importantly because of changes in the quality of the service or product that is sold at the nominally fixed retail price. Such non-price competition also can defeat collusion.
- 84. See Telser (1960) and Posner (1977).
- 85. The exposition here builds on Rey and Stiglitz (1988). See also Bonanno and Vickers (1988), and Gal-Or (1987).
- 86. In the extreme case where retailers are perfectly competitive, a retail price is equal to the wholesale price plus the marginal retail costs; if retail costs are constant, then retail prices for a product thus completely respond to the corresponding wholesale price and not at all to the wholesale prices of competing products, so that none of the described effects appear.
- 87. The collusion would not succeed if it could be eroded by the expanded sales of products outside the agreement, including the products of new entrants.
- 88. Situations involving a mixture of downstream and upstream collusion also can be imagined; for example, the colluding parties might be downstream retailers for a limited number of non-franchised brands plus the upstream franchisor. Analysis of whether resale price maintenance could facilitate such mixed collusion would involve considering the effects of resale price maintenance on both the upstream and downstream aspects of such collusion.
- 89. See for instance Aghion and Bolton (1987).
- 90. This situation may be relatively uncommon with business format franchises.
- 91. The strategies described in this and the previous paragraph fall into the general category of strategies by which one firm raises rivals' costs by purchasing some sort

- of exclusivity rights (here exclusive rights to particular retail locations or to particular retailers). Krattenmaker and Salop (1986) discuss generally the circumstances under which such strategies will allow an increased exercise of market power.
- 92. For different approaches to the analysis of exclusive dealing see Waterson (1990) which focuses on exclusive dealing and Krattenmaker and Salop (1986) which analyses exclusionary practices more generally. Some of Waterson's results can be adapted to the franchise case, but Waterson's model does not fit franchising in all respects; for example, the number of retailers is determined endogenously rather than controlled by the upstream manufacturer, and does not include any effects on returns to investment in know-how. Waterson also points out another way in which exclusive dealing might promote efficiency and competition: if retailers have some control of price, they may exercise more market power when they sell multiple rival products (and therefore consider the effect of a change in the price of one product on the demand for others they sell) than if they only retail a single product.
- 93. Even if the same provision is adopted by many or all of the franchises in a relatively unconcentrated market, there is little threat of collusion being facilitated. Vertical provisions, such as resale price maintenance or territorial exclusivity, may perhaps facilitate collusion, but do not in and of themselves constitute collusion or insure its effectiveness. Even if each franchisor controls the retail prices of its own franchisee, effective collusion still requires that they agree or collude on that price. Even with resale price maintenance such collusion will remain difficult to maintain in a structurally competitive market, just as it is difficult in such market conditions for fully integrated producers even though each controls his own retail prices.
- 94. The discussion is in terms of the structure of upstream and downstream supply, rather than upstream and downstream markets, to allow for different ways in which distribution may be organised and thus different market organisations. If, for example, each of the other brands is distributed through retailers owned by the upstream supplier, upstream markets would be largely eliminated by intra-firm transactions. While there would be no upstream market as such, the structure of upstream supply, the number and concentration of upstream suppliers and the ease of entry into upstream supply, would still be relevant for analysing the extent of competition faced by the franchise.
- 95. One way in which this story is incomplete is that it does not consider whether a potential entrant could succeed by acquiring rights to the retail locations from an existing supplier. If some existing suppliers are only marginally profitable, such a purchase could be mutually profitable. The story would be very different if all existing suppliers in this concentrated market were able to earn monopoly rents and the entrant could purchase rights to these retail locations only at a price that covered expected future rents in the absence of entry. For one discussion of some of these other issues that would be important in telling an analytically complete story see Krattenmaker and Salop (1986).
- 96. This argument is given in Mathewson and Winter (1986, p. 216).
- 97. As noted above, it has been argued that resale price maintenance or exclusive territories may complement direct controls by generating rents that give franchisees a strong incentive to avoid termination of the franchise relationship. As pointed out, however, this argument would justify resale price maintenance or exclusive territories only if franchisees would not otherwise expect to earn a stream of rents as a return on relationship-specific investments.

- 98. See in particular the article by S.G. Corones (1988), Senior Lecturer at the Faculty of Law in the Queensland Institute of Technology.
- 99. See Dominique Grisay (1989).
- 100. On this section see Treblicock and Zaid (1989).
- 101. The Province of Saskatchewan has some specific regulations on pyramidal franchising; and some provisions concerning drinking establishments in Ontario, Manitoba, Alberta and Nova Scotia regulations may have a bearing on franchising. See Trebilcock and Zaid (1989).
- 102. The articles and sections quoted correspond to the new presentation of the Act as amended in 1986.
- 103. None of these practices is a violation *per se* or gives rise to prosecution on a criminal charge, which is brought only if a Competition Tribunal prohibition is disregarded.
- 104. For the Competition Tribunal to make an order, the applicant needs to establish that i) the franchisor and/or his franchisees are in a controlling position, nationally or in one of the regions, taking particular account of market shares, the degree of concentration and barriers to entry; ii) that what is complained of is indeed an anti-competitive practice — Section 79 includes a nonexhaustive list of anti-competitive acts; iii) that the practice does substantially reduce competition, or is likely to do so. Moreover, even though the Tribunal can theoretically make an order requiring some trade secret to be disclosed, a disquieting possibility in connection with a franchise agreement, it can only actually do this to prevent some anti-competitive practice or remedy its effects. Subsection 5 of Section 78 is of particular interest for franchise agreements because it provides that the Section is not intended to affect the legitimate exercise of any right or enjoyment of any interest (e.g. licensing agreements) deriving under intellectual or industrial property legislation; however, the expression "pursuant only to the exercise of any right..." may suggest that Section 78 applies to acts constituting abuses of intellectual property rights.
- 105. In assessing a franchise case in the light of these provisions, the Director of Investigation and Research will need to examine the effects of the transaction on competition in the market concerned, which presupposes having identified the market beforehand; in many cases, the transaction concerned will probably not be likely to reduce competition substantially. Moreover, he will assess the effect of the merger on the other franchisees or potential franchisees, probably taking account of the procompetitive nature of most franchises and of the interest of maintaining an efficient franchise system, which should remove the majority of such transactions from the scope of these provisions. Lastly, since the prior notice requirement only applies to transactions involving an acquisition value in excess of C \$35 million, few franchise mergers would come under this provision.
- 106. Many opinions against the adoption of a specific regulation of franchising have been expressed on both the business and civil service sides. See, for example, the Ministerial replies, Assemblée Nationale, Masson, 3 November and 22 December 1986 and Roatta, 24 November 1986 (in Lamy, droit économique, paragraph 3675).
- 107. Journal Officiel de la République Française (JORF), 2 January 1990, page 9: Act No. 89-1008 of 31 December 1989 on the promotion of commercial and craft enterprises and the improvement of the economic, legal and social environment in which they operate; known as the "Doubin Act".

- Journal Officiel de la République Française of 9 December 1986. Décret d'application No. 86-1309 of 29 December 1986.
- On this and subsequent points, the annual reports of the Competition Council may be consulted.
- 110. The institutional nature of the Competition Council is the subject of a debate which goes beyond the scope of this report. On this question see, for example, Israel (1990).
- 111. Article 36 of Title IV authorises the Competition Council to bring legal action when it becomes aware that a practice falling under that article has occurred.
- 112. Articles 11 and following lay down the procedures for the application of this prohibition through referral to the Competition Council. Moreover, Article 11, paragraph 3, stipulates that if the facts are such as to warrant application of the penal sanctions provided for in Article 17, the Competition Council shall forward the case to the Chief Prosecutor, who may then ask the courts to impose the relevant penalties.
- 113. See Lepetit, (1987); P. Lepetit was at one time Rapporteur at the Competition Council.
- 114. See the 1987 and 1989 annual reports of the Competition Council.
- 115. Article 8 refers back to the language of Article 7 on restriction of competition.
- 116. 1987 Report of the Competition Council, page XXII.
- 117. Extract from the 1987 annual report of the Competition Council, pages XXII and XXIII. Decision No. 87-MC-03 on an application by Seda for interim protective measures against JVC.
- 118. In addition, refusals to deal that otherwise would be prohibited by Article 36 of Title IV are allowed if they meet the conditions of Article 10. See below.
- 119. The last paragraph of Article 10 provides for the possibility of exempting certain categories of agreement, including franchise agreements. The procedure is somewhat cumbersome, since it necessitates a decree and the advice for conformity of the Competition Council. It does, however, reflect a significant move towards EC block exemption mechanisms. A first step in that direction had already been taken with the 1985 Act.
- 120. Lepetit (1987).
- 121. As franchising took off, certain franchisors engaged in abusive practices, drawing up unbalanced forms of agreement and imposing them on totally inexperienced franchisees. The *Société Internationale du Siège* case described further on in the text is one example.
- 122. In 1975, the Paris Court of Appeal delivered a first decision of a benchmark nature on the Natalys agreements. In 1981, a franchisee (Mme Himbert) took her case to the Paris Tribunal de Commerce, which terminated the contract, pronouncing against her. On appeal by Natalys, on 13 November 1984 the Paris Court of Appeal upheld the original decision; Natalys again appealed and the Cour de cassation, on 12 January 1988, overthrew the Paris Appeal Court ruling and referred the case to the Versailles Court of Appeal. The latter delivered its decision on 9 March 1989, when it pronounced the agreement to be void because the sales prices were not clearly determined in the contract.

