1996

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Repository Citation

Meese, Alan J., "Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts" (1996). *Faculty Publications*. 541.
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ANTITRUST BALANCING IN A (NEAR) COASEAN WORLD: THE CASE OF FRANCHISE TYING CONTRACTS

*Alan J. Meese**

Antitrust law has largely succumbed to the hegemony of balancing. Courts applying the rule of reason are told to balance a restraint's procompetitive effects against its anticompetitive impact.¹ Mergers once deemed anticompetitive solely because they facilitated the exercise of market power are now evaluated by weighing the anticompetitive effects of such increased power against any efficiencies created by the transaction.² Finally, some activities once deemed per se illegal are now subject to a balancing approach, either by explicit application of the rule of reason,³ or by recognition of certain affirmative defenses to oth-

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1. Courts apply the rule of reason to restraints not deemed per se illegal. For the classic statement of the rule, see *Chicago Bd. of Trade v. United States*, 246 U.S. 231, 238-39 (1918) (holding that a court must consider all relevant factors in determining whether contract merely "regulates" or instead "destroys" competition); see also *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 57 n.27 (1977); *Capital Imaging Assocs. v. Mohawk Valley Medical Assocs.*, 996 F.2d 537, 543 (2d Cir.), *cert. denied*, 510 U.S. 947 (1993).

2. Compare *United States v. Philadelphia Natl. Bank*, 374 U.S. 321, 371 (1963) and U.S. DEPT. OF JUSTICE, MERGER GUIDELINES § 10 (1968) with *FTC v. University Health, Inc.*, 938 F.2d 1206, 1222-24 (11th Cir. 1991) and *American Medical Intl., Inc.*, 104 F.T.C. 1, 218-19 (1984) and HORIZONTAL MERGER GUIDELINES § 4 (1992) [hereinafter HORIZONTAL MERGER GUIDELINES]. See generally Oliver E. Williamson, *Economies as an Antitrust Defense: The Welfare Tradeoffs*, 58 AM. ECON. REV. 18 (1968) [hereinafter Williamson, *Welfare Tradeoffs*]. Indeed at one time, the presence of significant efficiencies apparently militated against a merger. See Timothy J. Muris, *The Efficiency Defense Under Section 7 of the Clayton Act*, 30 CASE W. RES. L. REV. 381, 402-07 (1980).

3. Compare *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284 (1985) (group boycott analyzed under rule of reason) and *Continental T. V.*, 433 U.S. at 49 (exclusive territory analyzed under rule of reason) and *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210 (D.C. Cir. 1986) (horizontal ancillary restraint analyzed under rule of reason) and *Polk Bros., Inc. v. Forest City Enters.*, 776 F.2d 185 (7th Cir. 1985) (same) with *United States v. Topco Assocs.*, 405 U.S.

erwise per se violations.⁴

Unlike many other balancing tests, the balancing framework familiar to antitrust scholars and practitioners is at least theoretically objective, if sometimes difficult to apply in practice.⁵ Drawing on neoclassical microeconomic analysis, this approach seeks to identify those instances in which anticompetitive effects — higher prices and distortions in the allocation of resources — caused by a restraint outweigh their procompetitive benefits, usually efficiencies in producing a product or service.⁶ While there is some dispute as to exactly which effects should count against a restraint — whether, for instance, transfers of wealth from consumers to producers should be deemed an anticompetitive effect⁷ — the theoretical economic framework within which these effects are quantified and compared is invariable, and comprise what one scholar calls a “basic partial equilibrium welfare economics model.”⁸

The law of tying has been a moderately fertile source of such balancing litigation, particularly in the per se context, where judges and scholars have identified several possible procompetitive justifications

596 (1972) (horizontal ancillary restraint per se illegal) and *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967) (exclusive territories per se unlawful), *overruled by Continental T. V.*, 433 U.S. at 36 and *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959) (group boycott per se illegal).

4. See, e.g., *Mozart Co. v. Mercedes-Benz of N. Am. Inc.*, 833 F.2d 1342 (9th Cir. 1987) (entertaining and sustaining an affirmative defense); *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033 (4th Cir. 1987) (entertaining, but rejecting, an affirmative defense); cf. Thomas G. Krattenmaker, *Per Se Violations in Antitrust Law: Confusing Offenses with Defenses*, 77 GEO. L.J. 165 (1988) (arguing that no contract is per se illegal, but that per se rules instead preclude the assertion of certain justifications for otherwise illegal conduct).

5. Cf. Frank H. Easterbrook, *What's So Special About Judges?*, 61 U. COLO. L. REV. 773, 779-82 (1990) (decrying the proliferation of multi-factor balancing tests); Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175 (1989) (same).

6. See *infra* text accompanying notes 61-66.

7. Compare ROBERT H. BORK, *THE ANTITRUST PARADOX* 110-13 (1993) (arguing that antitrust law should only be concerned with allocational, as opposed to distributional, effects of a restraint) with Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65 (1982) (arguing that the primary objective of antitrust law is distributive in nature).

8. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 369 (1985) [hereinafter WILLIAMSON, *ECONOMIC INSTITUTIONS*]; Williamson, *Welfare Tradeoffs*, *supra* note 2, at 20; see also BORK, *supra* note 7, at 107; Thomas C. Arthur, *The Costly Quest for Perfect Competition: Kodak and Nonstructural Market Power*, 69 N.Y.U. L. REV. 1, 15 (1994) (applying “Oliver Williamson’s famous tradeoff model” in the tying context); Lande, *supra* note 7, at 143 (employing identical models to illustrate approaches premised upon differing definitions of consumer welfare).

for otherwise per se illegal arrangements.⁹ This article focuses on one such defense, the "franchise goodwill" justification. As courts and others have recognized, a franchise tying contract — that is, a franchise contract that requires a franchisee to purchase inputs from a franchisor as a condition of receiving a franchise — can reduce the agency costs that result from the division of labor that characterizes the relationship between franchisor and franchisee. More precisely, such a requirement can prevent a certain class of opportunistic behavior by franchisees, namely, the failure to provide a product of a quality sufficient to maintain the reputational value of the franchise trademark, while free riding on the quality control efforts of others.¹⁰ Thus, for example, a requirement by a fast food franchisor that its franchisees purchase its food ingredients or paper products might be justified as an attempt to ensure that franchisees do not "skimp" on quality and dilute the reputation of the franchise trademark.¹¹

Under current law, once a plaintiff establishes the elements of a per se tying violation, the procompetitive benefits of a reduction in opportunistic behavior must be weighed against the anticompetitive effects of the tie, which presumably has been "forced" on the purchaser by the exercise of market power.¹² This weighing usually is not explicit, but instead takes the form of a less restrictive alternative analysis under which the justification will fail when a less restrictive means of achieving the objective is available, even when the benefits of the tie outweigh any anticompetitive effects.¹³

This article challenges the conventional analysis as applied to franchise tying contracts and questions its application in areas outside the franchise context as well. While consistent with the partial equilibrium welfare analysis employed in antitrust law generally, this conven-

9. See, e.g., *Fortner Enters. v. United States Steel Corp.*, 394 U.S. 495, 514 n.9 (1969) (White, J., dissenting) (discussing various procompetitive justifications); RICHARD A. POSNER & FRANK H. EASTERBROOK, *ANTITRUST* 809-10 (2d ed. 1981) (evocation of cartel); Roy W. Kenney & Benjamin Klein, *The Economics of Block Booking*, 26 J.L. & ECON. 497 (1983) (tying can reduce overinvestment in search).

10. See *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342, 1348-49 (9th Cir. 1987); see also *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 50-52 (9th Cir. 1971); Benjamin Klein & Lester F. Saft, *The Law and Economics Of Franchise Tying Contracts*, 28 J.L. & ECON. 345 (1985); cf. WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 39 (discussing incentives for franchisees to free ride); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 228 (1978) (same).

11. See, e.g., *Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*, 549 F.2d 368 (5th Cir. 1977); *Chicken Delight*, 448 F.2d at 50-52; *Little Caesar Enters. v. Smith*, 895 F. Supp. 884 (E.D. Mich. 1995).

12. See *infra* text accompanying notes 19, 23-27.

13. See *infra* text accompanying notes 46-50.

tional analysis is premised on an outdated preoccupation with monopolistic explanations for nonstandard contracts and misconceives the relationship between market power, on the one hand, and tying contracts that serve a procompetitive objective, on the other. In particular, this article demonstrates that a tying contract that reduces agency costs and enhances franchise goodwill by eliminating opportunistic free riding by franchisees is not "forced" on purchasers nor is it otherwise the result of market power. Instead, a contract that produces these benefits is presumably the result of a purely voluntary arrangement that divides between the parties those gains resulting from partial integration, integration that would occur regardless of whether the franchisor possessed market power.

Given the low transaction costs inherent in the franchisor-franchisee relationship, no rational franchisor with market power would use that power to impose such a tying requirement. Instead, the parties would negotiate for the term, and the franchisor would exercise its power simply by raising the price of the tying product: here, the franchise opportunity itself. Denomination of the benefits created by such a term as a "justification" or an "affirmative defense," then, improperly equates franchise tying contracts with other, presumptively anticompetitive, arrangements. Unlike the ordinary rule of reason or merger analysis, where the presence of market power suggests that procompetitive benefits coexist with anticompetitive effects, proof of procompetitive effects in the franchise context suggests that no legally cognizable anticompetitive effects are present. Thus, the partial equilibrium welfare analysis employed in other antitrust contexts and premised necessarily upon the presence of high transaction costs is ill-suited for the evaluation of tying contracts that produce these procompetitive effects, and, in fact, is unduly biased against such contracts.

The bias inherent in such a partial equilibrium analysis does more than lead to incorrect results. It leads to less efficient methods of controlling free riding and encourages forward integration by franchisors, integration that both destroys efficiencies otherwise realizable via the division of labor inherent in the franchise system and retards the growth of independent small business. In order to eliminate this bias, courts ought to alter the current framework by holding that a franchisor establishes the *prima facie* legality of a tying contract by proving that it eliminates free riding. Such an approach will not only ensure correct results; it will truncate the full-blown analysis undertaken when evaluating tying contracts, thus reducing litigation costs.

The conclusion offered here has implications beyond the franchise context, premised, as it is, on the inapplicability of a partial equilibrium

welfare analysis in low transaction cost settings. When the contract under scrutiny arises in such a setting, a conventional partial equilibrium analysis is ill-suited for a proper evaluation of the restraint.

I. BACKGROUND

The Supreme Court has stated that “[t]ying agreements serve hardly any purpose beyond the suppression of competition.”¹⁴ Yet, the Justices have never held that all contracts that condition the sale of one product upon the purchase of another are illegal. Instead, the Court has developed an elaborate analytical framework, best articulated in *Jefferson Parish Hospital District No. 2 v. Hyde*,¹⁵ for identifying tying contracts that are the result of anticompetitive “forcing,” that is, are imposed through the exercise of market power.¹⁶ Under this approach, a plaintiff may make out a per se violation by proving: (1) the existence of separate products; (2) conditioning the sale of one (tying) product on the purchase of another (tied) product; (3) the seller’s possession of power in the market for the tying product; and (4) substantial commerce in the tied product.¹⁷ Proof of these four elements gives rise to a pre-

14. *Northern Pac. Ry. v. United States*, 356 U.S. 1, 6 (1958) (quoting *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949)).

15. 466 U.S. 2 (1984).

16. *See* 466 U.S. at 12-15; *Fortner Enters. v. United States Steel Corp.*, 394 U.S. 495, 503-04 (1969). As explained below, there are “nonforcing” theories that explain how ties can, in some circumstances, have anticompetitive effects. The rationale of the per se rule, however, focuses on the threat of forcing. *See Jefferson Parish*, 466 U.S. at 12 (“Our cases have concluded that the essential characteristic of an invalid tying arrangement lies in the seller’s exploitation of its control over the tying product to *force* the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms. When such ‘*forcing*’ is present, competition on the merits in the market for the tied item is restrained and the Sherman Act is violated.”) (emphasis added); *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 895 (E.D. Mich. 1995) (forcing constitutes a necessary element in franchise tying case); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1231-33 (W.D. Tenn. 1995) (same).

17. *See Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 461-62 (1992); *Jefferson Parish*, 466 U.S. at 15-18. It should be noted that courts do not always deem a franchise opportunity — the ability to operate under the franchise trademark — to be a separate, tying product. Instead, courts generally find the trademark to be a separate product only in those circumstances in which a so-called “business format franchising” is involved, that is, where the franchisee produces the franchise product, and distributes it under the franchise trademark. If, by contrast, the franchisor is the ultimate source of the product, such that the trademark merely identifies the supplier, courts will not deem the trademark or the opportunity a separate, tying product. *See Jack Walters & Sons Corp. v. Morton Bldg., Inc.*, 737 F.2d 698, 704-05 (7th Cir. 1984) (explaining this distinction). However, where the franchise is of the latter, “source” variety, courts often treat the franchise product itself as a separate, tying product. *See, e.g., Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468, 478-81 (3d

sumption that the challenged arrangement is an illegal tie, that is to say, that the seller is using its market power over the tying product to "force" a buyer to purchase the tied product, and that the arrangement is, on balance, anticompetitive.¹⁸ Despite the "per se" label, however, this presumption is not conclusive. Some lower courts, at least, still admit the possibility of an "affirmative defense," in which a defendant endeavors to show that the arrangement is necessary to advance a procompetitive objective that outweighs the tie's anticompetitive effects.¹⁹

When a plaintiff is unable to establish the elements of a per se violation, courts analyze the arrangement under the rule of reason.²⁰ Under this approach, the plaintiff cannot rely upon the type of presumption present in the per se context, but instead must prove directly that the tie produces anticompetitive effects that outweigh its justifications.²¹ Of course, the same procompetitive benefits that might be proffered as jus-

Cir. 1992) (en banc) (treating Chrysler automobiles as the tying product); *Grappone, Inc. v. Subaru of New England, Inc.*, 858 F.2d 792, 797-98 (1st Cir. 1988) (treating Subaru automobiles as the tying product).

Most lower courts also require a showing that the seller has an "economic interest" in the sale of the tied product. *See, e.g.,* *Thompson v. Metropolitan Multi-List, Inc.*, 934 F.2d 1566, 1578-79 (11th Cir. 1991). In addition, at least one circuit may require a finding of an anticompetitive effect in the market for the tied product. *See A.O. Smith Corp. v. Lewis, Overbeck & Furman*, 979 F.2d 546 (7th Cir. 1992).

18. *See Jefferson Parish*, 466 U.S. at 13-15.

