Chapter 38

Franchising and Exclusive Distribution: Adaptation and Antitrust[1]

Francine Lafontaine and Margaret E. Slade

1. Introduction

Vertical restraints are contract clauses that one link in a vertical chain imposes on another. Most often vertical restraints arise in the context of distribution and in retail settings, with the upstream firm or manufacturer restricting its downstream distributors or retailers' choices. For example, a manufacturer might limit its retailer's product line or geographic market, or set the retail price.

In this chapter, we examine vertical restraints in franchising and distribution agreements. First, we give a brief outline of the history of franchising and present some data on franchising in the U.S. as of 2007, the year of the most recent economic census. We then discuss the extent to which franchise relationships rely on specific types of vertical restraints and the evidence regarding their efficiency or lack thereof. Next, we describe how changes in the antitrust treatment of some practices are affecting franchise contracts and franchise relationships today. Although we pay particular attention to the U.S., we also discuss the evolution of antitrust rules as they apply to franchise contracts in the European Union.[2] Finally, we conclude with some comments on the contractual nature of distribution and franchise relationships, and the need to

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[1] This paper borrows from some of our joint work, especially Lafontaine and Slade (2008 and 2012), as well as from Blair and Lafontaine (2005).

[2] For an international comparison of the legal treatment of franchising and the interface with antitrust more generally, see WIPO (2011). For a general treatment of vertical restraints and antitrust, see Winter, chapter 37 in this handbook.

reach a consensus concerning the role of, and harmonize the treatment of, restrictive contract clauses in distribution and retailing.

2. Franchising, History and Extent in the U.S. Today

Franchising is a form of business organization in which an upstream firm, the franchisor, enters into contractual relationships with downstream firms, the franchisees, who operate under the franchisor's trade name and usually with the franchisor's guidance. In some sense, franchising is as old as commerce itself. However, some attribute the origin of modern franchising to early 19th century German brewers, who granted pubs and taverns the right to sell their products and use their name.

According to Dicke (1992), franchising in the U.S. can be traced back to the mid 1800s when the McCormick Harvesting and Singer Sewing Machine Companies granted exclusive territories to sales agents in exchange for a franchise fee.[3] Initially, like other firms using agents at the time, these two companies imposed few restrictions on, and required limited qualifications from, their agents. Over time, however, both found that they needed more control if they were to protect their reputations and brands. The McCormick Harvesting Machine Company proceeded to establish company-owned branch houses throughout the United States and Canada, branch houses that were given oversight responsibilities for the sales agents in their territories. This allowed McCormick to systematize procedures and communications with its agents, thereby transforming them into what we would now call "dealers." The Singer Sewing Company addressed the need for control by converting many of the independent agencies into company

[3] See Dicke (1992) for more on the history of franchising in the United States, including a detailed account of its evolution at these two companies. See also Marx (1985) on the development of franchising in automobile retailing in the U.S.

outlets. It also devised a series of recommendations for the remaining agents as to how the offices should be run and, for the first time, required detailed financial reporting from them. The contracts and methods of control that Singer developed at the time are often described as the forerunners of the modern franchise agreement.

Coca Cola began developing its franchise bottling system in 1899, and car manufacturers and oil companies followed suit soon after.[4] The specific form of organization used by these firms, whereby the franchisor is a manufacturer who sells finished or semi-finished products to its dealers/franchisees, has since come to be known as "traditional" franchising. The franchisees in these systems sell their franchisor's products to consumers or to other firms in the distribution chain. The franchisor's profit from its dealer network flows from the markups that it earns on the products sold to franchisees. In contrast to business-format franchising, as described below, traditional franchisees do not pay running royalties.

Martha Matilda Harper is said to have created the first true business-format franchise.[5] And indeed, this entrepreneur grew her network of Harper Beauty Shops from the early 1890s onward using a business model that included all the components of a business format as described by the U.S. Department of Commerce today. To be sure, her network of hair salons was developed around the distribution of a product, which she manufactured in Rochester, NY,

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[4] Starting with the arrangements between German brewers and retailers, franchising has always been a common method of selling beer in Europe. For a discussion of exclusivity in U.K. beer sales, see Slade (1998 and 2011). This arrangement, however, is illegal in most states in the U.S. Nonetheless, contractual relationships between beer producers and their distributors are often exclusive and have several of the characteristics of franchise agreements.

[5] See, Plitt, (2000).

similar to traditional franchising. But sales of the tonic were only a small component of the business concept. To operate a Harper salon, a woman – all Harper franchisees were women – had to go through rigorous training and agree to abide by a set of rules that guaranteed customers the same quality of service at any Harper salon. Although there were more than 500 Harper salons in the U.S., Canada, and Europe by the mid 1920s, Matilda Harper's business did not survive her, and ultimately did not leave a visible mark.[6]

Many business format franchisors, such as A&W and Howard Johnson restaurants, established their franchise networks in the 1920s and 1930s. However, it was not until the1950s, with the advent of chains such as Burger King and McDonald's and the economic boom of the post-war era, that business-format franchising blossomed in the U.S. and Canada and, gradually, throughout much of the rest of the world. Business-format franchising today encompasses a large number of firms that provide a wide array of goods and services. In exchange for the business format, or trademark and way of doing business, franchisees typically pay a relatively small lump-sum fee at the beginning of the contract period as well as running royalties that are usually a fixed percentage of the franchisee's revenues. They also often contribute an additional fraction of their revenues to a separate advertising fund. Presumably, the advertising carried out with these funds benefits all franchisees as well as the franchisor.

Although often made, the distinction between traditional and business-format franchising is somewhat arbitrary. Dnes (1992) and Klein (1995), for example, argue that there is little economic difference between the two in terms of the type of agreements that franchisors rely on, the type of support that they provide, and the control that they exert. Moreover, when constructing theoretical models, researchers often make no distinction between the two types of

[6] However, one can still find the building that housed the Harper Laboratory in Rochester, NY.

franchising, and their models apply equally well to both. On the other hand, from a descriptive standpoint the distinction can be important because many countries outside the U.S. do not include traditional franchising in their data on franchising activities. The distinction also can be relevant from an antitrust perspective, particularly in relation to tying, as discussed below.

Historically, the U.S. government did not collect data on franchise activities in its economic censuses. In 1971, the U.S. Department of Commerce began publishing reports, "Franchising in the Economy," that provided data on franchising, which were obtained via franchisor questionnaires. Unfortunately, this initiative was terminated in 1986. With the 2007 Economic Census, the Census Bureau began a new effort to collect data on franchising, resulting in information on the franchising status of more than 4.3 million establishments across 295 6-digit NAICS industries.

The results of this effort, which were released in fall 2010, include data on sales, employment, payroll, and the number of establishments of franchised chains. As most franchised chains rely on dual distribution, operating both company owned and franchised establishments, the Census data also quantifies the level of activities of franchised and company-owned establishments separately within each sector.

We summarize some of the information generated by this effort in Tables 1 and 2.[7] In Table 1, we give an overview of the extent of franchising by showing the number of employer establishments, and total sales, total employment, and total payroll of the establishments of franchised firms. We also present information about the size of establishments, in terms of average sales, employment and payroll per establishment. The data are presented separately for traditional and business-format franchising.

