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THE PRESENT POSTURE OF FRANCHISING

HUGH B. HELM*

RECENT INCREASE in the use of franchising in merchandising, particularly in new commercial ventures involving copyrights and trademarks, necessitates a review and an analysis of the present posture of the law applicable thereto.

Jurisdiction over these matters is in the Department of Justice under the Sherman Act\(^1\) and in the Federal Trade Commission under Section 3 of the Clayton Act\(^2\) and Section 5 of the Federal Trade Commission Act.\(^3\)

Some lawyers approach the subject of franchising by sorting out and labelling franchises into different types, brands, or kinds. This is not necessary, and, in fact, leads to error, since the law of franchising is the same regardless of how the franchise is characterized. Therefore, this article will not define a franchise or franchises, but will rather say at the outset as at the conclusion: there is no legal magic in the word “franchise.”

The Commission's leading decision involving franchising is Carvel Corporation.\(^4\) Subsequently, the Commission issued a number of illuminating advisory opinions with respect to franchising.\(^5\) More recently, in File No. 693 7036 and File No. 693 7043, the Commission was requested to issue advisory opinions with respect to proposed franchise agreements, but it declined to issue them be-

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5. F.T.C., Advisory Opinion Digest No. 18, file no. 663 7004; F.T.C., Advisory Opinion Digest No. 72, file no. 663 7053; F.T.C., Advisory Opinion Digest No. 254, file no. 683 7125; F.T.C., Advisory Opinion Digest No. 278, file no. 683 7150.
cause of insufficient information without investigation as provided by 1.1 (a) and 1.1 (c) of the Rules of Practice.\textsuperscript{6} The touchstone by which the Commission has tested restrictions in franchise agreements has been whether or not the restraint imposed on trade thereby is reasonable.\textsuperscript{7} The question arises as to what extent, if any, the policy enunciated in \textit{Carvel}, and followed in four subsequent advisory opinions, has been modified in light of the more recent decisions of the United States Supreme Court involving franchises: \textit{Perma Life Mufflers, Inc. v. International Parts Corp.};\textsuperscript{8} \textit{Albrecht v. Herald Co.};\textsuperscript{9} \textit{United States v. Arnold, Schwinn & Co.};\textsuperscript{10} \textit{FTC v. Brown Shoe Co.};\textsuperscript{11} and \textit{FTC v. Texaco Inc.}\textsuperscript{12} What are the implications, if any, of these cases for the future approach toward franchising?

\textbf{CONSEQUENCES OF \textit{Carvel}}

In \textit{Carvel}, the Commission considered a franchise agreement concerned with the manufacturing and selling of soft ice cream. Under the franchise agreement, to protect the end product and the image of the franchisor, the dealer was required to purchase from Carvel, or from sources designated by Carvel, his entire requirements of mixes, toppings, flavors, cones and any other items which constitute a part of the end product sold at retail. The dealer was also required to purchase and use only the manufacturing and dispensing freezer manufactured by Carvel and was encouraged to purchase his other associated equipment from Carvel. The dealer was given some latitude in purchasing other equipment from other sources with the approval of Carvel, but was closely supervised in the purchase and use of such equipment (actually the examiner had found that Carvel discouraged this practice and that relatively little equipment was purchased by dealers from suppliers other than Carvel). The dealers were also required, by the terms of the franchise agreement, to operate in strict accord with the standard operating procedures prescribed by Carvel which regulated the operations of the store and equipment,

\begin{itemize}
\item \textsuperscript{6} 16 C.F.R. § 1.1 (1969).
\item \textsuperscript{7} \textit{Supra} note 4.
\item \textsuperscript{8} 392 U.S. 134 (1968).
\item \textsuperscript{9} 390 U.S. 145 (1968).
\item \textsuperscript{10} 388 U.S. 365 (1967).
\item \textsuperscript{11} 384 U.S. 316 (1966).
\item \textsuperscript{12} 393 U.S. 223 (1968).
\end{itemize}
the sanitation procedures to be followed, the methods to be used with respect to flavoring, freezing and dispensing the ice cream mix, and the varieties of ice cream and other products which may be manufactured from the basic mix. Dealers were not permitted to manufacture or handle any product not specifically prescribed by Carvel. The franchise agreement authorized Carvel to inspect the store records and operations of the dealer at such times as he desired. The franchise agreement was effective for a five year period with a five year renewal option. Breach by the dealer of any of the terms of the franchise entitled Carvel to terminate the franchise, with liquidated damages against the dealer. In the event of the termination of a franchise, irrespective of the cause, Carvel had the right to purchase all of the dealer's machinery and equipment in the store at a depreciation of its original cost of fifty per cent during the first year, with further depreciation in later years. Upon termination, the dealer was prohibited by the agreement from engaging in the sale of frozen dairy products for a period of three years within three miles of the store he operated.