19. *See Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342, 1348-1350 (9th Cir. 1987); *Metrix Warehouse, Inc., v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1040-42 (4th Cir. 1987) (entertaining but ultimately rejecting a defense); *United States v. Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd.*, 365 U.S. 567 (1961) (per curiam); *see also Little Caesar Enters.*, 895 F. Supp. at 888 (noting franchisees' failure to challenge the tie of proprietary items produced under a secret formula). The Supreme Court has never approved the assertion of an affirmative defense to a tying contract. In *Jerrold Electronics*, the government did not challenge in the Supreme Court the district court's finding that the tie was necessary to the development of a new product. *See Jerrold Electronics*, 365 U.S. at 567. Thus, the Court only affirmed that portion of the District Court's decision holding that the tie was no longer justified once the defendant had established itself in the new market. *See* 365 U.S. at 567. Moreover, the Court has asserted that most, if not all, procompetitive purposes could be served by means "less restrictive" than a tie. *See* sources cited *infra* note 60.

20. *See Jefferson Parish*, 466 U.S. at 29-31; *Town Sound*, 959 F.2d at 482-83 (holding that, absent a showing of market power, courts will analyze a tie under the rule of reason); *Grappone*, 858 F.2d at 796-98 (opinion of Breyer, J.) (reaching the same conclusion). *But see* *Digital Equip. Corp. v. Uniq Digital Technologies, Inc.*, 73 F.3d 756, 761 (7th Cir. 1996) (opinion of Easterbrook, J.) (holding that market power is necessary to prove a violation under the rule of reason).

21. *See Grappone*, 858 F.2d at 799 (citing *Jefferson Parish*, 466 U.S. at 31).

tifications for a per se violation are also relevant when such balancing occurs.²²

It is against this backdrop that some lower courts have long entertained what might be called a "franchise goodwill" defense — an assertion that the tie ensures that franchisees use inputs of a quality sufficient to maintain the image of the franchise, which is usually associated with a trademark.²³ For instance, in *Siegel v. Chicken Delight, Inc.*,²⁴ the Ninth Circuit entertained, but rejected, Chicken Delight's assertion that a requirement that its franchisees purchase from it cooking equipment, food ingredients, and paper products was on balance procompetitive because it ensured that its trademark was associated with a certain level of quality.²⁵ However, in *Mozart Co. v. Mercedes-Benz of North America, Inc.*,²⁶ the court, assuming *arguendo* that the plaintiff had established the elements of per se liability, found Mercedes's requirement that its dealers use only Mercedes or Mercedes-approved replacement parts justified by goodwill concerns, particularly in light of the jury's finding that no less restrictive alternative adequately advanced Mercedes's interest in quality control.²⁷

Economists have formalized this franchise goodwill defense, demonstrating that, in some cases, such contractual requirements are a response to the agency costs created by the division of labor that characterizes the franchisor-franchisee relationship. By separating the ownership of a trademark from its control, the franchise system allows a division of labor that creates substantial efficiencies.²⁸ These efficien-

22. See, e.g., *Grappone*, 858 F.2d at 799-800 (relying in part on *Jerrold Electronics* for the conclusion that the tie helped the defendant break into a new market).

23. See, e.g., *Mozart Co.*, 833 F.2d at 1348-51; *Metrix Warehouse*, 828 F.2d at 1040-41; see also *Midwestern Waffles Inc., v. Waffle House, Inc.*, 734 F.2d 705, 713 (11th Cir. 1984).

24. 448 F.2d 43 (9th Cir. 1971).

25. 448 F.2d at 51.

26. 833 F.2d 1342 (9th Cir. 1987).

27. See 833 F.2d at 1349. But see *Metrix Warehouse*, 828 F.2d at 1040-42 (finding the same arrangement illegal given the presence of a less restrictive alternative). *Mozart Co.* and *Metrix Warehouse* are compared in J. Brady Dugan, Note, *Contrasting Approaches to Economic Justifications in Tying Arrangement Analysis*: *Metrix Warehouse v. Daimler-Benz Aktiengesellschaft and Mozart Co. v. Mercedes-Benz of North America*, 12 GEO. MASON U. L. REV. 139 (1989).

28. Scholars have identified several efficiencies created by the franchise system. See, e.g., James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401 (1987) (stating that franchising leaves the control of operations in the hands of the party who better internalizes the benefits of its actions, the franchisee); Richard E. Caves & William F. Murphy II, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 574-75 (1976) (noting that franchising allows parties to realize the benefits of differing economies in the production of a service and the production of a national brand name); Klein & Saft, *supra* note

cies, however, come with a price. In relinquishing its control over the trademark, the franchisor leaves the quality of the products distributed under the mark in the hands of individual franchisees. Under these conditions, the reputation associated with the franchise trademark assumes the characteristics of a collective good, as no franchisee can exclude other franchisees from the benefits that flow from its own maintenance of high quality standards.²⁹

In such circumstances, individual franchisees will face insufficient incentives to produce quality products that maintain the trademark's reputation.³⁰ The benefits from any one franchisee's investment in quality will flow in large part to other franchisees. Concomitantly, each individual franchisee will recognize that it will enjoy the benefits of such investment by other franchisees. Each franchisee will thus find it rational to engage in opportunistic behavior at the expense of the franchise system — behavior that involves the sort of "free riding" that usually characterizes the production of collective goods.³¹ This free riding will consist of attempts to "cheat" customers, by providing them with products inferior to those ordinarily associated with the trademark, presumably at the same price charged by those fellow franchisees who maintain a higher level of quality.³² While this behavior might breach

10, at 350 n.20 (agreeing with Caves and Murphy); Rubin, *supra* note 10, at 226-30 (noting that franchising facilitates the efficient policing of franchisee investments in quality); see also Patrick J. Kaufmann & Francine LaFontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J.L. & ECON. 417, 429 (1994) ("[E]vidence in the literature suggest[s] that costs are higher in company-owned than in franchised outlets of the same chain.").

29. See Rubin, *supra* note 10, at 228; see also MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 14-16 (1965) (defining collective goods).

30. See Klein & Saft, *supra* note 10; G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J.L. & ECON. 503, 504-05 (1985).

31. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 39 (explaining generally the incentives of franchisees to free ride); Rubin, *supra* note 10, at 228.

32. See Klein & Saft, *supra* note 10, at 349-50; Mathewson & Winter, *supra* note 30, at 506-08; Rubin, *supra* note 10, at 228. Put another way, the ordinary franchise arrangement is characterized by negative externalities — externalities that can be imposed by one franchisee on its fellows via a suboptimal investment in quality. As Professor Rubin explains:

What is involved is a classic externality problem. If any one franchisee allows quality to deteriorate, he will generate revenue because consumers perceive him as being of the same quality as other stores with the same trademark. Thus, if one franchisee allows the quality of his establishment to deteriorate, he benefits by the full amount of the savings from reduced quality maintenance; he loses only part of the costs, for part is borne by other franchisees. All franchisees would lose something as a result of this deterioration in one franchise: consumers would have less faith in the quality promised by the trademark.

Rubin, *supra* note 10, at 228; see also Mathewson & Winter, *supra* note 30, at 506-10 (discussing the "horizontal externality" problem).

the franchise contract,³³ detection and punishment of such deviancy may well be prohibitively expensive.³⁴ By ensuring that franchisees purchase inputs of a certain quality, then, tying contracts can prevent a deterioration in the reputation of the franchise product and trademark.

Market mechanisms — for example, customer exit — often will not deter such conduct. This is especially the case when customers make one-time purchases and cannot readily observe quality beforehand.³⁵ Such customers are unable to protect themselves, and franchisees have little incentive to maintain individual, franchise-specific reputations for quality.³⁶ Thus, one commentator reports that, for many years, Standard Oil Company owned all service stations operating under its trademark along interstate highways, where few patrons are repeat customers, but allowed owner-operated franchise stations in neighborhoods where repeat trade was prevalent.³⁷ Presumably, the lack of repeat business along highways sharply reduced franchisees' incentives to maintain quality. Such complete vertical integration is a drastic remedy, which eliminates the gains inherent in the franchise system.³⁸ Yet, ab-

33. Even if such conduct does not violate the explicit terms of the franchise agreement, it may well violate an explicit or implicit "best efforts" term. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1111-30 (1981).

34. See Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 523, 575-80 (1981) (arguing that shirking by franchisees is a paradigmatic example of opportunistic behavior).

35. See Klein & Saft, *supra* note 10, at 350-51.

36. See Rubin, *supra* note 10, at 228.

37. See Keith K. Wollenberg, Note, *An Economic Analysis of Tie-In Sales: Re-examining the Leverage Theory*, 39 STAN. L. REV. 737, 754-55 n.114 (1987); see also Klein & Saft, *supra* note 10, at 348 n.15 ("Chicken Delight appears to have assured high-quality supply by granting franchisees fairly large exclusive territories and locating their outlets off the main highways."). All customers need not be repeat customers for such a strategy to be successful. Instead, so long as a franchisee cannot distinguish between repeat and one-time customers and discriminate against the latter, the presence of a significant proportion of repeat customers should induce the appropriate investment in quality. See *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468, 489 (3d Cir. 1992) (en banc); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 637-39 (1979) (explaining how, absent discrimination, the presence of some knowledgeable consumers in a market can prevent sellers from exploiting those consumers that are not well-informed).

38. See *supra* note 28; cf. *Continental T. V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 57 n.26 (1977) (holding that courts should not, under guise of protecting distributors, adopt rules that encourage manufacturers to integrate forward); *Standard Oil Co. v. United States*, 337 U.S. 293, 319-21 (1949) (Douglas, J., dissenting).

sent this or some other method of control, competition between franchise systems will suffer and output will fall.³⁹

Such shirking may even extend to the refusal by franchisees to provide an optimal level of goods or services ancillary to the "primary" product, either at the point of sale or in the aftermarkets.⁴⁰ In *Grappone, Inc. v. Subaru of New England, Inc.*,⁴¹ for instance, the court scrutinized an agreement that conditioned the right to sell Subaru automobiles on the dealer's agreement also to purchase a minimum number of spare parts. This arrangement may well have prevented dealers from free riding on the provision of parts and service by others.⁴² Similarly, in *Yentsch v. Texaco*,⁴³ the court evaluated Texaco's requirement that its dealers maintain clean washrooms and provide S&H Greenstamps and free glassware to customers who purchased a minimum amount of gasoline.⁴⁴ Such requirements were likely designed to present a uniform bundle of services to the public, and to prevent individual franchisees from luring consumers to nonconforming stations under the false expectation that such services would be available.

Not all tying contracts produce such procompetitive benefits; often conditions are not conducive to free riding by franchisees, thereby suggesting an ulterior purpose for these contracts.⁴⁵ However, even when a franchisor can demonstrate that a tying contract prevents free riding, current law rejects attempts to justify the agreement on this basis. Under current law, a demonstration that such a contract prevents opportunistic behavior does not render the challenged arrangement legal. In-

39. See Klein & Saft, *supra* note 10, at 349-51 (arguing that free riding results in lower demand for franchise products); cf. Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960). Of course, the free riding attributed to franchisees in this context differs from that ordinarily encountered in the vertical context. In the latter case, customers are in a real sense in complicity with the distributor who provides inferior service. In the former, the customer is a victim. See Klein & Saft, *supra* note 10, at 351.

40. See Rubin, *supra* note 10, at 228 (arguing that free riding extends to franchise relationship generally); see also note 17, *supra* (describing the so-called "source" franchises, pursuant to which the franchisee distributes a product manufactured by the franchisor).

41. 858 F.2d 792 (1st Cir. 1988).

42. See also *Southern Pines Chrysler-Plymouth, Inc. v. Chrysler Corp.*, 826 F.2d 1360 (4th Cir. 1987) (addressing a requirement that dealers carry a full line of automobiles); cf. *Continental T.V.*, 433 U.S. at 55 (noting that exclusive territories can facilitate aftermarket service); Kevin J. Arquit, *Resale Price Maintenance: Consumers' Friend or Foe?*, 60 ANTITRUST L.J. 447, 453 (1992) (concluding that resale price maintenance can assure optimal service in aftermarkets).

43. 630 F.2d 46 (2d Cir. 1980).

44. See 630 F.2d at 49-50.

45. See Klein & Saft, *supra* note 10, at 357-58 (suggesting that Chicken Delight utilized tying contracts to collect rents appropriated by price discriminating franchisees).

stead, the franchisor must prove that the benefits of the tie outweigh the anticompetitive effects that are presumed to exist once a per se violation has been "established."⁴⁶ Courts do not engage in this balancing explicitly, but instead scrutinize such an assertion by means of a less restrictive alternative test.⁴⁷ This test requires courts to reject any asserted justification for a tie, including a "franchise goodwill" justification, when the procompetitive objectives of the contract could be achieved through less restrictive means.⁴⁸ In *Chicken Delight*, for instance, the court rejected a "goodwill defense," finding that the defendant could have specified in the franchise contract the attributes of the inputs in question.⁴⁹ Conversely, when a tie is the least restrictive means of achieving its objectives, for example, when it is impossible to specify all the attributes of the input(s) in question, or when those inputs are produced pursuant to a trade secret, courts uniformly sustain the defense.⁵⁰

The hostility toward procompetitive justifications exhibited by the shifted burden of proof and the less restrictive alternative test flows naturally from the economic theory of ties adopted by the Supreme Court, as well as the economic assumptions governing balancing approaches in antitrust law generally. In *Standard Oil*, on which lower courts often rely for the application of the less restrictive alternative test,⁵¹ the Court discussed a different affirmative defense — the so-called "false attribu-

46. See *supra* note 19.

47. See, e.g., *Mozart Co. v. Mercedes-Benz of N. Am.*, 833 F.2d 1342, 1348-49 (9th Cir. 1987); *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1040-42 (4th Cir. 1987); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 51 (9th Cir. 1971).

48. See *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949); *International Salt Co. v. United States*, 332 U.S. 392, 397-98 (1947) (rejecting the assertion that a tie eliminated "false attribution problem" given the purported availability of less restrictive alternative); *Metrix Warehouse*, 828 F.2d at 1040-42; *Midwestern Waffles, Inc. v. Waffle House, Inc.*, 734 F.2d 705, 712-13 (11th Cir. 1984); *Chicken Delight*, 448 F.2d at 51; see also *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 483-84 (1992) (holding that summary judgment was improper given evidence that the tie was not necessary to ensure quality).

49. *Chicken Delight*, 448 F.2d at 51; accord *Metrix Warehouse*, 828 F.2d at 1040-42.

