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Tying Agreements in Franchising

What effects do tying agreements have on the franchise system of distribution?

THE franchise system of distribution continues to grow in importance. Retail sales of the approximately 380,000 franchising firms —both independent and company owned—approached $151 billion in 1973, nearly one-third of the $497 billion estimate for total retail sales. Independent, franchisee-owned units dominated the franchise system's retail sales, accounting for approximately 85% of the total. For 1974, franchising firms expected sales to exceed $159 billion, which would at least maintain their 30% share of total retail sales volume.[1] Concomitant with this rapid growth, however, has been the rise of substantial legal problems in franchising.

This article examines the legal problems confronting franchising and the efforts currently being made to help solve these problems. The controversy surrounding one of the most serious legal problems in franchising, the tying agreement problem, is reviewed. Finally, the results of an empirical study are presented to provide a better understanding of the impact of tying agreements on the franchise system of distribution.

Legal Problems in Franchising

In recent years, the franchise system of distribution has been deluged with legislation and litigation. Franchisee versus franchisor litigation has proliferated to the extent that some legal experts consider the legal problems facing the franchise industry to be of crisis proportions. Many prominent franchising companies have found themselves in court as a result of disenchanted franchisees. These companies include Shakey's, Mister Donut of America, Midas Muffler, Chicken Delight, Schwinn, H&R Block, Chick N'Joy, Chock Full O'Nuts, Mr. Steak, Electric Computer Programming Institute, The Southland Corporation (7-Eleven Stores), Network Cinema Corporation (Jerry Lewis), and A&W.

Sidney Diamond suggests that the current legal problems confronting franchising fall into three main areas: (1) misrepresentations by franchisors to potential franchisees about the operation of the franchise (the "disclosure" problem), (2) restrictions by franchisors on the source of supplies or services purchased by their franchisees (the "tying agreement" problem), and (3) onerous termination provisions in the franchise agreement (the "capricious termination" problem).[2] These problems are receiving the attention of trade associations in the franchising industry, state legislatures, the Congress, and the Federal Trade Commission (FTC),[3] as discussed below.

The two major franchising trade associations, The International Franchise Association and the National Association of Franchise Companies, are concerned about the legal problems facing their members and have tried to establish self-regulation through codes of ethics. However, since there are hundreds of franchisors that do not belong to either association, and since both associations lack effective sanctions to enforce their ethical codes, trade association efforts alone

1. U.S. Department of Commerce, *Franchising in the Economy, 1972-1974* (Washington, D.C.: U.S. Government Printing Office, 1974).

2. Sidney A. Diamond, "Federal Trade Commissioners Warn of Abuses in Franchising," *Marketing Insights*, October 27, 1969, p. 17.

3. Shelby D. Hunt, "Full Disclosure and the Franchise System of Distribution," in *Dynamic Marketing in a Changing World*, Boris W. Becker and Helmut Becker, eds. (Chicago: American Marketing Assn., 1973), pp. 301-304.

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are unlikely to eliminate the problems confronting franchising.

The individual states have begun to pass laws regulating the franchise industry. Although these state laws are chiefly of the "full disclosure" variety, a few states have also passed so-called fair practice laws. Full disclosure laws are designed to protect prospective franchisees from franchisor misrepresentations by requiring franchisors to provide each prospective franchisee with sufficient unbiased information to enable him to make a sound investment decision.[4] As part of the full disclosure provisions, franchisors usually must disclose any requirements that the franchisee purchase supplies from the franchisor or his designated suppliers. Full disclosure laws have been passed (as of this writing) in the legislatures of California, Hawaii, Illinois, Michigan, Minnesota, Oregon, Rhode Island, South Dakota, Washington, Wisconsin, and the Province of Alberta, Canada.