[7] For more on this, see Kosová and Lafontaine (2011).

To give a better sense of the sectors where franchising occurs, and of the extent of dual distribution, Table 2 shows the number of employer establishments across detailed 6-digit NAICS industries for those industries that rely on franchising the most (per these data). The top panel of the table pertains to traditional franchising whereas the lower panel is for business-format franchising. The data in this table are further broken down between establishments that are owned by franchisees and those that are owned by franchisors.

These tables establish a number of important facts about franchising. First, Table 1 shows that, in 2007, franchising firms operated more than 450,000 employer establishments, or about 10.45% of all employer establishments in these sectors. Also, sales through these amounted to almost 1.3 trillion dollars, or 9.2% of GDP of 14,061 trillion dollars. These firms moreover accounted for 7.9 million jobs in the U.S. economy. By comparison, it should be noted that U.S. manufacturing accounts for a total of 13.4 million jobs. In other words, franchising accounts for more than half as many jobs as does all manufacturing activity in the U.S. Clearly, the results of the 2007 Census confirm that franchising plays a vital role in the U.S. economy. [8] And as basically all franchising involves operations under exclusive trademarks, i.e. exclusive dealing, and much of it entails the use of other vertical restraints as well, and since such restraints are not limited to this context, as discussed further below, these figures also confirm that much business activity is carried out under some form of vertical restraint in the U.S. economy.

Table 2 shows that about 23% (or 102,379) of the 453,326 employer establishments of franchised companies are operated directly by franchisors. Put differently, while establishments

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[8] Like most data in the economic censuses, these data ignore non-employer establishments. This is an important omission in the context of franchising, and so all these estimates should be viewed as conservative.

of U.S. franchisors represent about 10.5% of total employer establishments in the economy, 77% of these are owned by franchisees, while the other 23% are owned and operated directly by franchisors. Except for new automobile sales, where state laws prevent car manufacturers to own dealerships[9], all of the sectors listed are characterized by dual distribution – both up and downstream ownership. This is not the result of aggregation across firms that use and do not use franchising – though not shown in this table, in reality, most individual franchisors operate both types of establishments. This fact has led a number of authors to explore factors that can explain the variation in the proportion of franchised outlets across franchised firms.[10] For our purposes here, however, the important point is that under upstream ownership, there are no vertical restraints: instead, the firm controls its distribution via vertical integration. When considering the legal treatment of vertical restraints, this implies that the alternative of vertical integration is a very viable option for most franchisors. Thus changes in the legal status of vertical restraints almost surely will result in changes in the extent to which these firms rely on vertical integration. In other words, an important concern in considering the rules that govern the use of vertical

[9] See Lafontaine and Scott Morton (2010) on these.

[10] See Blair and Lafontaine (2005) for data at the individual franchisor level, and Lafontaine and Slade (2007) for a survey of the empirical work on the propensity to franchise. Note that Lafontaine and Shaw (2005) use panel data approaches to show that mature franchisors operate a stable proportion of their outlets corporately, and that those with higher valued brands operate a greater proportion of such outlets. They argue that this is consistent with the franchisor's desire to protect its investment in the value of the brand from franchisee free riding. They also find, as prior empirical analyses also found, that more geographically dispersed chains rely on franchising more, a result consistent with agency-theoretic arguments for franchising.

restraints is that the imposition of strict rules may lead to a reduction in the extent to which firms rely on franchising, and hence in the set of opportunities available to potential franchisees.

3. Antitrust and its Role in Franchising and Distribution

From an antitrust perspective, the main concern with both traditional and business format franchising is that they rely extensively on vertical restraints of various forms. The vertical restraints that have received the most attention in the literature include the following:[11]

- Exclusive dealing – where a manufacturer requires that a retailer sell only her products – is perhaps the most common form of restraint. Indeed, basically all franchising involves some form of exclusive-dealing arrangement. For studies of exclusive dealing in, for example, beer distribution, see Asker (2004), Sass (2005) and Slade (2011).
- Exclusive territories – where a manufacturer assures a downstream firm that it will be the exclusive reseller of its brand in a geographic region – often accompany exclusive dealing. This restraint is common in franchising, and also in beer distribution in the U.S. (see Jordan and Jaffe 1987, Culbertson and Bradford 1991, and Sass and Saurman 1993).
- Tying occurs when a manufacturer requires that its customers purchase product B (the tied product) as a condition for obtaining what they really want, namely product A (the tying product). Tying was common for example in movie distribution (see Hanssen 2000).
- Resale price maintenance (RPM) – where the upstream firm exerts control over the price that the downstream firm can charge – can take the form of setting a specific price or a price floor or ceiling. Franchisors have been known to impose mostly downward pressure on franchisee prices, i.e. maximum RPM (see Blair and Lafontaine 2005).

[11] See chapters 32 to 37 in this handbook for more on these restraints.

Antitrust authorities have been concerned with all of these restraints as applied to franchising and distribution: exclusive dealing because of its potential to foreclose and exclude, exclusive territories due to its potential to create local monopoly power, tying because of the possibility of extending monopoly power from one sector to another, and RPM due to its similarity with horizontal price fixing.

Although the intent of antitrust law is to protect competition, a perhaps unintended consequence of that law is that it gave franchisees some incentives to make antitrust claims against their franchisors – where they can request treble damages – even when the fundamental dispute was, in essence, contractual (see e.g. Joseph, 2011, at 3).

Unfortunately, from a policy point of view, the theoretical welfare effects of vertical restraints are almost always ambiguous. In the remainder of this section, we discuss some evidence regarding the use of each of these restraints in franchising and distribution, and what is known about the effects of that use. In the next section, we explore the extent to which changes in the legal treatment of vertical restraints have affected franchise and distribution contracts.

3.1 Exclusive Dealing

Historically, antitrust authorities have treated exclusive dealing more leniently than other forms of vertical restraints.[12] Were that not the case, franchising could not have grown so rapidly and would not have assumed such an important position in modern economies. The tendency to treat exclusive dealing leniently is perhaps surprising. Indeed, with respect to vertical restraints, one of the major concerns of regulators has been their potential to foreclose competitors and to raise rivals' costs, and exclusive dealing clauses have greater potential than

[12] For a more complete discussion of exclusive dealing, see Marvel, chapter 35, in this handbook.

other vertical restraints to have such effects.[13] In spite of this concern, exclusive dealing has a long history in franchising. For example, in the early 1920s, Sinclair already required its licensed dealers to sell only Sinclair gasoline from pumps bearing its trademark.[14] Exclusive dealing is also used in other contexts, including movie and beer distribution. Heide et al. (1998), moreover, document that 46 of the 147 manufacturers they surveyed – all of them in the industrial machinery and equipment or electronic and electric equipment sectors – used exclusive dealing clauses in their contracts with distributors.

Given its prevalence, it is not surprising that the reasons for employing exclusivity clauses have been assessed empirically. Heide et al. (1998), for example, examined this question via survey data collected from manufacturers. They found that manufacturers who were more concerned that their promotional efforts, training, or general support of distributors might benefit their competitors were more likely to adopt such exclusivity. On the other hand, when it was costly for manufacturers to assess whether their dealers sold other manufacturers' products (i.e. when monitoring the behavior of dealers was difficult ex post), or when manufacturers perceived that their customers had a preference for multi-product distribution, they were less likely to rely on exclusive dealing. These results are consistent with the type of efficiency or principal-agent arguments that are proposed in the organization economics literature to explain the use of exclusivity restraints.