50. See *Mozart Co.*, 833 F.2d at 1349-50 (finding that the tie was justified in light of the jury's finding that no less restrictive alternative existed); *Krehl v. Baskin Robbins Ice Cream Co.*, 664 F.2d 1348, 1353 n.12 (9th Cir. 1982) (noting that when the "alleged tied product is manufactured pursuant to secret formulae, the specification alternative is not available"); *Susser v. Carvel Corp.*, 332 F.2d 505, 514-15 (2d Cir. 1964) (finding the proposed specifications for substitute products too detailed and complex); see also *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 888 (E.D. Mich. 1995) (noting the franchisees' failure to challenge the tie of certain proprietary items).

51. See *Metrix Warehouse*, 828 F.2d at 1040 n.12 (citing *Standard Oil*, 337 U.S. at 306); *Chicken Delight*, 448 F.2d at 51 (quoting *Standard Oil*, 337 U.S. at 306).

tion defense" — in some detail.⁵² The Court suggested that, if use of a particular input enhanced the quality of the service ultimately supplied to consumers, distributors would purchase the input willingly, that is, without a contractual requirement.⁵³ Thus, the Court continued, the presence of such a requirement indicated that market power was being exercised: "[O]nly the prospect of reducing competition would persuade a seller to adopt such a contract and only his control of the supply of the tying device . . . could induce a buyer to enter one."⁵⁴ Indeed, the Court continued, the presence of market power itself suggests that a defendant will employ a tie to "extend" that power.⁵⁵

This explanation of ties reflected the spirit of the times, a spirit that took as a given the allocation of economic tasks between intrafirm production, on the one hand, and market transactions, on the other.⁵⁶ Such an approach flowed naturally from industrial organization's exclusive focus on price theory.⁵⁷ Under this approach, all contracts that departed from some preconceived allocation of tasks between firms and the market were seen as symptoms of the exercise of monopoly power.⁵⁸ Professor Coase summed up this intellectual climate nicely:

52. See *Standard Oil*, 337 U.S. at 305-06. Of course, the false attribution defense is only analogous, and not identical, to the franchise goodwill defense, insofar as the former does not depend on the possibility of free riding. Still, lower courts rely on *Standard Oil*'s discussion in both contexts. See *supra* note 51.

53. See *Standard Oil*, 337 U.S. at 306 ("If the manufacturer's brand of the tied product is in fact superior to that of competitors, the buyer will presumably choose it anyway."); accord *Times-Picayune Publishing Co. v. United States*, 345 U.S. 594, 605 (1953) ("[A]ny intrinsic superiority of the 'tied' product would convince freely choosing buyers to select it over others, anyway."); *Metrix Warehouse*, 828 F.2d at 1041 (quoting same); see also *Fortner Enters. v. United States Steel Corp.*, 394 U.S. 495, 503 (1969) ("[B]ecause tying arrangements generally serve no legitimate business purpose that cannot be achieved in some less restrictive way, the presence of any appreciable restraint on competition provides a sufficient reason for invalidating the tie.").

54. *Standard Oil*, 337 U.S. at 306; cf. *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1232 (W.D. Tenn. 1995) (finding that a contractual provision requiring the purchase of the tied item itself establishes the existence of forcing); *Little Caesar Enters.*, 895 F. Supp. at 896 (same).

55. See *Standard Oil*, 337 U.S. at 306.

56. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 7.

57. See R.H. COASE, *INDUSTRIAL ORGANIZATION: A PROPOSAL FOR RESEARCH*, reprinted in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 57, 60-61 (1988) [hereinafter COASE, *INDUSTRIAL ORGANIZATION*]; see also WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 7; cf. Frank H. Easterbrook, *Workable Antitrust Policy*, 84 MICH. L. REV. 1696, 1701 (1986) ("Practices that look monopolistic (because they involve cooperation) may be beneficial. Cooperation is essential in complex economic endeavors. How much is too much is a thorny problem.").

58. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 19, 370-71 ("Since there [was] nothing to be gained by introducing nonstandard terms into market-mediated exchange, the use of contract restraints was presumed to have anticompetitive

One important result of this preoccupation with the monopoly problem is that if an economist finds something — a business practice of one sort or other — that he does not understand, he looks for a monopoly explanation. And as we are very ignorant in this field, the number of ununderstandable practices tends to be rather large, and the reliance on a monopoly explanation is frequent.⁵⁹

Tying contracts are such a suspect practice. Instead of relying on the market — the buyer's unfettered choice — such arrangements allocate by contract the selection of the tied product to the seller of the tying product, and thus depart from a preconceived division of responsibilities between buyer and seller. A focus on price theory as the criterion for interpreting contractual arrangements then, naturally leads one to suspect that tying contracts are "forced" on an unwilling purchaser through the exercise of monopoly power. Given these premises, it is perhaps not surprising that courts have required the defendant to show that the challenged tie is the *only* means of preserving goodwill.⁶⁰ Similar approaches govern other presumptively illegal arrangements.⁶¹

In the rule of reason context, proof that a contract restrains trade — usually accomplished by proof of market power — creates a presumption that the restraint is on balance anticompetitive and hence unlawful.⁶² The defendant can rebut this presumption and thus avoid a directed verdict only by adducing evidence from which the fact finder could conclude that the restraint serves procompetitive objectives that

purpose and [e]ffect."); Frank H. Easterbrook, *Is There a Ratchet in Antitrust Law?*, 60 TEXAS L. REV. 705, 715 (1982) (discussing the "inhospitality tradition of antitrust").

59. COASE, INDUSTRIAL ORGANIZATION, *supra* note 57, at 67.

60. *See* Standard Oil Co. v. United States, 337 U.S. 293, 306 (1949); International Salt Co. v. United States, 332 U.S. 392, 397-98 (1947); IBM v. United States, 298 U.S. 131, 138-40 (1936); *see also* Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 483-84 (1992).

61. Indeed, as suggested earlier, such a showing is generally a sufficient condition as well. *See* ABA SAMPLE JURY INSTRUCTIONS IN CIVIL ANTITRUST CASES B-103 (1990). Such an approach in this *per se* context is thus less hostile to assertions that procompetitive benefits justify a restraint than the approach taken in the rule of reason and merger contexts. In these contexts, the absence of a less restrictive alternative is merely a necessary condition for showing that a restraint or merger is ultimately procompetitive. *See, e.g.*, 7 PHILLIP E. AREEDA, ANTITRUST LAW ¶ 1507 (1986); HORIZONTAL MERGER GUIDELINES, *supra* note 2, at § 4.0 (stating that agencies will not challenge merger that is the least restrictive means of producing efficiencies that outweigh procompetitive effects).

62. *See* Capital Imaging Assocs. v. Mohawk Valley Medical Assocs., 996 F.2d 537, 543-46 (2d Cir. 1993) (holding that proof of market power or a naked restraint of output shifts the burden to the defendant); Chicago Prof'l. Sports Ltd. Partnership v. NBA, 961 F.2d 667, 673-74 (7th Cir. 1992) (holding that a naked restraint on output shifts the burden of justification to defendant).

outweigh its anticompetitive effects.⁶³ At this point, the ultimate burden of proof shifts back to the plaintiff, who can meet this burden by proving that either: (1) the objectives could be realized through a less restrictive arrangement, or (2) the agreement's benefits are outweighed by its anticompetitive effects.⁶⁴ Similarly, where a proponent of a merger that facilitates the exercise of market power asserts that efficiencies created by the arrangement outweigh any anticompetitive effects, courts and enforcement agencies require a showing that the efficiencies could not be achieved through a less anticompetitive transaction.⁶⁵ These tests, of course, constitute a form of partial equilibrium welfare analysis and thus only re-emphasize the influence of price theory on antitrust jurisprudence.⁶⁶

As shown below, the preoccupation with monopoly explanations identified by Professor Coase has led courts and scholars astray in their assessment of certain tying arrangements.⁶⁷ In particular, courts have misconceived the relationship between market power, on the one hand, and tying contracts that serve procompetitive objectives, on the other. Once the nature of this misconception is exposed, it becomes clear that the similar treatment of franchise tying contracts and presumptively anticompetitive restraints and mergers is not justified. Instead, a showing that a tie produces significant benefits undermines the premises that

63. See *United States v. Brown Univ.*, 5 F.3d 658, 678-79 (3d Cir. 1993); *Capital Imaging*, 996 F.2d at 543; see also 7 AREEDA, *supra* note 61, at ¶ 1507b ("Once the plaintiff satisfies his burden of persuasion on the existence of a significant restraint, he will prevail unless the defendants introduce evidence sufficient to allow the tribunal to find that their conduct promotes a legitimate objective.").

64. See *Capital Imaging*, 996 F.2d at 543; *Brown Univ.*, 5 F.3d at 679; see also *Chicago Prof'l. Sports*, 961 F.2d at 675. But cf. *American Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230 (3d Cir. 1975) (rejecting the least restrictive alternative test); Thomas C. Arthur, *Workable Antitrust Law: The Statutory Approach to Antitrust*, 62 TUL. L. REV. 1163, 1194 (1988) (suggesting that law on less restrictive alternatives is unclear).

65. See HORIZONTAL MERGER GUIDELINES, *supra* note 2, at § 4.0; *United States v. IVACO, Inc.*, 704 F. Supp. 1409, 1425-27 (W.D. Mich. 1989) (holding that the justification that a merger would facilitate the creation of a new product was not cognizable when such a product could be created by a less anticompetitive means).

66. See, e.g., BORK, *supra* note 7, at 107-15; WILLIAMSON, ECONOMIC INSTITUTIONS, *supra* note 8, at 369 (discussing the influence of "partial equilibrium welfare economics model" in antitrust analysis); Williamson, *Welfare Tradeoffs*, *supra* note 2; see also Wesley J. Liebeler, *Comments*, 28 J.L. & ECON. 335, 335-36 (1985) (noting that the rule of reason is employed "to balance the gains from increased efficiency against the losses from increased market power."). But see Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209, 278 (1986) (arguing that the rule of reason analysis accounts for efficiency claims "principally by subjecting assertions of anticompetitive effects to close scrutiny when plausible efficiency arguments are offered").

67. See *infra* text accompanying notes 68-81.

support this similar treatment. Thus, such a showing by a franchisor should rebut any presumption that the contract has been "forced" on a purchaser through an exercise of market power, a necessary condition to per se liability.

II. A MISGUIDED INQUIRY

A. *Missing the Mark*

As shown above, current law relies on an elaborate framework to sort procompetitive from anticompetitive tying contracts, a system parallel to that employed in other antitrust contexts.⁶⁸ Given this legal landscape, economists and others who assert the procompetitive benefits of such contracts and who attack results in particular cases emphasize the perceived lack of market power in most franchise contexts, as well as the absence of less restrictive alternatives that would advance the franchisor's procompetitive objectives.⁶⁹ Professors Klein and Saft, for instance, concede that franchisors possess some economic power as a result of the product differentiation associated with their respective trademarks.⁷⁰ They argue, however, that such power should not be deemed "market power" for antitrust purposes, and that the true market for the tying product is the market for all franchise opportunities, not simply the market for franchises in what might constitute a relevant product market for other antitrust purposes.⁷¹ They also assert that pur-

68. See *supra* text accompanying notes 14-27, 45-46.

69. See Dugan, *supra* note 27, at 152; Klein & Saft, *supra* note 10, at 345; Rubin, *supra* note 10, at 232.

70. See Klein & Saft, *supra* note 10, at 354-61. This concession seems compelled by economic evidence and theory. See Kaufmann & LaFontaine, *supra* note 28, at 437-38 (concluding that McDonald's purposely leaves economic rents downstream for franchisees).

71. Thus, even if consumers might view "fast food," for instance, as a relevant market, Klein and Saft would argue that the market in which to measure a franchisor's market power vis-à-vis prospective franchisees is a market that includes, for instance, the opportunity to operate a gasoline station. See Klein & Saft, *supra* note 10, at 356; Rubin, *supra* note 10, at 232. Others have suggested that, even if the market for the tying product is defined more narrowly, the *Jefferson Parish* definition of "market power" will "doom" the franchise tying cases. See *Jack Walters & Sons Corp. v. Morton Bldg., Inc.*, 737 F.2d 698, 704-05 (7th Cir. 1984) (opinion of Posner, J.) (dicta). As shown below, Judge Posner's prediction has proven premature in light of the Court's recent *Eastman Kodak* decision. See *infra* text accompanying notes 73-77. Moreover, whether "doomed" or not, franchise tying cases have continued to make their way through the federal courts long after the *Jefferson Parish* decision. See, e.g., *Digital Equip. Corp. v. Uniq Digital Technologies, Inc.*, 73 F.3d 756, 761 (7th Cir. 1996); *Roy B. Taylor Sales, Inc. v. Hollymatic Corp.*, 28 F.3d 1379 (5th Cir. 1994); *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468 (3d Cir. 1992) (en banc); *Faulkner Advertising Assocs. v. Nissan Motor Corp.*, 905 F.2d 769 (4th Cir. 1990);

portedly less restrictive alternatives will not advance procompetitive objectives equally well as outright requirements.⁷²

These critiques of current doctrine, while no doubt powerful in and of themselves, are ultimately inadequate to the task of creating a comprehensive method of analyzing tying arrangements in the franchise context. As an initial matter, these attacks do not account for the Supreme Court's recent *Kodak* decision, which found that the existence of relationship-specific investments can confer "market power" on a manufacturer, even when that manufacturer has no power in the market for the product in question.⁷³ Indeed, some scholars have suggested that *Kodak* requires a finding that market power is present whenever a seller faces a downward sloping demand curve, even if such power flows from nonstructural factors such as the presence of uninformed buyers.⁷⁴

Parts and Elec. Motors, Inc. v. Sterling Elec., Inc., 866 F.2d 228 (7th Cir. 1988); Grapone, Inc. v. Subaru of New England, Inc., 858 F.2d 792 (1st Cir. 1988); Mozart Co. v. Mercedes-Benz of N. Am., Inc., 833 F.2d 1342 (9th Cir. 1987); Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft, 828 F.2d 1033 (4th Cir. 1987); Queen City Pizza, Inc. v. Domino's Pizza, Inc., 922 F. Supp. 1055 (E.D. Pa. 1996); Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc., 917 F. Supp. 1208 (W.D. Tenn. 1995); Little Caesar Enters. v. Smith, 895 F. Supp. 884 (E.D. Mich. 1995); Acquaie v. Canada Dry Bottling Co. of N.Y., Inc., No. CV-90-4005(SJ), 1993 WL 741551 (E.D.N.Y. Nov. 8, 1993). Further, the approach offered here would dispense with any inquiry into market power when procompetitive effects are present, thus rendering procompetitive arrangements impervious to the fluctuating definitions of market power that have emanated from the Supreme Court over the past several decades. See also *infra* text accompanying notes 128-35; cf. Mozart Co., 833 F.2d at 1348-51 (assuming, *arguendo*, the presence of market power but finding the tie justified).

