The economics of franchising

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I. Introduction

The academic debate about the motivations for franchising and its impact on economic welfare is quite passionate. Roughly speaking, on one side markets are asserted to be competitive, so that new business practices can emerge only if they improve economic efficiency; businessmen "know their business" better than economists or regulators do, and the best possible regulatory policy is no regulation at all. On the other side, it is advised to rule out any kind of arrangement which may restrict one party's freedom of trade - which is the case of practically any provision in a franchise contract. The controversy reflects the opposition between different schools of economic thought, but it also hinges on divergences in the appreciation of the context and of the horizon of the analysis.

One's judgement on franchising depends largely on the benchmark used for the comparison. For instance, suppose a manufacturer imposes an exclusive dealing agreement to a distributor as part of a franchise contract. If compared with a situation where the distributor is an independent firm which deals freely with other manufacturers and competes with other independent distributors, such an exclusive dealing provision be seen as a restriction placed on the franchisee, as well as a barrier to the entry of potential competitors; the same kind of arrangement, however, would certainly be considered as a quite natural thing if it were to apply to a selling agent of the manufacturer, rather than an independent distributor. It is thus important, when evaluating the economic impact of franchising, to consider what would be the alternative options (internal versus external integration, for instance).

Moreover, the appreciation of the effects of franchising may well vary greatly with the horizon which is considered. For instance, suppose that some business practice do have anticompetitive effects in the short-run, enabling the partners to obtain some extra rent; this is not necessarily a practice to discourage if it enables the partners to receive the fruits of some initial investment, which otherwise would not have been made: negative effects in the short-run may well have positive effects in a long-run perspective. Of course, such arguments have to be carefully examined, since an abusive use of them can clearly lead to a too permissive position.

The presentation is organized as follows. First, Section II briefly describes the different provisions found in most usual franchising contracts. Then Section III discusses their rationale (private desirability), and their consequences on the economic welfare (social desirability). Section IV draws some considerations for competition policy. Finally, Section V provides a brief economic analysis of the actual competition policy and case law in OECD countries.

II. Definition of franchising

A franchise agreement usually involves several provisions, which relate to transfers from one side to the other (generally monetary transfers from the franchisees to the franchisor and technological or know-how transfers from the franchisor to the franchisees), and restrictions on both the franchisor's and the franchisees' sides. Here are listed some of these provisions, as well as some comments on their feasibility.[1]

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[1]. This classification and the section which follows build on the first part of P. Rey and J. Tirole, Vertical Restraints from a Principal-Agent Viewpoint, Marketing Channels: Relationships and Performance, L. Pellegrini and S. Reddy eds, 3-30, (1986).

1. **Franchise fee**

This is a provision according to which the franchisee must pay some fixed amount in order to carry on the franchisor's products or use the franchisor's brand name. This fee can be viewed as a special case of non-linear "wholesale" tariff between the franchisor and the franchisees. Other forms of non-linear prices include progressive rebates on the "quantity" bought by the franchisees. For a franchise fee provision to be effective, the franchisor needs only to observe who carries his products (if it was not the case, however, such a provision would be subject to arbitrage on the franchisees' side: one of the franchisees could buy the whole quantity in order to resell it to other franchisees).

More general non-linear tariffs may require more information: indeed, the possibility of arbitrage makes it necessary to observe not only the quantity bought by one franchisee, but also the quantity actually sold by each of them; otherwise, the franchisees could set-up a secondary market, making the non-linear pricing policy ineffective.[2]

2. **Royalties, or commissions**

This is an alternative way of transferring wealth from the franchisee to the franchisor, based on the franchisee's sales; it thus implicitly requires the franchisee's sales or revenue to be observed by the franchisor. It may however only require observing the total revenue.

3. **Resale Price Maintenance**

This provision dictates the choice of the final price to the franchisees. Variants of this restriction include the imposition of a price ceiling or the "recommendation" of a price floor. Resale Price Maintenance or price floors may be particularly hard to enforce if hidden price cuts cannot be prevented. (Hidden discounts can take various forms, including non monetary dimensions in the franchisee-consumers relationship, such as for instance the possibility of providing extra and non registered services, free delivery, etc.)

4. **Quantity fixing**

This provision specifies the quantity to be bought by the retailer. Variants of this restraint include quantity forcing, which imposes to buy a minimal quantity, and quantity rationing, which specifies a maximal quota. If demand is known and depends on the final price only, and if the franchisee cannot resell to other franchisees or "throw away the good", quantity forcing

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[2]. If the franchisor proposes progressive rebates (i.e., the average price per unit decreases with the quantity bought) then as with franchise fees, one of the franchisees could buy the whole quantity in order to resell it to the other franchisees. In the case, only the price associated with the total quantity matters. Suppose now that the average price increases with the quantity bought, and that there are two distributors, a "big" one and a "small" one. In the absence of arbitrage, the small one enjoys a lower (average) price. If arbitrage is possible, however, the small distributor can buy more than what he needs (thus paying an average price comprised between the two initial average prices), in order to resell his excess quantity to the big distributor; the best attitude for the distributors is to buy exactly the same quantity and then to trade at some internal and intermediate price. The franchisor would then be better off using this unique intermediate price.

is equivalent to a price ceiling, quantity rationing is equivalent to a price floor, and quantity fixing is equivalent to Resale Price Maintenance.

5. Exclusive territories

"Territory" should be here understood in a broad sense, since it may refer to any kind of market segmentation, and not only to a geographical interpretation. The assignment of exclusive territories can involve several levels of restrictions on both the franchisor and the franchisee. At a first level, the franchisor commits not to compete actively with the franchisee in a given territory and the franchisee commits not to develop a similar activity outside this territory. This corresponds for instance to the case where the franchisor dictate the location of establishments and let consumers sort themselves out. . Of course, this raises some commitment issues (in particular, either party may in some cases be able to indirectly compete or develop activities).

At a second level, the franchisee may commit to deal with no consumer from outside his territory (i.e., the franchisor effectively divides the market among the franchisees). This certainly raises important observability issues; for instance, in the spatial interpretation, the franchisor must be able to trace consumers[3] and to prove, in case of cheating, that the franchisee was aware of their origin, or at least that he was negligent in not obtaining the information.[4]

6. **Exclusive dealing**

This is a restriction placed on the franchisee, who accepts not to engage with any other business, or at least with any other business competing directly with the franchisor's objectives. This provision is sometimes accompanied with the obligation of carrying the franchisor's whole line of products.

7. **Tie-in**

This refers to forcing the franchisee to buy several goods from the franchisor. A special case of this consists in "requirements contracting", in which the franchisor requires the franchisee to buy all inputs and/or pieces of equipment exclusively from the franchisor. This of course supposes that the franchisor can check the origin of the inputs used by the franchisees, particularly if the inputs provided by the franchisor are over-priced.

This of course does not exhaust the list of possible contractual provisions found in franchise contracts, which are often dependent on the environment. For instance, if the franchisor is in charge of national advertising for his line of products, the contract may include a provision concerning the corresponding expenses. Other provisions may refer to technical help, professional training, stipulations on the franchisee's mode of business operation (regarding for example the quality of products or services), post-termination conditions, etc. Also, some provisions may be used in lieu of others to circumvent informational or observability problems; for instance, if the level of sales is not verifiable, the franchisor may want

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[3]. A possible way to do that is to use warranty cards or discounts coupons that must be sent back to the manufacturer with the customer's address written in.

[4]. Note that a franchisee can for instance make use of "forced" advertising spillovers to attract "innocently" the rival's consumers in his own territory.

to use a tie-in in order to use an input as a sales index (this can be a good idea if the input must be used in fixed proportion (packaging materials may be a good example) and if its origin is easily verifiable.

III. Economic analysis

Rather than dealing with each provision separately (which would not be natural since they are often used as a package), the discussion is arranged according to different types of motivations.

A first line of motivations corresponds to a search for a better vertical co-ordination between the franchisor and the franchisees (Part A); vertical restraints include a whole set of tools which permit a better mutual control and, so doing, reduce the inefficiencies which could result from a bad co-ordination; the consumers may gain from the reduction of these inefficiencies (particularly if it decreases double marginalisation problems, or if it eliminates free-rider problems in the provision of customers services), but may as well be worse off (e.g., if it adversely affects the level of quality or differentiation).

Since franchise agreements can be used as a vertical control device, we will then compare them with alternative ways to achieve vertical control, and in particular with vertical integration (Part B). Although we lack a complete theory of the firm, we can list some guidelines for the evaluation of the comparison between internal and external integration.

Lastly, we will discuss the impact of franchising on inter-brand competition, first in a short-run perspective, then in a long-term perspective (Part C).

A. Vertical coordination

The provisions found in franchise contract most often tend to a better control of the franchisees' activities by the franchisor. With the vertical structure, considered as a whole, can be associated a number of decision variables: wholesale prices, franchise fees, quantity purchased by the franchisees, quantity eventually sold to customers, selling efforts, franchisees' locations, etc. Neither the franchisor nor the franchisees can directly control all these variables: some of these variables are controlled by the franchisor only, some of them are monitored by the franchisees, and some of them cannot be perfectly controlled at all.

The decentralization of these decisions may generate externalities, which in turn can cause inefficiencies if they are not correctly taken into account. It is thus natural for the partners to look for some means of co-ordination between all these decision variables. In that respect, vertical restraints of the like mentioned above can certainly help. We will here list most usual types of externalities between upstream and downstream decisions, and see how adequately chosen provisions can correct them. We will then discuss, in each case, the impact on consumers' welfare.

1. Double marginalisation[5]

Double marginalisation refers to situations where both the franchisor and the franchisee add a mark-up on their costs, resulting in a "double" mark-up and too high prices. As an example, consider the case where the franchisee acts as a retailer for the franchisor's product. The externality stems from

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[5]. This externality has been analyzed by J. Spengler, Vertical Integration and Antitrust Policy, 58 J. of Political Economy, 347-352 (1950).

the fact that each partner, when setting his price (the wholesale price for the franchisor and the retail price for the franchisee), does not take into account the effect of this price on the other partner's profit. For instance the franchisee, when setting the retail price, only considers his own profit (roughly equal to the demand, multiplied by his mark-up over the wholesale price and the variable retail costs) and does not take into account that an increase in his price, which decreases the final demand, also decreases the franchisor's profit (roughly equal to the demand, multiplied by the wholesale mark-up). This externality is likely to lead to a final price above the level which would maximize the aggregate profits of both the franchisor and the franchisee.

A franchisor can correct this externality in various ways by imposing adequate restraints on the franchisee. A first and direct way is to stipulate the retail price (imposing a price ceiling is sufficient), or, alternatively, to force a minimum amount of sales; the wholesale price can then be used for pure transfers purposes.