A number of other empirical studies have attempted to understand the reasons for exclusive dealing by examining the consequences of its usage. Those studies again find considerable support for efficiency enhancing effects. For example, in the U.S. beer market, Asker (2004)

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[13] See Cabral, chapter 33, in this handbook for more on the theory of foreclosure.

[14] Federal Trade Commission v. Sinclair Refining Co., 261 U.S. 463 (1923).

finds that brewers that employ exclusive dealing arrangements have lower cost distributors than their competitors. Similarly, Sass (2005) finds that exclusive distribution is associated with greater brand and market sales, and Chen (2012) finds that exclusive distribution is probably adopted to prevent the erosion of efforts to promote individual brands that can occur when distributors handle large numbers of brands. In other words, empirical studies in the U.S. have uncovered little evidence of anticompetitive harm due to exclusive dealing (see Lafontaine and Slade (2008) for more on this). However, in the context of car retailing in Belgium, Nurski and Verboven (2011) find some evidence that exclusive dealing restrictions may be detrimental to consumers. We briefly revisit this study in our discussion of VRs in the EU, in Section 4.

3.2 Exclusive Territories

The 1890 Sherman Act made allocating exclusive territories *per se* illegal in the U.S., and this situation persisted until the Supreme Court's 1977 decision in Continental T.V. v. GTE Sylvania Inc. Since that time, exclusive territories have been subject to a rule of reason standard. Moreover, examples where manufacturers provide exclusive territories to their distributors are easy to find. For example, wholesale beer distributors and retail automobile dealers often operate under exclusive territorial clauses that protect them from entry of sellers of the same brand in their geographic selling areas. As a matter of fact, state laws governing new car sales in almost all U.S. states make it a requirement for manufacturers to demonstrate "need" to establish a new dealership in a dealer's "Relevant Market Area," as defined in the statute (rather than the territory the manufacturer might have defined).[15] In other words, state laws impose a requirement that antitrust laws deem potentially detrimental to consumers.

[15] See Lafontaine and Scott Morton (2010) for more on this.

An early example of the use of territorial restrictions in the U.S. – exclusivity in the distribution of Sealy mattresses – is the focus of a study by Mueller and Geithman (1991). Sealy introduced territorial restrictions in 1926, and those restrictions were found to be illegal under U.S. antitrust law by the Supreme Court in 1967. However, the first ban proved to be ineffectual as Sealy found ways to circumvent the law. As a consequence, a private antitrust suit was brought against Sealy and the new territorial restrictions were banned in 1975. Mueller and Geithman conclude that the restraints indeed had anti-competitive effects, as they led to local monopoly power and reduced output.[16]

From an efficiency perspective, however, exclusive territories can be used to provide some security to distributors and franchisees, or at least clarify how the manufacturer or franchisor's future plans might affect downstream operations. Table 3 shows the frequency with which franchisors in different industries offered exclusive territories to their franchisees according to the International Franchise Association (IFA) and Frandata's (1998) analysis of franchise disclosure documents. In this table, any form of exclusive territory, described by geography, population, miles, or number of vehicles, is counted as a yes. The table confirms that the majority of franchisors offered some form of territorial protection to their franchisees. Moreover, Azoulay and Shane (2001) found that a contractual guarantee of an exclusive territory significantly increased the likelihood that new franchised chains survive beyond their first few years in business. They interpret this to mean that territorial protection is so important to franchisees that young franchise systems that fail to offer such protection from encroachment are unable to attract franchisees, which leads to their failure.

[16] However, see Eckard (1994) for a criticism of their methodology.

Interestingly, 83.5 percent of the 170 new franchisors in Azoulay and Shane's (2001) data offered territorial protection. By contrast, in a 1993 study of the largest 50 restaurant franchisors, the Frandata Corporation found that only 26 of them offered some form of territorial exclusivity.[17] This is much lower than the proportion in Azoulay and Shane, or than the 80 percent reported in Table 3 for the sit-down restaurant industry, or even the 69 percent reported for the fast-food industry. It appears then that large franchisors, for whom claims of territorial encroachment are more likely to be an issue, have a lower than average propensity to offer territorial protection. Anecdotal evidence from Love (1986), who mentions how Ray Kroc, the founder of the McDonald's franchise system, offered exclusive territories to early franchisees, but then reduced the size of the territories over time and eliminated them entirely by 1969, suggests that the tendency of new franchisors to offer this protection while established franchisors do not do so as frequently, is a within-firm effect.

While one might expect that concerns over antitrust may be the reason that franchisors eschew the use of exclusive territories as they become large, or more dominant in their market, Azoulay and Shane (2001) mention an alternative motive for eliminating territorial protection as a franchisor becomes better established. They report that the main reason that franchisors give for not offering exclusive territories is the concern that "exclusivity would allow franchisees to hold them up through underdevelopment." In the words of one franchisor, "If they (franchisees) can't afford new stores and they don't operate well, they will slow down our growth if we can't put someone else in the area" (p. 353). Hence, development can be postponed due to franchisee liquidity constraints or, even worse, because a particular franchisee is not talented or ambitious

[17] Study results mentioned in "*Encroachment Issues in the Restaurant Industry*," 2nd Quarter *Franchise UPDATE* 14, 1994.

enough to operate more stores. Such concerns reduce the willingness of franchisors to provide territorial guarantees.[18] This problem is, of course, not insurmountable. In particular, grants of exclusive territories could be made contingent on some objective measures of franchisee performance. Such contingency clauses are common in master franchise agreements. Indeed, master franchise contracts not only provide territorial guarantees to the master franchisee, they also typically stipulate a fee to be paid for the rights to develop the franchise in the territory as well as a development schedule within the territory in question. The franchisor then evaluates the franchisee's performance in terms of number of outlets opened, and the territorial guarantee is predicated on this number reaching specific target values over time. The drawback to this approach is that the targets may be unrealistic, causing the master franchise agreement to fail.[19]

More generally, it is good practice for franchisors to state explicitly what they consider to be reasonable sales and profit levels per outlet, and for franchisees to know upfront that new outlets will be added when outlet sales in the region go above those levels. These types of safeguards for franchisors and franchisees go much beyond the simple grant of a territory, and are more closely aligned with other types of practices that franchisors currently use to minimize tension over geographic and other forms of expansion.

As mentioned briefly above, in addition to federal antitrust laws that govern exclusive

[18] See also Mathewson and Winter (1994) for a model emphasizing the role of exclusive territories in setting the starting point of future renegotiation processes in franchise relationships.