72. See Klein & Saft, *supra* note 10, at 353-54. Professor Klein places similar emphasis on the absence of market power at the time of contracting in a recent commentary criticizing the *Kodak* decision. See Benjamin Klein, *Market Power in Antitrust: Economic Analysis After Kodak*, 3 SUP. CT. ECON. REV. 43, 53 (1993). It should be noted that, while Professors Klein and Saft advocate the adoption of a rule of reason approach in the tying context generally, they do not explain how a fact finder is to weigh the procompetitive benefits of such contracts against their anticompetitive effects. The mere fact that a less restrictive alternative is also less effective, of course, does not prove that procompetitive effects predominate. This article, by contrast, argues that the presence of such procompetitive effects *ipso facto* suggests the absence of any anticompetitive impact, thereby rendering superfluous any inquiry into market power or anticompetitive effect of the sort ordinarily associated with the rule of reason. See *infra* text accompanying notes 138-41.

73. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992). See also PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* ¶¶ 1709.2a-c (Supp. 1995); Robert H. Lande, *Chicago Takes it on the Chin: Imperfect Information Could Play a Crucial Role in the Post-Kodak World*, 62 ANTITRUST L.J. 193, 200 (1993).

74. See Arthur, *supra* note 8, at 54-56; Michael S. Jacobs, *Market Power Through Imperfect Information: The Staggering Implications of Eastman Kodak Co. v. Image Technical Services and a Modest Proposal for Limiting Them*, 52 MD. L. REV. 336 (1993). Such an approach would be a throwback to the pre-Jefferson Parish days,

Such "nonstructural" market power, of course, is the very type that Klein and Saft concede that franchisors possess.⁷⁵ Thus, one scholar concluded that, if *Kodak* means what it says, "[f]loodgates would open for franchisees to sue franchisors."⁷⁶ Franchisees, sometimes relying on the reasoning of *Kodak*, continue to allege that franchisors with tiny shares of any "franchising market" possess "market power."⁷⁷

More important, such attacks suffer from a basic flaw, namely the implicit assumption that the presence or absence of some form of market power is necessarily relevant to a determination of whether ties are ultimately anticompetitive. This approach in turn seems to follow from the common assumption that tying contracts are "forced" on purchasers through the exercise of market power, whether or not they produce procompetitive benefits.⁷⁸ Similar assumptions underlie judicial state-

where the slightest product differentiation constituted "economic power" of the sort necessary for a per se violation. See *United States v. Loew's, Inc.*, 371 U.S. 38 (1962) (finding that a copyright confers economic power); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 49-50 (9th Cir. 1971) (finding that a trademark confers such power); see also *Eastman Kodak*, 504 U.S. at 496 (Scalia, J., dissenting) (arguing that the court's definition of market power is inconsistent with *Jefferson Parish*).

75. See Klein & Saft, *supra* note 10, at 357 (arguing that franchisors face downward sloping demand curves as a result of product differentiation); see also Arthur, *supra* note 8, at 33-36 (product differentiation can confer "market power" in the form of a downward sloping demand curve).

76. Eleanor M. Fox, *Eastman Kodak Company v. Image Technical Services, Inc. — Information Failure as Soul or Hook?*, 62 ANTITRUST L.J. 759, 766 (1994).

77. See *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 922 F. Supp. 1055, 1062-63 (E.D. Pa. 1996); Plaintiff's 1st Amended Complaint ¶ 64, *Little Caesar Enters. v. Smith*, 895 F. Supp. 884 (E.D. Mich. 1995) (alleging the possession of market power by Little Caesar); Plaintiff's 2d Amended Complaint ¶ 329, *Acquaire v. Canada Dry Bottling Co. of N.Y., Inc.*, No. CV-90-4005(SJ), 1993 WL 741551 (E.D.N.Y. Mar. 8, 1993) (alleging the possession of market power by Canada Dry because plaintiffs "are for all practical purposes locked into their distributorships").

78. See Klein, *supra* note 72, at 53 ("When a tie is anticipated and, therefore, a 'hold-up' is not occurring, it is clear that the level of competition should be measured before the buyer makes any specific investments. If the market at this point in time is competitive, then the tie is merely part of the freely negotiated competitive price."). The negative implication of this statement, of course, is that when true market power exists, the tie is not "freely negotiated," that is, it is "forced" on an unwilling franchisee. See RICHARD A. POSNER, ANTITRUST LAW 175-76 (1976) (arguing that the benefits created by an "imposed" tie must be weighed against its anticompetitive effects, but that the former will usually predominate). Indeed, many apparently believe that ties can only be obtained through an exercise of market power. See, e.g., Joseph P. Bauer, *A Simplified Approach to Tying Arrangements: A Legal and Economic Analysis*, 33 VAND. L. REV. 283, 332 (1980) (arguing that the existence of a tie *ipso facto* establishes that it was imposed through an exercise of market power); Ward S. Bowman, Jr., *Tying Arrangements And The Leverage Problem*, 67 YALE L.J. 19, 20 (1957) ("To sell or lease one commodity, the tying product, advantageously on condition that it be used with another commodity, the tied product, requires the existence of monopoly power — in economic theory, the ability to control supply.") (emphasis added); W. David Slaw-

ments that such benefits result from a "coerced purchase" of the tied item,⁷⁹ statements that recall the Court's conclusion in *Standard Oil* that any tying contract executed by a firm with market power has been imposed against the purchaser's will through the exercise of that power.⁸⁰

These assumptions are not attributable to such scholars; they instead flow naturally from the law of tying and its underlying economic assumptions.⁸¹ Whatever their source, however, the assumptions are misguided. A complete account of franchise tying contracts must recognize that, in light of the low transaction costs that characterize the franchise relationship, a franchisor will not use whatever market power it might possess to "impose" a tie when that tie can produce benefits associated with such contractual integration. Thus, the focus on market power and less restrictive alternatives, though perfectly natural given the partial equilibrium framework that dominates antitrust law and the premises that underlie tying jurisprudence, rests on a false analogy between procompetitive ties, on the one hand, and beneficial restraints or mergers that are characterized by the coexistence of procompetitive and anticompetitive effects, on the other. While a showing that procompetitive benefits flow from the latter class of conduct simply suggests further balancing along the lines of a partial equilibrium welfare analysis, economic theory suggests that such an approach is not useful in low transaction cost settings — that tying contracts that actually reduce free riding are unrelated to any exercise of market power. Thus, a showing by a franchisor that a tie produces such effects should negate any presumption of "forcing" and establish the contract's *prima facie* legality.

son, *A New Concept of Competition: Reanalyzing Tie-In Doctrine After Hyde*, 30 ANTITRUST BULL. 257 (1985) (same); see also Warren S. Grimes, *Antitrust Tie-In Analysis After Kodak: Understanding the Role of Market Imperfections*, 62 ANTITRUST L.J., Winter 1994, at 263, 285. But see Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 COLUM. L. REV. 515, 546 (1985) (arguing that power over a tying product is not necessary for the creation of certain procompetitive benefits).

79. See *Krehl v. Baskin-Robbins Ice Cream Co.*, 664 F.2d 1348, 1353 n.13 (9th Cir. 1982) ("In some cases, however, this coerced purchase may be justified as necessary to prevent the sale of inferior goods under the franchisor's trademark.") (emphasis added).

80. See *Standard Oil v. United States*, 337 U.S. 293, 305-06 (1949); *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1041 (4th Cir. 1987) (contending that if the tied product were superior, the buyer would purchase it "willingly," without a contractual requirement); *Paul E. Volpp Tractor Parts, Inc., v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1209 (W.D. Tenn. 1995) (stating that the existence of a contractual requirement establishes "forcing"); *Little Caesar Enters. v. Smith* 895 F. Supp. 884, 896 (E.D. Mich. 1995) (same).

81. See *supra* text accompanying notes 51-68.

B. Preventing the Free Ride (Voluntarily)

Given the assertion that certain tying contracts mitigate free riding, it may seem odd to argue that such contracts are unrelated to economic power. After all, such free riding is the result of reputation's status as a collective good, a status made possible by the inability of a franchisee to charge a price to those who reap the benefits of its use of quality inputs.⁸² Thus, free riding is in reality a *symptom* of purely voluntary contracts, a symptom that is usually cured by coercion.⁸³

It would seem, then, that a franchisor would have to use market power or some other means of coercion to mitigate the free riding problem, as no franchisee would voluntarily agree to a contract preventing such behavior. Indeed, in other contexts, economists have suggested that market power may be exercised to prevent free riding.⁸⁴

Such a conclusion would only further complicate the analysis of franchise tying contracts. Certainly the realization would call into question the Supreme Court's assertion in *Standard Oil* that beneficial ties need *not* be imposed by an exercise of market power.⁸⁵ Still, by conceding that market power *is* being exercised, this approach would provide little guidance to courts that must separate procompetitive from anticompetitive ties.⁸⁶ Indeed, under such a rubric, the least restrictive alternative approach would seem to make sense as a means of "sifting" the exercise of market power out of what otherwise may be a procompetitive arrangement; that is, forcing firms to achieve their objectives

82. See OLSON, *supra* note 29, at 14-16.

83. See *id.* at 12-16; see also *Lehnert v. Ferris Faculty Assn.*, 500 U.S. 507, 520 (1991) (recognizing the compelling state interest in preventing free riding by coercing nonunion employees to support a union financially); *Abood v. Detroit Bd. of Educ.*, 431 U.S. 209 (1977).

84. See OLSON, *supra* note 29, at 145 (arguing that trade associations use monopoly power to coerce contributions to support lobbying efforts); Thomas G. Moore, *The Purpose of Licensing*, 4 J.L. & ECON. 93, 114 (1961) (same); cf. Telser, *supra* note 39, at 87 ("[A] necessary condition to a manufacturer's use of resale price maintenance is that he must possess some degree of monopoly control over the price of the product because his product is differentiated in economically relevant respects from competing products."). But cf. Alan J. Meese, *Limitations on Corporate Speech: Protection for Shareholders or Abridgment of Expression?*, 2 WM. & MARY BILL RTS. J. 305, 336-37 (1993) (concluding that corporations mitigate certain free rider problems without exercising market power).

85. See *Standard Oil Co. v. United States*, 337 U.S. 293, 306 (1949).

86. Cf. Edward A. Snyder & Thomas E. Kauper, *Misuse of the Antitrust Laws: The Competitor Plaintiff*, 90 MICH. L. REV. 551, 589 (1991) (arguing that the anticompetitive effects of vertical integration coexist with procompetitive benefits, rendering it difficult to screen procompetitive practices from anticompetitive ones).

with the least possible exercise of market power.⁸⁷ Otherwise, parties would be at the mercy of juries acting pursuant to instructions that say no more than "determine which is larger: the procompetitive or the anticompetitive effect."⁸⁸

Happily for all concerned, no such result is required. Contrary to the suggestion above, the exercise of market power is not necessary for the creation of a tying contract that eliminates free riding. Instead, when such a contract does create these benefits, bargaining between the parties in a competitive environment will result in such agreements. Moreover, given the propensity of this process to produce these contracts, any attempt by a franchisor to "impose" a beneficial tying requirement by exercising market power would be an irrational waste of that power, requiring, as it would, the franchisor to charge less than the monopoly price. Thus, a showing by a franchisor that the tie does, in fact, produce these benefits suggests that no market power has been exercised and obviates the need for any further balancing.⁸⁹

That the parties would agree freely to such a contractual requirement can be shown easily. Assume that a franchisor awards 100 franchises. In a world in which bargaining is costless, these 100 awardees would agree collectively to invest in the optimal amount of quality to associate with the trademark under which they would operate.⁹⁰ More formally, franchisees would agree collectively to invest in quality until the marginal dollar invested in superior inputs yielded less than one dollar in collective benefits in the form of increased demand for the franchise product that results from a reputation for high quality. Such an agreement would occur, without the intervention of the franchisor and regardless of whether the franchisor possessed market power. Each franchisee would recognize that whatever benefits it might derive individually from the right to free ride — that is, to spend less

87. See generally 7 AREEDA, *supra* note 61, ¶ 1505; Grimes, *supra* note 78, at 285.

88. See ABA SAMPLE JURY INSTRUCTIONS IN CIVIL ANTITRUST CASES A-7-8; *cf.* Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210, 230 n.11 (D.C. Cir. 1986) ("Weighing effects in any direct sense [in a rule of reason case] will usually be beyond judicial capabilities.").

89. *Cf.* Krattenmaker & Salop, *supra* note 66, at 278 nn.216-17 (suggesting that efficiency "justifications" for suspect conduct are usually assertions that the conduct is not suspect — not an exercise of market power in the first place).

90. This assumes, of course, that these 100 franchisees could differentiate themselves from franchisees operating under agreements with other franchisors. Absent such differentiation, other franchisees could reap the benefits of investment by the 100. Such differentiation, and the resulting reduction in free riding, is one function of trademark law. See William M. Landes & Richard A. Posner, *Trademark Law: An Economic Perspective*, 30 J.L. & ECON. 265, 270 (1987).

than the optimal amount on inputs — would be outweighed by the individual benefits, in the form of increased demand for its products it would secure if each of its fellow franchisees refused to exercise that same right. Put another way, even though each franchisee would begin with the right to impose severe externalities on its fellows by using inferior inputs, bargaining between the parties would result in an agreement not to exercise that right. This foreseeable result, of course, is a necessary implication of the Coase Theorem.⁹¹

In reality, significant transaction costs prevent the creation of such an agreement. Bargaining over this type of contractual term would prove to be intractable, as individual franchisees would have an incentive to “hold out,” seeking bribes for their commitment not to free ride.⁹² Indeed, by threatening to “free ride” on the efforts of their fellows, one or a few franchisees could extort most of the benefits of maintaining high quality.⁹³ Moreover, enforcement of such an agreement would be impractical. Because actions for breach of contract would probably prove to be an inadequate sanction,⁹⁴ franchisees would have to adopt collectively some termination procedure to facilitate self-help.⁹⁵ For instance, they could agree to force a sale, upon a majority vote, of a franchisee caught shirking. Yet such a mechanism would give rise to opportunistic behavior by franchisees, who could threaten termination of franchises to appropriate their value.⁹⁶

91. See generally R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

92. See OLSON, *supra* note 29, at 40-41. A particularly aggressive franchisee could threaten even to engage in quality investment that is suboptimal from an individual perspective and, by means of such a threat, appropriate to itself gains greater than those produced by the proper collective investment in quality. Cf. WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 34 n.5 (1987).