Another way to keep the retail price down is to use two-part tariffs; this allows the franchisor to charge a wholesale price just equal to his (marginal) cost, and to use the franchise fee to appropriate (all or part of) the profits. In this setting, the franchisee is the residual claimant of the aggregate profit, i.e. he is the receiver of any marginal profit associated with a modification of the retail price: he is thus induced to choose the price which, given the cost and demand conditions prevailing on the market, maximizes the aggregate profits.

The franchisee will no longer be the residual claimant for the aggregate profit, however, if he is competing with other franchisees (in the extreme case of pure price competition between non-differentiated retailers, the retail price reflects the wholesale price only, it does not respond to fluctuations on the final demand); it may thus be necessary to divide the market among the franchisees (i.e. to assign exclusive territories) in order to induce efficient decisions.

It should be stressed that correcting this vertical price externality also benefits consumers, since it eventually leads to lower retail prices; this effect can summarized as "there is nothing worse than a monopoly, except a chain of monopoly". Of course, other things being equal, it is better to have competitive pressures at the upstream level (competition between franchisors will eventually also lead to lower final prices).

The two types of mechanism mentioned above (stipulating prices or quantities,and using two-part tariffs) may fail to succeed, however, when there are important uncertainties (on future streams of demand, for instance, or on future retail costs) and the franchisee is risk-averse (using two-part tariffs, with a wholesale price equal to the upstream marginal cost, makes the franchisee bear all the risk).[6] Also, these mechanisms pre-suppose that the franchisor knows perfectly the franchisee's cost and demand conditions, in order to choose the right prices or quantities, or to tailor the franchise fee

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[6]. If, using a two-part tariff, the franchisor charges a wholesale price equal to his marginal cost, the franchisee will bear the whole risk associated with his own cost and demand fluctuations; with resale price maintenance, he will be insured against demand fluctuations but will bear the whole risk on the retail costs; with quantity fixing, he will again bear the whole risk on both costs and demand (since he can sell the same quantity at a higher price when demand is higher). In all cases, if the retailer is risk-averse the optimal franchise contract results from a trade-off between efficiency and insurance motives (see P. Rey and J. Tirole, The Logic of Vertical Restraints, 76 American Economic Review, 921-939 (1986)).

so as to appropriate the rent associated with his technology. If the franchisees have better information on the local cost or demand conditions, then again it is efficient to delegate all relevant decisions to them (and in particular to avoid resale price maintenance). Of course, if the agent is risk-averse, the franchisor will have to trade-off this ex post efficiency argument with insurance motives.Note that the trade-off chosen by the franchisor may differ from the one that would be optimal from the total welfare point of view. For instance, from the total welfare point of view, prices should respond fully to changes in the (marginal) retail cost and not at all to changes in the consumers' demand (which is best achieved via strong competition among franchisees), whereas from the profits point of view, prices should generally respond partly to both types of changes (which is better obtained by reducing competition among franchisees, e.g. by giving them exclusive territories).[7]

2. Other vertical externalities: promotional effort[8]

A second class of vertical externality between a franchisor and a franchisee relate to the provision of retail service (retailers can often provide sales efforts which increase the demand for the goods they distribute: free delivery, information and advise, after-sale services, etc.). This retail service, or effort, can also correspond to ensuring a given level of "quality" (the freshness of the beer, the taste of the hamburger, the safety of the car repair, etc.). This type of effort can generate both vertical externalities (which are analyzed below) and horizontal externalities (see section 4).

Suppose first that there is no competition at the retail level. Again, in a decentralized organization, when deciding on the level of his effort the retailer does not take into account the effect of his decision on the total profit, but only on the part he receives: failing to take this externality into account is likely to lead the retailers to provide too low levels of such effort.

An obvious remedy for the franchisor is to impose a control on the franchisee's provision of such services (the equivalent of resale price maintenance for the double marginalisation problem). Indeed franchise contracts often include guidelines of this kind: sometimes, for instance, the franchisor sets up a quality control device; indirect control devices include exclusive dealing (which prevents the seller from exerting effort in the sale of competing goods) or tie-ins (which allows a control on the quality of inputs).

Alternatively, using resale price maintenance and a franchise can do as well (or better, when the franchisor has poor information about the level or quality of services provided). The idea is that monitoring the wholesale and retail prices allows the franchisor to control both the eventual price offered to consumers and the franchisee's incentives to provide a sufficient level of effort (this incentive is proportional to the retail price mark-up over the wholesale price and the other variable costs). The franchise fee can then be used to adjust the monetary transfers between franchisor and franchisee.[9]

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7. For more on this, see P. Rey and J. Tirole, The Logic of Vertical Restraints, 76 American Economic Review, 921-939 (1986).

8. See for instance G. Mathewson and R. Winter, An Economic Theory of Vertical Restraints, 15 (Spring), Rand J. of Economics, 77-96 (1984).

9. These mechanisms will not work correctly, however, if the franchisor has also to provide some effort (national advertising for instance). In this case, the optimal franchise contract will have to

The last mechanism described in the previous subsection can also work. This is actually a quite general principle: as long as all the relevant actions for the aggregate profits are undertaken by the franchisee, it is an optimal contract for the franchisor to "sell" his technological know-how for a fixed price (the franchise fee), charge a wholesale price equal to his own marginal cost, and let the franchisee decide freely upon his actions: this way the franchisee will choose the best decisions - and the franchisor can ask for the highest fee.

The impact on the consumers' surplus is less clear-cut. Compared with a situation where no franchise agreement is signed, the consumers' price is likely to be lower and the level of retail services is likely to be higher. If it is the case, then integration clearly benefits to the consumers. It may however be the case that the increase in the provision of services leads to an increase in the final price. The question is then to determine whether or not the extra services are worth the extra costs for the consumers. This relates to the difference of objectives between the franchisor and franchisees for one part and the consumers for the other part; considering an increase of the services provided, the consumers are interested by the effect on their surplus, whereas the franchisor/franchisees structure is interested by the effect on the profit, i.e. on the consumers' demand rather than the consumers' surplus.[10] No definite answer can thus be given from a theoretical point of view, and empirical tests are rather difficult to implement.

The analysis somewhat differs when there are several retailers competing against each other. As before, competitive pressures decrease double marginalisation problems; but they also lead retailers to propose services adapted to consumers' preferences (consumers will choose the retailers who offer the best package of price and services)[11]. As a result, franchising, by allowing integration, may have beneficial or detrimental effects on the consumers' welfare (without franchising, i.e. in a disintegrated setting, retail competition ensures that the level of services is efficient given the wholesale price; this wholesale price is however determined by the manufacturer, and can be higher than in the franchising -integrated- setting).

The comparison between a disintegrated setting and a franchise co-ordination (which mimics an integrated structure) therefore much depends on the degree of retail competition in the disintegrated option. If there is no retail competition at all, the double marginalisation problem is important and the retailers, taking into account only part of the profits, are likely to provide insufficient services; then integration via franchising is likely to have beneficial effects. To the contrary, tough competition at the retail level makes the double marginalisation problems vanish and, given the

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trade-off the incentives for both levels of effort.

10. The consumers' surplus relates to the average quantity bought (or the "average consumer's utility"), whereas the consumers demand relates to the marginal quantity bought (I;e. the utility of the "marginal consumer" who, at the margin, is indifferent between buying or not); see for instance M. Spence, Monopoly, Quality and Regulation, 6 Bell J. of Economics, 417-429 (1975), and E. Sheshinski, Price, Quality and Quantity Regulation in Monopoly, 43 Econometrica, 127-137, (1976).

11. See W.S. Comanor, Vertical Price Fixing and Market Restrictions and the New Antitrust Policy, 98 Harvard Law Review, 983-1002, (1985), and B. Caillaud and P. Rey, A Note on Vertical Restraints with the Provision of Distribution Services, INSEE discussion paper, (1986), for a detailed analysis.

wholesale tariffs, leads retailers to provide socially efficient prices and levels of services; integration may however still have beneficial effects if it leads to lower wholesale prices.

The franchisor may also provide some effort which directly affects his franchisees' profits (for example, he could undertake a national advertising campaign). Again, with linear pricing the franchisor is likely to provide an insufficient level of effort (since his margin -- the difference between the wholesale price and his marginal cost -- is only part of the total margin of the vertical structure - the difference between the retail price and the retail cost).

When it is the case, the franchise contract either stipulate the level of effort to be provided (if the franchisor can commit himself), or must give the franchisor incentives to provide the correct level of effort. In particular, charging a wholesale price equal to the marginal cost and recovering the profits through a franchise fee will not be efficient anymore, since the franchisor has then no incentive to make any effort at all [12]. The optimal franchise contract in this case would rather make the franchisor the residual claimant of marginal profits. This can for instance be done by lowering the franchise fee and increasing the wholesale price, either directly or via the use of tie-ins (by forcing the franchisee to buy high-priced inputs). Alternatively, the franchisor may require high royalties. In all cases, however, it will be necessary to use resale price maintenance (or tough retail competition) to avoid double marginalisation problems.

Moreover, since it is generally impossible to have both the franchisee and franchisor as residual claimants, it may not be possible to achieve full efficiency when incentives must be provided at both the upstream and downstream levels; the franchise contract will in such situations reflect a compromise between the franchisor's and franchisees' levels of effort.[13]

3. Horizontal externality at the franchisor's level

An example is when the franchisee uses several inputs, some from the franchisor, some from other producers (in the fast food industry, for instance, the retailer often buys food from the franchisor, but could buy elsewhere the other materials and pieces of equipment). In the absence of franchising agreement, an upstream monopolist would charge a wholesale mark-up, inducing the downstream units to excessively substitute other inputs.

In such cases it may be more efficient to have the upstream monopolist buy the other inputs and resell them to the downstream unit, using tie-ins if necessary. Alternative remedies include the use of two-part tariffs or royalties, which both can decrease the distortion in the wholesale price). However, input substitution may not be an important feature in most franchising situations.

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12. If the franchisor s his technology, his profit then does not depend on the level of sales (at least if his marginal cost is approximately constant); he could thus the technology at a high price, promising some level of sales, and then make no effort to guarantee this level of sales.

13. It is possible to make both parties residual claimant through the use of a third party (such as an intermediate distributor, for instance), as illustrated by B. Holmstrom, Moral Hazard in Teams, 13 Bell J. of Economics, 324-340 (1982). Such an incentive device is however subject to collusion (i.e., the franchisor and the franchisees could collude in order to free-ride at the expense of the mediator).

4. Horizontal externalities at the franchisees' level

Certainly one of the most often quoted problems refers to the possibility for a retailer to "free-ride" on the efforts provided by other retailers.[14] A well-known example is the provision of pre-sale information (for instance, via free brochures, salesmen' advice, demonstrations, etc.) by retailers to consumers who then go and buy from other retailers.

We already mentioned that retail competition can result in levels of services which differ from those which would be chosen by the franchisor if he could dictate them. But here the point is that the service provided by a retailer can directly benefit another retailer; moreover, since the retailer who provides the service is forced to charge a higher price than a retailer who does not provide it, consumers have indeed an incentive to visit the first one and buy from the second one. In the extreme case where the service provided cannot be appropriated at all, clearly no service will actually be provided.