- 123. Decision of 9 March 1989 by the Versailles Court of Appeal, to which the Cour de cassation had referred the case on 12 January 1988. Since the agreement between Natalys and Mme Himbert did not determine these elements, the Versailles Court of Appeal deemed that the contract could only be considered to be an exclusive distribution agreement and not, as the franchisor maintained, a franchise agreement.
- 124. For the full quotation, see the decision itself.
- 125. 14 June 1984, 5ème Chambre. This was the first example in case law of Article 1129 of the Civil Code being applied to franchise agreements. The Court of Appeal deemed the franchise agreement to be a sales agreement concerning successive deliveries and thus subject to the terms of Article 1129, and therefore ruled the agreement void on two grounds, in that neither object nor sale price had been clearly stated.
- 126. The inter-relationship between these two fields of legislation is, however, sometimes close, as unfair business practices could at the same time restrict competition and vice versa. For example, a boycott is considered an unfair practice under the AUC and a restrictive business practice under the ARC.
- 127. See E. Niederleithinger and L. Ritter (1989).
- 128. See K. Stockmann and V. Strauch (1987).
- 129. See K. Stockmann and V. Strauch (1987).
- 130. Federal Supreme Court 1976, "Fertigbeton", WuW/E BGH 1458.
- 131. See K. Stockmann and V. Strauch (1987).
- 132. See K. Stockmann and V. Strauch (1987).
- 133. FCO Metro, 1975, WuW/E, BKartA 1583.
- 134. For this, see OECD (1978 p. 30 and 1989, p. 34).
- 135. See K. Stockmann and V. Strauch (1987).
- See Federal Cartel Office, Annual Activity Report of the FCO, 1985/86, Bundestagsdrucksache 11/554, p. 33.
- 137. Law No. 54 of 14 April 1947, as amended.
- 138. See T. Nishimura (1989).
- 139. The degrees of impediment identified in the General Designation are "without good reason", "unduly", and "unduly in the light of normal business practices". Quotations here and in text from Nishimura (1989).
- 140. Cases of misleading disclosure may be covered by Paragraph 8 of the General Designation (deceptive customer inducement).
- 141. See Lucio (1989).
- 142. As an EC member, Spain is affected by EC competition regulations including the 1988 Exemption Regulation for franchise agreements which is directly applicable in the Member States; for further details see the description of EC provisions in Chapter IV.
- 143. See Sohlberg (1989, pp. 8-11).
- 144. The Commission did not find any Swedish term equivalent to franchising and decided to keep the English expression. See English Summary SOU 1987:17.
- 145. See Howe (1988, pp. 439-445).

- 146. See ABA Antitrust Section (2d ed. 1984), at 14 and following for a discussion of these rules.
- 147. 435 U.S. 679, 692 (1978).
- 148. 435 U.S. 679 (1978) at 690-692.
- 149. See *Midwestern Waffles, Inc. v. Waffle House, Inc.*, 1983-2 Trade Cas. (CCH) § 65,567 (N.D. Ga. 1982), *aff* d, 734 F.2d 705 (11th Cir. 1984).
- 150. See Seagood Trading Corp. v. Jerrico, Inc., 924 F.2d 1555, 1565-66 (11th Cir. 1991).
- 151. The Petroleum Marketing Practices Act regulates aspects of the franchise relationship involved in the distribution of motor fuel under a trademark owned or controlled by the refiner.
- 152. Product and trade name franchises were defined as "an independent sales relationship between supplier and dealer in which the dealer acquire(s) some of the identity of the supplier... Typical of this segment are automobile and truck dealers, gasoline service stations and soft drink bottlers...accounting for an estimated 70 per cent of all franchise sales for 1988". Business format franchises were defined as "characterised by an ongoing business relationship between franchisor and franchisee that includes not only the product, service and trademark, but the entire business concept itself a marketing strategy and plan, operating manuals and standards, quality control and a continuing process of assistance and guidance. Restaurants, non-food retailing, personal and business services, rental services, real estate services and a long list of other service businesses fall into the category of business format franchising".
- 153. Pre-sale disclosure requirements are primarily intended to prevent fraud and mis-representation, but also are widely viewed as serving an economically rational purpose. They correct a perceived informational imbalance that could impair optimal capital allocations by preventing fully-informed investment decisions. Disclosure requirements target distribution arrangements in which the seller implicitly promises, by offering a common brand name or mark, to provide the business investor with a market for the goods and services to be sold, also to provide the benefits of its expertise in the successful operation of the business, typically expressed in claims that "no prior experience is required". In such circumstances, the investor is presumed to lack access to material information essential to an informed investment decision, absent required disclosures, because the offer requires complete reliance on the seller.
- 154. See the discussion below.
- 155. A third element, required payment of a franchise fee that exceeds a specified sum (\$500 under the federal regulations and typically \$100 under state laws) is designed to avoid imposing disclosure costs that are disproportionate to the investment risk undertaken.
- 156. Federal Trade Commission Franchise Rule, 16 C.F.R. §§436.2(a)(1)(i) and (2).
- 157. California Corporation Code, §31005(a). This "California definition" is used in all but five of the state laws requiring pre-sale disclosures. The minority employ a "community of interest" standard in lieu of the "prescribed marketing plan" test. The "community of interest" approach has been more widely adopted in relationship law definitions, undoubtedly because it is generally considered broader in scope and coverage. The relationship laws adopting that definition extend their protections not

- only to business format franchisees, but to most other distributors of brand-name products and services.
- 158. For more information on the Community case law and regulatory provisions, see de Cockborne (1989), Gast (1989).
- 159. On this subject, see Dubois. Mr. Dubois is Head of Division in Directorate-General IV (Competition) of the Commission of the European Communities.
- 160. Regulation of the Council No. 19/65, OJEC 533 (1965) empowers the Commission to apply Article 85, paragraph 3 by block exemption regulation.
- Commission Note on agreements of minor importance of 3 September 1986. OJEC No. C 231 of 12 September 1986.
- 162. *Grundig-Consten*, joined cases 56 and 58/84, judgment of 13 July 1966, ECR 299 [1966]; and for the 1964 Commission decision, OJEC 161, 20 October 1964, p. 2545. The characterisation of the case is in European Commission, First Report on Competition Policy, 1972. Also see Fejo (Ch. 7) for a discussion of the case.
- 163. Another case, decided at about the same time, also was important for establishing the coverage of vertical agreements: *Italy v. the Council and Commission of the EEC*, case 32/65, judgment of 13 July 1966, (1966) ECR 389.
- 164. This case is discussed in more detail in Chapter IV in the section on territorial restrictions.
- 165. See descriptions in European Commission, First Report on Competition Policy, para. 47; and Thirteenth Report on Competition Policy, paras. 26-32.
- Metro v. Commission, Cases 26/76, judgment of 25 october 1977, (1977) ECR 1875; and Metro v. Commission, Case 75/84, judgment of 22 october 1986, (1986) ECR 3021.
- 167. See for example, European Commission, Fifth Report on Competition Policy, paras. 12-13 and Thirteenth Report on Competition Policy, paras. 33-39.
- 168. European Commission, Thirteenth Report on Competition Policy, p. 38; this discussion is based primarily on paras. 33-34 of this report and para. 12 of the Fifth Report on Competition policy.
- 169. *Metro v. Commission*, Cases 26/76, judgment of 25 October 1977, (1977) ECR 1875, para. 20.
- 170. European Commission, Fifth Report on Competition Policy, para. 13.
- 171. European Commission, Thirteenth Report on Competition Policy, para. 34.
- 172. Pronuptia v. Schillgalis (1986) ECR 353 (Pronuptia judgment).
- 173. Pronuptia judgment.
- 174. Pronuptia judgment.
- 175. Pronuptia judgment.
- 176. Pronuptia judgment.
- 177. Pronuptia judgment, para. 27.
- 178. Pronuptia judgment para. 23.
- 179. The Court also found that such provisions were "capable of affecting trade between Member States". *Pronuptia* judgment para. 27.
- 180. Pronuptia judgment, para. 24.