[19] See Kalnins (2004) on the frequency of failure of master franchise agreements in international markets, which he attributes to development schedules that are too aggressive.

territories, state regulations have resulted in territorial protection for new car dealers in the U.S.[20] All states require that car dealers be licensed in the state, thereby preventing manufacturers from retailing cars directly, or through other channels. In addition, most states protect auto dealers against what they refer to as encroachment by requiring that a car manufacturer demonstrate a "need" to establish a new dealership. Combined, these restrictions prevent manufacturers from adjusting dealer networks to match changing demand patterns. They have also been a major impediment to the development of, for example, Internet distribution of new cars. Finally, in almost all states it is illegal for manufacturers to require that franchisees purchase vehicles that they have not ordered, which amounts to a prohibition against quantity forcing. Unfortunately, a dealer who has an exclusive territory might exercise market power in that region, with the result that prices are too high and quantities sold too low from the manufacturer's point of view. In the absence of regulation, the manufacturer could turn to quantity forcing to lower prices, increase

[20] According to Dicke (1992), early dealer contracts at Ford for example also involved territorial exclusivity, even before the Sealy contracts. He notes that the standard yearly contracts introduced in 1908 by the company were simple, but covered such matters as pricing, quantity forcing, and territorial protection. Specifically, "a dealer agreed to purchase a set number of cars each month at a discount of 15 to 25 percent and to sell them only at prices established by Ford." (Dicke, 1992, at 64). Dealers were also bound to keep an inventory of parts and repairs on all cars made by Ford, whether they had made the sale or not. Then "In exchange for meeting the terms of his contract, the dealer received the exclusive right to sell Ford products in a clearly defined area […] Ford reserved the right to fine and/or cancel any dealer who engaged in cross-selling, that is selling to customers who lived outside the dealer's territory, or `bootlegging,' as the wholesaling of cars to unauthorized dealers was called." (idem, at 65)

total surplus, and reduce deadweight loss. As should be clear from the description of the state laws however, car manufacturers are not able to address the problem via quantity forcing, opening new dealerships, or selling cars directly to customers. The consequence, according to the few studies that have considered the effect of these state laws, is that cars sell at higher prices than they would absent the laws. For example, Smith (1982) finds that the territorial exclusivity for car dealers has led to higher prices and lower service levels, i.e. fewer hours of operation.

The Petroleum Marketing Practices Act at the federal level, and state laws governing liquor distribution, also provide territorial protection to dealers. Contrary to the findings for autos, however, in the beer industry Sass and Saurman (1993) conclude that territorial exclusivity, whether mandated or privately chosen, leads to higher demand through its effect on promotion, which is procompetitive or at least not anticompetitive.

Most recently, a few authors have assessed the effects, both potential and actual, of the change in policy that resulted in a ban of exclusive territories in new car retailing in the EU. Brenkers and Verboven (2006) find that, if a manufacturer's capacity to grant exclusive territories and to choose dealers selectively resulted in double margins, the change to a system where manufacturers could no longer grant exclusive territories would greatly benefit car buyers via reduced prices. In contrast, Zanarone (2009), who examined the effect of banning exclusive territories on the other clauses found in the franchise contracts of 19 car dealer networks in Italy, found that prior to the ban manufacturers relied on a mix of exclusive territories and quantity floors. After the ban, they introduced standards on verifiable marketing and service inputs, such as floors on advertising and the number of salespeople. He interprets this as evidence that manufacturers used exclusive territories to prevent free riding and induce desired dealer services. Thus, once exclusive territories were prohibited, they switched to other contractual devices to

achieve the same goals, presumably at higher cost.

In sum, the evidence that relates to the motives for adopting, and the effects of using, exclusive territories is somewhat mixed. Often, other restraints are used along with exclusive territories, and conclusions reached in the literature are sensitive to the set of other restraints used or available to manufacturers. Thus much more work will be needed before a consensus on the effects of particular restraints such as exclusive territories can be reached.

3.3 Tying

Among vertical restraints, tying has one of the most varied legal histories.[21] For one thing, unlike exclusive dealing and exclusive territories, tying is still *per se* illegal under U.S. law.[22] However, for it to be so, certain conditions must be met, which seems like a contradiction in terms. In addition to the existence of a tie, which would be sufficient in other *per se* circumstances, the following conditions must apply: First, the two products or services must be separate, which eliminates tying claims for products such as left and right shoes. Second, the seller must have sufficient market power in the tying good market, which eliminates cases where the buyer has many alternative trading partners in that market. And third, the arrangements must affect a "not insubstantial" amount of commerce, which eliminates arrangements that have little economic importance. In practice, these conditions mean that, with respect to tying, *per se* illegality is not very different from a rule of reason standard.

The use of tying contracts to assure input quality and thereby protect the value of a manufacturer's or franchisor's trademark has a long history. It has also been subject to various legal restrictions under U.S. antitrust laws and EU competition policy. A major early test of

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[21] For a more general discussion of tying, see Hovenkamp, chapter 36 in this handbook.

[22] Tying became *per se* illegal with the *International Salt Co. v. United States* decision in 1947.

tying in distribution occurred in the U.S. in 1917 when the Motion Picture Patents Company, the first great film trust, was sued for tying the sale of movie projectors to the purchase of films. The defendant lost the case, but on the basis of patent, not antitrust law. Nevertheless, this case gave rise to the leverage theory of tying.[23]

Other landmark decisions involved major oil refiners in the U.S., all of whom required that lessee dealers operating under their brands sell only their gasoline. Prior to the 1960s, most of them extended that requirement to include tires, batteries, and accessories, allegedly to ensure the quality of all products and services offered at their dealerships. Those requirements, however, were found to be in violation of U.S. antitrust laws.[24] As to open supply, i.e. the notion that dealers might be allowed to sell gasoline from different sources under their refiner's tradename, Marvel (1995) notes that "The Lanham Act, governing trademarks, was interpreted to require retailers to keep gasoline of different brands physically separate, stored in separate tanks and dispensed through separate and clearly marked pumps. Few dealers availed themselves of the opportunity to operate multibrand outlets." (p. 213).

Tying similarly became an issue in later years for business-format franchising. In its 1971 *Siegel v. Chicken Delight* decision, the court held that the requirement that franchisees in a fast-food chain purchase paper products and other inputs from their franchisor was an illegal tie. The court reasoned that in this type of business, the franchisor could ensure product and input quality, and thus consistency, by providing its franchisees with a set of approved suppliers rather than requiring that the franchisee purchase the input from the franchisor (who obtained it in turn from the manufacturer). This decision has been interpreted to mean that a business-format

[23] See Gift (2008).

[24] See Marvel (1995) for a detailed discussion and references to relevant court cases.

franchisor's trademark and method of doing business is a tying product that, for antitrust purposes, should be considered separate from food or other items that franchisees are required to purchase from their franchisors. Later, in *Krehl v. Baskin-Robbins Ice Cream Company* (1982), a franchisee alleged that Baskin-Robbins illegally tied its ice cream to the Baskin-Robbins trademark. Although ice-cream stores are often considered a type of business-format franchise, the court nonetheless noted that "the franchised outlets serve merely as conduits through which the trademarked goods of the franchisor flow to the ultimate consumer." The court thus found that Baskin-Robbins ice cream was not a separate product from the Baskin-Robbins trademark, and as such there was no tie-in. In other words, as in traditional franchising, the court found that input purchase requirements in the subset of franchised chains that amount to distribution franchises were not tying arrangements.