In the order dismissing the complaint, which was brought against Carvel under Section 5 of the Federal Trade Commission Act, the Commission set aside the hearing examiner's initial decision concerning the franchise agreement and Carvel's operations thereunder. The Commission concluded that the hearing examiner was wrong in his conclusion (1) that the Carvel agreements were a part of a general plan and purpose to restrain interstate commerce, and (2) that the restrictions imposed on Carvel's licensees were not reasonably related to Carvel's right—and obligation—to control the quality of its trademark product and the identity and image of its trade name.\(^ {13} \)

The Commission also held that there had been a failure of proof as to anti-competitive effects.

In Carvel, the Commission tested restrictions in the franchise agreement by the touchstone of whether the restraints imposed on trade thereby were reasonable. This test was applied with protection of the quality of the end product in mind. The four advisory opinions involving franchise agreements which have been prepared subsequent to the Carvel decision have applied the doctrine enunciated by the Commission in Carvel. However, the restrictions on franchisees considered in the four advisory opinions were far less burdensome than

\(^ {13} \) Supra note 4, at 12.
those involved in *Carvel*. Advisory Opinion Digest No. 278 was concerned with the franchising of pizza shops. The franchise was not restricted, for example, in sources from which he might purchase his mixes and supplies. The nature of the product or service involved and the particular problems presented in the three other requests for Commission consideration raised, generally, different issues than those involved in *Carvel*. Advisory Opinion Digest No. 18 involved a franchise for a service of dispatching written communications. Advisory Opinion Digest No. 254 involved a franchise for a service of providing a comprehensive check-cashing program. Advisory Opinion Digest No. 72 involved the franchising of tape recorders and accessories. Food recipes and the preservation of the quality of end products were not involved. The restrictive covenants in the franchises were far less onerous than those in *Carvel*, giving the franchisees great latitude in buying and selling without any coercion.

Subsequent to the issuance of its advisory opinions dealing with franchising, the Commission decided the *L.G. Balfour Co.* case in which there is a suggestion that *Brown Shoe* limits the application of *Carvel*. Commissioner Jones, who prepared the opinion in *Carvel* as well, frankly states in *Balfour*:

In *Carvel*, we found that the franchise agreement was an exclusive distributorship and the substantiality of foreclosure should be evaluated under *Tampa*'s criteria. Both of these cases preceded the Supreme Court’s decision in *Brown Shoe Co.*, supra, which reaffirmed the Commission’s right to strike down restrictive agreements even without proof that the contracts amount to a full-fledged violation of § 315 when the proceeding is under § 5. The court was satisfied that Brown's


15. Clayton Act § 3, 15 U.S.C. § 14 (1964) provides: "That it shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies or other commodities, whether patented or unpatented, for use, consumption or resale within the United States or any Territory thereof of the District of Columbia or any insular possession or other under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce."

franchise program conflicted with the central policy of both § 1 of the Sherman Act and § 3 of the Clayton Act and held that in declaring the franchise program unfair the Commission acted well within its authority, even in the absence of a showing of the § 3 element of "substantiality." 18

DECISIONS SUBSEQUENT TO Carvel

All of the potential issues that might arise in connection with franchising were not considered in Carvel. Decisions of the United States Supreme Court subsequent to Carvel dealing with various aspects of franchising will now be examined for possible implications as to the Court's attitude toward franchise agreements:

FTC v. Brown Shoe Co.

In Brown Shoe, the Court was concerned with a record which showed beyond doubt that Brown, the country's second largest manufacturer of shoes, has a program which requires shoe retailers, unless faithless to their contractual obligations with Brown, substantially to limit their trade with Brown's competitors. This program obviously conflicts with the central policy of both § 1 of the Sherman Act and § 3 of the Clayton Act against contracts which take away freedom of purchasers to buy in an open market. 19

The Court had no difficulty in finding that the Commission has the power under Section 5 of the Federal Trade Commission Act to arrest the indicated trade restraints in their incipiency. Brown Shoe would indicate a limitation on the restraints which a franchisor might impose on a franchisee with respect to his freedom to purchase in the open market, but it should be remembered that the Court specifically noted that Brown is the second largest manufacturer of shoes.