Fair practice laws have been passed in the legislatures of California, Connecticut, Delaware, New Jersey, Virginia, Washington, and Wisconsin. These laws are designed to protect the franchisee by prohibiting the franchisor from using unfair or deceptive acts or practices. Although fair practice laws differ substantially from state to state, franchisors are usually prohibited from such practices as: (1) requiring a franchisee to purchase goods or services from the franchisor or his designated suppliers unless it is reasonably necessary to maintain control over the nature and quality of the goods or services; (2) discriminating between franchisees in the charges of royalties, goods, services, advertising services, and the like, unless reasonably justifiable; (3) selling a product or service to a franchisee for more than a fair or reasonable price; (4) competing with, or granting franchises to compete with, a franchisee in the relevant market area specifically listed in the franchisee agreement; and (5) from terminating, canceling, or failing to renew a franchise without good cause. The burden of proving good cause or reasonability of a restrictive purchasing agreement is the responsibility of the franchisor.

On the federal level, the U.S. Senate has been considering a franchise full disclosure act, which would require disclosures similar to those of the state bills. Likewise, during February of 1972 the Federal Trade Commission held hearings on a proposed trade regulation rule concerning full disclosure in franchising.[5] Again, the actual provisions would parallel the Senate bill and the state legislation. The FTC has not yet given final judgment on the proposed ruling.

Tying Agreements in Franchising

As the state legislatures, Congress, and the FTC both pass and ponder legislative solutions, the flood of franchisee versus franchisor litigation continues. Much of the litigation concerns restrictions by the franchisor on the source of supplies. The Select Committee on Small Business feels that

> one of the more serious problems facing franchisors is the matter of "tie-ins," the policy whereby a seller, by conditioning the sale of a desirable product over which he has sufficient control, upon the purchase of other less desirable products, requires the purchaser to buy both the "tying" and the "tied" products from him.[6]

In the case of franchising, the tying product is the franchise itself and the tied products are the supplies the franchisee must purchase to operate his business. Benjamin Glosband, a legal expert, believes the problem of restrictions on the source of supplies or services is at the heart of almost every complaint pending against franchisors:

> The Federal Trade Commission has received numerous complaints alleging that the franchisor is requiring the franchisee to purchase supplies at outrageous prices from the franchisor or designated supplier. This type of complaint has been the basis of a number of antitrust suits—governmental and private—charging the franchisor with involvement in an exclusive dealing arrangement or a tie-in arrangement.[7]

4. See same reference as footnote 3. for a detailed discussion of the provisions of full disclosure laws.

5. FTC Proposed Rule Involving Disclosure Requirements and Prohibitions Concerning Franchising, 4 T.R. Rules ¶ 38,029 (February 1972).

6. *The Impact of Franchising on Small Business*, Hearings Before the Subcommittee on Urban and Rural Economic Development (Washington, D.C.: U.S. Government Printing Office, 1970), p. 23.

7. Benjamin A. Glosband, "The Franchising Dilemma," *Trial*, Vol. 8 (July-August 1972), p. 34.

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The present article will first examine the pros and cons of tying agreements in franchising, will briefly review the legal status of tying agreements, and then will present the results of an empirical investigation of three basic questions concerning the impact of tying agreements in franchising: (1) How widespread is the practice of franchisees being required to purchase supplies from their franchisors? (2) Do franchisees who are required to purchase supplies from their franchisors pay competitive prices for these supplies? (3) What are the effects, if any, on franchisees of this requirement?

Tying Agreements: Pro

Franchisors give two primary justifications for requiring their franchisees to purchase supplies from them: (1) the franchisor can buy the supplies cheaper because of volume purchases, and (2) the purchase requirements are necessary to insure uniform quality control throughout the franchise system. Many franchisors indicate in their brochures that their mass purchasing power is one of the advantages of being a franchise member. For example, one brochure states that the franchisor

> negotiates volume contracts with all purveyors and suppliers. These contracts are based on high quality and low prices. [The franchisor] makes all items available to the individual operator at the exact price of the contract. The overall advantage of this centralized buying power reflects a saving to the operator of approximately 4 percent of his gross, for which he is paying only 2.5 percent. . . .[8]

Many franchisors also maintain that purchase requirements are the only effective means of insuring quality control. According to William Sandberg, contributing editor of the *Franchise Journal*, there are numerous cases where franchisees have completely ignored quality standards when the franchisor relinquished strict control over the franchisees' purchasing procedures.[9] A. L. Lapin, Jr., past president of the International Franchise Association, contends that franchisors, franchisees, and American consumers are all harmed when quality control cannot be assured. He maintains that:

> The franchisor, who cannot be assured of his ability to direct the uniformity and preserve the quality of his product, will simply elect to cease franchising. The franchisee, who cannot be assured that the consumer acceptance of his franchised goods or services can be protected by the franchisor, will have lost much of the value of his investment. The American consumer cannot but be harmed by the deterioration in quality and the decreased confidence in the individual outlet which will inevitably flow from the atrophy of the franchising system.[10]

Tying Agreements: Con

In addition to royalty payments, franchise fees, and rent payments, a major way for franchisors to secure revenue is through the sale of supplies and raw materials to their franchisees.[11] Equity suggests that franchisors should be permitted to make a return on this service as long as franchisees reap the benefits claimed for centralized or mass purchasing. However, critics claim that franchisors are requiring franchisees to purchase supplies and raw materials at prices far above those of the competitive market. Numerous cases have been cited in support of this contention. As examples of this practice, the Select Committee on Small Business reported that: "A gallon of maraschino cherries costing $1.50 was just relabeled by Howard Johnson and priced at $4.50. Shakey's charges $21.50 for the spice blend which costs them $3.00."[12] In the committee's eyes, these were but two examples where franchisors were requiring their franchisees to purchase supplies at exorbitant prices.

According to Harold Brown, a strong critic of franchising, one hardly need speculate on the consequences of overcharges. As an illustration, Brown cites the case of a prominent restaurant chain with more than 500 outlets:

> In 1945, about 20 percent were owned by the franchisor and 80 percent by the franchisees. By 1960, the situation had reversed, and the franchisor owned more than 80 percent of the outlets. The financially pressed franchisees had cut down on servings and service, borrowed to the limit, and ultimately surrendered their franchises to the franchisor—expressing gratitude for being released from personal guaranty.[13]

8. *Weekly Digest*, October 5, 1968, p. 8.
9. William Sandberg, "Are Franchise Controls Necessary?" *Franchise Journal*, March 1971, p. 21.
10. Same reference as footnote 6, p. 267.
11. Milton Woll, "Sources of Revenue to the Franchisor and Their Strategic Implications," *Journal of Retailing*, Vol. 44 (Winter 1968–69), p. 14.
12. Same reference as footnote 6, p. 5.
13. Harold Brown, *Franchising—Realities and Remedies* (New York: Law Journal Press, 1973), p. 28.

Brown argues that preventing the franchisee from buying on the open market harms the franchisee, the third-party supplier, and the consumer.[14] Franchisees are prevented from making purchases at the lowest prices and on the best available terms. Third-party suppliers, therefore, lose the opportunity to compete for the trade of the franchisees. And, in turn, the consumer suffers because of the secondary interference with the normal operation of the marketplace.

Tying Agreements: Legal Issues

Is it legal for franchisors to have purchase requirements or tying agreements? As previously discussed, tying agreements may arise out of a franchisor's effort to control both the quality and the uniformity of his trademarked products or services. Such control can be both legally and commercially necessary. Federal law, according to the Lanham Act, provides that a trademark owner *must* insure that the products or services identified by the mark meet all owner quality standards or risk cancellation or abandonment of his trademark rights.[15] The Lanham Act, however, specifically provides that an antitrust violation is not condoned by trademark law.

Tying provisions in franchise agreements have to date presented both a trade regulation problem under Section 5 of the Federal Trade Commission Act and an antitrust problem under Section 1 of the Sherman Act and Section 3 of the Clayton Act. Franchisors should be aware of the conditions under which tying agreements are considered illegal. FTC Commissioner Wilbur Dixon suggests that four criteria should be applied in determining whether tying arrangements are illegal: (1) Does the arrangement in question involve two or more distinct items, one of which (the tying product—the franchise) may be obtained only if the other(s) is also purchased? (2) Is the tying item invested with sufficient economic power to restrain competition in the tied product(s)? (3) Is a "not insubstantial" amount of commerce affected by the arrangement? And, if these first three questions can be answered affirmatively, (4) Is the respondent able to demonstrate by way of affirmative defense that the tie-in is necessary to ensure the quality of its products, or that no less restrictive means than the tie-in may be used to ensure such quality?[16]