More generally, such horizontal externality gives rise to a public-good problem, gives franchisees incentives to free-ride on each other and eventually leads to insufficient levels of services[15]. To correct this bias, it is necessary to give the franchisees a property right on their service and to protect them from "unfair" competition. Resale price maintenance is an effective means to prevent discounting and reduce the consumers' incentives to visit other stores than those who provide the service. Exclusive territories, in its strongest form, is also a good protection.

The welfare analysis is less dubious than in subsection 3, since in the absence of franchise agreement, the level of services would be much too low from the private point of view (i.e. considering profits only), and thus generally too low from the social point of view too (taking the consumers' surplus into account). The argument can only be applied, however, to situations were pre-sales services are inappropriable[16]. Such inappropriable services are likely to be less important in the case of repeat purchases (e.g. in small towns as opposed to large cities or along major highways). Note that a better control of the effort provided by the franchisees allows the franchisor to provide a consistent level of quality across numerous outlets.

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[14]. Initially emphasized by L. Telser in his article Why Manufacturers Want Fair Trade?, 3 J. of Law and Economics, 86–105 (1960), this problem has been more recently analyzed by, among others, G. Mathewson and R. Winter, The Economics of Vertical Restraints in Distribution, in New Developments in the Analysis of Market Structures, New-York: MacMillan, (1982), and The Economics of Franchise Contracts, 28 J. of Law and Economics (1985).

[15]. Suppose for instance that two franchisees distribute the franchisor's good in two distinct parts of a city, and that advertising can only be made through a local newspaper covering the whole city: a retailer will then receive only half of the benefits associated with his advertising expenses, and benefit from the other franchisee's effort. Each of them will invest less than what would be efficient, and partly rely on the other's effort.

[16]. This kind of argument has for instance been used for the beer industry, the service consisting in ensuring to distribute only fresh beer. Along this line of argument, the guarantee of beer freshness is a public good on which retailers can free-ride. In this case, however, the service could become appropriable by indicating the date of fabrication on the labels; consumers could then choose to buy from retailers distributing only fresh beer.

This assurance can also be of value per se in lowering search costs and reducing risk[17].

In a similar way, exclusive dealing can be used to give a property right to the franchisor on his own promotional effort and brand image: if this effort is not appropriable, franchisees could use the franchisor's name to attract consumers and then diverts them to competitive brands (which can be priced lower if the competitive manufacturer did not incur the same promotional expenses)[18].

B. Franchising Versus Internal Vertical Integration

We saw in Part A that a disintegrated organi may generate inefficiencies, not only from monopolistic profits points of view, but also from consumers' surplus point of view. The provisions found in franchise agreements can be used to reduce these inefficiencies. Alternatively, a manufacturer could try to resolve these inefficiencies by integrating the distribution sector, i.e. by having his own outlets and own salespeople. To evaluate the merits of franchising, it is thus necessary to compare these two ways of vertical co-ordination.

In order to do so correctly, it would be necessary to have a complete theory of the firm, e.g. to explain when a firm acts more efficiently than two separate firms, and what is the best internal organi of a firm. This refers to co-ordination problems, i.e. to informational issues and transactions costs (are they higher or lower within the firm or without the firm?), as well as to "institutional imperfections" such as legal or institutional constraints, capital and labor market imperfections, etc. In the absence of such a complete and definite theory, we will content ourselves to try to list some guidelines usually invoked in favor of or against each type of integration. We will distinguish two types of arguments: the first group of arguments relates to capital constraints, whereas the second group focuses on vertical control issues.

1. Capital markets imperfections

Capital constraints have been identified as a major motivation for firms to favor franchising over internal expansion. A firm with a promising format but little capital may find it easier to tap the accumulated capital of potential franchisees or their access to local credit markets than to raise substantial funds on its own. Further, even if a small or young firm has access to capital markets, in periods of tight money the high cost of capital may again favor tapping the funds of potential franchisees rather than trying to finance internal expansion (the situation may of course be reverse for mature franchisors with established access to national capital markets, who can benefit from better terms than available to potential franchisees).

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17. see for instance B. Klein and L.F. Saft, The Law and Economics of Franchise Tying Contracts, 28 J. of Law and Economics, 345, 349 (1985).

18. See H. Marvel, Exclusive Dealing, 25 J. of Law and Economics, 1-26 (1982), for more on this. In France a trial opposed the Carrefour chain of distribution and Rossignol, the ski manufacturer. Carrefour was accused to use Rossignol's brand name to falsely attract consumers (important rebates were announced on Rossignol skis, but only few of them were available, so that consumers, once arrived in Carrefour store, had to leave or choose another brand).

These capital constraints are of particular importance to new firms (or firms new to a national market) because of the importance in achieving scale economies.

Capital constraints may also play a role when seeking to enter foreign markets, since financing may be available at better rates to local potential franchisees.

2. Vertical control

As we saw, an important motivation for the restrictions imposed on franchisees is to achieve a better control over their decisions, in order to reach a better vertical co-ordination. It is thus necessary to compare these external policing methods with internal ones (note that company-owned outlets, like franchisees, have to be monitored: vertical integration is not per se a panacea).

It is not an easy task to compare external and internal policing costs since, at least theoretically, all external policing methods can be mimicked in an internal incentive scheme where the outlet manager receives all the outlet profit and pays a fixed premium for that. In practice, however, limitations seem to restrict such possibilities. Although we lack a convincing theory on these limitations, we can formulate some general observations.

It is in particular generally admitted that company-owned outlets are tempted to provide insufficient effort[19] (e.g., it is not possible in general to ask the manager an important "franchise" fee)[20]. On the contrary, an independent entrepreneur is unlikely to be slothful but, as we have seen, his interest can be at odds with the franchisor's interests, particularly if he can free-ride on the franchisor's brand name. Also, direct monitoring may be easier to implement in an internal organi, which usually involves more information exchanges. Lastly, one can reasonably suppose that the free-rider problem is likely to more important for mature franchisors (which have accumulated more goodwill, and whose brandname is more established), and that the cost of directly controlling the effort is likely to decline when the number of outlets increases in a given area (there are economies of scale in the monitoring cost, and the concentration of outlets permits useful comparisons).

Another dimension of the vertical co-ordination concerns the communication of relevant information. For instance, the local outlet can have a better information about the local demand and cost conditions. Again, using two-part tariffs may ensure that the franchisee will make good use of his information. However, the franchisor may find it difficult to determine correctly the level of the franchise fee for the technology and, moreover, the provision of incentives may conflict with insurance motives. On the other hand, giving a fixed salary to an internal manager reduces his incentives to

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19. See for instance the already mentioned articles of Martin and Mathewson and Winter.

20. A possible explanation of this limitation can be found again in the imperfection of capital markets: it is usually easier for a constituted firm to raise funds than it is for a private individual (even if the individual has access to a capital market, he may face higher rates than a firm does).

Also, the impossibility for a firm to enter into materially binding long-term contracts with an employee makes it difficult for an internal compensation scheme to duplicate the incentives associated with running his own business.

cheat, but may also reduce his incentive to provide a sufficient effort and, in particular, to collect the relevant information.

C. Franchising and Inter-brand Competition

In Parts A and B were addressed vertical control issues: franchise contracts may constitute a good way to achieve a better vertical co-ordination and may thus result in higher efficiency. It follows that franchisor and his franchisees could to some extent be considered like a unique entity, and that what really matters is the competition between these entities. If markets are really competitive, one might expect full efficiency. We thus now turn to the effect of franchising on inter-brand competition in imperfectly competitive markets.

We will first distinguish short-run effects. As we will see, franchise agreements can in this framework be used as a competition-reducing device. We will then move to long-run effects; although franchising can again have anti-competitive effects, it may also have substantial pro-competitive ones.

1. Anti-competitive effects in the short-run

We will distinguish two possible anti-competitive motives for franchising; although they both relate to some kind of horizontal collusion, they do not go the same way: the first one refers to horizontal cartelization at the downstream level (dealer cartels), and does not seem to apply in most franchise situations; the second deals rather with collusion at the upstream (manufacturer) level, and may more adapted to franchise situations.

a. Horizontal cartelization at the downstream level

Franchise agreements can clearly serve to sustain a cartel arrangement among franchisees to fix retail price, to limit output and to divide markets. In this case, the franchise restrictions may not be meant to enhance efficiency by internalizing externalities, but merely to create an institution whose only task is to maintain co-operation.

b. Franchising and upstream competition

It has been argued that some provisions in the franchise contracts can be used to help competing franchisors to sustain collusion. For instance, resale price maintenance can help to sustain high prices by eliminating the desirability of secret wholesale price cuts, or by making public some private information[21].

Another line of arguments hinges on a strategic use of franchise agreements[22]. In an imperfectly competitive framework, franchise agreements may be efficient in the sense that profits are higher, but the gains to the franchisors and franchisees are at the expense of consumers. The idea is that decreasing competition among franchisees (e.g., by assigning exclusive

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21. See Telser, supra note ???, and R. Posner, The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision, 45 Univ. of Chicago Law Review, 1–20 (1977).

22. The exposition here builds on P. Rey and J. Stiglitz, Vertical Restraints and Producers' Competition, 32 European Economic Review, 561–568 (1988). See also G. Bonanno and J. Vickers, Vertical Separation, Journal of Industrial Economics (1989), and E. Gal-Or, Duopolistic Vertical Restraints, Working Paper 650, Graduate School of Business, Univ. of Pittsburgh.

territories) also decreases competition at the upstream level, by making less attractive franchisors' price cuts.

For instance, consider the case of manufacturers distributing their products through franchised networks. If one of the franchisors decreases his wholesale price, his franchisees will absorb part of this price decrease, and moreover his competitor's franchisees will also respond by decreasing their own prices; both effects lower the increase in demand that can be expected by the franchisor, and thus contribute to refrain the franchisor from decreasing his price. In other words, reducing competition among franchisees tend to lower the sensitivity of the demand perceived by the franchisors, compared with situations where they directly compete with each other or distribute their products through competitive retailers.[23] This way franchise agreements decrease the degree of competition between manufacturers.

2. Competitive effects in the long-run

a. Investment protection

Long-term franchise contracts may facilitate trade between franchisors and franchisees when they must make relationship-specific investments: in the absence of long-term contract, the fear of ex-post opportunistic behavior is likely to induce under-provision of such investments. If the franchise activity involves the franchisor's know-how, for instance, it is important for the franchisor to be assured that competitors will not get this know-how at the same times as his franchisees; similarly, a franchisee will be reluctant to make any specific investment if nothing prevents the franchisor to locate another franchisee next to him once the investment has been sunk. This argument is only valid, however, when initial investments are important and specific to the relationship (i.e., become worthless if the relationship is broken).[24]

b. Market foreclosure and barriers to entry

Long-term franchise contracts can tend to foreclose the franchisor's market, and thus prevent ex post efficient entry.[25] The idea is that an incumbent franchisor can protect himself against the future apparition of more efficient competitors by forcing franchisees to buy durably from them. Durable requirements contracts, for instance, may raise barriers to the entry

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[23]. In the extreme case where retailers are perfectly competing, a retail price is equal to the wholesale price plus the marginal retail costs; retail prices for a product thus completely respond to the corresponding wholesale price and not at all to the wholesale prices of competing products, so that none of the described effects appear.