FTC v. Texaco

Also subsequent to Carvel, the Supreme Court decided the Texaco case. Mr. Justice Black, speaking for the Court, stated:

That Texaco holds dominant economic power over its dealers is clearly shown by

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17. The Sherman Act § 1, 15 U.S.C. § 1 (1964), provides in relevant part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal."

18. Supra note 14, at 41. Cf. subsequent Texaco doctrine of inherent coercion, infra notes 20 and 22 and accompanying text.

19. Supra note 11, at 321.
the record in this case. In fact, . . . [Texaco does] not contest the conclusion of the Court of Appeals below and the Court of Appeals for the Fifth Circuit in Shell that such power is “inherent in the structure and economics of the petroleum distribution system.”

In reaching unfair methods of competition in Texaco under Section 5 of the Federal Trade Commission Act Mr. Justice Black said:

While the success of this arrangement in foreclosing competitors from the TBA market has not matched that of the direct coercion employed by Atlantic, we feel that the anticompetitive tendencies of such a system are clear, and that the Commission was properly fulfilling the task that Congress assigned it in halting this practice in its incipiency. The Commission is not required to show that a practice it condemns has totally eliminated competition in the relevant market. It is enough that the Commission found that the practice in question unfairly burdened competition for a not insignificant volume of commerce [citations omitted].

The Commission was justified in concluding that more than an insubstantial amount of commerce was involved.21

The result in Texaco is well characterized by Mr. Justice Stewart in his dissent as a “per se rule of 'inherent' coercion.”22 Thus, when the Commission proved the powerful economic set-up of Texaco, it could infer that the competitive injury was substantial. It is, therefore, safe to assume that if the Commission had had before it in Carvel the Brown Shoe and Texaco opinions, proof of competitive injury would not have been required.

United States v. Arnold, Schwinn & Co.

In Schwinn, the Court was concerned with a franchising plan in the retail bicycle industry which restricted the retailers' freedom as to the territories in which they might sell and the customers to whom they might sell. The Court held that in the normal business situation, the franchisor's restrictions on franchisee's freedom with respect to territories and customers is illegal per se under Section 1 of the Sherman Act.23 The Court characterized the normal business situation as that in which the manufacturer parts with title, dominion or risk with respect to the article. The Court also noted that Schwinn "was not a newcomer, seeking to break into or stay in the bicycle business. It was not a 'failing company.' On the contrary, at the initiation of [the offending] practices it was the leading bicycle pro-

20. Supra note 12, at 226.
21. Supra note 12, at 230.
22. Supra note 12, at 232.
ducer in the Nation."\(^{24}\) The significance of this caveat for future cases involving franchises cannot now be predicted with confidence, but the Court very well might not apply the rule enunciated in Schwinn to comparatively small or new franchise operations or involving products substantially different from bicycles. Furthermore, a vertical situation where title is retained is not typical of a true franchise agreement.

**United States v. Sealy, Inc.**

In *United States v. Sealy, Inc.*,\(^{25}\) the Court was concerned with so-called franchise agreements involving territorial restrictions in the mattress manufacturing industry. These arrangements were not true franchise agreements conferring rights and privileges *from the top down*, inasmuch as the members were the owners. In view of the Court's analyzing these agreements as constituting horizontal territorial limitations, this opinion adds little to a projection of the Court's thinking with respect to true franchises. However, exclusive territories were prohibited by the Court in these cases, although it was not on a vertical basis as a true franchise agreement would be.

**Albrecht v. Herald Co.**

In *Albrecht*, the Court was concerned with an agreement between a franchisor and franchisee whereby the franchisor fixed maximum prices at which his product (a daily newspaper) was to be sold by the franchisee. The Court applied the doctrine of *Kiefer-Stewart Co. v. Joseph E. Seagram & Sons Inc.*\(^{26}\) and held that such an agreement between franchisor and franchisee to fix maximum prices is a *per se* violation of Section 1 of the Sherman Act.

**Perma Life Mufflers, Inc. v. International Parts Corp.**

In *Perma Life Mufflers*, the Court was concerned with franchise agreements involving shops for the repair and replacement of automobile mufflers. The issues before the Court were essentially procedural, but it may be said that in dealing with those issues the Court

\(^{24}\) Supra note 10, at 374.