93. Cf. OLSON, *supra* note 29, at 41 (“Whenever unanimous participation is required, any single holdout has extraordinary bargaining power; he may be able to demand for himself most of the gain that would come from any group-oriented action.”); Meese, *supra* note 84, at 322 (arguing that the requirement of unanimous consent for corporate speech would create severe holdout problems).

94. See Muris, *supra* note 34, at 575 (“[F]ranchisees can ‘cheat’ on quality in ways that are costly to detect and prove. Moreover, clauses specifying elements of quality will often prove expensive to draft in complete detail and certainly to enforce in court . . .”).

95. Cf. Benjamin Klein, *Transaction Cost Determinants of “Unfair” Contractual Arrangements*, 92 PAPERS & PROC. AM. ECON. ASSN. 356 (1980) (concluding that the threat of termination by a franchisor can deter shirking); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981).

96. Cf. Muris, *supra* note 34, at 577 (describing the incentives of the franchisor to engage in such behavior). Such incentives would be particularly keen in this context.

In the real world, then, one would not expect such an agreement. There is, however, another mechanism for ensuring an optimal investment in quality and the resulting reputation of the franchise system. As sole owner of the franchise trademark, the franchisor internalizes the benefits associated with the elimination of free riding. The vehicle of such internalization, is, of course, the compensation that the franchisor receives for use of the trademark by franchisees. Such compensation usually takes two forms: an up-front payment for a franchise opportunity and an annual franchise fee, measured as a percentage of gross revenues.⁹⁷ By eliminating free riding, then, the franchisor can enhance the compensation it receives for the sale of each franchise. Franchisees, of course, will be willing to pay more "up front" for the right to participate in a franchise system not characterized by free riding, and aggregate franchise fees will rise, as reduced free riding translates into higher demand and revenues.

Given its status as sole owner of the franchise trademark, we would expect the franchisor to attempt to maximize its revenues by including a tying requirement in any contract ancillary to the alienation of the franchise trademark.⁹⁸ Moreover, because the franchisor can refuse to part with the trademark absent an agreement to such a term, it can exclude from the benefits of quality enhancement those prospective franchisees who will not agree to adhere to the requirement.

Of course, once the standard franchise contract includes such a term, individual franchisees might be willing to pay a premium for a franchise contract without it. Having received such an atypical contract, the maverick could then free ride on the efforts of those franchisees who had signed the standard contract and thus were using inputs of sufficient quality. However, any "free riding premium" that a maverick would be willing to pay would necessarily be less than the revenue that a franchisor would forgo as a result of the failure to include the require-

Unlike franchisors, franchisees have no long-term reputational interest to protect, and thus would be more likely to engage in such opportunistic behavior. *See id.* at 577-78 (arguing that continuous dealing in franchises by franchisors necessitates the maintenance of reputation and thus deters opportunistic terminations). Moreover, no single franchisee would be accountable for such actions, further attenuating whatever reputational loss would attend termination of a franchise.

97. *See* Antony W. Dnes, *A Case-Study Analysis of Franchise Contracts*, 22 J. LEGAL STUD. 367, 382 (1993) (noting that the most common method of franchisor compensation is the "coupling of a lump sum with a sales royalty"); Kabir C. Sen, *The Use of Initial Fees and Royalties in Business-Format Franchising*, 14 MANAGERIAL & DECISION ECON. 175 (1993).

98. *Cf.* *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 221-23 (D.C. Cir. 1986). *See generally* Richard A. Epstein, *Holdouts, Externalities, and the Single Owner: One More Salute to Ronald Coase*, 36 J.L. & ECON. 553, 556-57 (1993).

ment in the maverick's contract, as other franchisees, recognizing the reduced value of the opportunity, would pay less for it, and the franchisor would receive lower franchise fees.⁹⁹ Put another way, while the franchisor may "offer" franchise contracts that do not include such a requirement, it will do so only at a price higher than any franchisee is willing to pay.¹⁰⁰

Thus, even though the franchisor's relinquishment of control over the trademark and the resulting division of labor between franchisor and franchisee might suggest that each prospective franchisee has the "right" to impose externalities on the franchise system by purchasing inferior inputs, the parties will instead allocate the right to choose inputs to the franchisor.¹⁰¹ More precisely, where circumstances are conducive to free riding, the franchisor will induce the franchisee prospectively to internalize the externalities resulting from the use of inferior inputs by offering to "unbundle" the right to choose inputs from the right to employ the trademark for a higher price, a price that reflects the harm imposed on the franchise system by the free riding that would follow such unbundling.¹⁰² Because this harm, and the resulting higher price, are greater than the gain from free riding to any individual franchisee, we would not expect any franchisee to negotiate for such unbundling.¹⁰³ In this way, the law's designation of the franchisor as "sole owner" of the franchise trademark ensures that the reputation associ-

99. Indeed, to the extent that franchisors are compensated by franchise fees, franchisees need not "recognize" the deleterious effects of free riding for such bargaining to take place. So long as the franchisor can predict the reduction in franchise fees that would result from free riding, it will internalize the effects of unbundling the trademark from the right to select the franchisee's inputs. Moreover, failure to include such a clause in one contract will negate the franchisor's ability to warrant that such clauses are included in all contracts. *See infra* text accompanying notes 106-14.

100. *Cf.* WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 33-34 (arguing that a seller will charge higher prices for contracts that do not contain safeguards that can prevent opportunistic behavior).

101. *See id.* at 27 (concluding that nonstandard contracts are often methods of properly assigning complex property rights).

102. *Cf.* Coase, *supra* note 91, at 4-6; WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 33-34.

103. It bears emphasis here that the franchisor's decision to charge a higher price to those franchisees that would opt for a contract without a tying requirement is logically unrelated to any exercise of market power insofar as that price is justified by the higher cost — that is to say, the externalities borne by the franchise system that result from a franchisee's failure to abide by such a requirement. *See generally* *United States v. Loew's, Inc.*, 371 U.S. 38, 55 (1962) (cost-justified price differential does not constitute forcing); William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937 (1981) (defining power as the ability to price above cost); Donald F. Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50, 66-67 (1958).

ated with the trademark never becomes a collective good in the first place.¹⁰⁴

Seen in this light the inclusion of a tying clause can be a form of product differentiation that enhances the value of the franchise, value that will be divided between the franchisor and franchisees.¹⁰⁵ Such differentiation consists of more than a promise by an individual franchisee to purchase certain inputs only from the franchisor; it also depends on each franchisee's knowledge that other franchisees are observing similar terms.¹⁰⁶ Franchisees cannot observe such adherence directly; they must depend on the franchisor to police uniform adherence to the rule.¹⁰⁷

A franchisee cannot observe in advance whether a franchisor has included similar terms in prior contracts, or whether the franchisor intends to include them in all future contracts.¹⁰⁸ Of course, thoroughly rational franchisees will realize that franchisors will include such clauses unless doing so reduces the value of the franchise trademark.¹⁰⁹ Less rational franchisees, concerned that a franchisor may act opportunistically by refusing to include or enforce these terms in some contracts, must rely on a warranty by the franchisor that such terms have

104. See R.H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357, 360 (1974) (arguing that the proper assignment of property rights can transform a collective good into a private one); Epstein, *supra* note 98, at 556-57 (arguing that the legal assignment of property rights should replicate the "sole owner" standard so as to minimize externalities and holdout problems).

105. In this sense, franchise contracts are analogous to other contracts that are, in fact, products. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212-15 (1991) (arguing that states compete to provide the most efficient corporate law in the form of enabling statutes that are analogous to standard contracts).

106. See generally R. Preston McAfee & Marius Schwartz, *Opportunism in Multilateral Vertical Contracting: Nondiscrimination, Exclusivity, and Uniformity*, 84 AM. ECON. REV. 210, 223-24 (1994) (describing the incentives of franchisors to make credible commitments regarding the uniformity of contractual terms).

107. As Professor Rubin explained:

[W]e must consider what the franchisee is buying when he buys a franchise. The main item purchased is the trademark of the franchise. This is valuable because consumers have a good deal of information about price and quality sold by establishments with a given trademark. Consumers have this information precisely because the franchisor polices franchises and makes certain that quality standards are maintained.

Rubin, *supra* note 10, at 227-28.

108. In this way, a franchise is analogous to a durable good, the characteristics of which cannot be observed in advance. See generally George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 489-90 (1970).

109. See *supra* notes 97-98 and accompanying text.

been and will be included and enforced in each contract.¹¹⁰ By giving such a warranty a franchisor can expose itself to common law fraud actions and place a substantial asset — its reputation — at risk.¹¹¹ Just as a corporation can distinguish its securities by making warranties about its operation,¹¹² or as a state can distinguish its corporate law,¹¹³ so too can a franchisor distinguish its product by warranting that it will seek and enforce requirements that control free riding.¹¹⁴

Such a warranty need not consist of an explicit contractual clause. An oral statement of extrinsic fact — “this is a form contract, the same terms apply to everyone” — will suffice.¹¹⁵ Indeed, in many states,

110. Cf. McAfee & Schwartz, *supra* note 106, at 223-25. Alternatively, a franchisor could commit always to offer the same terms to all franchisees. *See id.* at 215; Kaufmann & LaFontaine, *supra* note 28, at 430 (noting that “McDonald’s typically allows its franchisees to rewrite their franchise contract at the termination of the original agreement, at the [same] terms offered to new franchisees”). Such a commitment would eliminate any possibility that a “maverick” franchisee would be willing to pay a franchisor not to include a tying requirement in its contract. For, once such a contract was available to the maverick, it would become available to all, thus destroying its value to the maverick. *See supra* text accompanying notes 98-100.

111. *See* Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461, 470-71 (1981); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1303-06 (1981) (describing the product differentiation theory of warranties).

112. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 677 (1984).

113. *See* ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 37-44 (1993).

114. Such differentiation, of course, makes possible the most effective method of enforcing the various terms in the franchise contract, including the tying requirement, namely, the threat of termination, which deprives the franchisee of the economic rents associated with its right to distribute its product under the trademark. *See* Kaufman & Lafontaine, *supra* note 28 (concluding that McDonald’s leaves rents downstream to facilitate the control of franchisees through the threat of termination); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

115. *See* *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1545 (7th Cir. 1990) (“A silent contract does not prevent action based on an antecedent lie.”); *Caribe BMW, Inc. v. Bayerische Motoren Werke Aktiengesellschaft*, 821 F. Supp. 802, 806 (D.P.R. 1993) (recounting the allegation that a franchisor “incorrectly represent[ed] that these contracts were ‘standard’”), *vacated*, 19 F.3d 745 (1st Cir. 1994); cf. *Data Gen. Corp. v. Grummon Sys. Support Corp.*, 1991-1 Trade Cas. (CCH) ¶ 69,487, at 66,073 (D. Mass. 1991), *affd.*, 36 F.3d 1147 (1st Cir. 1994). Indeed, the covenant of good faith implied in each contract may itself prohibit differential treatment that undermines the value of a franchise opportunity. *See* *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 728 (7th Cir. 1979) (holding that a covenant of good faith prevents a franchisor from destroying “the right of the other party to enjoy the fruits of the contract”); *Hentze v. Unverferht*, 604 N.E.2d 536, 539 (Ill. App. 1992) (same). Moreover, contractual terms that differ from those contained in the franchisor’s standard contract are not enforceable absent disclosure and conscious assent by the franchisee. *See* RESTATEMENT (SECOND) OF CONTRACTS § 211 (1979).

such a warranty need not be given at all because laws compel the disclosure of tying requirements and prohibit discriminatory treatment of franchisees.¹¹⁶ In New York, for instance, a franchisor must register its proposed standard franchise agreement with the state, and disclose any requirement that a franchisee purchase goods from the franchisor.¹¹⁷ An attempt to enforce a provision not included in the registered agreement, or failure to enforce one of its terms against certain franchisees, likely would be illegal.¹¹⁸ Finally, legal duties to one side, franchisors possess powerful incentives to make and keep such promises. By maintaining a reputation for uniform policing, a franchisor will enhance its own wealth as well as that of the franchise system as a whole.¹¹⁹

Moreover, unlike the situation attending our hypothetical agreement between 100 franchisees, there is no potential for a holdout problem. Such holdouts can only occur when a franchisee possesses the right to reduce its investment in quality and sell the resulting goods under the same trademark used by the other ninety-nine franchisees. Because trademark law protects the franchisor's status as "sole owner" by assigning it a true "property right" in the trademark,¹²⁰ a franchisee can only obtain the right to distribute products under the mark pursuant to a contract with the franchisor. As already shown, the franchisor's sta-

116. See MICH. COMP. LAWS ANN. § 27(e) (West 1989) (prohibiting discrimination among franchises); see also Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R., pt. 436 (1996).

117. See N.Y. GEN. BUS. LAW § 683(2)(k) (McKinney 1996).

118. See N.Y. GEN. BUS. LAW § 687 (McKinney 1996) (addressing fraudulent and unfair practices).

119. This is not to say that such negotiation will eliminate the incentive to free ride. It is one thing to negotiate a contract; it is another to monitor and enforce compliance with its terms. See generally WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 43-84; Muris, *supra* note 34. Indeed, as explained *infra*, the very presence of a mechanism that reduces free riding and improves the quality reputation associated with the trademark itself creates a *stronger* incentive on behalf of individual franchisees to free ride, in breach of the tying requirement. See *infra* text accompanying notes 214-18. This fact does not change the analysis offered here, however. Whether or not individual franchisees plan to free ride, the presence of a workable contractual requirement that improves the reputational value of the trademark will increase the value of each franchise to each potential franchisee.

120. See *Wesley-Jessen Div. of Schering Corp. v. Bausch & Lomb, Inc.*, 698 F.2d 862, 867 (7th Cir. 1983) ("Bausch & Lomb's loss of control over its reputation justifies a finding of irreparable harm even if it could demonstrate no loss of sales or market share."); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972) (defining a "property right" in economic terms as the ability to protect an interest by injunction and/or an action for punitive damages); Fred S. McChesney, *Deception, Trademark Infringement, and the Lanham Act: A Property-Rights Reconciliation*, 78 VA. L. REV. 49, 55 (1992) (noting that economic theory suggests that the law should assign a true property right to the owner of a trademark).

tus as sole owner will induce it to adopt provisions that ameliorate free riding, and to exclude from use of the trademark those who will not abide by those terms. Moreover, when a tying requirement can reduce free riding, the individual gains from such behavior will be outweighed by the resulting harm to the franchise system, and no individual franchisee will be willing to pay a sufficient price to convince the franchisor not to include such a requirement.¹²¹ In these circumstances, there is simply no opportunity for a franchisee to hold out.¹²²

C. *Exercise of Power or Voluntary Agreement?*

The mere fact that a franchisor *could* convince a franchisee to agree to a provision that prevents opportunistic behavior does not, as a logical matter, preclude its imposition by an exercise of market power, an imposition that would require an antitrust tribunal to treat the contract under scrutiny as a tie and to engage in the sort of partial equilibrium welfare analysis described earlier.¹²³ Further analysis, however, shows that, in light of the low transaction costs involved, the presence of such benefits strongly suggests that a requirement that produces such benefits is not a consequence of “forcing” — that a firm with market power would not choose to exercise that power by imposing such a requirement. As a result, partial equilibrium welfare analysis is an improper vehicle for evaluating the sort of tying contracts under discussion.