[24]. Even long-term contracting need not be sufficient to induce efficient levels of investments, particularly if it is difficult or prohibitively costly to specify all possible relevant contingencies. For an analysis of incentives to under-invest in the absence of complete long-term contracts, see for instance P. Grout, *Investment and Wages in the Absence of Binding Contracts: A Nash Bargaining Approach*, 52 Econometrica, 449-460 (1984), W. Rogerson, *Efficient Reliance and Damages Measures for Breach of Contract*, 15 Rand Journal of Economics (1984), O. Hart and J. Moore, *Incomplete Contracts and Renegotiation*, 56 Econometrica, 755-786 (1988), and P. Aghion, M. Dewatripont and P. Rey, *Renegotiation Design with Unverifiable Information*, MIT Discussion Paper (1989).

[25]. See for instance P. Aghion and P. Bolton, Contracts as Barrier to Entry, 77 American Economic Review, 388-401 (1987).

of competing manufacturers. Such contracts can be accepted by franchisees if the franchisor leaves them part of the extra rent they enjoy via these long-term contracts.

Exclusive dealing may constitute another barrier to entry, since it increases the cost of a potential competitor, who has then to set-up his own retail network. This can be an important barrier when distribution involves large economies of scope.

Clearly such effects can be anticompetitive and have socially inefficient consequences, particularly if contracts cover a long period.

It has been argued that other provisions in franchise agreements may also play a role as an entry deterrent, particularly in the presence of legal restrictions on predation. For instance, assigning exclusive territories to independent franchisees, as opposed to running his own stores, can serve as a barrier to entry; the idea is that independent retailers will be more responsive (aggressive) if a competitor enters one of the market: when considering lowering his price, he will not take into account the loss of profits it generates in the other markets. Thus, the franchisor can use the franchise agreement in order to commit to be a tough competitor in case of entry.

c. Entry stimulation and incentives to innovate

When franchise contracts are used to circumvent inefficient vertical or horizontal externalities, as described in section B, by the same token they also provide better incentives to enter the "vertical channel" which includes both the upstream and the downstream markets. They also give higher incentives to invest in new technologies, since they make it possible to recover all the corresponding benefits. In this case, short-run beneficial effects have also, clearly, long-term pro-competitive effects.

But even if short-term competitive effects are negative, however, they may still provide better incentives to enter the vertical channel or to engage in developing a new product or a new technology; therefore, they may still strengthen competition among franchisor-franchisee "entities" and thus have pro-competitive and positive efficiency effects in a long-run perspective. The total effect may then be either positive or negative, depending on the relative importance of long-term efficiency enhancement and short-term anti-competitive effects.[26] Clearly the long-term effect will be the most important in sectors involving potentially a large technological progress.

d. Franchising, information and norms

Till now we have neglected an important aspect of franchising, which relates to information disclosure. Indeed it is part of most franchise contracts that the franchisor must give the franchisees all the relevant information for running the business. Of course, the same information might be given to agents running the franchisor's own outlets, but the franchising is generally viewed as generating more information disclosure: this relates in part to the moderate length of franchise contracts (but there are sometimes post termination provisions which limit the use of the disclosed information); it also relates to the way franchisees are recruited (since they have to pay

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[26]. In the extreme case of perfect competition among franchisor-franchisee "entities", many concerns about the short-term impact on the consumers of franchise contracts disappear. Long-term beneficial effects of franchise contracts, however, need not suffice to achieve this ideal situation.

to enter the agreement, franchisees need a minimal amount of information before being recruited).

Moreover, the franchise activity tends to lead to the definition of norms, i.e. to the emergence of unified methods, which also facilitate the circulation of information. These unified methods have also beneficial effects on the entrepreneurial market: candidate entrepreneurs (approximately defined as people having access to some funds and willing to run a small unit) can this way choose among a much larger choice.

IV. Which recommendations for competition policy?

Section III has stressed the multiplicity of effects which can be associated with the usual clauses of the franchise contracts. In the view of competition policy considerations, it is useful to summarize the pro– and anticompetitive effects of their various provisions, and to emphasize the conditions under which these effects are likely to be important.

We begin with the remark that many effects are ambiguous, in the sense that they may go one way or the other depending on the characteristics of the situation under consideration (Part A). Moreover, different provisions have similar effects in a given context and opposed ones in other contexts. We therefore argue that no simple rule, such as *per se* legality or illegality for specified provisions, can *a priori* be asserted on an unquestionable basis.

This is not to say that such a simple rule should not be retained as the only reasonable one, since the alternative solution –– a rule of reason, or a contingent rule –– may well be difficult or prohibitively costly to enforce.

We then go further on and emphasize that some of the characteristics of the relationship, including the structure and degree of competition in the franchisor's market, the franchisor's market share, the franchisor's relative experience in this market, the barriers to entry in this market, the possible scarcity of franchisees or outlet locations, the importance of non-appropriable services,[27] etc., can help policymakers to define general recommendations which can make a rule of reason more operational (Part B).

A. A many-sided economic evaluation

For the sake of presentation we stick to the distinction between internal or intrabrand effects (related to the franchisor/franchisees relationship), on the one hand, and external or interbrand effects (related to the relationships between the franchisor/franchisees structure and other vertical entities), on the other hand. Intrabrand effects are associated with better coordination within the vertical franchisor/franchisees structure, whereas interbrand effects can tend to either increase or reduce the competition between separate vertical structures.

1. Intrabrand efficiency or coordination effects

[27]. That is, services which can be provided by one party and the returns of which can be appropriated by another party. The supply of customer information is a good example.

a. Double marginalisation problems

Among the internal problems double marginalisation stands out. This problem is however important only when both the franchisor and the franchisees have significant market power, that is if both interbrand and intrabrand competition are weak. Interbrand competition can be weak if for example there are no close substitutes for the franchisor's "products" (understood in a broad sense, since it may apply to a business format franchise), whereas intra-brand competition can be for example weakened by the assignment of exclusive territories to franchisees. When a double marginalisation problem is important, it can be solved via the use of two-part tariffs (franchise fees permit the recovery of part of the profits without increasing the wholesale prices), or via the imposition by the franchisor of a maximum retail price. On the contrary, granting franchisees exclusive territories would only exacerbate the problem. It must be emphasized that any provision which enables the partners to eliminate this kind of problem (thereby including price ceilings) also benefits consumers (that is, both profits and consumer surplus are increased).

b. Free-rider problems

Other internal effects concern the provision of customer services and the celebrated free-rider problem for non-appropriable services. Here three points should be emphasized for a proper economic assessment of these effects.

- First, a problem may exist only if the customer services which are alluded to are not contractible or if it is too costly to include or enforce a corresponding provision in the franchise contract. For example, the free-rider argument cannot be invoked with "services" which entail having a minimum number of employees, a fact which can be easily verified.
- Second, when the benefits associated with the supply of customer services cannot be taken away from the supplier, then the analysis is complex and its results are ambiguous. If for example the customer service consists in having a "nice" presentation of the products (which may indeed be difficult to completely characterize in a contract), the service provided by a franchisee is unlikely to directly benefit another franchisee. If moreover the franchisor has some market power, then free competition among franchisees may lead to a more efficient provision of services -- from the total surplus point of view, i.e. adding the consumer surplus to the profits --, but the firms may prefer to engage in various practices (such as territorial restrictions and/or resale price maintenance) in order to implement less efficient but profit-increasing levels of services. It should be emphasized that in such circumstances, no easy test (such as for instance the demand-increasing test proposed by Posner) may give any definite conclusion about the economic efficiency of the practices involved. The divergence between the firms's point of view and the total economic welfare point of view tends however to vanish when there is strong competition in the franchisor's market.
- Thirdly, for those services which are both non-contractible and non-appropriable, the free-rider problem may indeed be important and lead to an under-provision of these services, from the total economic welfare as well as from the firms' points of view. In this case, any practice which helps to resolve the problem should be encouraged. This *a priori* includes price restrictions as well as exclusive arrangements or territorial privileges.

c. Risk-sharing issues

Lastly, there is another important aspect of coordination within the franchise relationship, which relates to the way risks about cost and demand fluctuations are shared between the franchisor and his franchisees. Here again, the various provisions found in the franchise contracts may serve to achieve more profitable risk-sharing arrangements between the two sides, but there may be a divergence between what is profitable from the firms' point of view and what is socially desirable when taking also into consideration the consumer surplus.

2. Interbrand competition effects

Franchise agreements may have anticompetitive effects in the short-run, and both pro-competitive and anti-competitive effects in the long-run.

a. Short-run effects

In the short-run, franchise agreements may serve to sustain a cartel arrangement designed to maintain high prices, limit output and divide markets among franchisees. Colluding distributors or firms acting in a same market for services may thus be tempted to set up fake franchise agreements in order to further their collusive agreement. But franchise contracts can also be used to decrease short-run competition among franchisors as well. In that respect, two points should be stressed.

- First, the way franchisors may decrease competition among themselves is by delegating some decisions to their franchisees, and particularly by giving them more freedom in the choice of their prices. Clearly resale price maintenance does not go in that direction since it limits the franchisees' freedom to set their prices. On the other hand, the assignment of exclusive territories, which decreases intrabrand competition, indeed gives the franchisees more freedom in the choice of their prices. There is thus here an important difference between price and territorial restrictions, and of the two types of restrictions, territorial ones seem to constitute a better device for reducing competition among franchisors.
- Second, this franchisors' competition-reducing argument is likely to be the most important for markets where initially there is a low degree of competition.

b. Long-run effects

In the long-run, there are both pro- and anticompetitive lines of arguments.

On the anticompetitive side, franchise contracts may serve to raise barriers to the entry of potential competitors of the franchisor. This may be particularly the case if contracts include exclusive dealing provisions which cover a long-period of time and either there is a scarcity of potential franchisees or outlet locations, or there are economies of scope in the distribution of the franchisor's types of products. A franchisor may also deter the entry of potential competitors by requiring his franchisees to buy from him fairly large quantities of goods for a long period of time, or also by dividing the market between independent franchisees, which allows a selective price war in case of geographically limited entry.

Procompetitive arguments refer to the stronger incentives the franchise arrangement can give potential entrants to effectively enter a market. They are three-fold.