\(^{26}\) 340 U.S. 211 (1951).
expressed a "mood" of hostility to unreasonable and oppressive restrictions in franchise agreements. A reading of the case reveals there was substantial agreement in all five opinions of the majority that the franchise agreement between Midas and its franchisees contained illegal restrictive covenants, bearing on exclusive territories, full-line forcing or tying arrangements of mufflers and tail pipes, and buying only from franchisors. Of course the Court was not ruling on the franchise agreement as such, but on a preliminary matter; however, its opinion plainly indicates how the majority felt on the subject of rights of franchisees.

The foregoing summary of recent United States Supreme Court decisions concerning franchise agreements suggests that in the particular areas with which the cases are concerned, the general approach in *Carvel* of testing the proposed restriction in terms of reasonableness would no longer be followed. Furthermore, the Court's opinions to which we have referred, generally reflect a hostility to restraints which franchisors may impose upon franchisees.

It may be doubtful whether the doctrine of ancillary restraints as first enunciated in *U.S. v. Addyston Pipe & Steel Company*,27 was ever helpful in analysis, but in view of the Court's decisions in *Schwinn* and *Brown Shoe*, it is apparent that such doctrine now is likely to blur rather than facilitate analysis. What the Court is increasingly concerned with is the actual impact of restrictive arrangements on competition.28

CONCLUSION

The characterization of the arrangement between a supplier and a dealer as a franchise is of no particular legal significance in the applications of laws administered by the Commission. To the contrary such characterization may lead to confusion in the analysis of the legal issues involved. Definitions breaking franchises down into categories are not helpful. Furthermore, the Supreme Court has given evidence of viewing historical franchise arrangements more critically than heretofore and has expressed a mood of hostility toward all burdensome restrictions on franchisees.

The legality of a franchise agreement can best be examined in

27. 85 F. 271 (6th Cir. 1898), aff'd 175 U.S. 211 (1899).
On the basis of Supreme Court decisions since *Carvel*, it appears that franchisors cannot: (a) fix prices at which sales can be made by franchisees; (b) generally, cannot restrict franchisees with respect to their territories and customers. The test of reasonableness should be applied to other restraints imposed by franchisors or franchisees. Doubtless all restraints on franchisees should be viewed with a critical eye, the unmistakable trend being toward protection of franchisees.

*Carvel* has not been overturned by the Supreme Court, but it has been considerably modified and its application restricted. What remains is good law, subject to the same touchstone of the reasonableness of any restraints imposed on trade by a franchise agreement in the areas left untouched. This is but another way to emphasize effect on competition.

Franchising is here to stay and probably will be on the increase. It is a simple, easy way to raise capital and to merchandise copyrighted and trademarked goods. It is also a convenient way to put a new product on the market, particularly food, without large cash outlays. Although it affords great opportunity to the small businessman, it also has great potential for fraud on small investors. It is, therefore, vitally necessary that franchisees be protected from unscrupulous franchisors who use their economic power to over-reach them.

In considering the lawfulness of franchises in the future, two general propositions should be kept in mind: (1) There is no legal magic in the word “franchise.” It is no excuse for placing a franchisee in an economic strait-jacket or coercing his compliance with restrictive covenants that restrain competition in favor of the franchisor; and (2) the increasing concern of the Supreme Court for the freedom and protection of franchisees under franchise arrangements.

To be specific, it is recommended that franchisors govern themselves by the following postulates:

1. Franchisors cannot fix prices at which franchisees may sell.
2. Franchisors generally, cannot restrict franchisees in their purchases.
3. Franchisors cannot generally allocate territories in which franchisees may sell.
(4) Franchisors cannot generally dictate customers to whom franchisees may sell.

(5) Franchisors cannot generally prevent franchisees from selling and carrying in inventory items other than the franchised items.

(6) Franchisors cannot be arbitrary or economically oppressive in termination of franchises.

We qualify some of the caveats above with the word “generally” because of the implication in Schwinn and Simpson v. Union Oil of California to the effect that the smallness of a new business and the fact that it is entering into a new market may be treated as an exception by the Court, or the fact that title has not passed in a vertical merchandising arrangement may also be treated as an exception by the Court. It is also possible that the Court may apply the de minimis rule to the effect on competition in cases of obvious insubstantiality.