In the Carvel case, the FTC dismissed a proceeding under Section 5 of the FTC Act against Carvel (a soft-service ice cream franchise), despite Carvel's requirement that its ice cream mix was to be purchased only from Carvel-designated sources.[17] The commission chose not to define the restriction as an illegal tie-in; rather, it decided to examine whether the supply restrictions were reasonably ancillary to the protection of the trademark and vindicated Carvel on this basis. In *Susser v. Carvel*, the court found that a tie-in did exist, but concluded that ingredient-supply restrictions were justified by the need for quality control connected with the problem of ingredient secrecy.[18]

In the Chicken Delight case, several franchisees challenged Chicken Delight's franchising contracts under Section 1 of the Sherman Act, seeking treble damages.[19] Chicken Delight required that its franchisees purchase specified cookers, packaging items, and food preparation mixes. Apparently, the prices they were required to pay for these products were higher than those of similar products generally available from alternate sources. The franchisees challenged the agreements as unlawful tying arrangements. The court rejected the "quality control" defense of the franchisor as applied to the packaging products. The court reasoned that any competent packaging manufacturer could have supplied satisfactory packaging upon proper specification of printing type and color. However, as to the tied dips, spices, and cookers, which allegedly impart a secret unique flavor to the Chicken Delight product, the district court recognized that, under *Carvel*, "the quality control defense is relevant." The court then sent this issue to the jury with the instructions that it accept the "quality control" defense only if "specifications for a substitute would be so detailed that they could not practically be supplied."[20] The jury determined that quality control could have been effected by means other than a tie-in.

A recent timely decision concerning Chock Full O'Nuts Corporation provides further clarification as to how the FTC will interpret the "quality control" defense.[21] Chock Full O'Nuts required its 38 franchisees to purchase from it a large number of: (a) food products manufactured by the franchisor

14. Same reference as footnote 13.

15. The Lanham Act, 15 U.S.C. 1055, 1064(c)(1) 1127 (1964).

16. In re Chock Full O'Nuts Corp., Inc., 3 Trade Reg. Rep. ¶ 20,441 (October 1973).

17. In re Carvel Corp., [Transfer Binder] Trade Reg. Rep. ¶ 17,298 (August 1965).

18. *Susser v. Carvel*, 332 F.2d 505 (1964).

19. *Siegel v. Chicken Delight*, 448 F.2d 43 (1971).

20. In re Siegel v. Chicken Delight BNA ATRR No. 467 (June 23, 1970), B-1, B-4.

21. Same reference as footnote 16.

(e.g., coffee, bakery goods, and hamburger), (b) food products *not* manufactured by the franchisor (e.g., milk, french fries, and soft drink syrups), and (c) nonfood products *not* manufactured by the franchisor (e.g., napkins, straws, and glasses). Chock Full O'Nuts defended its practice of tying the sale of these products to the sale of the franchise by asserting that it was necessary to maintain uniform quality throughout all its restaurants. The FTC held that the "quality control" defense was applicable *only* where it was not practicable to specify the ingredients in such a way as to render the item duplicable by competing manufacturers. Upon examining the difficulty of adequately specifying the ingredients for the various tied products, the FTC ruled:

> [Chock Full O'Nuts Corp.] successfully proved its affirmative defense [to tying charges] of maintaining quality control with regard to its coffee and baked goods, but not as to its other distinctive products that franchisees were obligated to purchase.[22]

This decision seems consistent with *Carvel* and *Chicken Delight*.

The franchisor faces the conflict between his duty under the Lanham Act to protect the trademark through quality control and his duty to avoid violations in the various antitrust laws. This dilemma has been referred to as the "revolving door" since, by satisfying the requirements of one statute, the franchisor may find that he has violated another.[23] Several experts have suggested that in the vast majority of cases quality control can be accomplished by less restrictive means than tying agreements.[24] In those cases where quality control considerations dictate tying agreements, prudence suggests that franchisors charge prices that are reasonably competitive with other suppliers.