- First, the profit-increasing effects of franchising, as mentioned above, tend to make entry more attractive, since higher returns can be expected. (This argument holds whether both profits and consumer surplus, or only profits, are increased.) This argument is certainly relevant when the franchise system is indeed used by a new firm in order to enter and compete effectively with already established firms, or when it is used by a young firm which is already established in a market, but in a small scale, in order to expand and reach an efficient scale of operation. The argument is also relevant on the franchisees' side. Lastly, franchising may also permit a firm which is already present in a market to enter other neighboring markets. This latter feature may be particularly important in the case of the European Economic Community, where completion of the internal market in 1992 is aimed at promoting intra-community trade and business.

- Second, when some know-how or other form of investment from the franchisor is involved, the provisions found in franchise contracts can be used to protect the franchisor's rights on this investment. This in turn provides incentives to invest in developing new forms of business or in improving existing ones. This argument is particularly relevant when the franchisor's know-how concerns his experience in conducting business, since this form of know-how may be difficult to protect in more standard ways, e.g. via the use of patents or licensing agreements. This is not to say that all forms of investment always need to be encouraged, or that it is always valuable to increase the level of investment, whatever the level already achieved. However, the difficulty of protecting the kind of know-how involved in the franchise business may be thought of as likely to generate too little investment in the absence of such protection.

- Lastly, by generating standard ways of running retail outlets or of providing certain kinds of services, the franchise method may also favor the entry of would-be franchisees. And using the franchisor assistance and trade-mark enables the newly established franchisees to compete more effectively with the franchisor's rivals, and in particular with integrated chain-store outlets.

3. The ambiguity of the effects of the various provisions

The above summary of the various effects of the most common provisions found in franchise contracts makes it clear that each of them may have beneficial or detrimental effects, depending on the context in which they are used and the purpose they serve. Resale price maintenance may be desirable if for example it tends to lower prices by decreasing double marginalization problems; it may be undesirable if it is mainly used to sustain a cartel among pseudo franchisees. Exclusive dealing is good when it protects the franchisor's know-how from being diverted, it may be bad if it raises barriers to the entry of potential competitors. Territorial protection has efficiency-enhancing effects when it allows free-riders problems to be solved; unfortunately, it may as well serve to reduce not only intrabrand, but also interbrand competition.

The above summary also stresses that the various provisions may be substitutes in some cases, and yet have opposite effects in other circumstances. For example, both resale price maintenance and territorial restrictions may serve to eliminate free-rider problems; when double marginalization problems are concerned, however, these problems are exacerbated by granting the franchisees exclusive territories, whereas they can be solved by the use of resale price maintenance (more precisely, by the specification of price ceilings by the franchisor).

This discussion clearly does not point towards the adoption of automatic rules such as *per se* legality or illegality, nor does it militate in favor of a uniform treatment for all provisions found in franchise agreements. There is definitely no way to ensure that vertical restrictions are "conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use".[28] There is no way either to ensure that these restrictions always have beneficial effects.

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[28]. *Northern Pac. R. Co.*, 356 U.S. at 5, and *WHite Motor*, 78 S.Ct. at 518.

B. Some guidelines

An automatic *per se* rule cannot however be rejected on the sole basis that a given provision may have both pro- and anticompetitive effects. Such a simple rule may allow the saving of many "transaction costs" associated with long trials, difficulties of enforcing more sophisticated rules, and so on. Therefore an alternative solution such as a rule of reason, or a contingent rule may be preferable only if some guidelines can be provided to all concerned parties — judges and antitrust commissions as well as business partners. These guidelines must at the same time be of general application and yet be precisely specified, so that clear messages are sent to all interested parties.

Fortunately, the above discussion enables us to indeed provide such general guidelines, in relation to three considerations. The first consideration concerns the importance of the non-appropriability of some customer service in giving rise to free-rider problems. The second consideration refers to the structure of the franchisor's market. The third consideration deals with the possible franchisor's investment and know-how. The last consideration relates to the duration of franchise contracts.

1. Customer services and free-rider problems

Section III has stressed the diversity of the nature of customer services, as well as the difference in the economic analysis which can be applied to them. Let us simply recall here that free-rider problems can arise only for those customer services: (i) which cannot be provided for in the contract, or at least for which contracting and enforcement costs may be prohibitively high; (ii) whose benefits cannot be appropriated with certainty by the one who provides them, but on the contrary may be realized by the ones who do not provide them. These two conditions should be borne in mind each time free-rider arguments are advanced.

2. The franchisor's market structure

As the reader will have noticed, most arguments given above are drastically affected by the degree of interbrand competition.

For example, some provisions may have an effect which is desirable from the firms' point of view because they permit better coordination between the franchisor and his franchisees, but yet have a negative impact from the global economic point of view. However, almost all effects which aim at such better coordination within the franchise network, with the possible exception of risk-sharing effects, are also socially desirable when there is strong competition between this franchise network and other (franchised or not) networks.

Consider now the possible use of vertical restraints, such as territorial privileges, as interbrand competition-reducing devices. This kind of effect is likely to be the more important in markets where there exist a limited number of large firms. It is likely to be insignificant when these restrictions are designed by a small franchisor in order to introduce his products in larger markets.

In an analogous manner, the argument about increasing barriers to entry loses part of its force when applied to a small-scale franchisor who has to compete with long-established firms.

It is not sufficient to consider the franchisor's market share, however. Even if the franchisor is a marginal competitor, he may decisively contribute to foreclose the market to potential competitors if the other firms in the market have also their own means to raise barriers to entry. As an example (quite unrealistic but particularly illustrative), suppose that long-established firms have secured the control of all but one appropriate retail location in each relevant area of the market; then if a franchisor gets control over the remaining locations, he definitely forecloses the market, preventing any potential entrant from competing effectively, even though this particular franchisor may have a very small share of the total market. It is thus important to consider not only the franchisor's market share, but also the general structure and degree of concentration in the relevant market.

Also, the analysis must take into account the dynamic perspective as well. Even if several markets have the same structure at a given point of time, the evaluation of the economic impact of a franchisor's practices may (or should) differ from one market to another if one of these markets is a mature one, with little prospect of growth and relatively high barriers to entry, whereas another market is relatively young, expanding rapidly or with low barriers to entry. (The example above, about the possible scarcity of adequate locations, made implicit reference to a mature market with few expansion perspectives.) The procompetitive effects of the franchise contracts on interbrand competition are likely to be the greatest in the latter kind of situation, and more generally in transitory phases associated with high degrees of innovation, a large turnover of firms and high rates of economic growth.

3. **The franchisor's know-how**

It has already been largely emphasized that the protection of the franchisor's know-how may add specific reasons to the desirability of some of the provisions found in franchise contracts, not only from the profits' point of view, but also from a global economic perspective. We do not insist on this point much more here, but make two remarks.

- First, the provisions which are particularly likely to help protect the franchisor's know-how are exclusive provisions, which prevent the franchisee from unduly appropriating the benefits of this know-how by using it to distribute competing goods or by engaging, directly or indirectly, in activities similar to those of the franchisor. The provisions which monitor the use of this know-how after the termination of the contract are also relevant here.

- Second, provisions which may be thought of as reducing the degree of competition faced by the franchisor may nevertheless be socially desirable up to some point if they constitute the only way to give future franchisors sufficient incentives to innovate. This line of reasoning must however be applied cautiously, since it obviously may give rise to abuses of all sorts, by creating an exception in the regulatory framework, which can be difficult to monitor.

One possible way to deal with this latter problem might be to grant exemptions for a limited period of time. However, this may be difficult to implement in the context of franchise relationships, since it is certainly difficult to exactly evaluate the economic impact of the indicted provisions, and would thus be difficult to determine what a fair duration should be, leading to costly negotiations or litigation between the firms and the authorities in charge of determining the duration of the exemption. Also, since the franchise relationship is usually an on-going relationship, there would certainly be an important increase in the renegotiation costs of the contract at the time where the exemption would vanish — accompanied by a corresponding increase in the workload of the courts.

4. The duration of the contracts

Apart from the problem just discussed, the duration of franchise contracts is an important factor that needs to be taken into account when assessing the pros and cons of these contracts. Although long-term contracts are useful to guarantee the returns from sunk-cost investments by placing some limits on a wide variety of opportunistic behavior, they may also have important anti-competitive effects when they serve to raise barriers to entry. Competition policy should therefore be cautious about contracts which cover a long period of time. It certainly would be important to ask firms which sign a long-term contract to prove that indeed there are good reasons to do so, such as the necessity of important relationship-specific initial investments, which cannot be protected in any other way.

Along the same line, the time-horizon concerned by post-termination clauses has to be carefully taken into consideration. A non-competition clause may be tolerated when it applies to, say, a period of one year, and yet be judged as excessive if applying to a longer period of time.

V. An analysis of the application of competition policy

We finally turn to an analysis of the application of competition policy in OECD countries, in the light of the above discussion. This section is organized provision by provision.

A. Territorial restrictions

Broadly speaking, territorial restrictions, which tend to reduce intrabrand competition, benefit from a relatively permissive status when part of a franchise agreement.

The Australian TPC, for instance, has stressed that although Coca-Cola granted each franchisee a monopoly position in each territory, the franchise agreement had pro-competitive effects as well. Interestingly, the TPC insists that territorial exclusivity must be limited to a "reasonable" period, generally not exceeding five years. The lack of complaints by competitors, cited by the Commission, should however be treated with caution, since these territorial restrictions may indeed serve to decrease interbrand competition as well as intrabrand competition.

The Canadian example also provides interesting insights. Although franchise agreements benefit from a favorable view in general, the antitrust authority will interfere when a substantial part of the franchisor's market is affected by the franchise arrangement. It will not interfere, however, when the agreement only covers a limited period of time, in order to facilitate the entry of new products or new firms. It may however be too early to assess the feasibility of implementing this contingent rule.

In the United States, Continental TV v. GTE Sylvania was the first case where the Supreme Court mentioned the possible pro-competitive effects of territorial restrictions on interbrand competition, and substituted the Rule of Reason for the *per se* illegality established in the Schwinn case. The Supreme Court also stressed the adverse effects that a *per se* rule may have on small and independent business.

Justice White, however, concurring in the judgment, mentioned the difference between absolute customer restrictions and more limited types of restrictions. He recalled that under Schwinn's customer restrictions, the franchised dealers were not allowed to sell to discounters or other non-franchised dealers. Sylvania's location restrictions, on the contrary, though they "inhibited to some degree the freedom of the retailers to dispose of the purchased products by requiring the retailer to sell from one particular place of business[, yet let the retailer] still free to sell to any type of customer — including discounters and other unfranchised dealers — from any area."[29] Therefore, the restrictions employed by Sylvania were supposed to have less intrabrand competition-reducing effects than those employed by Schwinn.