- 181. Pronuptia judgment, para. 27.
- 182. The Court gave three reasons. First, a franchising contract was characterised by "the use of a single business method and the payment of royalties in return for the advantages provided under the franchise agreement" rather than by "obligations of supply and purchase, which may or may not be reciprocal" as in the contracts covered by the exemption. Second, the exclusive dealing Regulation listed "the restrictions and obligations which might be imposed on the exclusive distributor, but did not mention those which may be imposed on the other party to the contract, while in the case of a franchise agreement...the obligations undertaken by the franchisor, in particular the obligations to provide know-how and to assist the franchisee, were of particular importance". Third, the Court noted that "the list of obligations which may be imposed on the distributor" under the exclusive dealing exemption "does not include the obligations to pay royalties or the obligations ensuing from provisions which establish the control strictly necessary for maintaining the identity and reputation of the network". Pronuptia judgment, paras. 28-34. The Commission, in its subsequent Pronuptia decision of 17 December 1986, para. 27, pointed out that retail franchise agreements are different, in nature and in content, from the bilateral obligations accepted by the parties, both in cases of exclusive distribution contracts and dealerships in a selective distribution system.
- 183. Decision of 17 December 1986, OJEC No. L 13/39 ("Pronuptia decision"); see especially paras. 20, 34-37.
- 184. Pronuptia decision I.A.(6) and B.(9).
- 185. In some cases, some changes were required in the agreements before the exemption was approved. Yves Rocher, Decision of 17 December 1986, OJEC No. L 8/49, 10 January 1987; Computerland, Decision of 13 July 1987, OJEC No. L 222/12, 10 August 1987; ServiceMaster, Decision of 14 November 1988, OJEC No. L 332/28, 3 December 1988; Charles Jourdan, Decision of 2 December 1988, OJEC No. L 35/31, 7 February 1989.
- 186. Pronuptia decision, paras. 26-27.
- 187. Pronuptia decision, para 40.
- 188. OJL 359/46, 28.12.88. On the legal framework of franchise agreements in the EEC as a whole, see Gast (1989).
- 189. Regulation No. 4087/88 Preamble 7.
- 190. Regulation No. 4087/88 Preamble 8.
- 191. Regulation No. 4087/88 Preamble 9 and 10.
- 192. Regulation No. 4087/88 Preamble 12 and 15.
- 193. Regulation No. 4087/88 Preamble 5. In a master-franchise, the relationship between franchisor and franchisees is made through a third undertaking, the master-franchisor.
- 194. Wholesale franchise agreements are not covered by the Regulation because of the lack of experience of the Commission in that field. (Preamble 5). Moreover, wholesalers purchase goods simply in order to resell them to third parties who are not the end users. Neither are industrial franchise agreements covered by the Regulation, since they present characteristics that differ from those of the other types of franchise. The Commission points out that they consist of manufacturing licences based on patents and/or technical know-how, combined with trademark licences, and that some of them may benefit from other block exemptions if they fulfil the

necessary conditions (Preamble 4). From the competition standpoint, one crucial difference between industrial franchise and distribution franchise is that the former is a horizontal relationship between two manufacturers who are potential competitors, whereas the latter creates a vertical relationship between franchisors and franchisees.

- Regulation of 23 July 1984, OJEC No. L 219/15, 16 August 1984; Regulation No. 556/89 of 30 November 1988, OJEC No. L 66/1 of 4 March 1989.
- 196. Article 1.3(a).
- 197. Article 1.3(b).
- 198. Know-how is defined as "a package of non-patented information, resulting from experience and testing by the franchisor, which is secret, substantial and identified" Regulation No. 4087/88 Article 1.3 (g).
- 199. Article 1.3 (f).
- 200. Article 1.3 (g), (h), (i).
- 201. Various types of know-how and technical assistance described in franchise agreement decisions of the Commission. The Commission identified the know-how and technical assistance in the *Yves Rocher* agreement as follows: "before a beauty salon is opened (by a franchisee), *Yves Rocher* arranges training sessions for him on the organisation and running of the Centre and on the beauty products and treatments available there. It provides further training from time to time during the currency of the contract... (and) advises and assists the franchisee on the organisation and running of a Centre" (procedures, purchases, advertising). In the case of *Pronuptia*, the Commission described the know-how as consisting of the franchisor's assisting franchisee with "selecting the site and the premises, shop fitting and stocking, regular training of the franchisee and his staff, promotion and advertising...and with continuing information and advice on innovation, promotions, market analysis, purchasing, etc".

The distribution network of *Charles Jourdan* (footwear and handbag sales) includes both franchisees and franchise-corner retailers. The franchisee receives know-how and continuing assistance particularly in purchasing, decoration concept, establishment and maintenance of stock and management information and advertising. The Commission observed that the information passed on to the franchise-corner retailer was "both more limited and covered fewer fields than that provided for franchisees ... Franchise-corner retailers only received information on purchasing and fashion trends ... No provision was made for management assistance". The Commission found that the know-how made available to the franchisee was "substantial" and "did give the trader (franchisee) a clear advantage over competitors". That was why, "in addition to the prestige of the trade mark, actual or would-be independent traders were prompted to conclude such agreements with the Charles Jourdan group".

In the case of the *Computerland* franchise (distribution of microcomputer products), the Commission noted that the franchisor provided the franchisee with "continuing support services including training, information, advice, guidance and know-how regarding the Computerland methods in store management, operation, financing, advertising, sales and inventory, based on Computerland's empirical experience in the area of retail sales of microcomputer products throughout the world ... The franchisee received advance information on numerous brands of new products and how they could be used together ... as well as advice as to which among the many new products were likely to succeed on the market". The application by

ServiceMaster (housekeeping, cleaning and maintenance services) for clearance of its franchise agreement gave the Commission an opportunity for a decision involving a service franchise. The Commission found that know-how was "often more important in the supply of service than in the supply of goods, because each service required the execution of particular work and created a close personal relationship between the provider of the service and its receiver. Therefore, the protection of the franchisor's know-how and reputation could be even more essential for service franchises than for distribution franchises, where mainly the goods advertise the business by carrying the trade mark of the producer or distributor". However, the Commission did feel that it would be useful to point out that it considered "that despite the existence of specific matters, service franchises show strong similarities to distribution franchises and could therefore basically be treated in the same way as distribution franchises".

- 202. And these provisions would be exempted if in some case they did infringe Article 85(1) Regulation No. 4087/88, Article 3.3.
- 203. While the Regulation allows many provisions to protect know-how, Article 5 (discussed below) prohibits two provisions involving know-how. Franchisees must not be prohibited from using licensed know-how after termination of an agreement if that know-how has become generally available (other than by breach of agreement); and franchisees must not be prevented from challenging the validity of property rights that form part of the franchise.
- 204. Article 4(a): "the franchisee is free to obtain the goods that are the subject-matter of the franchise from other franchisees: where such goods are also distributed through another network of authorised distributors, the franchisee must be free to obtain the goods from the latter".
- 205. Article 4(b): "where the franchisor obliges the franchisee to honour guarantees for the franchisor's goods, that obligation shall apply in respect of such goods supplied by any member of the franchised network or other distributors which give a similar guarantee, in the common market". The same obligation concerning a guarantee applying in the common market is specified in Commission Regulation No. 123/85 on the application of Article 85(3) of the Treaty to certain categories of motor vehicle distribution and servicing agreements.
- 206. Article 4(c): "the franchisee is obliged to indicate its status as an independent undertaking; this indication shall however not interfere with the common identity of the franchised network resulting in particular from the common name or shop sign and uniform appearance of the contract premises and/or means of transport". The Commission Decision of 13 July 1987 on the *Computerland* case sets out these obligations in detail (OJEC No. L 222/12, 10 August 1987, I B 4).
- 207. Also known as "the list of the seven deadly sins".
- 208. To qualify for exemption, agreements also must meet the conditions of Article 4.
- 209. Regulation No. 4087/88 Preamble (16).
- 210. See Article 8 for a list of all the circumstances in which the Commission may withdraw the benefit of the Regulation.
- 211. Commission Regulation (EEC) No. 1984/83 of 22 June 1983 on the application of Article 85(3) of the Treaty to certain categories of exclusive purchasing agreements. OJEC, 30 June 1983, Vol. L 173.