It is axiomatic that firms cannot exercise market power twice.¹²⁴ A firm that possesses market power over the tying product cannot *both*

121. See *supra* text accompanying notes 98-103.

122. See Epstein, *supra* note 98, at 557 (arguing that the common law’s definition and assignment of property rights is designed to minimize the combined costs associated with externalities and holdouts). See generally RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 62 (1992) (claiming that the common law’s choice of assignment of property rights is designed to mitigate the bilateral monopoly problem); Calabresi & Melamed, *supra* note 120 (reaching the same conclusion). Vigorous competition among franchisors does not change this result; so long as those franchisors who adopt and adhere to such a policy are able to identify themselves to the public via trademarks and to franchisees via warranties, franchisees will, *ceteris paribus*, prefer contracts with those franchisors that prevent free riding by including and enforcing a requirements term.

123. Cf. R. Glenn Hubbard & Robert J. Weiner, *Efficient Contracting and Market Power: Evidence from the U.S. Natural Gas Industry*, 34 J.L. & ECON. 25, 25-26 (1991) (arguing that the efficiency and market power explanations for particular contractual arrangements “are hardly mutually exclusive”); Snyder & Kauper, *supra* note 86, at 589 (claiming that the same factors that suggest that vertical integration will produce procompetitive effects are also necessary conditions for anticompetitive effects).

124. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 39 n.8 (1984) (O’Connor, J., concurring).

charge a monopoly price for the product *and* use its power to “force” a customer to take the tied product as well.¹²⁵ A firm that uses its market power to induce consumers to purchase an unwanted tied product must price below the monopoly level, thereby “convincing” the purchaser to take a tied product that is either inferior or more expensive than its alternatives.¹²⁶

Thus, firms that possess market power face a choice: exercise that power by reducing output and pricing at a monopoly level, or set output above the monopoly level, using the resulting reduction in the monopoly price to induce consumers, or franchisees, to purchase the “unwanted” tied product.¹²⁷ A firm that uses some quantum of its market power to control free riding in this way must increase output above the monopoly level and thereby forgo a portion of the monopoly profit that it would otherwise earn. More specifically, a franchisor that wishes to “impose” an input requirement on prospective franchisees must increase the number of franchises above that which it would otherwise offer, thereby reducing the monopoly overcharge it would otherwise enjoy.

Given these alternatives, it seems clear that, other things being equal, a franchisor faced with a choice between employing market power to impose a tying requirement or simply agreeing to such a requirement through negotiation would choose the latter course to avoid sacrificing part of its monopoly profit. In other words, given the enhanced demand for the franchisor’s product that results from its warranty that all its franchisees purchase inputs from it, there is simply no need to “induce” such an agreement by exercising market power. Any such attempt to impose the requirement would constitute irrational behavior, behavior that antitrust law does not lightly presume.¹²⁸ Thus,

125. See *Jefferson Parish*, 466 U.S. at 39 n.8 (O’Connor, J., concurring).

126. See *Jefferson Parish*, 466 U.S. at 39 n.8 (O’Connor, J., concurring); *Grapone, Inc. v. Subaru of New England, Inc.*, 858 F.2d 792, 795 (1st Cir. 1988); HERBERT HOVENKAMP, *ECONOMICS AND FEDERAL ANTITRUST LAW* 217-18 (1985) (tying is equivalent to raising price); cf. 15 U.S.C. § 14 (1994) (§ 3 of Clayton Act) (prohibiting the sale of *or discount on* the tying product on the condition that the buyer not purchase from the seller’s competitor); 9 AREEDA, *supra* note 61, at ¶ 1700i (arguing that conditioning the receipt of a discount on the tying product upon the purchase of the tied product is indistinguishable from an outright refusal to sell the tying product separately). Indeed, some scholars characterize tying as the purchase from customers, here franchisees, of the right to exclude the seller’s competitors from the tied product market. See *Krattenmaker & Salop*, *supra* note 66, at 215, 219-22.

127. See *Grapone*, 858 F.2d at 795.

128. See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 593-95 (1986); see also *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 967 (7th Cir. 1989) (“A plaintiff who imputes to a defendant actions that ‘make[] no economic sense’ needs solid proof to survive a motion for summary judgment.”) (quoting *Matsushita Elec.*,

where a franchisor proves that a tying requirement reduces free riding, the very existence of such benefits suggests two things. First, that the tie is a voluntary arrangement between the parties for the purpose of realizing the benefits of reducing opportunistic behavior. Second, that whatever market power the franchisor might possess is reflected in its output of franchises, that is, the number of franchise opportunities it awards. In these circumstances, any exercise of market power consists solely of a perfectly legal reduction in output that enhances the price of such opportunities.¹²⁹

This analysis implicitly assumes the absence of transaction costs — that a franchisor can costlessly explain to each potential franchisee the substantial benefits associated with a franchise opportunity that is not beset with free riders and that the parties can costlessly negotiate over its creation. It could be argued that, when such costs are present, the franchisor will choose to avoid them by using its market power to impose such a requirement outright, thereby avoiding the market failure that results from these information costs.¹³⁰ However, such a strategy will be rational only if these costs exceed the cost of imposing such an arrangement by the exercise of market power. The latter cost, of course, consists of the sum of the net present value of (1) the annual monopoly profits foregone to induce acceptance of the tying requirement, and (2) the cost of revealing to each franchisee the extent of the discount from the monopoly price offered to induce acceptance.¹³¹

Because trademark law assigns to the franchisor a property right in the use of the trademark, franchisors need not individually “convince” franchisees to “give up” any “right” to free ride. Instead, franchisors can include without cost a tying requirement in the standard franchise contract which governs the alienation of the trademark.¹³² The fact that

475 U.S. at 587). While the franchisor *will* charge a lower price to those franchisees that accept the requirement, this differential does not reflect any exercise of market power but instead simply reflects the externalities to the franchise system that would result from “unbundling” the ownership of the trademark from the right to choose inputs. See *supra* note 103 and accompanying text.

129. See *Jefferson Parish*, 466 U.S. at 14 (stating that antitrust law draws a distinction between the mere enhancement of price and the use of monopoly power to “leverage” into other markets).

130. Cf. Kaplow, *supra* note 78, at 526-27 (arguing that the rationality of a leveraging strategy depends on the prices of substitutes for the tied product).

131. Cf. George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 218-19 (1961) (claiming that the rationality of incurring information costs depends on the benefits of the search).

132. See *Northwestern Natl. Ins. Co. v. Donovan*, 916 F.2d 372, 377 (7th Cir. 1990) (noting that standardized contracts reduce transaction costs); RESTATEMENT (SECOND) OF CONTRACTS § 211 cmts. a & b (1979) (same). Indeed, contract law facilitates this reduction in transaction costs by rendering unenforceable contractual terms

franchisees are not willing to pay a sufficient price for the exclusion of such a term is not a result of high transaction costs, but instead reflects the benefits associated with the elimination of free riding.¹³³ Thus, the bargaining costs associated with creating a source tying requirement are most likely lower than the costs of forcing a franchisee to accept it by exercising market power. In fact, even when bargaining costs exceed the costs of imposing a tying requirement through the exercise of market power, such a strategy may still not be rational. In some cases, this difference may be less than the loss of income that results from the lower demand for the franchises that will presumably occur as franchisees become less educated about the benefits of a tying requirement.¹³⁴

There is a more fundamental reason why firms need not exercise market power to induce acceptance of a tying requirement that reduces free riding. The use of such power is only necessary when potential franchisees recognize the benefits of free riding and must be "convinced" to consent to a provision that renders this behavior more difficult. Any franchisee, however, that recognizes the value of free riding also will recognize the value of its elimination; thus, no "convincing" through the exercise of market power will be necessary.

It should be noted that the analysis offered here does not depend upon an assumption that there are no conditions under which a firm

that are outside the reasonable expectation of the party signing the standardized contract. See *Weaver v. American Oil Co.*, 276 N.E.2d 144 (Ind. 1971) (refusing to enforce an unreasonable term in a standard franchise contract when the franchisor had not disclosed the existence of the term); RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1979). Given this background rule, it is less likely that franchisors will include such terms and thus more likely that franchisees will rely on the franchisor's judgment as to the standard terms, reducing the cost of negotiation. See RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b; cf. R.H. COASE, *The Firm, the Market, and the Law*, in *THE FIRM, THE MARKET, AND THE LAW*, *supra* note 57, at 28 (The law can "make transactions more or less costly by altering the requirements for making a legally binding contract").

133. See *supra* text accompanying notes 98-104. Of course, if a franchisee were willing to pay a sufficient price to induce such unbundling, it could be inferred that the benefits of eliminating free riding are attenuated, and franchisors would maximize their income by excluding it.

134. Of course, firms will only supply such information to potential franchisees if the firm can capture the benefits of such provision, i.e., if potential franchisees cannot use that information elsewhere without purchasing the franchise in question. Cf. Telser, *supra* note 39, at 92 n.6 (noting that groups of competitive manufacturers must collectively adopt resale price maintenance in order to avoid free rider problem). See generally Howard Beales et al., *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 503-04 (1981) (describing the positive externalities often inherent in information production). However, there is no apparent use for such information outside the potential franchise relationship. Thus, one would expect that franchisors can, in fact, internalize fully the benefits of producing such information.

with market power can enhance its profits through a leverage strategy.¹³⁵ Such a strategy may well be possible in limited circumstances.¹³⁶ The *Jefferson Parish* test, however, is in no way tailored toward identifying these circumstances, but is designed to identify instances of "forcing." Thus, proof by a franchisor that the arrangement produces procompetitive benefits should, at the least, cast upon the plaintiff a burden of proving that the conditions conducive to a leverage strategy do, in fact, exist.¹³⁷

D. Implications for Balancing

The realization that tying contracts that produce these benefits are logically unrelated to the exercise of market power has powerful implications for the law governing the "franchise goodwill" justification, and for other antitrust balancing tests as well. To begin with, this realization entirely undermines the premise, articulated in *Standard Oil*, that beneficial tying requirements need not be "imposed" by contract — that departures from atomistic competition in the form of the existence and enforcement of a tying contract necessarily flow from the exercise of monopoly power.¹³⁸ This result in turn calls into question the law's

135. Cf. BORK, *supra* note 7, at 372-73 (claiming that a profitable leveraging strategy is impossible); Kaplow, *supra* note 78 (arguing that a viable leverage strategy is possible).

136. See Alexander C. Larson, *Antitrust Tie-In Analysis After Kodak: A Comment*, 63 ANTITRUST L.J. 239, 264 (1994) ("[T]he papers produced in the economics literature on tying and leverage theory do not support the efficacy of tying as a means of leveraging under plausible assumptions, and they support the efficacy of tying and leveraging only under assumptions that are not plausible.").

137. In this vein, Tom Arthur has called my attention to the distinction, drawn by Franklin Fisher, between "exemplifying theories" and "generalizing theories." See Franklin M. Fisher, *Games Economists Play: A Noncooperative View*, 20 RAND J. ECON. 113, 117-18 (1989). According to Fisher, "[e]xemplifying theory does not tell us what *must* happen. Rather it tells us what *can* happen." *Id.* at 117. Models showing that leverage can be a profitable strategy are exactly of this variety, that is, they simply show that a profitable leverage strategy *can* happen under certain limited conditions. See Larson, *supra* note 136, at 264. No model of which the author is aware concludes that the existence of the four *Jefferson Parish* factors renders a profitable leverage strategy likely, let alone certain. Thus, proof by a franchisor that the contract produces procompetitive benefits such that forcing is most likely not present undermines any presumption of anticompetitive effects. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 466-67 (1992) ("Legal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law.").

138. See *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949); *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1041 (4th Cir. 1987) (claiming that no tying requirement would be necessary if the purchase of the tied product had beneficial effects); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1231-32 (W.D. Tenn. 1995); *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 896 (E.D. Mich. 1995) (holding that the existence of a contractual tying re-

assumption that benefits created by a per se illegal tie necessarily coexist with anticompetitive effects.¹³⁹

These insights sever any logical connection between the usual partial equilibrium welfare rubric for analyzing mergers and trade restraints, and the approach to procompetitive justifications in the tying context. The conventional framework, of course, is premised on the existence of significant transaction costs; absent such costs an exclusionary practice that allowed a firm to obtain market power would not occur, as consumers and others harmed by the practice would pay the firm to abandon it.¹⁴⁰ In such a context, a showing of significant procompetitive benefits merely requires the fact finder to balance those benefits against the anticompetitive effects of the arrangement, a process spearheaded by the less restrictive alternative test.¹⁴¹ In the latter, such a showing rebuts the presumption, articulated in *Jefferson Parish*, that a defendant with market power is exercising that power — that it is engaged in “forcing” — whenever it seeks and enforces a tying contract. Absent such forcing, the rationale for per se treatment or any presumption of anticompetitive effects collapses, as does the rationale for the balancing implied by a partial equilibrium welfare framework. Thus, regardless whether the plaintiff can prove the four elements of a per se tying claim outlined in *Jefferson Parish*, a showing by a franchisor that the challenged tie produces significant benefits should rebut any presumption of forcing and require the conclusion that the arrangement is, in fact, an agreement unrelated to the exercise of market power, and thus prima facie legal.

Such an approach would not constitute a rule of per se legality for tie-ins. A plaintiff could prevail, for instance, by showing that it paid a

quirement establishes the element of forcing); see also Bowman, *supra* note 78, at 19 (arguing that monopoly power is necessary to require the purchase of the tied item); cf. COASE, INDUSTRIAL ORGANIZATION, *supra* note 57, at 64-68 (discussing economists' tendencies to search for monopolistic explanations to business practices they do not understand).