The practical result of this jurisprudence has been that most business-format franchise contracts in the U.S. today rely on approved suppliers rather than input purchase requirements for purposes of quality control, except in the special cases where the input is proprietary or indistinguishable from the trademark in customer's minds. This can be seen in Table 4, which shows the frequency with which franchisors required that franchisees buy some inputs from them in 1988 and 1989, the only years for which information on such requirements is available for a large number of franchisors (see Blair and Lafontaine, 2005, Ch. 6). The data indicate that franchisors involved in various types of retail activities frequently impose input purchase requirements. Franchisors that provide mostly services, on the other hand, typically do not require that franchisees buy inputs from them. What may seem surprising, on the other hand, is the frequency of purchase requirements in the restaurant and fast-food sectors. Michael (2000) examined the use of tying in these sectors specifically using the franchise disclosure documents

of 100 different restaurant and fast-food franchisors. He found that 30 of them required franchisees to purchase some product from the franchisor. Among the 30 firms with purchase requirements, on average the value of required purchases represented about 8.4 percent of all franchisees' wholesale purchases. Moreover, consistent with the arguments above, firms with the largest proportions of purchase requirements tended to sell only proprietary products, such as batter for pancake houses or ice cream for family restaurants (e.g., Brigham's and Howard Johnson respectively).

Given that a consequence of the *Chicken Delight* decision was to rule out one of the "per-unit" type of mechanism by which franchisors could extract franchisee rent, it would be expected to lead to an increase in reliance on royalty rates and advertising fees by those franchisors who are constrained by this ruling. And indeed, the data in Blair and Lafontaine (2005, Ch. 3) show that royalty rates are lower for business-format franchisors involved in retail compared to services, which again is consistent with the idea that in distribution franchises, franchisors extract some profits via markups on the products they sell to franchisees in a manner similar to traditional franchising.

Like the separate products aspect of tying, market definition issues also have proved controversial. In particular, a spate of franchise tying suits that occurred in the 1990's can be traced to a notion of market definition spawned by the Supreme Court's 1992 decision in *Eastman Kodak v. Image Technical* Services. This case involved the tie of one aftermarket product (repair services) to another (repair parts). Specifically, for years, Kodak sold its proprietary repair parts to independent service organizations (ISOs) so they could provide maintenance and repair services to owners of Kodak copiers and micrographic equipment. When Kodak changed its policy and refused to sell its repair parts to the ISOs, Kodak became the only

source of maintenance and repair services to its end customers. Image Technical Service and seventeen other ISOs sued Kodak alleging that it had illegally tied its service to its repair parts.

Kodak argued that since it sold its equipment in competition with other manufacturers, it could not have appreciable economic power in the aftermarket for repair parts (tying good). In essence, Kodak argued that the relevant product market for antitrust analysis is the primary market for photocopying and micrographic equipment, rather than the aftermarket for repair parts. The Supreme Court, however, rejected Kodak's reasoning and ruled that the relevant market for determining market power is based on "the choices available to Kodak equipment owners." Accordingly, it held that the relevant market was the market for replacement parts for Kodak equipment. Moreover, since the repair parts were proprietary, Kodak was found to have a market share of virtually 100 percent. The Supreme Court concluded that since repair parts for Kodak equipment are unique (i.e., neither IBM nor Xerox repair parts will fit a Kodak copier), the owners of Kodak copiers were now "locked in" to Kodak services if they want to keep their copiers operational. The only alternative is to switch to another brand of copier. But the Court reasoned that the high costs associated with switching prevented this option from being economically viable and provided Kodak with the power to exploit the locked-in owners.[25]

Franchisees employed the lock-in argument to support their claims of illegal tying in the franchise tying cases of the 1990's, simultaneously asserting that the market for the tying product was restricted to the market for the defendant's franchise, and the market for the tied product was the market for supplies to a particular franchise system. The cases also focused on the

[25] For an analysis of the reasons for vertical restraints by durable good producers, see Blair and Herndon (1996). It should also be noted that switching to an IBM copier merely locks one in to a different repair parts supplier. As such, it does not solve the customer's problem.

franchisor's refusal to approve or allow alternate sources of supply, or restrictive policies of approving alternate suppliers.

Among these cases, *Queen City Pizza, Inc. v. Domino's Pizza, Inc.* (1996, 1997) was the most influential. Queen City Pizza and ten other Domino's Pizza franchisees, along with the International Franchise Advisory Council, filed suit against Domino's, alleging various antitrust violations, including two tying claims. First, they alleged that Domino's illegally tied other ingredients and supplies to the purchase of fresh pizza dough, and second, they alleged that Domino's illegally tied ingredients and supplies to the franchise license itself. Integral to these complaints were the allegations that Domino's unreasonably withheld its approval of alternative sources of supply and provided incomplete product specifications, thereby eliminating viable competitive sources of supplies to the franchise system. The net effect was that Domino's franchisees purchased approximately 90 percent of their ingredients and supplies from the franchisor even though Domino's typically did not produce these goods; rather, it purchased them from third parties and resold them to its franchisees.

Interestingly, the court concluded that Kodak was not applicable in the context of franchise tying suits, and the *Queen City* litigation ultimately was resolved in favor of the franchisor. The district court noted that "[t]he economic power DPI [Domino's Pizza Inc.] possesses results not from the unique nature of the product or from its market share in the fast food franchise business, but from the franchise agreement." The Third Circuit affirmed the lower court's reasoning, and further noted: "If Domino's Pizza, Inc. acted unreasonably when, under the franchise agreement, it restricted plaintiffs' ability to purchase supplies from other sources, plaintiffs' remedy, if any, is not under the antitrust laws." In other word, the court made

a distinction between a franchisor's pre and post contractual market power. This, in our view, is correct.

Barkoff (2008) notes that this and other decisions since that time make it unlikely that franchisees today would be successful in a franchise tying case. And indeed, there is some evidence that a few business-format franchisors, including Domino's, have now put in place extensive distribution systems with the goal of supplying most of the inputs that their franchisees need. Thus the effect of *Chicken Delight* seems to have dissipated in the last decade or two. Although the move from antitrust to contract law has many advantages, in particular the removal of treble damages, it is not without problems. As Grimes (1999) points out, a franchisor could collude with a designated vendor (named in a sourcing requirement), allowing the vendor to charge a high price in return for a rebate. This could lead the franchisor to search for the highest rebate rather than the best quality/price package.[26] This problem, however, is not resolved under the standard remedy of approved supplier programs proposed in, and largely adopted after, the *Chicken Delight* decision unless franchisors are required to approve several suppliers for each input in each market, a task that is not only demanding, but also unlikely to yield the kind of purchasing economies that franchisees often seek from their affiliation with a franchisor.

3.4 Resale Price Maintenance

Resale Price Maintenance or RPM has an even more checkered antitrust history in the U.S.[27] Indeed, in 1911 the U.S. Supreme Court declared minimum RPM to be *per se* illegal, and in 1968 the Court extended the minimum RPM *per se* rule to include maximum RPM. However, in 1997 the Court overruled its 1968 extension to maximum RPM, and in 2007 it overturned its

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[26] Note that input prices are not stipulated in franchise contracts.

[27] For a more general discussion of RPM, see Klein, chapter 34 in this handbook.

ban on minimum RPM.[28] Nevertheless, since many states have their own RPM laws, the legal status of minimum RPM in the U.S. is still far from clear today.