- 212. Commodore Business Machines Pty Limited v. Trade Practices Commission (1990) ATPR 41-019; and Trade Practices Commission v. Sony (Australia) Pty Limited (1990) ATPR 41-053.
- 213. See Corones (1988), p. 25.
- 214. Zaid (1989) describes this case; The policy of A & M was not to defray advertising costs if the prices advertised were not equal to or higher than the cost to the dealer, as fixed periodically by price circulars (although the dealer could choose to advertise the prices he wished at his own expense). A & M pleaded that its policy was to protect small dealers against wholesalers who could buy their stock more cheaply; the accused also argued that its policy had only a limited effect since it affected only the products advertised and did not apply to all the products sold. The Court ruled that nothing justified this price maintenance practice and sentenced the Company, which had discontinued the practice on discovering that it was illegal, to a fine of C\$ 3500.
- 215. Rv. Campbell (1984) 3 C.C.C. 112 (Ont.C.A.).
- 216. Rv. H.D. Lee of Canada Ltd. (1980), 57 C.P.R.2d 186 Que.Ct S.P.
- 217. The accused, a supplier of petroleum products, compelled one of its retailers to buy all of his petrol from it and, by agreement, granted him a price subsidy of 3 cents per litre provided he matched the competition and did not lower his prices. Because of a price war in his district, the retailer was forced to cut his prices, whereupon the supplier froze its subsidy while waiting for prices to rise. The Court held "this policy violates the statute because it indirectly discourages the dealer from reducing his price. In applying the policy to the dealer, the agreement was even more in violation of the Section because it prohibited him from ever initiating a downward price." Zaid (1989).
- 218. See Zaid (1989).
- 219. The principles on which the tribunals based their rulings were clearly set out in the Ontario Court of Appeal's decision on *R. v. Browning Arms Co. of Canada Ltd.* (1974), 15 C.P.R.2d 97 (Ont C.A.): "The aspect of deterrence to others who might be tempted to commit a similar offence is clearly an important factor to be taken into account ... The aspect of deterrence to the convicted corporation is also of importance, although not as important as that of deterrence to others... The size of the convicted corporation, the scale of its operations, the range of products sold by it and of products affected by illegal practice are all questions to be taken into account. The nature of the market itself, in the particular commodities which are the subject of the charge, is also a matter of consideration. Does the accused company sell a wide range of products or only few? Does it have many competitors with respect to those products, or only few? Are its products sold by thousands of dealers or only by carefully selected 'franchise holders'?".
- 220. Zaid (1989), however, considers that it is no longer an absolutely clear imperative since the case of *R v. Philips Electronics Ltd.* (1981) 53 C.P.R. 2d 74 Ont.C.A. aff'd (1981)59 C.P.R. 2d 212, when the Supreme Court upheld the Ontario Appeal Court's ruling on Philips' advertising for certain of its goods, which on some occasions mentioned the price as being "\$49.95" and on other occasions as "only \$49.95". The Supreme Court ruled that for the offence to be patently demonstrated two things had to be proved: first, that there had been an attempt to bring pressure to bear with a view to raising the price, and second, that this attempt had taken the form of an agreement, threat, promise or some other similar means. The majority opinion

had been that advertising in itself could not be said to take such a form. From this franchisors might conclude that it is not strictly necessary to include the mention "or less than ..." in advertising in which a price is given. However, a cautious view must be taken, since where no such mention is made there may always be a presumption that the price has been fixed.

- 221. Opinion of 1 December 1983 on the competition situation in the perfumery products selective distribution sector.
- 222. See the opinion of the Competition Council, para. 138, and also D. Achach (1987).
- 223. Decision No. 89-D-43, BOCCRF No. 1 of 3 January 1990.
- 224. 1989 annual report of the Competition Council, p. 161.
- 225. 1989 annual report of the Competition Council, pp. 157, 161.
- 226. Veronique Selinsky (1990).
- 227. 1989 annual report of the Competition Council, pp. 161-163.
- 228. The Paris Court of Appeal later partly overturned the Competition Council's decision, considering that the sports footwear manufacturers did not choose their distributors on the criterion of whether or not they belonged to a supermarket-type distribution chain. The Court consequently reduced the amount of the fines imposed on the manufacturers. Paris Court of Appeal, Decision of 7 June 1990.
- 229. Lypobar-La Croissanterie, Paris Court of Appeal decision of 10 March 1989. Only accessorily did the Paris Court of Appeal mention the criminal sanction imposed on the franchisor by the Competition and Consumer Directorate for unlawful price imposition in the terms of the 1945 Ordinance 45-1483 (the provisions of which in respect of competition have since been amended with the adoption of the 1986 Ordinance). The defendant was sentenced for unlawfully imposing beverage prices.
- 230. BGH "Telefunken" (1986) WuW/E BGH 2238.
- 231. This section is largely based on Nishimura (1989), which contains more details.
- 232. (29)6 Minshu 888, Supreme Court.
- 233. (29)6 Minshu 951, Supreme Court.
- 234. Ministry of Commerce, Reports and Decisions Review of the Commerce Act 1986 (1989, p. 12).
- 235. Bollard (1989, p. 7).
- 236. Eagles (1986a, p. 355).
- 237. Eagles (1986a, p. 355).
- 238. See Mendelsohn (1989).
- 239. See Howe (1988).
- 240. In *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), the maker of a medicine sued a wholesaler who obtained his product at cut price by inciting others to breach their price agreement with Dr. Miles. Rejecting the plaintiff's arguments, the Court ruled that a manufacturer who sold his medicine to a wholesaler did not have the right to restrict the sale by intervening in the purchaser's price decision: "A general restraint upon alienation is ordinarily invalid" and, where its intent is to stifle competition by price fixing, the restraint "is injurious to the public interest and void."
- 241. 465 U.S. 752 (1984) at 764, N.9 and 768.

- 242. As noted in the decision, 465 U.S. 752 (1984) at 761.
- 243. 465 U.S. 752 (1984) at 759.
- 244. 465 U.S. 752 (1984) at 762.
- 245. 465 U.S. 752 (1984) at 763-764.
- 246. 465 U.S. 752 (1984) at 763-764.
- 247. Quotations and discussion from 485 U.S. 717 (1988) at 724-726.
- 248. Quotations and discussion from 485 U.S. 171 (1988) at 726-228.
- 249. 110 S. Ct. 1984 (1990).
- 250. 110 S. Ct. 1984 (1990) at 1892.
- 251. Deutsche Phillips, 5 October 1973, OJL 293/40. The description of this decision is based on Fejo. Also see European Commission, First Report on Competition Policy, para. 55, for a similar, earlier decision, Agfa-Gevaert, EC Bulletin No. 2/1970, Part 2, Chapter 1, Sec. 5.
- 252. The Commission in its First Report on Competition Policy (1972, p.63), noted of its policy that "Although national systems of resale price maintenance authorised by some national legislations were not directly implicated, the Commission's intervention with regard to measures intended to protecting them by isolating national markets within the EEC was not without repercussions on the systems themselves".
- 253. Vertical price restrictions also have not been accepted in selective distribution agreements. It is interesting to note, however, that the Court in the first *Metro* decision did point to the possibility that the desire to maintain retail prices may promote non-price competition:
  - For specialist wholesalers and retailers the desire to maintain a certain price level, which corresponds to the desire to preserve, in the interest of consumers, the possibility of the continued existence of this channel of distribution in conjunction with new methods of distribution based on a different type of competition policy, forms one of the objectives which may be pursued without necessarily falling under the prohibition contained in Article 85(1), and if it does fall thereunder, either wholly or in part, coming within the framework of Article 85(3). This argument is strengthened if, in addition, such conditions promote improved competition inasmuch as it relates to factors other than price. [Metro v. Commission, judgment of 25 October 1977, Case 26/76, (1977) ECR 1905.]
- 254. See, however, the case where fixed prices for newspapers were exempted under Article 85-3 (Agences et messageries de la presse, 1987).
- 255. Para. 13.
- 256. Court Pronuptia Decision, paras. 23 and 24.
- 257. See de Cockborne, op. cit, pp. 283 & foll. Article 86 may also be applied in cases of abuse of dominant position.
- 258. *Pronuptia* decision, OJEC 13, 15 January 1987 p. 39 para. 12(c).
- 259. Pronuptia decision, para. 26.
- 260. See Commission Note, OJEC No. C 95/3 of 23 April 1986.
- Commission decision, 17 December 1987, OJEC No. L 8/49, 10 January 1987 para. 30.