139. See *supra* text accompanying notes 60-66; cf. Richard Craswell, *Tying Requirements in Competitive Markets: The Consumer Protection Issues*, 62 B.U. L. REV. 661, 688 (1982) (arguing that firms with market power have incentives to minimize costs by adopting efficient contractual terms); Alan Schwartz, *A Reexamination of Non-Substantive Unconscionability*, 63 VA. L. REV. 1053, 1071-75 (1977) (same).

140. See KENNETH G. ELZINGA & WILLIAM BREIT, *THE ANTITRUST PENALTIES* 3-4 (1976); Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules — A Comment*, 11 J.L. & ECON. 67, 70 (1968) (“Assuming no transaction costs, those who lose from the relative underproduction of monopolies could bribe monopolists to produce more.”); Krattenmaker & Salop, *supra* note 66, at 268-70 (explaining how transaction costs prevent parties from investing sufficiently in the preservation of competition).

141. See *supra* text accompanying notes 62-66.

premium price for the tied product that was unjustified by any quality or efficiency considerations.¹⁴² This premium would suggest that the benefits were illusory, and that the tying requirement was imposed by sacrificing monopoly profits, perhaps as a vehicle for price discrimination.¹⁴³ Or, a plaintiff could prevail by showing directly that the benefits claimed by the defendant do not exist.¹⁴⁴ It warrants emphasis, however, that such a showing should not be inferred merely from the existence of concentrated markets.¹⁴⁵

One may fairly ask at this point what this approach would add to current law. After all, does not the law's present tying requirement that a private plaintiff prove an upcharge to obtain damages filter procompetitive from anticompetitive ties, and obviate the need for any change in current standards?¹⁴⁶

The framework advocated here would differ markedly from current law for three reasons. First, where the government, as opposed to a private party, challenges a tie, there is no need to prove an upcharge to obtain equitable relief.¹⁴⁷ Second, much of the private litigation over franchise tying contracts arises in the context of franchise terminations

142. See *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 52 (9th Cir. 1971) ("To ascertain whether an unlawful arrangement for the sale of products has caused injury to the purchaser, the cost or value of the products involved, free from the unlawful arrangement, must first be ascertained.").

143. See *infra* text accompanying notes 202-12. As Richard Craswell suggests, such a premium may in some circumstances be justified as a device for risk sharing among franchisees, for those franchisees that succeed will pay a higher total premium than those that do not. See Craswell, *supra* note 139, at 686-87.

144. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 483-84 (1992) (rejecting the "false attribution" defense when the tie did not, in fact, enhance quality). For instance, a plaintiff could prevail by showing that the tying requirement in question was enforced only sporadically. See *Data Gen. Corp.*, 1991-1 Trade Cas. (CCH) ¶ 69,487, at 66,073 (D. Mass. 1991). Under the current state of the law, of course, lax enforcement may simply suggest that the franchisor fears treble-damage suits. It could be argued that a plaintiff should be allowed to prevail by showing that the tied product is actually inferior to the product the plaintiff wishes to purchase — that the tying requirement is a means of "dumbing down" the product associated with the trademark. There may, however, be an independent procompetitive value to such uniformity, even at the expense of some increased quality. See *Will v. Comprehensive Accounting Corp.*, 776 F.2d 665, 668 (7th Cir. 1985) (noting that a franchise source tying requirement "appears to be useful to clients — perhaps because of the standardized method of doing business, perhaps because of Comprehensive's policing of its franchisees").

145. At any rate, even if current law did countenance such balancing in this context, the presence of a "less restrictive alternative" would not indicate that the challenged practice was unreasonable. See *infra* text accompanying notes 171-85.

146. See *Chicken Delight*, 448 F.2d at 52 (outlining the standards for proof of damages).

147. See 15 U.S.C. §§ 4, 25 (1994).

or challenges to such contracts by competitors who want to sell the tied product.¹⁴⁸ In such cases, plaintiffs need not, under current law, prove any upcharge, but upon proving a tie, may recover damages flowing from the termination itself, or — in the case of a competitor suit — profits on lost sales of the tied product.¹⁴⁹ Third, even when no termination is involved, and a franchisee simply seeks damages from an upcharge, current standards governing proof of antitrust damages are less rigorous than those governing proof of a case-in-chief.¹⁵⁰ Thus, the approach offered here will do a far better job than current law at sorting coercive ties from those that constitute voluntary contractual integration.

Failure to implement this approach will do more than simply deter the adoption of procompetitive tying contracts. Maintenance of current standards also threatens to destroy many of the benefits produced by the specialization of function inherent in the franchise system.¹⁵¹ By forcing franchisors to adopt less effective contractual methods of preventing opportunistic behavior, for instance, these standards may dissuade the franchisor from departing with control of the trademark in the first place — encouraging the franchisor to integrate forward into the sale and distribution of the franchise product.¹⁵² Such integration need not assume an “all or nothing” character; franchisors simply may decide to integrate forward in a higher percentage of locations.¹⁵³ Not only will such integration eliminate the efficiencies flowing from vertical disintegration, it will also diminish the role of independent small businesses in the economy.¹⁵⁴

148. See, e.g., *Digital Equip. Corp. v. Uniq Digital Technologies, Inc.*, 73 F.3d 756 (7th Cir. 1996) (addressing a termination dispute); *Roy B. Taylor Sales, Inc. v. Hollymatic Corp.*, 28 F.3d 1379 (5th Cir. 1994) (same), *cert. denied*, 115 S. Ct. 779 (1995); *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468 (3rd Cir. 1992) (en banc) (addressing a suit by a competitor); *Faulkner Advertising Assocs., Inc. v. Nissan Motor Corp.*, 905 F.2d 769 (4th Cir. 1990) (same), *on reh'g.*, 945 F.2d 694 (4th Cir. 1991) (en banc) (affirming lower court per curiam); *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033 (4th Cir. 1987) (same); *Yentsch v. Texaco, Inc.*, 630 F.2d 46 (2d Cir. 1980); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208 (W.D. Tenn. 1995).

149. See *Metrix Warehouse*, 828 F.2d at 1042-45; *Yentsch*, 630 F.2d at 59 n.19.

150. See *Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100 (1969); *Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 563 (1931).

151. See *supra* note 28.

152. See, e.g., *Klein & Saft*, *supra* note 10, at 356 n.39 (recounting that Jack-in-the-Box terminated 642 franchises after settling tying litigation).

153. See *Mathewson & Winter*, *supra* note 30, at 520 (suggesting that excessive free riding by franchisees may lead franchisors to integrate forward).

154. See *supra* note 28 (detailing various efficiencies created by franchising); cf. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 57 n.26 (1977) (claiming that

When failure to apply the standard suggested here does not lead to forward integration, it may still attenuate the benefits of the franchise system by inducing franchisors to obtain additional methods of ensuring that franchisees actually perform agreements to invest in quality control. In the absence of a straightforward and easily monitored tying requirement, franchisees may be induced to provide other assurances of performance, such as agreements to make additional investments in assets that are specific to the franchise relationship.¹⁵⁵ Such investments, of course, are inefficient absent their function as an assurance of contractual performance and will place franchisees at a greater risk of opportunistic behavior.

III. POSSIBLE COMPLICATIONS

The above analysis suggests that, when a franchise tying contract produces significant procompetitive benefits, the arrangement should be presumed procompetitive, regardless of the presence of that power. This conclusion, however, is premature: a few considerations may counsel a more nuanced approach.

A. *Raising Rivals' Costs*

The framework advocated here provides a method of identifying those instances in which, despite the presence of market power, a tying contract has not been forced on a franchisee by means of an exercise of that power. Yet, the mere fact that a contract has not been forced on a franchisee through market power does not, *ipso facto*, require the conclusion that the agreement is procompetitive or competitively neutral. Indeed, the central insight of the "raising rivals' costs" school is that a firm with little or no pre-existing market power can obtain or enhance such power by means of a contract that raises the price its competitors must pay for inputs.¹⁵⁶

A "raising rivals' costs" strategy is at least theoretically possible in the franchise context. By requiring franchisees to purchase some in-

courts should not, under the guise of protecting distributors, adopt rules that encourage suppliers to integrate forward); *Standard Oil Co. v. United States*, 337 U.S. 293, 319-21 (1949) (Douglas, J., dissenting) (same).

155. See Klein & Saft, *supra* note 10, at 352-53.

156. See Thomas G. Krattenmaker & Steven C. Salop, *Analyzing Anticompetitive Exclusion*, 56 ANTITRUST L.J. 71, 79 (1987); Krattenmaker & Salop, *supra* note 66, at 251 ("[A] firm need not enjoy or acquire traditional market power to gain the ability to price above preexclusionary-rights competitive levels."); see also Thomas G. Krattenmaker et al., *Monopoly Power and Market Power in Antitrust Law*, 76 GEO. L.J. 241, 249 (1987).

puts from *it* and not from independent sellers, a franchisor could eliminate a certain quantity of demand from the market for those inputs, depriving at least some of those independent sellers of the minimum scale necessary to operate in the market and thus "create" a more concentrated market for the inputs in question.¹⁵⁷ Such concentration, of course, could facilitate collusion among the input's remaining producers, raising the costs faced by the franchisor's rivals, and thus allow the franchisor to raise its prices above its own costs.¹⁵⁸ Assume for a moment that conditions are ripe for such a strategy: there exist a concentrated market for the input(s) in question, barriers to entry into those markets, an arrangement that forecloses a substantial share of those markets, and inputs that are a significant portion of the cost of the franchise product. In these circumstances a franchisor without market power could "purchase" from its franchisees commitments not to deal with independent sellers of the tied product, perhaps by providing a discount on the price of the franchise.¹⁵⁹ Indeed, to the extent that franchisees are able to share in any market power created by such contracts, by, for instance, raising their own prices, no such purchase would be necessary. Instead, franchisees eagerly would agree to such an arrangement, and the two parties would allocate between themselves the resulting supracompetitive profits.¹⁶⁰

There is, of course, no logical connection between proof of a *prima facie* case under *Jefferson Parish*, and the likelihood that a tying contract implements a "raising rivals' costs" strategy. As already noted, the pre-existence of market power, a necessary condition for liability under the *Jefferson Parish* framework, is not relevant to proof that a contract raises rivals' costs.¹⁶¹ And, even if the four *Jefferson Parish* factors are present, no "raising rivals costs" strategy can succeed unless several additional conditions outlined above — substantial foreclosure of the market for the inputs in question, barriers to entry into those markets, and inputs that account for a substantial portion of the cost of the ultimate franchise product — are also present. Thus, a plaintiff seeking to establish a *prima facie* case under such a theory would bear a much heavier burden than plaintiffs under the *Jefferson Parish* framework;

157. See Krattenmaker & Salop, *supra* note 66, at 240-42; see also Steven C. Salop, *Measuring Ease of Entry*, 31 ANTITRUST BULL. 551, 563-65 (1986) (describing the role of a minimum viable scale as a barrier to entry).

158. See Krattenmaker & Salop, *supra* note 66, at 240-42.

159. See generally *id.* at 223-30.

160. See Herbert Hovenkamp, *Mergers and Buyers*, 77 VA. L. REV. 1369, 1376-77 (1991) (demonstrating that vertically related firms can cooperate to create and share the resulting supracompetitive profits).

161. See *supra* note 156 and accompanying text.

heavier, even, than advocates of a rule of reason approach to all tying contracts usually support.¹⁶² Finally, private plaintiffs would have to establish that they suffered antitrust injury — a difficult task, perhaps, for franchisees who signed such an agreement hoping to share in the monopoly profits created by it — and then seek damages for supra-competitive profits lost as a result of termination of a franchise.¹⁶³

Given all the hurdles a plaintiff would have to overcome to make out a *prima facie* case, it seems doubtful that such litigation would ever reach the stage at which procompetitive benefits would be deemed relevant.¹⁶⁴ If it did, however, proof of such benefits would not negate the possibility that the contract produced substantial anticompetitive effects. In fact, where franchisees cooperate in a cost-raising strategy, the presence of procompetitive benefits simply provides additional inducement for the parties to enter into the arrangement. And, even if franchisees would otherwise resist such a strategy, the existence of procompetitive benefits attenuates the incentive to resist, at least when no less restrictive alternative will produce the same or similar benefits.

Although a complete consideration of the question is beyond the scope of this article, it does not appear that, under current law, the possibility that anticompetitive effects will predominate justifies allowing a tribunal to condemn such an arrangement because an anticompetitive tying contract designed to raise rivals' costs is in some sense analogous to unilateral exclusionary conduct by a monopolist.¹⁶⁵ Allegedly exclusionary practices that do not involve cooperation among competitors usually are deemed anticompetitive only if they exclude rivals from the market on a basis other than superior efficiency,¹⁶⁶ or are explicable only on the hypothesis that they will lead to the acquisition of market

162. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 38-39 (1984) (O'Connor, J., concurring) (proposing a rule of reason framework for the evaluation of tying contracts).

163. See Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEXAS L. REV. 1, 38-39 (1984) (arguing that distributors who profit from resale price maintenance schemes should not recover profits lost as a result of termination); see also ELZINGA & BREIT, *supra* note 140, at 88-90 (describing the law regarding *in pari delicto*). But see *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 139-40 (1968) (refusing to recognize the *in pari delicto* defense to distributor suit), *overruled in part on other grounds by Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984).

164. See *Krattenmaker & Salop*, *supra* note 66, at 267 ("Certainly, in most industries, exclusionary rights contracts cannot be profitably employed for anticompetitive ends.").

165. See *Will v. Comprehensive Accounting Corp.*, 776 F.2d 665, 669 (7th Cir. 1985) ("Tying is not cooperation among competitors, the focus of § 1, it is aggressive conduct akin to monopolization under § 2 of the Sherman Act.").

166. See *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 605 (1985); *Trans Sport, Inc. v. Starter Sportswear, Inc.*, 964 F.2d 186, 189-190 (2d Cir.

power.¹⁶⁷ A franchise tying contract that would be negotiated by the parties regardless of the presence of market power or the possibility of its acquisition cannot be condemned under this standard, with the result that the presumption advocated here should arise even in those instances when the relevant markets appear ripe for a successful anticompetitive strategy. Any other approach would likely deter procompetitive contracts and, indeed, prevent certain firms from adopting practices that, by hypothesis, also will be adopted by their competitors.¹⁶⁸

Of course, if a firm that otherwise appears to have adopted a cost-raising strategy has adopted restraints *more* restrictive than those actually employed by its competitors, a court should conclude that the restraints are only explicable on the hypothesis that the franchisor is attempting to obtain market power. This is not to say, however, that the mere ability to hypothesize a less restrictive alternative should render such a contract illegal. Antitrust policy does not prevent admitted monopolists from adopting otherwise legitimate practices simply because those practices may solidify the monopolist's position.¹⁶⁹ Similarly, franchise contracts that would be adopted absent any expectation of market power ought not to be deemed unreasonable.¹⁷⁰

1992) (Marshall, J.) (holding that a practice which is supported by a legitimate business justification cannot be deemed exclusionary).