Impact of Tying Agreements in Franchising

The data used to explore the three basic questions concerning the impact of tying agreements in franchising came from a study on the economic effects of franchising conducted at the University of Wisconsin-Madison.[25] The data base is a national probability sample of 664 completed questionnaires from franchisees in the fast-food restaurant area. The sample of franchisees was drawn from lists of franchisee names and addresses supplied by franchisors and from the yellow pages of telephone directories. Empirical results from this survey are presented for each of the three questions.

Extent of Practice

The first question examined was: *How widespread is the practice of franchisees being required to purchase supplies from their franchisors?* The results of the survey indicated that about 70% of the responding franchisees were required to purchase at least some of their operating supplies from their franchisors. Of those franchisees who had to purchase from their franchisors, the median percentage of total operating supplies that they purchased from this source was 50%. It appears that tying agreements, far from being just an isolated practice that involves only a few franchisors, affect the overwhelming majority of franchisees, who must purchase at least some of their supplies from their franchisors.

Prices Charged for Supplies

The second research question asked: *Do franchisees who are required to purchase supplies from their franchisors pay competitive prices for these supplies?* The results, reported in Table 1, show that only 24.8% of the franchisees believed they paid lower prices to the franchisor than they would in the open market, while 47.0% believed they paid higher prices to the franchisor. The remaining 28.2% perceived their franchisors' prices to be about the same as the prices of equivalent items they could purchase elsewhere. Therefore, although a substantial number of franchisees apparently felt they got a price advantage by purchasing from their franchisors, many more believed they were being overcharged.

Effects of Purchase Requirements

The third basic question concerned: *What are the effects, if any, on franchisees of being required to purchase supplies from their franchisors?* In order to investigate or draw any conclusions with respect to this extremely broad question, three specific questions on the effects of purchase requirements should be explored: (1) Do franchisees who are required to purchase supplies from their franchisors have lower incomes than other franchisees? (2) Are franchisees who are required to purchase a large proportion of their supplies from the franchisor less satisfied with the franchise re-

22. Same reference as footnote 16.
23. Same reference as footnote 13, p. 150
24. Donald F. Turner, "The Validity of Tying Arrangements Under the Antitrust Laws," *Harvard Law Review*, Vol 72 (November 1958), p. 64.
25. Urban B. Ozanne and Shelby D. Hunt, *The Economic Effects of Franchising* (Washington, D.C.: U.S. Government Printing Office, 1971).

TABLE 1
FRANCHISEES' PERCEPTIONS OF THE COMPETITIVENESS OF
FRANCHISOR PRICES FOR SUPPLIES

Response Category[a]	N	Percent
1. Franchisor's prices are over 25% lower	3	.7
2. Franchisor's prices are 5% to 25% lower	107	24.1
3. Franchisor's prices are about the same	125	28.2
4. Franchisor's prices are 5% to 25% higher	150	33.9
5. Franchisor's prices are over 25% higher	58	13.1
Total	443[b]	100.0

[a]Response categories to the following question: Which statement best describes the prices you are charged as compared with prices of equivalent items you could purchase elsewhere?
[b]Only the 464 franchisees who purchased supplies from their franchisors answered this question. Twenty-one of these 464 either did not answer the question or said they did not know.

lationship than franchisees who must purchase only a small proportion of their supplies from their franchisors? (3) Are franchisees who are charged high prices by their franchisors less satisfied with the franchise relationship than franchisees who are charged low prices? These issues were approached in the questionnaire by asking the franchisee: (1) what his family income was from his franchised business before taxes, (2) whether he planned to renew his franchise agreement when it expired, and (3) how satisfied he was with the profitability of his franchised business up to this time.

Using an F test, it was determined that franchisees required to purchase supplies from their franchisors had significantly lower incomes than franchisees not required to purchase supplies from their franchisors. As used in this study, franchisee income included profit plus owner's salary and any salaries paid to spouse and unmarried children.