Comparing the U.S. to the EU, the treatment of maximum RPM was more stringent in the U.S. after the *Albrecht v. Herald Company* decision in 1968. In its 1997 State Oil Company v. Khan decision, however, the Court returned the antitrust treatment of maximum resale price fixing to a rule of reason standard. This decision, which for all intents and purposes, permits maximum resale price restraints, has made the treatment of maximum RPM in the U.S. closer to that of the EU. On the other hand, the 2007 Supreme Court decision in *Leegin Creative Products, Inc. v. PSKS, Inc*., also moved minimum resale price maintenance to a rule of reason standard. This has widened the gap in policy between the two regions, since minimum RPM remains a hardcore offense in the EU.

The Leegin case involved a manufacturer of leather goods and accessories (Leegin) and one of its retail distributors (PKSK). Leegin had a policy of refusing to sell its products to retailers who priced below its suggested retail prices. When Leegin learned that PKSK was discounting, it suspended sales to that retailer. In response, PKSK sued Leegin, alleging illegal RPM. However, PKSK lost its case. The Leegin decision thus makes it no longer *per se* illegal for manufacturers and franchisors to impose minimum retail prices on goods that they sell to franchisees for resale. Nevertheless, individual state antitrust laws, as well as the hostility of some state attorneys general towards minimum RPM, can make it difficult for such firms to control downstream prices.[29] Furthermore, since business-format franchisors "sell" intellectual

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[28] Note that setting a specific price is both minimum and maximum RPM.

[29] Even though, in contrast to federal law, the fair trade laws that were adopted by many states after the depression allowed minimum RPM, in recent years some states (e.g., Maryland in 2009)

property such as trademarks, rather than goods, the legacy of Leegin for that sector is unclear.

In general, franchise RPM cases in the U.S. suggest that franchisors have been constrained more often by rules against maximum resale price maintenance than those against minimum RPM. In other words, when franchisors have tried to control their franchisees' prices, they have exerted pressure for their franchisees to reduce rather than increase their prices (see e.g. Blair and Lafontaine, 2007, Ch. 7). There are a number of possible reasons for franchisors' concern with lower prices. For one, franchisees with exclusive territories can exercise market power and thus charge prices that are too high from the franchisor's perspective per the usual double margins argument. Moreover, maintaining a maximum price level might also be a way to overcome demand externalities. Indeed, when brand loyalty is important, franchisees who charge high prices can damage the brand and thus reduce sales at other establishments as well as their own. Unlike franchisors, franchisees do not capture this externality. Finally, in some circumstances, royalties on sales might lead upstream firms to care more about downstream revenues than downstream profits, which would cause a similar divergence in desired prices.

As with the other vertical restraints, the theoretical effects of RPM are ambiguous. Unfortunately, given the historically harsh treatment of such practices, it has also been difficult to examine the effects of RPM, maximum or minimum, empirically. Ippolito (1991), however, is a rare exception. She examined the population of all 203 reported cases of resale price maintenance in the US between 1975 and 1982, a period during which a fairly broad

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have passed laws that permit a *per se* challenge to minimum RPM. For a discussion of federal/state conflicts, see Joseph (2010) and Barkoff (2010) and the references therein. The effect of the change in Maryland has been analyzed by Bailey and Leonard (2010) and found to be minimal for video games.

interpretation of what constitutes RPM was adopted by the courts, and during which she argues the courts adhered quite strictly to the *per se* standard. She shows first that vertical restraints are often used together. Firms simultaneously relied on other vertical restraints in 122 of the RPM cases, most frequently territorial, tying, or customer restrictions (49, 31 and 32 of the cases respectively). Cases of RPM also often involved other charges, in particular horizontal price fixing in 30, and refusal to deal in 40 of the cases. In addition, she finds evidence that a non-trivial portion of RPM cases, namely 65% of all private, and 68% of all public cases in her data, arise in contexts where products can be classified as complex, new, or infrequently purchased, which are the types of products where the special services theory for RPM is most likely to hold. Another largely overlapping segment of both private and public cases arose in resale contexts where dealers can influence the quality of the final good or the customer's experience in important ways. Here again, manufacturer controlled pricing can alleviate the fundamental principal-agent problem that efficiency motives and organizational economics emphasize. Yet another set of mostly franchising cases seems well explained by concerns over vertical sales-effort externality problems. She concludes that collusion was not the primary explanation for the RPM practices that were prosecuted during this period.

To the best of our knowledge, the more recent changing stance regarding the role of RPM in franchise and distribution has not led to significant changes in the contracting practices of franchisors and manufacturers *per se*. However, there are signs that some franchisors are trying to assume more control over the prices that their franchisees set. For example, McDonald's has removed a statement from its web site – a statement that was quoted in Blair and Lafontaine (2005, ch. 7) – to the effect that franchisees are free to choose retail prices. For its part, Burger

King recently settled a dispute with its franchisees over the maximum prices of some menu items. Before *Khan*, we expect the franchisees in that dispute would have had a stronger hand.

4. Contract Adaptation in the EU

There have not been large changes in the form and content of franchise or distribution agreements in the U.S. despite changes in the antitrust treatment of tying and resale price maintenance over the last couple of decades. However, some practices and clauses related to territories and other sources of competition have been expanded and/or clarified. Similarly, some franchisors have increased the extent to which they provide inputs to their franchisees.

During the same period, however, more dramatic changes have occurred in the antitrust treatment of vertical restraints in Europe. After a series of decisions regarding franchise relationships in the late 1980's, the European Commission (EC) adopted a Block Exemption Regulation on franchise agreements, which took effect on February 1st, 1989 and remained in effect until May 2000. It was then superseded by a new 2000 Block Exemption Regulation (BER) on Vertical Restraints. Finally, the 2000 BER and Guidelines for Vertical Restraints were replaced by new 2010 versions, which are expected to remain in force until June 2022. This is in sharp contrast to the U.S., where there are no comprehensive guidelines on vertical restraints.[30] In what follows, we briefly summarize the effects of the EU legal changes on franchising and contrast the treatment of restraints in the EU with that in the U.S.

The original Block Exemption on franchise agreements gave franchisors a great deal of flexibility to impose or rely on exclusive territories, exclusive dealing, tying, and some price

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[30] After the 1985 Vertical Restraints Guidelines were rescinded by the Clinton administration, no new comprehensive policy document has appeared.

restraints – but minimum RPM was still not allowed. The BER and guidelines on Vertical Restraints are in general stricter, but they do provide a safe haven under which small firms are exempt. In practice, because most franchisors fall within the safe heaven, i.e. they have less than 30% of the market, as do their franchisees, the effects of the new guidelines are likely to be felt most extensively in distribution franchises, such as car, beer, and gasoline retailing. On the other hand, the goal of opening competition across markets within the EU led to rules against territorial restrictions that are more stringent than they used to be for franchise firms, and more stringent than in the U.S. In addition, restrictions on Internet presence and distribution, which are discussed extensively in the latest Guidelines, are now viewed as more strict in the EU. Finally, the EU Vertical Restraints Regulation includes rules related to post-term non-compete clauses, or non-compete obligations imposed on a buyer after the termination of a contract with a seller. The guidelines require that they be "indispensable to protect know-how transferred by the supplier to the buyer",[31] limited to only the point of sale used during the contract, and no longer than one year. In the U.S., there is no consistent non-compete policy, with some states enforcing while others do not enforce such restrictions.