- (1979) ATPR Commission Decision (Authorisations and Notifications) 35-200 at 16, 416.
- 263. (1977-1978) ATPR Commission Decision (Authorisations and Notifications).
- 264. However, penalties may still be incurred under Section 17 if refusal to sell constitutes an anticompetitive practice in the terms of Section 8.
- 265. M. Reynaud v. Association des loueurs français d'automobiles operating the Interrent network. Court of appeal of Aix-en-Provence, 17 September 1986; Cour de cassation, Chambre Commerciale, 14 February 1989.
- 266. See: Federal Cartel Office, Annual Activity Report 1985/86, Bundestagsdrucksache 11/554, p. 33.
- 267. This section is based on Nishimura (1989).
- 268. Eagles (1986b, p. 383).
- 269. See Mendelsohn (1988).
- 270. Territorial restrictions were a *per se* violation only in instances where the manufacturer parted with title. Prior to *Schwinn*, the prevailing rule seemed to be that territorial restrictions should be judged under the rule of reason. See Neale and Goyder (1980, pp. 284-285).
- 271. The dealers were considered franchisees under U.S. terminology, but probably would not have been considered franchisees under EC definitions.
- 272. For purposes of comparison, Schwinn had only about 12.5 per cent of the U.S. bicycle market at the time that case was brought, and its share was falling. These facts were a central part of criticism of the Schwinn decision. See Neale and Goyder (1988, p. 285).
- 273. See Zeidman (1988), §9.47, and cases cited there.
- 274. Commission decision, OJEC 161, 20 October 1964 ("Commission Grundig Decision"): Court of Justice, Consten and Grundig v. Commission, Joined Cases 56 and 58/64, judgment of 13 July 1966. Also see the discussion of both decisions in Fejo (1990)
- 275. Court Grundig Judgment at 339.
- 276. Court Grundig Judgment at 341.
- 277. Court Grundig Judgment at 342.
- 278. Commission Regulation No. 4087/88, Article 2.
- 279. Commission Regulation No. 4087/88, Preamble para. 10.
- 280. Commission Regulation No. 1 4087/88, preamble para. 12. It is worth noting that in granting the individual exemption for the *Pronuptia* agreement the Commission had given two reasons why the agreement satisfied this condition of Article 85(3): first, franchisees could compete with each other because they remained free to sell to all customers regardless of where they were residents, and to sell to each other; and second, *Pronuptia* faced interbrand competition from other manufacturers that did not use franchise distribution. OJCE 13, 15 January 1987 p. 38, para. 37.
- 281. Commission Decisions *ATPR* (Authorisations and Notifications) 365-100 pp. 15, 661.
- 282. CJEC Decision No. 164/84 of 28 January 1986. EEC Court of Justice.

- 283. On appeal by Natalys, the Cour de cassation overthrew the decision handed down by the Paris Court of Appeal in 1984. The Cour de cassation sent the case for a new hearing by the Versailles Court of Appeal (Versailles Court of Appeal, Decision No. 173/89 of 9 March 1989, *Natalys v. Himbert*).
- 284. The distributor did, however, undertake to purchase goods to the value of at least 70 per cent of her previous year's turnover.
- 285. A formal report dated December 1982, to which the Paris Court of Appeal referred in its decision of 1984, showed that the exclusivity clause had been violated regularly and to a substantial extent.
- 286. Article 11: Unjustly dealing with the other party on condition that the said party shall not deal with a competitor, thereby tending to reduce transaction opportunities for the said competitor.
- 287. Hill and Jones (1986, p. 60).
- 288. Eagles (1986b, p. 385).
- 289. The relevant provisions of Section 3 are: "It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or to make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods... of a competitor or competitors of the... seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in line of commerce".
- 290. Neale and Goyder (1980, pp. 265-269) discusses decisions prior to 1980.
- 291. See comments in Neale and Goyder, (1980, pp. 268-269) and Scherer and Ross.
- 292. The Court also took into consideration the fact that six of the supplier's main competitors, who together accounted for a 42 per cent share of the market, also used the same type of contract. This led to some uncertainty about the extent to which the cumulative effect of these contracts was a controlling factor in the decision, and thus the significance of the decision for future cases. See discussion in Neale and Goyder (1980, p. 270).
- 293. 365 U.S. 320 (1961) at 329.
- 294. See Neale and Goyder, op.cit., pp.270-272; and ABA Antitrust Section (2nd ed. 1984, 96-97).
- 295. In re Marico Co., 50 F.T.C. 485, 487 (1953). The discussion in this and the following paragraph is based on American Bar Association Antitrust Section (2d ed. 1984, p.98).
- 296. 62 F.T.C. 679 (1963), rev'd sub nom. *Brown Shoe Co. v. FTC*, 339 F.2d 45 (8th Cir. 1964), rev'd 384 U.S. 316 (1966).
- 297. Discussed in Bozk (1978) as well as American Bar Association Antitrust Section (2d ed. 1984). The GTE Sylvania case is discussed above in the section on territorial restrictions.
- 298. Quote from decision given in ABA Antitrust Section (2d ed. 1984, p. 99).
- Ryko Mfg. v. Eden Servs., 823 F.2d 1215 (8th Cir. 1987) and Chuck's Feed and Seed Co. v. Ralston Purina Co., 810 F.2d 1289 (4th Cir.) cert. denied, 108 S.Ct.94 (1987). Quote from 823 F.2d 1215 (8th Cir. 1987) at 1233.

- 300. See de Cockborne (1989, p. 278).
- 301. The exemption applies on condition that "the franchisee is free to obtain the goods that are the subject-matter of the franchise from other franchisees: where such goods are also distributed through another network of authorised distributors, the franchisee must be free to obtain the goods from the latter".
- 302. Pronuptia judgment, para. 21.
- 303. Pronuptia judgment, para. 21.
- 304. Pronuptia decision, para. 12.
- 305. On this "open-closed" distinction, see the article by Jean Calvo (1988).
- 306. Commission Regulation 1983/83, Article 2.2(b).
- 307. Preamble (5), Regulation No. 18 84/83.
- 308. See the discussion in the previous chapter.
- Competition Council Decisions of 1987 involving, in particular, M. Chapelle, Sony and JVC.
- 310. 1989 annual report of the Competition Council, page XXXIX. The existing agreements were found to violate Article 7.
- 311. See Azema (1987).
- 312. Competition Council Decision No. 89-D-39 (1989).
- 313. 1989 annual report of the Competition Council, page XXXIII.
- 314. See J. Threard and C.Bourgeon (1991).
- 315. "In this respect the most enterprising are not the least at risk, since it is those who have the most recently invested money to promote a product who lay themselves open to being forced to agree to continue the contractual relationship 'at any price'".

  J. Threard and C. Bourgeon (1991, p. 22).
- 316. See Hill and Jones, op.cit., 61.
- 317. See I. Eagles (1986 b, op.cit., 385).
- 318. See Zeidman.
- 319. In this case, the single newspaper in a small town refused to accept advertisements from businesses that advertised over the only radio station. The Court ruled that this action was an illegal attempt to exclude a competitor in order to maintain its local advertising monopoly. See Neale and Goyder (1980 pp. 129-30).
- 320. Given the stakes and the parties' unequal forces, termination and non-renewal of franchise agreements is strictly regulated at both Federal and State level, especially as regards the sale of alcoholic beverages, gasoline and automobiles. Usually prosecutions are brought because there is an alleged breach of these regulations (most frequently and most recently infringement of the Petroleum Marketing Practices Act).
- 321. In these circumstances only Holiday Inn's Board of Directors could grant the franchise. The Chairman of the Board recommended that American Motor Inns seek an understanding with the franchisees who had objected.
- 322. See Zeidman.
- 323. Commission Pronuptia decision, OJL 13, 15 January 1987, p. 39 para. 27.

- 324. In the *Pronuptia* case, the Court of Justice of the EC was of the opinion that prohibition of the assignment by the franchisee of his rights and obligations under the contract without the franchisor's approval protected the latter's right to freely choose the franchisees, on whose business qualifications the establishment and maintenance of the network's reputation depended (*Pronuptia* judgment, para.20). In its decision on the *Yves Rocher* case, the Commission pointed out that the franchisor is logically entitled to choose the partners it wants and turn down applicants who do not, in its view, have the personal and business qualifications which it requires for the application of the formula it has developed (Commission Decision, para. 41). Screening franchisees does not restrict competition. In its decision on the *Charles Jourdan* case, the Commission clearly upheld the franchisor's right to limit the number of its franchisees, seeing this as reflecting its desire to establish an integrated and interdependent network receiving continuous assistance. The members of the network had therefore to be limited in number (para. 30).
- 325. European Commission, Thirteenth Report on Competition Policy, para. 34.
- 326. The definition in Article 77(5) is the following: "(a) one company is affiliated with another company if one of them is the subsidiary of the other or both are the subsidiaries of the same company or each of them is controlled by the same person; (b) if two companies are affiliated with the same company at the same time, they are deemed to be affiliated with each other; (c) a partnership or sole proprietorship is affiliated with another partnership, sole proprietorship or a company if both are controlled by the same person".
- 327. See Connelly (1976).
- 328. The decision handed down on 6 March 1984 by the Federal Court of Appeal, to which the defendant subsequently appealed, bore only on a point of a constitutional nature.
- 329. Also, Article 30 of the 1986 Ordinance prohibits tying the sale of a product (or service) to consumers to the purchase of another product (or service).
- 330. Decision No. 87-D-34 on the clause in agreements between oil companies and petrol filling stations that concerns the return of tanks and equipment. 1987 annual report of the Competition Council.
- 331. Paris, 1ère Chambre, 5 May 1988, BOCC of 11 May 1988.
- 332. See Federal Cartel office, Annual Activity Report 1985/86 Bundestagsdrucksache 11/554, pp. 32-33.
- 333. Article 10 of the notification: "unjustly causing the other party to purchase a commodity or service from oneself or from an entrepreneur designated by oneself by tying it to the supply of another commodity or service, or otherwise coercing the said party to deal with oneself or with an entrepreneur designated by oneself."
- 334. See Eagles (1986b, p. 382).
- 335. See Mendelsohn (1988, p. 119).
- 336. Reported in the 1989 annual report of the United Kingdom to the OECD, CLP (90) 3/17, p. 11.
- 337. According to Professor Areeda and Professor Turner, leverage is loosely defined here as a supplier's power to induce his customer for one product to buy a second product from him that would not otherwise be purchased solely on the merit of that second product.