The results, as reported in Table 2, also indicate that the proportion of supplies franchisees were required to purchase from their franchisors was negatively related to both measures of franchisee satisfaction. Franchisees who did not plan to renew their franchises were required to purchase a significantly higher percentage of their supplies from their franchisors than franchisees who planned to renew their franchises. Likewise, franchisees who were very dissatisfied with the profitability of their franchised business were required to purchase a high percentage of their supplies from the franchisor, while franchisees

TABLE 2
FRANCHISEE SATISFACTION AS A FUNCTION OF
TWO FRANCHISOR SUPPLY PRACTICES

Measures of Satisfaction	Proportion of Supplies Required[a]	Prices Paid for Supplies[b]
Plans to Renew Franchise		
1. If no	43.2%	3.8
2. If yes	29.8	3.3
Satisfaction with Franchise Profitability		
1. Very dissatisfied	48.9	3.9
2. Dissatisfied	42.4	3.6
3. Neither satisfied nor dissatisfied	42.1	3.3
4. Satisfied	31.6	3.3
5. Very satisfied	12.1	3.2

[a]Mean responses are reported in percents.
[b]Mean responses are reported. "Prices paid for supplies" was measured using the five-point scale shown in Table 1, where higher scale values indicate higher prices.
Note: All the relationships depicted in this table were found statistically significant at the .001 level by Kruskal-Wallis H tests.

who were very satisfied with the profitability of their franchises purchased a smaller proportion from their franchisors.

The results in Table 2 also indicate that the prices franchisees paid for supplies were negatively related to both measures of franchisee satisfaction. Franchisees who did not plan to renew their franchises reported paying higher prices to their franchisors for supplies than franchisees who did plan to renew their franchises. Franchisees who indicated dissatisfaction with the profitability of the franchise also reported paying higher prices to their franchisors for supplies than franchisees who indicated satisfaction with the profitability of their franchises.

Summary, Conclusions, and Recommendations

The numerous complaints charging franchisors with involvement in tying arrangements suggest that the practice is quite widespread. In the study of fast-food franchisees reported here, approximately 70% of the respondents indicated that they were required to purchase at least some of their supplies from the franchisor. Of those franchisees who were required to purchase from the franchisor, the median percentage of total operating supplies involved was 50%.

Proponents of franchising justify tying agreements on the basis of mass purchasing and quality control. Critics of franchising, in contrast, allege that franchisors are charging franchisees exorbitant prices for supplies. The results of this study show that, as perceived by franchisees, some franchisors do, in fact, pass along bargain prices on supplies due to volume purchasing discounts. However, many more franchisees perceived their franchisors to be charging prices that were higher than competitive market prices.

When franchisors use tying agreements as a means to extract higher than competitive market prices, tying agreements may have deleterious effects on the franchisee's income and his satisfaction with the franchise relationship. The results reported here showed that franchisees who were required to purchase supplies from their franchisors had lower incomes than franchisees who were not required to purchase supplies from their franchisors. The results also showed that franchisees who were required to purchase a greater proportion of supplies from their franchisors and were charged higher prices by franchisors for supplies were less satisfied with the franchise relationship.

The preceding discussion strongly suggests that the widespread practice of tying agreements has deleterious effects on the franchise system of distribution. Franchisors obviously have a vested interest in the health of the franchise system and, therefore, should reconsider their policies of using tying agreements to surreptitiously generate revenue from their franchisees. Franchisors who are currently using tying agreements to generate the revenue needed to maintain their franchise programs should consider offering their franchisees new agreements with provisions that reflect an adequate royalty and a less restrictive supply program. With respect to franchisees who reject the new contract, franchisors legally may be able to continue to impose the purchase requirements. Several franchisors have successfully converted the majority of their franchisees to royalty contracts, and these companies do continue to collect income from nonroyalty franchisees in the form of surcharges on certain supplies.[26] Efforts by franchisors to correct the problems associated with tying arrangements in franchising may forestall onerous, restrictive legislation and regulation, slow down the flood of litigation, and strengthen the franchising system of distribution.

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26. *Franchising and Antitrust*, Sixth Annual Legal and Government Affairs Symposium (Washington, D.C.: International Franchise Association, 1973), p. 14.