This line of reasoning is however only half convincing:

- On the one hand, it is true that the provision not to sell to customers from outside his own territory has a bigger impact on intrabrand competition than a simple location restriction. The argument about the possibility of selling to unfranchised dealers is however less convincing. In fact, even if reselling is allowed, there may well be an implicit general understanding that franchisees should not engage in such a practice (e.g., such as selling to discounters which are present in another franchisee's territory), since this would result in indirect competition and would eventually decrease every franchisee's profits. (Justice White actually did not mention whether there was a substantial competitive pressure, for Sylvania products, from the part of discounters, integrated outlets or other type of unfranchised dealers.)
- On the other hand, there is no clear argument for placing a border line between "absolute" and "limited" or "passive" exclusive territory, as suggested by Justice White and as also emphasized by the Swedish NO and by the European Economic Community Commission and Court of Justice (a franchisee is allowed to sell "passively" if he is allowed to accept orders from outside his territory). In the Pronuptia case, for example, the European Commission indeed stressed that the location restriction did not prevent customers from choosing where to buy the goods[30] (it also mentioned that the franchisees were free to sell to each other).[31] This, however, does not seem, as such, a conclusive argument. All the arguments listed by the Commission to advocate allowing the location provisions (including the need to remunerate the franchisees' initial investments, to give franchisees incentives to exert important efforts, etc.), are also valid for those stronger provisions which would tend to give franchisees an absolute protection from intrabrand competition. Therefore the borderline relies on considerations which however are not made explicit in the Commission decision. (One could for example recall that one of the main aims of the Treaty of Rome was to improve interstate trade and business among member countries, which explain for a large part the suspicion to any exclusive practice which could seem to restrict imports.) In that respect, it is interesting to note that no or only few references are made to the Pronuptia's market share (quite large in France, and relatively small in the other European countries), or to a possible time limit to the exemption granted (it seems that the Pronuptia territorial restraints would remain valid even if Pronuptia were to gain a dominant position in the European market).

This borderline between "absolute" and "limited" territorial protection has been recalled in all successive cases (Yves Rocher, Computerland, Service Master, Charles Jourdan, ...) and constitutes one of the building blocks of the franchise exemption regulation. The preliminary considerations of that regulation state in particular that "to guarantee that [intrabrand]

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29. Id. at 2563.

30. European Economic Community Commission decision on *Pronuptia*, Official Journal No. L 13/39, at 37.

31. European Economic Community Commission decision on *Pronuptia*, Official Journal No. L 13/39, at 37.

competition cannot be eliminated for a substantial part of the products in question, it is necessary that parallel imports remain possible..."[32], and Article 5, point g, asserts that agreements cannot be exempted under which "the franchisees are required not to sell [...] the goods or services the franchise is about to final users because of their residential address."[33] Therefore, although the Commission recognizes that reducing intrabrand competition may in some contexts increase interbrand competition, it nevertheless insists on maintaining a "substantial amount of intrabrand competition. This calls for three remarks:

- First, there may be some circumstances where it may be difficult to distinguish between "absolute" and "limited" territorial protectionist. The franchise exemption regulation allows the franchisor to commit himself not to compete with his franchisees, either directly or indirectly,[34] and it also allows him to require that his franchisees should not compete "actively" in other franchisees' territories.[35] Since there are no limitations imposed on the size of the territories, a franchisor may indeed be able to use such provisions in order to grant his franchisees a quite high level of intrabrand protection.
- Second, as stressed above, there is no obvious reason for placing there an "automatic", *per se*-like borderline. Higher degrees of protection from intrabrand competition may be desirable in transitory phases where a franchisor seeks to enter a new market, whereas even limited protection should be ruled out when it is used by long-established, dominant firms, in order to facilitate collusion. It is true that this limited exemption rule is the best compromise to be found among the set of *per se* rules, but it is not clear that such automatic rule should be favored over a more contingent one, based on pre-specified characteristics of the market. In particular, designing or allowing more permissive rules for small firms may decrease the delays and the costs associated with administrative or judicial procedures — both being especially important for small firms.
- Third, too rigid rules can be dangerous for the following reason. When a situation appears for which the rule clearly leads to inappropriate conclusions, there is a good chance that the authorities in charge of the application of the rule will do their best to circumvent it. Then they may either be unsuccessful, in which case inappropriate actions are undertaken, or they may indeed succeed, in which case the whole rule may fall to pieces. For instance, before the design of the franchise exemption regulation, the Commission did succeed in getting around Article 85(1) of the Treaty of Rome. But this was thanks to a quite extensive use of Article 85(3), which *inter alia* requires the business practice under consideration to prove itself "indispensable" — the Commission quickly concluded that (limited...) exclusive territories were actually indispensable to induce franchisees to invest their time and money. In Pronuptia, the Commission even asserted that the granting of exclusive territories was a necessary counterpart for the

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32. European Economic Community Commission Regulation No. 4087/98 on the application of Article 85(3) of the Treaty of Rome to categories of franchising agreements, 30th November 1988, published in Official Journal No. L 359/46, 28th December 1988, p. 282 (point 12).

33. Id, p.285.

34. Id., at article 2, point a, p. 284.

35. Id., at article 2, point d, p. 284.

payment of the initial franchise fee (among other things, to be fair),[36] a somewhat self-contained argument. This extensive use of Article 85(3) can in turn lead Article 85(1) becoming void. In particular, the jurisprudence created under Article 85(3) in the context of vertical restraints might in this spirit be applied inappropriately to horizontal arrangements.

B. Exclusive dealing arrangements

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

Several OECD countries indeed aim at distinguishing between the situation franchisors well-established in their markets ("major suppliers") and the situation of new entrants, and are apparently succeeding in doing so. In Canada, the Bombardier case is particularly interesting. Article 49.4.a of the Competition Act allows the Competition authorities to exempt exclusive dealing provisions, for a reasonable period, when these provisions mainly serve to facilitate the entry of a new firm or of a new product. The Restrictive Trade Practices Commission then clarified this provision[37] and developed an interesting analytical framework for the evaluation of the relative importance of Bombardier in its market (including Bombardier's market share, financial strength and record of innovation, the evolution of relative market shares, the availability of other distributors for competing manufacturers, the choice offered to consumers in remote locations, ...).

In the United States, the decision of the Supreme Court in Tampa Electric v. Nashville Coal goes in the same direction, although is does not provide substantial analytical tools (the Court simply asserted that affecting 0.77% of the coal market was not significant enough to be considered as a violation of competition regulations). The Federal Trade Commission went further, accepting a 7 to 8% market share in the Beltone Electronics case, on the grounds that this manufacturer's sales were declining (so that the exclusive dealing arrangement could be interpreted as a means to place the firm in a good position for a new start), that other distributors were available to competing manufacturers, and that the arrangement aimed to stimulate the distributors' efforts to promote Beltone's products. Apparently, however, no need was mentioned for a possible protection of the franchisor's investments.

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36. Pronuptia decision, p. 253, at 36.

37. See the section on exclusive dealing in chapter V.

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

The European emphasis on the necessity of the exclusive arrangement for the protection of the franchisor's rights is definitely interesting. The difference between core products and secondary ones is also interesting, but the exclusivity requirements for secondary products could be interpreted as a tie-in, in thus could be analyzed as such rather than being automatically ruled out. Also, the role of the last restriction — the interdiction of preventing a franchisees from buying the franchisor's products from other franchisees — is not clear. For example, this interdiction could be used by the franchisor to sustain a non-linear tariff — such as progressive rebates for large quantities — in order to give franchisees incentives to promote the franchisor's products, a perfectly honorable purpose. It can also be used to achieve a better protection of the franchisor's rights. On the other hand, allowing franchisees to buy from each other does not seem to have important effects on interbrand competition or on the risk of market foreclosure.

C. Price restrictions

Price restrictions succeed in generating a broad consensus among the different countries. Indeed, all countries are very suspicious of restrictions which aim to limit the franchisees' freedom to choose their own price, and it is difficult to find another topic where there is such an unanimity. Resale price maintenance is always unlawful. Only more limited restrictions —such as for instance the use of recommended prices— are tolerated and even then sometimes only in exceptional circumstances such as promotional campaigns for the introduction of new products.

The Canadian position is representative of the tough positions taken against restrictions which aim at controlling prices. The Canadian Competition Act proscribes not only resale price maintenance, but also any attempt or intention to fix resale prices. This prohibition of course applies to direct tools of price control, but it applies to indirect tools as well, such as financial or non-financial incentives schemes, refusals to deal with price-cutters, etc.[38] "Attempt" or "intention" to control resale prices is to be understood in a broad sense, so that franchisors have to be cautious about any related provision, including the use of recommended prices. Other

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[38]. See the presentation of the Canadian position in chapter V, section A.

countries are more permissive about the use of recommended prices, or apply different treatment to the use of price floors and price ceilings.

What is most striking from the economic point of view is perhaps not the strong contrast between the unanimity against price restrictions, on the one side, and the more or less sympathetic attitude that may be found towards non-price restrictions such exclusive territories, on the other side; it may rather be the lack of corresponding contrast in the economic reasoning which underlies them. We briefly review below the economic pros and cons of price restrictions, as compared with the ones associated with non-price restrictions. There appears to be no marked contrast between the "necessarily bad" price restrictions and the "possibly good" non-price restrictions. On the contrary, both types of restrictions may have both desirable and undesirable effects; moreover, many arguments actually used in recent American and European cases in which non-price restrictions were finally allowed could indeed be used as well in support of price restrictions. There does appear to be a difference, however, between the economic impact of price floors (the imposition by the franchisor of minimum resale prices) and the possible effects of price ceilings (the imposition of maximum prices).

1. Economic pros and cons of price versus non-price restrictions

a. Intrabrand competition

We begin with intrabrand effects, which relate to coordination problems within the vertical franchisor/franchisees structure, and then discuss the effects on interbrand competition between separate vertical structures. We provide a brief review of the economic effects of price control and of non-price restrictions. To make it quicker and clearer, we concentrate on exclusive territories for non-price restrictions; on the other hand we distinguish when relevant between price floors and price ceilings.

First, vertical restrictions have unambiguously desirable effects when used to resolve <u>double marginalization</u> problems. Imposing maximum resale prices can indeed help the franchisor avoid such problems. On the other hand, setting price floors could not help, and assigning exclusive territories would only worsen the problem, since it would grant the franchisees some extra monopolistic power for the franchisor's product.

Let us now address the <u>free-rider problem</u> for the provision of customer services. As we already mentioned, for those services which are both non-contractible and non-appropriable, free-rider problems may lead to an under-provision of these services, not only from the firms' points of view, but also from the total economic welfare point of view. In this case, both private and social objectives converge, and any practice which helps to resolve the problem should be encouraged. This clearly applies to the use of exclusive territories since this prevents the franchisees, at least partially,[39] from free-riding on each other's efforts. But this also applies to resale price maintenance, and more precisely to the imposition of minimum resale prices. Indeed, by eliminating intrabrand price competition and guaranteeing a minimum mark-up to franchisees, the franchisor can promote intrabrand non-price

[39]. Free-riding is ruled out if exclusive territories are understood in their strongest meaning, i.e. if one franchisee is not allowed to deal with customers located in other franchisees' territories. If exclusive territories are understood in a weaker sense, i.e. if only "active" selling activities are forbidden outside one's own territory, then free-riding may not be totally prevented, but nonetheless it is more difficult and less fruitful.

competition and induce a higher provision of services on behalf of the franchisees.