- 338. For critical studies of the leverage theory, see R. Bork (1978).
- 339. 365 U.S. 1 (1958) at 5-4.
- 340. For example in *International Salt Co. v. United States*, 332 U.S. 392, 396 (1947): "it is unreasonable *per se*, to foreclose competitors from any substantial market."
- 341. See the discussion on the requirements for finding a violation in ABA Antitrust Section (2d ed. 1984, pp. 76-77).
- 342. Some courts tend to consider that in order to establish their rights under Section 1 of the Sherman Act, plaintiffs must also show that they have suffered injury. Referring to previous case law, in particular *Siegel v. Chicken Delight*, Justice Schwarzer in the case of *Casey v. Diet Center Inc.* 590 F. Supp. 1561 (N.D.Cal.1984) took this view and concluded that "a party to a tying arrangement has not suffered economic harm from the inflated price of the tied product where the seller might simply have reduced that price to a competitive level and correspondingly increased the price of the tying product. Thus, to demonstrate the injury necessary to establish defendant's liability, plaintiff must prove that the payment for both the tied and tying product exceeded their combined fair market value".
- 343. ABA Antitrust Section (2d ed. 1984), 77.
- 344. For a detailed examination of this subject, see Minnesota Law Review, June 1983, "A clarification and reformulation of prevailing approaches to product separability in franchise tie-in sales"; and also Pasahow (1988).
- 345. For example, the Supreme Court ruled that advertisements in a newspaper's morning and evening editions were not separate products (*Times-Picayune Publishing Co. v. United States*, 345 U.S. 594, 613-14 (1953) but that prefabricated homes and financing for their purchase were separate products (*Fortner Enterprises, Inc. v. United States*, 394 U.S. 495 (1969)). See citations to other decisions in ABA Antitrust Section, *Antitrust Law Developments* (2d ed. 1984 pp.78-81); and ABA Antitrust Section (1988, I-74-77).
- 346. In this case the tying practice was in the end deemed lawful, since the majority of the judges, unlike Judge Lumbard who wrote the decision, accepted the reason for it given by Carvel, i.e. that the tying arrangement was justified by the necessity for Carvel to establish quality controls to protect its trademark. Nor did the majority follow Judge Lumbard's opinion that the fact that the franchisees had abandoned their right to deal with suppliers of their choice attested the franchisor's economic leverage.
- 347. Baskin-Robbins also was accused of violating the antitrust laws by utilising a dual distribution system and/or conspiring to fix wholesale prices.
- 348. 664 F.2d at 1354.
- 349. 664 F.2d at 1353-4.
- 350. The alleged tied products were leases for store premises.
- 351. Compare ABA Antitrust Section (2d ed. 1984, p.81) where the Ninth and Fourth Circuit decisions are described as similar, and the discussion in Pasahow (1988, p.382), in which the logic and different result for business format franchising are stressed.
- 352. 466 U.S. 2 (1984) at 18-19.
- 353. 466 U.S. 2 (1984) at 21-22.
- 354. Ibid.

- 355. This summary of findings prior to *Jefferson Hospital* is based on that in ABA Antitrust Section (2d ed. 1984, pp.84-88).
- 356. In particular, *International Salt Co. v. United States*, 332 U.S. 392 (1947) and *IBM Corp. v. United States*, 298 U.S. 131 (1936).
- 357. Times-Picayune Publishing Co. v. United States, U.S. 345 (1953); Northern Pacific Ry. v. United States, 356 U.S. 1 (1958) at 6.
- 358. 371 U.S. 38 (1962) at 45.
- 359. *United States Steel Corp. v. Fortner Enterprises*, Inc. 429 U.S. 610 (1977) (Fortner II) at 506. An earlier decision involving the same case found the issue to turn on whether the seller could raise price or impose burdensome terms, i.e. a tie-in, on "any" appreciable number of buyers within the market. 394 U.S. 495 (1969) at 504.
- 360. 448 F.2d 43, 50 [9th Cir. 1971, cert. denied 405 U.S. 955 (1972)].
- Susser v. Carvel Corp., 332 F.2d 505, 519-21 (2d Cir. 1964), cert. dismissed, 381 U.S. 125 (1965).
- 362. United States Steel Corp v Fortner Enterprises, 429 U.S. 610, 620 (1977) (Fortner II); United States v Loew's Inc. 371 U.S. 38, 45 (1962); Northern Pacific Ry. Co v United States, 356 U.S. 1 (1958).
- 363. 466 U.S. 2 (1984) at 12. The Court listed three conditions that could create such market power: large market power, possession of a patent or similar monopoly, and where the seller offered a unique product competitors could not. In a concurring opinion, Judge O'Connor argued that while these conditions might help give a seller market power, they were not sufficient alone to confer market power. 466 U.S. 2 (1984) at 37 n.7.
- 364. Suit had been brought by Dr. Hyde, an anaesthetist, against the Jefferson Parish Hospital for alleged violation of §1 of the Sherman Act, claiming that the exclusive contract between the hospital and a firm supplying anaesthesiological services constituted unlawful tied selling as any surgery at the hospital required use of the hospital's anaesthetist. The Fifth Circuit, reversing the District Court, had ruled that the disputed clause was unlawful *per se*. The Supreme Court found for the defendant, holding that the tie-in clause was not illegal given the absence of market power over the tying product. The market share of 30 per cent was not sufficient to find market power, and market power could not be found based on "market imperfections" such as patients' preference for hospitals close to their home, lack of price awareness, or lack of information on quality of service circumstances.
- 365. See the discussion in Pasahow (1988, pp. 388-391).
- 366. See Klein and Saft (1985, pp.345, 356).
- 367. In *International Salt Co v. United States*, 332 US 392 398 (1947) and in *IBM Corp v. United States*, 298 U.S. 131, 139-140 (1936) as well as on its affirmation *per curiam* in *United States v. Jerrold Elecs Corp.* 187 F. Supp 545 (E.D.Pa 1960) aff'd per curiam, 365 U.S. 567 (1961).
- 368. The rejection of this "new business" defence in *Siegel v. Chicken* did not show the argument no longer would be accepted. The Ninth Circuit stated in support of its refusal that "Whatever claim Chicken Delight might have had to a new business defence in 1952 a question we need not decide the defence cannot apply to the 1963-70 period. To accept Chicken Delight's argument would convert the new business justification into a perpetual license to operate in restraint of trade."