The automobile industry has received particularly close scrutiny from EU competition authorities. In 1995 the European Commission passed a regulation prohibiting price floors and quantity ceilings in car distribution, and in 2002 it enacted Regulation 1400/2002, an even stricter regulation that, among other things, eliminated exclusive territories and sales targets or quantity forcing. With the exception of certain hardcore practices, however, the automotive block exemption also created safe havens for car manufacturers, distributors, and repair shops.

[31] European Commission, Guidelines on Vertical Restraints (2010/C130/01) in Official Journal of the European Union No. C 130, p. 1, of 19 May 2010.

In 2010, a new automotive BER (Regulation No 461/2010) was passed that superseded the old. This new version is generally considered to be less restrictive than the old. In particular, as of 2013, new car sales will be subject only to the general BER on Vertical Restraints. Repairs, maintenance, and spare parts – the after market –have been subject to the new automotive BER since 2010, and are treated somewhat more harshly by said BER. The distinction between the two markets was made because the primary market was thought to be workably competitive whereas problems were perceived to remain in the after market.

We highlight some of the most important differences between the old and new regimes.[32] In the new car market, manufacturers will be able to impose exclusive dealing restrictions that cover up to 80% of a dealer's requirements instead of the former limit of 30%. In addition, the market share thresholds will be 30% for both up and downstream firms whereas formerly only the manufacturer's share was considered. Also, as long as the market share thresholds are met, it will be possible to impose clauses that prevent dealers from opening new dealerships. Exclusive territorial clauses are still prohibited. In the after market, authorized repair networks are unapt to benefit from the block exemption because markets are treated as brand specific, and thus market shares more easily exceed the thresholds. Moreover, technical information must now be made available to independent repairers; manufacturers are not allowed to use warranties to prevent owners from using independent repair service providers; and spare parts must be freely available to all service facilities.

Not surprisingly given these changes in policy, the automobile sector has been the subject of several empirical studies. Given the changes in the legal system, it should come as no surprise for example that franchisors and dealers have adapted their behavior in response to the new

[32] For more on the new block exemption for autos, see Zuehlke and De Stafano (2010).

environment. Of particular interest, we note again that public policy towards vertical restraints in franchise contracts can have unforeseen consequences. This is true because franchisors have many tools at their disposal to control franchisees. It therefore follows that banning one practice can lead to the adoption of others. Thus Zanarone (2009)'s study of how some franchisors adapted to changes in the 2002 EU law towards vertical restraints shows that, once exclusive territories became illegal, the number of car manufacturers who imposed price ceilings, required dealers to abide by a variety of explicit standards, and required dealers to contribute to an advertising fund that the manufacturer controlled, went up significantly. He explains the latter two changes as direct responses to reduced dealer incentives to advertise and provide pre-sales services. As for price ceilings, he suggests that they may have become necessary to prevent dealers from circumventing quantity floors – something he argues they could do by selling aggressively outside their territories while maintaining supra-normal prices in their own, perhaps isolated, markets.

Nurski and Verboven (2011) studied the likely effect of the change in regulation in the new car market in Belgium. They found that a ban on exclusive dealing would benefit consumers in this market in that it would favor smaller entrants and provide buyers with increased spatial availability. They therefore conclude that the European Commission's 2010 decision to facilitate exclusive dealing might not have been warranted. Unfortunately, their analyses abstract away from issues of dealership profitability, such as the potential extra costs of carrying and servicing more brands at a dealership, and the type of dealer incentive issues that efficiency arguments for exclusive dealing typically focus on.

Finally, although the EU controls competition policy that affects more than one member state, individual member states deal with those practices that affect competition within national

boundaries. In that context, the UK Office of Fair Trading (OFT) recently undertook a major review of the newspaper and magazine distribution industry. In 2009, however, it announced that it would not refer the sector to the UK Competition Commission. In other words, it did not find sufficient evidence of competitive harm to pursue a case. A key reason for this was that developments benefiting consumers had come about from the review and self assessment of distribution agreements undertaken by members of the industry. However, the sector was not given a clean bill of health, and the OFT did not rule out the possibility of further review.

The OFT ruling is consistent with the empirical findings of Ferrari and Verboven (2011) concerning Belgian magazine distribution. In particular, those authors find evidence suggesting that a government ban on restrictive licensing or on uniform wholesale prices would have little effect on upstream profits. They conclude that the rationale for those practices is unlikely to be anticompetitive, and should be sought elsewhere.

5. Conclusion

The extent to which federal antitrust law in the U.S. is binding on the nature of franchise contracts is almost surely less today than it was in the 1970's and 1980's. To illustrate, Barkoff (2008) notes that in the mid-1970s:

> "The need for the franchise lawyer to be educated in matters of antitrust law had been exacerbated by the antitrust decisions in the 1960's […] today one would not be wrong to describe antitrust law as being almost irrelevant with respect to the franchise community. A slight exaggeration? Yes, but not that far off." (Barkoff, 2008, 1).

In particular, with the 1997 State Oil v. Kahn decision, maximum RPM – the type of price restraint that franchisors have tended to impose – has been returned to the rule of reason. Since, in a competitive environment, retail price is no higher under maximum RPM than it would

be otherwise,[33] most economists believe that this restraint should not be *per se* unlawful. Similarly, in the years since the 1971 *Chicken Delight* tying decision, there has been a clear trend away from the logic in that case. In particular, in one important subsequent decision, the *Queen City Pizza v. Domino's Pizza Inc*., which was specific to franchising, the U.S. Court of Appeals for the Third Circuit rejected the logic proposed in the then recent Kodak case. Instead it ruled that as long as the input purchase requirements imposed by a franchisor were described in its disclosure documents, such requirements would not be considered a violation of antitrust laws.

While federal U.S. antitrust regulation seems to have much less impact on franchise contracts today, state antitrust laws may still be relied upon in some contexts. Furthermore, state laws governing the distribution of goods such as cars, gasoline, and beer, continue to affect the types of vertical restraints that can, or must, be applied to these relationships.

The conflict between federal and numerous state antitrust laws, as well as cross-state variation in the standards of enforcement, are problems that continue to inhibit the rational development of franchising in the U.S. This is the case because many franchisors operate nationally, and are thus subject to regulation by numerous jurisdictions. Given the division of power in the U.S., we are not optimistic that federal/state harmonization will occur in the near future.[34]

In the EU, meanwhile, the new block exemption and vertical restraints guidelines put in place in 2000 and then in 2010 have modified the treatment of franchise contracts, especially

[33] In an oligopoly, however, maximum RPM can actually raise retail prices (see Perry and Besanko 1991).

[34] Of course, many U.S. franchisors also operate internationally, and harmonization across countries is even less likely.

clarifying issues surrounding the use of exclusive territories and Internet distribution for firms operating in the Union. But here again, individual country antitrust laws can affect what can be included in distribution and franchise contracts, or even the existence of certain types of contracts,[35] and how these relationships work.