It is interesting to recall at this point the arguments summarized by the Supreme Court of the United States to support its Sylvania decision, which moved the legal status of exclusive territories from *per se* illegality to a treatment under a rule of reason:

> "Established manufacturers can use [vertical restrictions] to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. [...] The avaibility and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free-rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did."[40]

One hardly needs to emphasize that these arguments could be used, with the very same words, to advocate a rule-of-reason treatment for resale price maintenance. Let us briefly recall, however, that there are also arguments according to which both price and non-price restrictions can be used by a franchisor to raise intrabrand profits, at the expense of consumer surplus and total welfare.

b. Interbrand competition

Let us now address interbrand competition, beginning with short-run effects:

- Resale price maintenance or the design of minimum prices can clearly have negative effects when the franchise agreement serves merely to sustain a cartel arrangement designed to maintain high prices, limit output and divide markets among franchisees. Two remarks are however in order. First, such "fake" franchise agreements could as well use the assignment of exclusive territories to achieve similar negative effects. Second, such horizontal cartel agreements are more generally undesirable as such, and clearly deserve specific treatment.
- But franchise contracts can also be used to decrease short-run competition among franchisors as well. The general idea is that franchisors can induce a less competitive behavior by delegating some decisions to their franchisees and in particular by decreasing intrabrand competition within their franchised network and giving their franchisees more freedom in the choice of their prices. This clearly cannot be achieved through resale price maintenance, but location restrictions, on the contrary, can go in this direction.
- Another line of argument, which is indeed sometimes used against resale price maintenance, is that it can be used to sustain a cartel among franchisors undertaking not to engage in price competition.[41] The idea there

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[40]. Continental T.V. Inc. v. GTE Sylvania, 433 U.S. at 55. Also reproduced by the Supreme Court in its decision in Business Electronics Corporation v. Sharp Electronics Corporation, at 12.

[41]. In the decision of the Supreme Court of the United States in White Motor Co. v. United States, for example, Mr. Justice Brennan asserted that "[r]esale price maintenance is not only designed to, but almost invariably does in fact, reduce price competition not only among sellers of the affected product, but quite as much between that product and competing brands." See

is that when resale prices are fixed, one franchisor will have less incentive to cheat on the cartel agreement and lower his prices, since his price decrease will not be transmitted to end users.[42] This argument has not yet been neatly formalized, however, and it stills lacks convincing empirical evidence. In particular, it implicitly relies on the assumption that the franchisor can undertake not to modify the price imposed on his franchisees. This supposes that the franchise contract makes it impossible to renegotiate the resale price conditions, or at least that it makes resale prices more difficult or costly to renegotiate than wholesale prices. Otherwise, a franchisor could "cheat" on the cartel agreement by modifying both the resale prices and the wholesale prices at the same time. Moreover, such a cartel formation between franchisors can only appear under favorable circumstances, which include the existence of barriers to entry, a high level of concentration, etc., and may be quite easily identified.

Let us finally address long-run effects on interbrand competition:

- We saw that in the long-run, anticompetitive lines of argument relate to entry deterrence, and that for example territorial restrictions, which allow a selective price war in case of geographically limited entry, can indeed have such undesirable effects. Resale price maintenance, on the contrary, does not have such negative effects, except if the franchisor temporarily sets maximum resale prices at a predatory level to prevent the entry of a potential competitor or to push an actual rival out of the market.
- Lastly, procompetitive arguments partly rely on the fact that, by allowing to achieve better efficiency or even by merely facilitating rising profits in the short-run, franchise arrangements can attract or motivate more potential entrants, particularly when important investments need to be sunk to enter the market. This applies both to price restrictions and territorial restrictions. It is again interesting to recall the arguments of the Supreme Court of the United States in its Sylvania decision:

> "Vertical restrictions reduce intrabrand competition by limiting the number of sellers of a particular product competing for the business of a given group of buyers. Location restrictions have this effect because of practical constraints on the effective marketing area of retail outlets. Although intrabrand competition may be reduced, the ability of retailers to exploit the resulting market may be limited both by the ability of consumers to travel to other franchised locations and, perhaps more importantly, to purchase the competing products of other manufacturers. None of these key variables, however, is affected by the form of the transaction by which a manufacturer conveys his products to the retailers.
>
> Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These "redeeming virtues" are implicit in every decision sustaining vertical restrictions under the rule of reason. Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers. [...] For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumers."[43]

The Supreme Court clearly recognizes that vertical restrictions (location restrictions, in that particular case) may have negative effects on intrabrand competition, and yet advocates a rule of reason because of the

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372 U.S., at 268, 83 S.Ct., at 704.

[42]. See for example R. Posner, "Anti-trust: Cases, Economic Notes and Other Materials" 134 (1974); "Antitrust Policy and the Supreme Court: An Analysis of the Restricted Distribution, Horizontal Merger and Potential Competition Decisions", 75 Columbia Law Review 282, 294 (1975).

[43]. Idem at 54-55.

possible "redeeming virtues" of these restrictions on interbrand competition. This can clearly be applied to price restrictions as well.

2. Per se illegality versus a rule of reason

The above brief review of the pros and cons of price and territorial restrictions can be summarized as follows. In terms of intrabrand unambiguously efficiency-enhancing effects, the setting of maximum prices has the advantage that it reduces double marginalization problems. Both resale price maintenance and territorial restrictions, on the other hand, can be used to eliminate free-rider problems. Other arguments can be used against both types of restrictions, since both can be used in such a way as to increase intrabrand profits but decrease total welfare. Turning to interbrand competition effects, territorial restrictions can be used by franchisors as a competition-reducing device. On the other hand, it has been asserted that resale price maintenance can serve to sustain a cartel. Lastly, arguments about the long-run desirable effects on interbrand competition can be applied to both types of restriction.

a. The comparability of price and non-price restrictions

This review does not argue for a sharp distinction in the legal treatment of price versus non-price restrictions. If the emphasis is placed on the possibility of undesirable effects, both should be per se unlawful. If, on the contrary, some attention is paid to the possibility of intrabrand efficiency-enhancing effects or desirable long-run effects on interbrand competition, then a rule of reason could be applied to both. In that respect, it is interesting to note that in Japan, resale price maintenance is tolerated in particular cases, especially when property rights are involved.

The strong contrast between the status of price and non-price restrictions may also lead to lengthy debates about their precise status when both are present in a franchise contract. It has for example been argued that non-price restrictions should be considered as per se illegal when they are part of "price conspiracy". In Monsanto Co. v. Spray-Rite Service Corp., the Court of Appeals for the Seventh Circuit stated that "Monsanto's otherwise lawful compensation programs and shipping policies were per se unlawful if undertaken as part of an illegal scheme to fix prices". [44]The Court of Appeals quoted the Supreme Court, which stated in White Motor that "[i]n any price-fixing case restrictive practices ancillary to the price-fixing scheme are also quite properly restrained"[45]. The Court of Appeals even asserted that the rule of reason should apply "only if there is no allegation that the territorial restrictions are part of conspiracy to fix prices" (emphasis added)[46]. The Supreme Court then eventually replaced "allegation" with "proof",[47] and insisted on being careful not to undercut the holding of Sylvania that non-price restrictions are to be judged under the rule of reason:

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[44]. Spray-Rite Service Corp. v. Monsanto Co., United States Court of Appeals for the Seventh Circuit, 684 F.2d 1226, quoting 433 U.S. at 41 n.9 and 51 n.18.

[45]. White Motor Co. v. United States, 372 U.S. 253, 260 (1963).

[46]. 684 F. 2d, at 1237.

[47]. 465 U.S. at 759.

"the need to ensure the viability of Sylvania is an important consideration in our rejection of the Court of Appeals' standard of sufficiency of the evidence".[48]

b. The opposition between minimal and maximal prices

The above analysis of the pros and cons of price restrictions has also emphasized the difference between the effects of price ceilings, on one hand, and those of minimum resale price maintenance, on the other hand. Price ceilings can be used to eliminate double marginalization problems, whereas price floors cannot. Conversely, price floors can be used to decrease intrabrand competition, whereas price ceilings cannot. The main potential harmfulness of price ceilings seems to be their possible use for deterring entry, by setting prices at a predatory level. Also, when used to indirectly control the level of services provided by the franchisees, they may have negative effects when these services are more valuable from the social point of view than from the profits point of view, and when moreover interbrand competition is weak. See for instance the decision of the Supreme Court of the United States in Albrecht v. Herald Co.:

> "Maximum prices may be fixed too low for the dealer to furnish services essential to the value which goods have for the consumer or to furnish services and conveniences which consumers desire and for which they are willing to pay".[1]

But price floors, on the other hand, can have similar negative effects when services are more valuable from the profits point of view and, more importantly, they can serve to sustain a cartel agreement, at least between franchisees.

There is thus a strong difference between the effects of imposing minimum prices, on one hand, and maximum prices, on the other hand. This must be contrasted with the fact that some countries, such as France,[2] Germany[3] or the United States, tend to treat maximum price fixing schemes in exactly the same way as any other kind of price restriction. In United States v. Socony-Vacuum Oil Co., for example, the Supreme Court of the United States recalled that "[u]nder the Sherman Act a combination formed for the purpose and with the effect of raising, depressing, fixing, pegging, or stabilizing the price of a commodity in interstate or foreign commerce is illegal per se" (emphasis added).[4] Other references on price ceiling being per se illegal in the United States can also be found in Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc.[5], Albrecht v. Herald Co.[6], and Arizona v. Maricopa County Medical Society.[7]

The arguments given to sustain this position are sometimes rather dubious. For example, in Albrecht v. Herald Co. the Supreme Court of the United States held:

> "[...] schemes to fix maximum prices, by substituting the perhaps erroneous judgment of a seller for the forces of the competitive market, may severely intrude upon the ability of buyers to compete and survive in that market."[8]

It is doubtful that a franchisor and his franchisees would agree on a price fixing schemes, however, it were to lead to such inefficiencies as described above. Also, in the same decision, the Supreme Court quite wrongly asserted that:

> "[...] if the actual price charged under a maximum price scheme is nearly always the maximum price, which is increasingly likely as the maximum price approaches the actual cost of a dealer, the scheme tends to acquire all the attributes of an arrangement fixing minimum prices".[9]

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[48]. 465 U.S. 752, at 759.

It is true that maximum price fixing schemes can be designed to implement low prices (even predatory ones). They nevertheless work in the opposite way, compared with minimum price fixing agreements.