- 369. Judge Lumbard expressed a contrary opinion, referring to the decision on *Engbrecht v. Dairy Queen Co.* 203 Supp 714 (D. Kans. 1962) which concerned a similar, though smaller, franchise ice cream store chain.
- 370. One commentator, concludes: "What will develop from the Ninth Circuit's tolerant attitude...remains to be seen. The opinion suggests a potentially important shift on this issue." Pasahow, (1988, p. 393).
- 371. See Zeidman (1988 §9.55).
- 372. Martino v. McDonald's Sys, 625 F Supp 356 (ND III 1985).
- 373. Austra Tanks Pty, Ltd. v. Running (1983) 5 ATPR 40-340.
- 374. Lloyd Ships v. Davross Pty, Ltd. (1987) 9 ATPR 40-769.
- 375. See Les Petites Affiches, 18-24 May 1987, pp. 6-7.
- 376. Simone Daul, La Gazette du Palais, 17-18 July 1985, p. 12.
- 377. Paris Court of Appeal, 12 January 1988.
- 378. Colmar Court, 9 June 1982 {D. 1982.553, note J.J. Burst} and note by Simone Daul, *La Gazette du Palais*, 17-18 July 1985, op. cit.
- 379. Le Chapelier Act of 2-17 March 1791 proclaiming the principle of freedom of trade and industry.
- 380. Résumé of the Européenne de données, Juris base.
- 381. See Federal Cartel Office, Annual Activity Report 1985/86, Bundestagsdrucksache 11/554, p. 33.
- 382. See E. Niederleithinger and L. Ritter (1989).
- 383. Howe (1988, p. 442).
- 384. See Mendelsohn (1989).
- 385. See, e.g. National Society of Professional Engineers v. United States, 435 U.S. 679, 688-689 (1978).
- 386. See generally: *United States v. Addysten Pipe and Steel Co.*, 85 Fed. 271, 281-283 (6th Cir. 1989) aff'd, 175 U.S. 211 (1989); *LektroVend Corp. v. Vendo Co.*, 66- F.2d 255 (7th Cir. 1981), cert denied, 445 U.S. 921 (1982); *Sound Ship Building Corp. v. Bethelehem Corp.*, 387 F. Supp. 252, 255 (D.N.J.), aff'd, 533 F.2d 96 (3rd Cir.), cert. denied, 429 U.S. 860 (1976).
- 387. Article 3.1(c).
- 388. Article 3.1(c).
- 389. Pronuptia decision para. 25(i).
- 390. Eagles (1986b, p.382).
- See e.g., Colorado Pump & Supply Co. v. Febco, Inc., 472 F.2d 637, 640-41 (10th Cir.), cert. denied, 411 U.S. 987 (1973); Pitchford v. PEPI, Inc., 531 F.2d 92, 100-01 (3d Cir. 1975) cert. denied, 426 U.S. 935 (1976); Famous Brands, Inc. v. David Sherman Corp., 814 F.2d 517, 524 (8th Cir. 1987).
- 392. 252 F.2d 441 (4th Cir. 1958) at 449-50.
- 393. See, e.g., Brandeis Machinery Co. v. Barber Greene Co., 1973-2 Trade Cas. (CCH) para. 74, 672 (W.D. Ky. 1973); Earley Ford Tractor, Inc. v. Hesston Corp., 556 F. Supp 544 (W.D. Mo. 1983).
- 394. Article 3.1(f).

- 395. See, for instance, *Metro v. Commission*, Judgment of 25 October 1977, Case 26/76, (1977) ECR 1873.
- 396. Pronuptia decision, para. 27.
- 397. Pronuptia decision, para. 27
- 398. Commission Regulation (EEC) No. 1983/83, article 3(a)
- 399. United States v. Serta Associates, Inc., 296 F. Supp 1121, 1125-27 (N.D. Ill. 1968), aff'd per curiam, 393 U.S. 534 (1969); Mt. Vernon Sundat, Inc., v. Nissan Motor Corp., 1976-1 Trade Cas. (CCH) para. 60, 842 (E.D. Va. 1976). In Serta, the court held that the co-operative advertising programme, when combined with surveillance of all retailer advertising violated the "strict per se prohibition of all tampering with price". Id. at 1126. In Mt. Vernon Sundat, the court struck down a co-operative advertising program that contained a "strong recommendation" to use the manufacturer's suggested resale price and was enforced through dealer surveillance and a requirement for reimbursement that the dealer's advertisements contain no statements suggesting price competition among Datsun dealers. Id. at 68, 676-677.
- 400. In re *Nissan Antitrust Litigation*, 577 F.2d 910 (5th Cir.), cert. denied, 439 U.S. 1072 (1978).
- 401. Id. at 915-17.
- 402. Id. at 1525.
- 403. See, e.g., the consent order secured in *United States v. E.I. DuPont de Nemours & Co.*, 1980-1 Trade Cas. (CCH) para 63, 570 (N.D. Ohio 1980); *Totes, Inc.*, 96 FTC 335 (1980).
- 404. See 4 Trade Reg Rep. (CCH) para 39,057 (May 21, 1987).
- 405. See *The Magnavox Company*, Docket no. 8822, 5 Trade Reg. Rep. (CCH) para. 22.805.
- 406. Pronuptia decision para. 25.
- 407. Pronuptia decision para. 25.
- 408. Murat case, OJEC No. L 348 of 10 December 1983.
- 409. IBM case, OJEC No. L 118 of 4 May 1984.
- 410. Commission Regulation (EEC) No. 1983/83, Article 2.3(c).
- 411. Territorial restrictions were not generally considered *per se* illegal prior to the Schwinn ruling. In a 1963 case, *United States v. White Motor Co.*, 372 U.S. 253 (1963), the Supreme Court had declined to find territorial allocations illegal *per se*. See e.g. Neale and Goyder (1980, p. 284)
- 412. This point about the *GTE Sylvania* decision is made in Mathewson and Winter (1986, p. 218)
- 413. See the excerpt from the decision quoted in Chapter IV
- 414. For a discussion of the issue before the Court, see ABA Antitrust Section (2d ed. 1984, pp. 67-70)
- 415. The main opinion disagreed. The Ninth Circuit had distinguished *Schwinn* and *Sylvania*, but the main opinion overruled the Ninth Circuit, finding the two cases indistinguishable, and instead replaced *Schwinn's per se* treatment of territorial

- restrictions by the rule of reason approach. See the discussion in ABA Antitrust Section (2-d ed. 1984, p. 69)
- 416. Continental TV Inc. v. GTE Sylvania, 433 U.S. (1977) at 2562
- 417. 388 U.S. (1967), at 368, 374 and 87 S.Ct. at 1860, 1863
- 418. Continental TV Inc. v. GTE Sylvania, 433 U.S. at 2551, 2562 n. 29
- 419. Neale and Goyder (1980, p. 285)
- 420. While Justice White urged that a distinction based on the strictness of territorial restrictions was important, the main opinion of the Court in *Sylvania* did not agree that it was appropriate to consider strict territorial restrictions *per se* illegal
- 421. 433 U.S. (1977), at 2563
- 422. Decision (87/17/EEC) OJ L13, 15 January 1987, p. 39 at para. 37.
- 423. To justify stronger restrictions, Article 85(3) would require finding that they were also indispensable.
- 424. Commission Regulation No. 4087/88, preamble para. 12.
- 425. Commission Regulation No. 4087/88, article 2-a.
- 426. Commission Regulation No. 4087/88, article 2-d.
- 427. See Regulation No. 4087/88, preamble para 12.
- 428. See the section on exclusive dealing in Chapter V.
- 429. It should be noted, however, that while such obligations are stated in Article 3 of the franchise block exemption to be acceptable only "in so far as they are necessary to protect the franchisor's industrial or intellectual property rights or to maintain the common identity and reputation of the franchised network", the non-opposition procedure specified in Article 6 may allow such obligations to be included in acceptable agreements even if they do not meet these conditions, so long as the obligations are not expressly prohibited by Article 5.
- 430. More generally, obligations covered by these provisions of the franchise block exemption might be analysed as tying arrangements under U.S. law. See the comments below on the relationship between current U.S. treatment of tying and the EC block exemption regulation.
- 431. In New Zealand however, under the Commerce Amendment Act 1990, resale price maintenance may be authorised by the Commerce Commission in cases where benefits can be shown to outweigh anticompetitive effects.
- 432. See the presentation of the Canadian position in Chapter IV.
- 433. Free-riding is ruled out if exclusive territories are understood in their strongest meaning, i.e. if one franchisee is not allowed to deal with customers located in other franchisees' territories. If exclusive territories are understood in a weaker sense, i.e. if only "active" selling activities are forbidden outside one's own territory, then free-riding may not be totally prevented, but nonetheless it is more difficult and will have less effect on incentives to provide services.
- 434. As Klein and Murphy (1988) note, however, this argument is not complete, since franchisees still would have more incentive in engaging in non-price competition to increase the supply of services whose benefits were appropriable than those whose benefits were inappropriable. As a result, to promote the desired supply of services whose benefits were non-appropriable, minimum price restrictions might be