Experimentation is part and parcel of the evolution of any mode of organization, and franchising is no exception. As a business organization, franchising has evolved, and will continue to evolve. Presumably, what works well is retained and refined and what does not work well is discarded in an evolutionary manner. The changing legal environment has been one of the factors leading to changes and refinements. For example, the strategy initially adopted by Chicken Delight, which was to earn income by requiring franchisees to purchase inputs exclusively from the franchisor instead of relying solely on a sales-based royalty or fixed fee, was found in violation of U.S. antitrust laws. As a result of this decision, business-format franchisors moved away from input purchase requirements toward approved supplier clauses and adopted approaches where the franchisor is available as a potential, but not a required, source of supplies. This same decision also implied that business-format franchisors would move toward franchise fees and royalties on sales as their main sources of income. However, in recent years, the increased tolerance of antitrust authorities towards requirements stipulated in franchise contracts has led at least some franchisors to increase the role they play in the sourcing of inputs for their franchisees. Similarly, disputes over territorial rights in the quick-service restaurant sector and in hotel chains in the 1990's led many of the firms in those industries to include much more detailed territorial definitions in their contracts. Franchisors also have developed more

[35] See Slade (1998) for an analysis of a U.K. decision that limited dual distribution in beer retailing, a common practice in Europe that is illegal under post-prohibition state laws in the U.S.

systematic review processes for new sites and adopted policies for allocating new units to owners of nearby outlets, thereby resolving at least part of the conflict. In industries where encroachment through alternative channels (e.g., Internet sales) has been more problematic, a number of franchisors have worked on ways to channel part of the sales or profits to local franchisees while others have opted to stay out of the alternative channels. In all cases, franchise contracts, and hence franchisor-franchisee relationships, have been modified as the institutional and legal environments have evolved. This process is a slow one, but we believe that the trend towards treating vertical issues within the context of contract rather than antitrust law is here to stay.[36] We view this as a positive development, one that allows disputes between franchisors and franchisees, i.e. parties to a contractual relationship, to be brought forth and decided in the U.S. by reference to actual, rather than treble, damages. Nevertheless it is not a panacea as some post contract issues may still raise legitimate antitrust concerns (see also Barkoff, 2010).

[36] In some sense the treatment of vertical restraints has come full circle: for example, the first tying case was decided under patent, not antitrust law. See Hovenkamp and Hovenkamp (2010).

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Table 1: Traditional v. Business Format Franchising

	Establishments of				
	Franchising Firms, Total	Traditional Franchising Firms	%	Bus. Format Franchising Firms	%
# of Establishments	453,326	66,223	0.15	387,103	0.85
Sales ($000)	1,288,171	867,559	0.67	420,612	0.33
Employment	7,881,975	1,480,265	0.19	6,401,710	0.81
Payroll ($000)	153,680	56,144	0.37	97,535	0.63
Employment per Estab.	17.39	22.35		16.54	
Sales per Estab.	2,842	13,100		1,087	
Payroll per Estab.	339.00	847.80		251.96	

Source: 2007 Economic Census, Core Business Statistics Series: Summary Statistics by Franchise Status for the United States and Authors' Calculations

Table 2: U.S. Establishments by Franchise Status and Industry, 6-digit NAICS

NAICS	Sector	Establishments			Franchisee Owned Establishments		Franchisor Owned Establishments	
		Sector Total	# in Franch. Chains	% in Franch. Chains	Number	% of Sector Total	Number	% of Sector Total
312111	Soft-drink manuf.	472	87	18.43	76	16.10	11	2.33
441110	Automobile dealers, new	24,888	24,888	100	24,888	100	0	0
447110	Gasoline stations with convenience stores	97,508	33,991	34.86	17,194	17.63	16,797	17.23
447190	Gasoline stations, no convenience store	21,248	7,257	34.15	4,811	22.64	2,446	11.51
	Total Traditional Franchising Sectors	195,297	91,893	47.05	72,357	37.05	19,536	10.00
722211	Fast-food restaurants	211,313	124,898	59.11	97,262	46.03	27,636	13.08
722110	Full service restaurants	220,089	30,130	13.69	20,643	9.38	9,487	4.31
721110	Hotels and motels (except casinos)	48,108	22,585	46.95	20,655	42.94	1,930	4.01
531210	Offices of real estate agents and brokers	109,472	22,009	20.10	19,667	17.97	2,342	2.14
722213	Snack and nonalcoholic beverage bar	50,491	16,721	33.12	15,413	30.53	1,308	2.59

713940	Fitness and recreational sports centers	31,919	9,082	28.45	8,593	26.92	489	1.53
561720	Janitorial services	53,814	6,569	12.21	5,833	10.84	736	1.37
812112	Beauty salons	81,632	6,502	7.97	6,179	7.57	323	0.40
445120	Convenience stores	25,510	5,896	23.11	3,249	12.74	2,647	10.38
446130	Optical goods stores	13,149	5,776	43.93	375	2.85	5,401	41.08
	Other Bus. Format Sectors	3,295,252	111,265	3.38	80,721	2.45	30,544	0.93
	Total Business Format Franchising Sectors	4,140,749	361,433	8.73	278,590	6.73	82,843	2.00
	Total Franchising	4,336,046	453,326	10.45	350,947	77.42	102,379	22.58

Source: 2007 Economic Census, Core Business Statistics Series: Summary Statistics by Franchise Status for the United States and Authors Calculations

Table 3: Exclusive Territories

Sector	Number of Franchisors	Number with Exclusive Territories	%
Automotive	89	62	70
Baked Goods	39	28	72
Building & Construction	70	61	87
Business Services	57	42	74
Children Products and Services	27	24	89
Education Products and Services	21	20	95
Fast Food	197	136	69
Lodging	39	13	33
Maintenance Services	77	49	64
Personnel Services	35	33	94
Printing	21	14	67
Real Estate	39	26	67
Restaurants	99	79	80
Retail Food	60	27	45
Retail Non-food	130	101	78
Service Businesses	105	90	86
Sports and Recreation	37	31	85
Travel	14	8	57
Total	1156	844	73

Source: IFA Educational Foundation and Frandata Corp. (1998), as reproduced in Blair and Lafontaine (2005), chapter 8.

TABLE 4: MANDATORY PURCHASE REQUIREMENTS

	1988			1989		
Sector	N	Number of Firms With	Percent	N	Number of Firms With	Percent
Automotive	56	13	23.2	54	14	25.9
Business	96	19	19.8	93	14	15.1
Contractors	18	7	38.9	20	7	35.0
Cosmetic	14	3	21.4	17	4	23.5
Education	8	1	12.5	12	5	41.7
Fast Food	119	51	42.9	112	45	40.2
Health & Fitness	20	11	55.0	12	6	50.0
Home Furnishings	14	4	28.6	14	4	28.6
Hotels & Motels	9	1	11.1	5	1	20.0
Maintenance	45	12	26.7	47	16	34.0
Personal Services	52	14	26.9	56	14	25.0
Real Estate	15	1	6.7	17	5	29.4
Recreation	11	4	36.4	11	5	45.5
Rental	15	2	13.3	18	3	16.7
Restaurants	37	16	43.2	39	18	46.2
Retail Food	22	13	59.1	22	12	54.5
Retail Other	92	22	23.9	81	24	29.6

Total	643	194	30.2	630	197	31.3

Source: Blair and Lafontaine (2005), chapter 6.