Other countries, however, have adopted a more permissive position towards the use of maximum prices. For example, Australia generally allows a supplier to stipulate maximum prices. In Canada, a franchisor can advertise a retail price provided it is clearly indicated that actual prices can be lower. The Commission of the European Economic Community considered that a franchisor's recommendation to his franchisees not to set prices above the level advertised in promotional campaigns did not fall under Article 85(1) of the Treaty of Rome. Also, in a recent decision, USA Petroleum Co. v. Atlantic Richfield Co., the United States Court of Appeals for the Ninth Circuit recognized that: "Maximum and minimum price fixing may have different consequences in many situations."[10] It however also recalled that maximum price fixing schemes were per se illegal under the Sherman Act. In the same case, the Supreme Court reaffirmed the illegality of such agreements, but it also asserted that "[a]ctions per se unlawful may nonetheless have some procompetitive effects"[11] and eventually found that the plaintiff, a competitor, had not shown any antitrust injury.

c. Suggested prices

Lastly, let us briefly mention that the per se rule against price restrictions may lead firms to find alternative, but related, ways to formally circumvent this rule, such as the use of more or less strongly "suggested" or "recommended" prices; moreover, it can lead unconvinced Courts or other antitrust authorities to "close their eyes" to such practices, which may potentially produce inconsistent decisions. For instance, in Business Electronics Corp. v. Sharp Electronics Corp., Business Electronics (BE in the following) and another retailer (Hartwell) were authorized by Sharp to sell its electronics calculators in a given area. In response to Hartwell's complaints about BE's prices, Sharp terminated BE's dealership. Although there was some non-negligible amount of indirect evidence suggesting the existence of a "price conspiracy" between the respondent and the other retailer[12], the United States Court of Appeals for the Fifth Circuit and later on the Supreme Court refused to apply the per se rule because of the lack of explicit agreement on prices or price levels.[13]

D. Tie-ins

Like all other vertical restraints, tie-ins may be either harmful or beneficial, depending on the context in which they are used. This is reflected in the jurisprudence adopted in the various countries, which all apply a more or less flexible rule of reason. We begin with the question of the definition of a tying arrangement, and then comment on the application of the rule of reason.

1. The definition of the tying product

The definition of a tying "product" has raised an important controversy, the question being whether the franchisor's name, in itself, should be considered as a tying product. This controversy has been particularly intense in the United States, where in 1971 the Court of Appeals for the Second Circuit, in Bernard Susser v. Carvel Corp., was the first to consider the franchisor trademark and the inputs provided as separate products. The Court of Appeals for the Ninth Circuit reaffirmed this position in Siegel v. Chicken Delight, Inc. (1980), Krehl v. Baskin-Robbbins Ice Cream Co. (1982) and Hamro v. Shell Oil Co (1982). This line of argument could have led to consider the selling of a "XYZ" shoe as a tying arrangement, since it requires to buy simultaneously the shoe and its "XYZ" trademark. Meanwhile, however, the Court of Appeals for the Forth Circuit advocated in Principe v. McDonald's

Corp. (1981) that "[t]o characterize the franchise as an unnecessary aggregation of separate products tied to the McDonald's name is to miss the point entirely".[14] The Supreme Court eventually clarified the situation in 1984, in Jefferson Parish District No. 2 v. Hyde. The Court's discussion on the definition of a product, with its emphasis on the existence of a corresponding market, implies that a product and its trademark could not be considered as two separate products.

It should be emphasized, however, that in the case of a business-format franchise, the "way-of-doing-business" can be identified as a product as such. For example, in Principe v. McDonald's Corp., the Court of Appeals rightly asserted that "McDonald's offers its franchisees a complete method of doing business from the design of the menu board to the amount of catsup on the hamburgers". This "complete method" definitely characterizes a product. There is indeed a final demand for this type of products —people looking for a "fast food"— and there is also an offer side —there exist some big competitors (Burger King, etc.), as well as a competitive fringe. This is not to say, however, that all "ingredients" should necessarily be considered as intrinsically part of the "product". For example, there exists a separate market for soft drinks, and requiring a franchisee to distribute only some specific brand of such drinks —putting aside quality considerations — clearly looks like a tying arrangement. Therefore one has to be very careful about the definition of the separate "products".

2. The application of a rule of reason

One of the main arguments against tie-ins lies on the possibility that the franchisor has "sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product."[15] This leveraging of market power can indeed be harmful when: (i) the franchisor has some market power in the market of the tying product; and (ii) the franchisor forecloses a non-negligible share of the market for the tied product. These two conditions are reviewed below.

(i) The first condition on the franchisor's market power for the tying product has been interpreted in various ways. In the United States, Justice Lumbard took in Carvel an extreme position, stating:

> "Despite the absence in the record of substantial economic data, [...] I believe that such power may be presumed from the use of the Carvel trademark as the principal feature of the Carvel franchise system."

Although this interpretation — according to which the use of the franchisor's trademark constitutes a sufficient evidence of the franchisor's market power — has been confirmed in Siegel v. Chicken Delight, Inc., it has been properly replaced, later on, with an interpretation based on an economic appreciation of the franchisor's weight in the market for the tying product. The threshold level of importance for the characterization of market power seems however to have been relatively permissive, since in Jefferson Parish Hospital District No. 2 et al. v. Hyde, for example, the Supreme Court considered that a 30% market share was "insufficient as a basis to infer market power",[16] even though it recognized at the same time that there existed "market imperfections which allowed the hospital to charge noncompetitive prices — it is immediately added in the decision of the Court that "[w]hile these factors may generate "market power" in some abstract sense, they do not generate the kind of market power that justifies condemnation of tying."[17]

(ii) The second condition, which relates to the structure of the market for the tied product, is often missing in the application of the rule of reason to tie-ins. It should however be stressed that, even if the franchisor succeeds in using a significant market power in one market to force his franchisees to buy other goods as well, this tying arrangement may have little impact on the competition in the other markets if his franchisees represent only a negligible share of the customers of the other products. Chicken Delight's requirement to buy packing items, for example, may have only negligible consequences on the competition in the packing industry.

On the other hand, tie-ins can efficiency-enhancing effects. This is the case, for example, when tying arrangements permit the avoidance of price distortions and which would otherwise induce inefficient input substitution -- an argument which does not seem to be much accounted for in the European jurisprudence, which is rather strict on tie-ins.

In the United States, Siegel v. Chicken Delight, Inc. provides for another possible rationale and pro-efficient use of tie-ins. Rather than requiring any franchise fee or royalties, Chicken Delight used the packing items needed franchised business operation as a "counting device" to recover a return proportional to the volume of sales. This counting device was found to be efficient and effective, in that it was simple and prevented for example the franchisees from cheating on their reported sales. The Court of Appeals, however, rejected this argument and, although Chicken Delight's franchisees represented a pretty small share of customers for similar packing devices, condemned the tying requirement -- in the absence of franchise fees and royalties, the franchisor did not survive very long after the decision.

Other efficiency-enhancing effects are also called for, such as the preservation of the franchisor's goodwill quality reputation. The existence of these effects should however be checked carefully. In that respect, the distinction drawn by the Canadian Restrictive Trade Practices Commission between efficiency effects in the joint production of the tying and tied products, on the one hand, and quality arguments used to justify tying arrangements for inputs, on the other hand, seems particularly relevant. Lastly, it should also be checked that there does not alternative tools with similar efficiency-enhancing effects, but without the anticompetitive effects mentioned above.

E. Refusal to deal and Non-competition provisions

We first make a few remarks on refusals to deal, and then briefly discuss the role of non-competition provisions.

1. Refusal to deal

In most cases would-be franchisees must meet certain skills or ability requirements, or must have a minimal financial strength for the success of the franchise. As long as these requirements can be precisely formulated and are clearly necessary, franchisors must certainly be allowed to refuse any candidate who would fail to meet these requirements -- and franchisors are actually allowed to do so.

The case is of course less clear when relevant requirements cannot be made explicit or are based on features which are difficult to verify. It should be stressed, however, that the right to refuse a potential franchisee is a necessary counterpart to most of the other restrictions discussed above. Suppose for example that a franchisor decides to grant his franchisees with exclusive territories. This is possible only if he can guarantee a franchisee that no other franchised outlet will appear in the given territory, which in turn implicitly requires the ability to refuse to deal with any potential franchisee in this territory.

For that reason it is difficult to define a relevant jurisprudence for refusals to deal independently from the positions adopted in favor or against other types of restrictions. When a high initial fee is involved, however, a distinction could be drawn between a refusal to deal with a would-be franchisee and the unilateral termination of an existing franchise agreement. A similar distinction may be relevant when the franchise operation requires important specific investments on the franchisees' side.

2. Non-competition provisions

Franchise contracts often include a provision according to which the franchisee cannot engage in direct or indirect competition with the franchisor, either during the duration of the contract, or for some period after the termination of the contract, or both. When it applies to the period covered by the contract, such a restriction usually constitute a corollary to other restrictions, such as territorial restraints or exclusive dealing arrangements. In that case, they must be judged along the same line as the restriction of which it is the counterpart. On the other hand, when applying to some period after the termination of the contract, such a provision must have its own justification. The most convincing justification relates to the protection of the franchisor's specific investment in the franchise business. It is particularly relevant when the franchisor transfers some know-how and technical skills to his franchisees. Such post-termination restrictions have however non-negligible consequences on interbrand competition, and the franchisor's rights -- which affect competition in the long-run -- have to appropriately balanced with these *ex post* negative effects. Many countries have decided to allow such a post-termination restriction for a period of at most one year, which seems a reasonable compromise.

1. Albrecht v. Herald Co., 390 U.S. 145, at 152-153 (1968).

2. The Competition Commission, for example, did not allow perfume producers to prohibit advertising which would include prices below recommended prices.

3. Section 15 of the ARC.

4. United States v. Socony-Vacuum Oil Co., 310 U.S. 150, at 223.

5. Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. at 211, 213 (1951); there was in that case an additional horizontal component since the agreement was between two suppliers that had agreed to sell liquor only to wholesalers adhering to maximum prices above which the wholesalers could not resell.

6. Albrecht v. Herald Co., 390 U.S. at 145 and 152-53 (1968).

7. Arizona v. Maricopa County Medical Society, 457 U.S. at 332 (1982).

8. Albrecht v. Herald Co., 390 U.S. 145, at 152 (1968).

9. Ibid.

10. USA Petroleum Co., v. Atlantic Richfield Co., United States Court of Appeals for the ninth Circuit, 859 F. 2d 687 at 8.

11. Atlantic Richfield Co., v. USA Petroleum Co., U.S. Supreme Court decision, May 14, 1990.

12. Among other things, BE's retail prices were often below the prices suggested by Sharp, Hartwell complained to Sharp on a number of occasions about BE's prices, and BE was terminated no more than one month after Hartwell's ultimatum that he would terminate his own dealership unless Sharp ended its relationship with BE within 30 days.

13. For the Court of Appeals decision, see 480 F.2d 1212. The Supreme Court produced its decision on May 2, 1988.

14. Principe v. McDonald's Corp., 631 F.2d 303.

15. Northern Pacific Railway Co. v. United States, 356 U.S. 594 at p. 6.

16. <u>Jefferson Parish Hospital District No. 2 et al. v. Hyde</u>, 466 U.S. 2, 104 S. Ct. at 1566-1568.

17. Idem.

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