- packaged with other provisions, for example direct specification that certain services be provided. See the discussion of these issues in Chapter II.
- 435. Continental TV Inc. v. GTE Sylvania, 433 U.S. (1977) at 55. Also quoted by the Supreme Court in its decision in Business Electronics Corporation v. Sharp Electronics Corporation, 485 U.S. 717 (1988) at 724-5.
- 436. In the absence of competition, however, differences in retail cost would only be passed on in part.
- 437. 433 U.S. (1977) at 54-55.
- 438. 465 U.S. 752 (1984) at 762-3.
- 439. 485 U.S. 717 (1988) at 727-728.
- 440. 465 U.S. 752 (1984) at 768.
- 441. For more detail on these findings, which are only incompletely summarised here, see Chapter 441. IV.
- 442. 485 U.S. 717 (1988) at 725-6.
- 443. In the earlier Supreme Court decision in *White Motor Co. v. United States*, Mr. Justice Brennan asserted that "resale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only among sellers of the affected product, but quite as much between that product and competing brands"; 372 U.S., 253 (1963) at 268.
- 444. The Court cited Posner (1975).
- 445. The franchise structure with market power would choose an inefficiently low level of retail services if inframarginal consumers value the services more than marginal consumers (assuming the absence of horizontal externalities and free-riding).
- 446. United States v. Socony-Vacuum Oil Co., 310 U.S. 150, at 223 (1940).
- 447. Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. at 211, 213 (1951); there was in that case an additional horizontal component since the agreement was between two suppliers that had agreed to sell liquor only to wholesalers adhering to maximum prices above which the wholesalers could not resell.
- 448. Albrecht v. Herald Co., 390 U.S. at 145 and 152-53 (1968).
- 449. Arizona v. Maricopa County Medical Society, 457 U.S. at 332 (1982).
- 450. 390 U.S. 145, at 152-153 (1968).
- 451. 390 U.S. 145, at 152 (1968).
- 452. 390 U.S. 145 at 152 (1968).
- 453. USA Petroleum Co. v. Atlantic Richfield Co., 859 F. 2d 687 (9th Cir, 1988).
- 454. USA Petroleum Co. v. Atlantic Richfield Co., 1105. Ct. 1884 (1990).
- 455. Among other things, BE's retail prices were often below the prices suggested by Sharp. Hartwell complained to Sharp on a number of occasions about BE's prices, and BE was terminated no more than one month after Hartwell's ultimatum that it would terminate its own dealership unless Sharp ended its relationship with BE within 30 days.
- 456. For the Court of Appeal decision, see 480 F. 2d 1212.
- 457. Regulation No. 4087/88, Article 2-3.

- 458. Northern Pacific Railway Co. v. United States, 356 U.S. 1 (1958) at p. 6.
- 459. Jefferson Parish Hospital District No. 2 et al. v. Hyde, 466 U.S. 2 (1984).
- 460. The 9th Circuit Court, citing *Jefferson Parish*, found that this last requirement was satisfied by showing a substantial volume of commerce was foreclosed, suggesting a more market-based approach to the latter requirement. For citations to cases see ABA Antitrust Section (2d. ed. 1984, pp. 88-89, and 1988, pp. I-82-84), on which the discussion of U.S. jurisprudence in this paragraph is based.
- 461. Regulation No. 4087/88, Articles 3-1-a and 3-1-b.
- 462. So long as the franchise agreement affects trade between EC Member states and could have an appreciable impact on market conditions; an agreement that does not satisfy these conditions is not subject to Article 85(1).
- 463. Definitions of distribution arrangements designed to match current business practice, as are those of EC competition policy, are less likely to induce businesses to choose arrangements different from those they otherwise would prefer. The difficulty arises when businesses' practices change, either because conditions change or simply because of new innovations in institutional arrangements. The advantages of such a change might in many cases be outweighed by the disadvantage of no longer qualifying for the same competition policy treatment. As a result, the new arrangement might only be observed and competition policy definitions might not be adjusted. The availability of individual case-by-case exemptions outside a block exemption procedure, again as under EC law, helps because it makes exemptions possible for new arrangements that do not "fit" existing definitions and regulations. Still, seeking individual exemptions will be costly (in direct costs, in delay and in uncertainty of outcome), and therefore could somewhat deter the development of new arrangements. The lack of competition and the consequent harm may, however, be brought to the Commission's attention by another firm. In some circumstances other firms might be harmed by the provisions and therefore likely to complain; a complaint is less likely in a market with structural conditions such that vertical provisions allow the exercise of greater market power by all incumbent firms in a market.
- 464. See the discussion in Chapter III.
- 465. Regulation No. 4087/88, preamble, para. 8.
- 466. Regulation No. 4087/88, preamble, para. 15 and 16, and Article 8.
- 467. European Economic Community Regulation No. 556/89 on the application of Article 85(3) of the Treaty of Rome to certain categories of know-how licensing agreements, published in Official Journal No. L 66/1, 4th March 1989.
- 468. See for example the discussion in OECD (1989).
- 469. Nungesser v. Commission, Case 258/78, (1982) E.C.R. 2015.
- 470. (1982) ECR 2015 at 2063.
- 471. Commission Regulation No. 2349/84, OJ No. L 219/15, 16 August 1984.
- 472. Commission Regulation No. 556/89, OJ No. L 66/1, 4 March 1989.
- 473. Also, approved dealers could use the franchisor's brand name inside their outlet but not outside.
- 474. See for instance Kovar (1987).

- 475. And, as pointed out above, the cost tradeoffs and thus the most efficient rules, could vary across jurisdictions.
- 476. See Mendelsohn (1985, p. 104), which suggests that franchisor control over the number and location of franchisees, but without any guarantees of exclusivity to franchisees, is sufficient to insure viability of franchisees because of the franchisor's own interest in their viability.
- 477. It should be acknowledged that under Article 85(3) finding that a provision is indispensable is a necessary precondition for granting an exemption. Thus there is little latitude for finding that while franchises might have alternatives to exclusive territories, on balance these alternatives are sufficiently inferior that such provisions should not be prohibited.
- 478. Economic analysis does help one understand the factors that would make one or the other tool preferable for the franchise.
- 479. Additional evidence that retail services increased still would not discriminate between the hypotheses. Collusion on prices might be followed by non-price competition that increased services; such competing away of what otherwise would be monopoly rents could further reduce efficiency. These and similar problems are discussed in detail in T. Overstreet (1983).
- 480. Overstreet (1983, p. 163).
- 481. H. Hax, Vertikale Preisbindung in der Markenartikelindustrie, Köln-Opladen (1961); cited and conclusions described in Picot (1991).
- 482. A rule with more consideration of economic effects than *per se* rules, but less than detailed case-by-case analysis, will be efficient (and will lower overall costs) if, beginning from a *per se* rule, some greater consideration of the economic effects of provisions at first reduces the cost of "wrong decisions" by more than it increases enforcement costs, but at some point further analysis begins to add more to enforcement costs than is saved.
- 483. See for example U.S. Department of Justice, "Antitrust Enforcement Guidelines for International Operations" (10 November, 1988), esp. 19-22; and U.S. Department of Justice, "Vertical Restraint Guidelines" (23 January, 1985).
- 484. This follows the description of a new Notice adopted in 1987 in Commission of the European Community, *Sixteenth Report on Competition Policy*, 1987, p. 37.
- 485. In addition, public policy towards franchising may be influenced by policies other than competition policy, such as industrial or commercial policy.
- 486. In principle one could specify a single goal that would combine the objectives of maximising total surplus and consumer surplus. The objective would be to maximise the sum of producer surplus and consumer surplus, where producer surplus was multiplied by a weight with a value between zero and one. If producer surplus (and implicitly consumer surplus) had a weight of 1.0, this would be equivalent to maximising the unweighted sum of the two, which is total surplus. If producer surplus received a weight of 0.0, the goal would be to maximise only consumer surplus. This composite rule points out there are other possibilities created by giving producer surplus a weight greater than zero but less than 1.0, so that a greater weight is placed on consumer surplus but the effect on total surplus still is considered.
- 487. Quantitatively, however, vertical restraints can be expected to increase consumer surplus in fewer cases than they increase total surplus. Since it can be presumed that businesses always expect the vertical restraints they adopt to increase profits,

- restraints may sometimes increase total surplus but not consumer surplus, while we would never expect consumer surplus to increase when total surplus did not. That difference may affect not only the result of analyses in particular cases, but the balance of costs and benefits of adopting a *per se* or other simple rule.
- 488. Commission of the European Communities, *Sixteenth Report on Competition Policy*, 1987, pp. 13-14.
- 489. Not all sort of market segmentation and resulting economic price discrimination necessarily reduce economic efficiency. It should be pointed out, however, that a strict policy of prohibiting all barriers could be judged the best way to eliminate barriers that do cause inefficiency on the grounds that an attempt to identify and prohibit only barriers that reduced efficiency would in practice fail to detect and prohibit many barriers that are inefficient. In effect, this approach says that a *per se* rule against market divisions and barriers is most efficient even though some individual decisions might be different if examined individually.
- 490. Of course typically anticompetitive behaviour, such as simple monopoly pricing, both redistributes and imposes a deadweight loss that reduces the sum of producer and consumer surplus. Also, if what otherwise would be a pure transfer leads producers to spend resources competing for increased profits what economists call rent-seeking but without generating an equal amount of consumer surplus, the net effect would be a fall in total surplus and economic efficiency. In other words, the effects no longer would be purely redistributive.
- 491. This line of argument is similar to that presented in the OECD (1989) report on intellectual property rights, which recommended taking into account the possible long-term beneficial effects on the promotion and diffusion of new technologies when assessing the impact of various restrictions on inter-brand competition.
- 492. Even in the case where there are few franchisors, they may face competition by other, non-franchised forms of business.
- 493. This may be the case not only when there is no retail competition, but also when retail outlets are monopolistically competitive; see e.g. Mathewson and Winter (1986, pp. 214-215).

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