167. See Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981).

168. See *Telex Corp. v. Industrial Business Mach. Corp.*, 510 F.2d 894, 928 (10th Cir. 1975) (holding that a practice adopted throughout the industry could not be deemed monopolistic); *Krattenmaker & Salop*, *supra* note 66, at 222 (arguing that contracts that resulted from "competition on the merits" should not have been deemed anticompetitive even if they foreclosed rivals from the market).

169. Cf. *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104, 116 (1986) (" '[I]t is in the interest of competition to permit dominant firms to engage in vigorous competition . . . ' ") (quoting *Arthur S. Langenderfer, Inc. v. S.E. Johnson Co.*, 729 F.2d 1050, 1057 (6th Cir. 1984)).

170. The careful reader will wonder why a franchisee would agree to a provision that, while procompetitive in the short run, would ultimately drive up the price of the franchise, if a raising rivals' costs strategy were successful. Two reasons come to mind. First, even if franchisees would collectively prefer something other than a tying requirement, free riding among widely dispersed franchisees may well prevent individual franchisees from expressing these actual preferences. See Kaplow, *supra* note 78, at 531-36; *Krattenmaker & Salop*, *supra* note 66, at 268-70 (arguing that because competition is a public good, free rider problems will prevent parties from investing sufficiently in its preservation). Second, and perhaps most important, franchisees may assist a franchisor in obtaining market power and thus share in its fruits. See *Hovenkamp*, *supra* note 160, at 1380-81. Indeed, a raising rivals' costs strategy in this context involves raising the costs of rival franchisees, the ultimate purchasers of the inputs in question. Thus, "higher costs for the franchisor's rivals" actually translates into higher prices charged by the franchisees' rivals and thus higher prices, revenues and profits for the franchisees of the franchisor that has "imposed" the tying requirements contract. The franchisor, of

B. *Less Restrictive Alternatives*

Tying contracts are not the only method of controlling free riding. One can imagine various alternative methods of policing a franchisee's investments in quality, such as input specifications or the designation of suppliers other than the franchisor that purportedly maintain a sufficient level of quality.¹⁷¹ Thus, one might concede that tying requirements *could* be imposed through a perfectly competitive contracting process while also relying on the presence of alternatives to assert that, in fact, such tying requirements are anticompetitive.¹⁷² After all, why would a franchisee agree to such a tying requirement when alternatives are available that present less danger that a franchisee might ultimately be subject to a less competitive market for the tied product?¹⁷³ Under this reasoning, the procompetitive benefits that result from the tie are in some sense coincidental in that a franchisor has forced the franchisee to accede to a method of achieving those benefits that is unnecessarily restrictive of competition.¹⁷⁴ This, of course, is the approach taken by current law: the presence of a less restrictive means of achieving the procompetitive objectives of a presumptively illegal restraint *ipso facto* requires its condemnation.¹⁷⁵

There is less to this argument than meets the eye. To begin with, the adoption of tying provisions in markets that are not susceptible to

course, will share in these anticompetitive profits as it realizes higher income from franchise fees.

171. See, e.g., *Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft*, 828 F.2d 1033, 1039-42 (4th Cir. 1987) (finding a tie-in unlawful when a "less restrictive alternative" of specification is available); cf. *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 904-905 (E.D. Mich. 1995) (finding that "forcing" is not present when a franchisee has the option to purchase specified "tied products" elsewhere); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1232-35 (W.D. Tenn. 1995) (same).

172. See *Turner*, *supra* note 103, at 62. It should be noted that *Turner*, an early champion of the less restrictive alternative approach is also a father of the "inhospitably" tradition of antitrust. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 19.

173. See *Bowman*, *supra* note 78, at 19-20 (arguing that an attempt to impose a tie would fail in a perfectly competitive market). But see *supra* note 170 (explaining that franchisees may desire to share in any monopoly profits created by such a scheme).

174. See *Kaplow*, *supra* note 78, at 540-52 (noting that ties may be adopted for mixed motives). Of course, proponents of such an objection would recognize that even when a defendant possesses market power, the adoption of such a restrictive practice is only possible given a different sort of free riding problem among franchisees and others who purchase the input in question. Absent such a free rider effect, franchisees would collectively resist the imposition of the tie. Thus, these proponents would continue, the fact that franchisees accede to such a restrictive method of controlling free riding tells us nothing about its efficiency. See generally *id.* at 531-36.

175. See, e.g., *Metrix Warehouse*, 828 F.2d at 1040-42.

anticompetitive strategies strongly suggests that less restrictive alternatives can be a suboptimal solution to the free riding problem.¹⁷⁶ While efficacious in the abstract, alternatives such as product specifications are more costly to enforce than a tying requirement.¹⁷⁷ In addition to writing and publishing such specifications, firms must also monitor compliance.¹⁷⁸ Such monitoring is likely to be especially costly given the incentives of franchisees to cheat and cover up their non-compliance.¹⁷⁹ Indeed, to the extent that an outright tie reduces the cost of monitoring franchisee behavior, franchisors need to induce less franchise-specific investment to deter cheating.¹⁸⁰

Less restrictive alternatives are also likely to be less effective. No franchisor can regularly inspect more than a fraction of its locations, and such inspections are imperfect methods of determining input qual-

176. See *Will v. Comprehensive Accounting Corp.*, 776 F.2d 665, 673-74 (7th Cir. 1985) (stating that the absence of market power suggests that the practice cannot be anticompetitive); *Telex Corp. v. International Business Mach. Corp.*, 510 F.2d 894, 928 (10th Cir. 1975) (holding that a practice employed by firms without market power cannot be monopolistic). The federal reports are replete with instances in which purported ties were imposed by firms with *no* power in *any* relevant product market, let alone power in a market for franchises. See, e.g., *Grappone, Inc. v. Subaru of New England, Inc.*, 858 F.2d 792, 793 (1st Cir. 1988) (addressing a situation in which Subaru had a .25% market share of the American automobile market, and the plaintiff, whose stationary read "Grappone Pontiac," had made no Subaru-specific investments); *Will*, 776 F.2d at 670-75 (franchisor obtained tie despite lack of market power); *Yentsch v. Texaco, Inc.*, 630 F.2d 46, 58-59 (2d Cir. 1980) (presenting a situation in which the plaintiff signed a dealer agreement with full knowledge of the tie, and there was no showing that Texaco possessed market power); cf. *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 26-29 (1984) (holding that a 30% market share does not create market power).

While it is theoretically possible that such contracts could have been designed to *obtain* market power via a raising rivals' costs strategy, see *supra* text accompanying notes 156-70, there is no indication that any of the cases in question involved contracts or market structures that were conducive to such a strategy. See *Krattenmaker & Salop*, *supra* note 66, at 250-51 (listing various factors which are necessary for a cost-raising strategy).

177. See 9 AREEDA, *supra* note 61, at ¶ 1716d4; Klein & Saft, *supra* note 10, at 353-54; Richard S. Markovits, *Tie-Ins and Reciprocity: A Functional, Legal, And Policy Analysis*, 58 TEXAS L. REV. 1363, 1382 (1980); Dugan, *supra* note 27, at 150.

178. See Klein & Saft, *supra* note 10, at 353-54; Markovits, *supra* note 177, at 1382; Dugan, *supra* note 27, at 150.

179. See Dugan, *supra* note 27, at 151 (claiming that the incentive for dealers to cheat renders policing more costly). Given these incentives, it would seem that only surprise inspections would suffice. Under a tying contract, by contrast, the franchisor only needs to monitor the ratio of sales, e.g., franchise fees, to input purchases. See *Roy B. Taylor Sales, Inc. v. Hollymatic Corp.*, 28 F.3d 1379, 1381 (5th Cir. 1994) (describing how franchisor monitored the purchase of the tied product). Monitoring purchases from other suppliers cannot serve as a substitute. Those suppliers themselves will be subject to a free rider problem. See Klein & Saft, *supra* note 10, at 353-54.

180. See Klein & Saft, *supra* note 10, at 352-53.

ity. Such considerations no doubt explain findings by juries that no less restrictive alternative would adequately protect the interest asserted.¹⁸¹

The presence of less restrictive alternatives, then, says little, if anything, about whether the challenged contract is the result of "forcing."¹⁸² Regardless whether the franchisor possesses market power or hopes to obtain it, parties will, other things being equal, adopt a tying requirement whenever such a clause is less costly to implement — which is to say, always — even when the alternative is equally effective.¹⁸³ Thus, the fact that parties have chosen such a tying requirement is as consistent with a procompetitive objective — minimizing joint costs — as with an anticompetitive one — "forcing" or attempting to raise the costs of rivals.¹⁸⁴ This analysis suggests that, whatever the efficacy of a less restrictive alternative analysis in other contexts, the law should not, as it does now, treat the presence of a less restrictive alternative as conclusive evidence that the contract is anticompetitive.¹⁸⁵

181. See, e.g., *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342, 1348-51 (9th Cir. 1987).

182. Professor Kaplow suggests that, even when a tie is more effective than its alternatives, the presence of a less restrictive alternative still should be dispositive because the cost savings of choosing a tie are often "minuscule." He also claims that the realization that a less restrictive alternative is more costly is of uncertain significance. See Kaplow, *supra* note 78, at 543. As shown in the text, however, this realization is quite significant, suggesting, as it does, an alternate explanation — cost-minimization — for the employment of a tying requirement instead of a less restrictive arrangement. Given this alternate explanation, the adoption by current law of a conclusive presumption that a tie is the result of "forcing" based solely upon (1) satisfaction of the *Jefferson Parish* test, and (2) the presence of a less restrictive alternative, appears unreasonable. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 466-67 (1992) ("Legal presumptions that rest on formalistic distinctions rather than actual market realities are generally disfavored in antitrust law."). This is so even when a tie is only marginally more effective than its alternatives: even firms with market power will seek to minimize costs, and, in the quest to do so, every little bit helps.

183. This is a necessary implication of the Coase Theorem. See Coase, *supra* note 91. Of course, in those cases in which a predatory counterstrategy is otherwise rational, franchisees may choose to bear the higher costs associated with the less restrictive alternative, so long as those costs are lower than the expected harm flowing from successful predation, discounted by the probability of such success. However, this fact does not change the analysis in the text, which is in no way dependent on the ability of franchisees to engage in such a strategy.

184. Cf. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 596-97 (1986) (holding that summary judgment is mandated when the evidence is equally consistent with procompetitive and anticompetitive conduct); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 762-64 (1984) (same).

185. See *Eastman Kodak*, 504 U.S. at 466-67 (holding that antitrust presumptions should rest on actual market realities). Even if the proffered alternative is as effective and no more costly to implement than an outright tying requirement, it does not follow that failure to adopt it establishes that the tying requirement is the result of forcing or an attempt to obtain market power. As both options implement the legitimate objective

C. *Lock-ins*

The tentative conclusion just reached assumes that a franchisor with market power can exercise that power simply by enhancing price. Given this option, any use of such power to impose a tying requirement to which parties would otherwise agree squanders monopoly profits that the franchisor could have earned, quite legally, by raising its price.¹⁸⁶ But what of power obtained *after* the franchise has been sold? Under current law, such power can arise once the cost to the franchisee of switching to a different franchise is significant, for instance, if the franchisee has made significant investments specific to the relationship that cannot be recovered by selling the franchise.¹⁸⁷ In such cases, the franchisor possesses significant power over the franchisee, power that by its nature cannot be exercised by raising the franchise sale price.¹⁸⁸

It seems perfectly natural for a franchisor to exercise such power by imposing a tying arrangement.¹⁸⁹ By threatening to terminate the relationship and requiring the franchisee to purchase inputs at a supracompetitive price as a condition of retaining the franchise, the franchisor can exploit its newly found "monopoly power."¹⁹⁰ In these

equally well, the failure to adopt the less restrictive means is as consistent with a random selection of one over the other as it is with an attempt to exercise or obtain market power.

186. See *supra* text accompanying notes 124-29.

187. See *Eastman Kodak*, 504 U.S. at 476-77; 9 AREEDA & HOVENKAMP, *supra* note 73, at ¶ 1709.2c (1995 Supp.). *Kodak* also suggests that such a lock-in can occur when the tying requirement is present from the beginning, but not recognized by the purchaser. See *Kodak*, 504 U.S. at 473-76; see also Craswell, *supra* note 139, at 672-73 (arguing that buyers might not recognize ties at the outset, even if ties are contained in a standard contract). This article assumes that such a strategy would not be possible in the franchise context in light of the sophistication of potential franchisees as well as the existence of state and federal laws mandating disclosure of such tying requirements in writing. See *supra* text accompanying notes 115-19; see also William F. Baxter & Daniel P. Kessler, *Toward a Consistent Theory of the Welfare Analysis of Agreements*, 47 STAN. L. REV. 615, 618 n.23 (1995); Craswell, *supra* note 139, at 697-98 (arguing that the failure to disclose tying requirements terms is best addressed by consumer protection laws); Mark R. Patterson, *Product Definition, Product Information, and Market Power: Kodak in Perspective*, 73 N.C. L. REV. 185, 251 (1994) (describing federal disclosure rules).

188. Cf. *Moore v. Tandy Corp.*, 819 F.2d 820, 822 (7th Cir. 1987) (explaining how the presence of relationship-specific investments can leave a franchisee at the mercy of a franchisor that can terminate the relationship at will).

189. See Lande, *supra* note 73, at 200 & n.24.

190. See 9 AREEDA, *supra* note 61, at ¶ 1712e. (addressing the ability of a tie to evade private price ceiling). Of course, the franchisor need not in all circumstances threaten to terminate the franchise outright to exploit this power. It can instead reduce the allocation of products to the distributor or take other action that threatens the value of the franchise. See *Grappone, Inc. v. Subaru of New England, Inc.*, 534 F. Supp. 1282, 1286-87 & n.16 (D.N.H. 1982) (addressing a situation in which the franchisor never

circumstances, it seems, the mere presence of procompetitive benefits does not *itself* suggest that the tie is the result of voluntary contractual integration. Instead, whatever incentives exist to create such an arrangement coexist with an incentive to use it to reap monopoly profits that are otherwise unobtainable, such that a rational franchisor might attempt to eliminate free riding *and* charge a supracompetitive price for the tied product.¹⁹¹

In response, it should be noted that any such argument assumes that the franchisee has failed to protect itself *ex ante* from those actions — threats of termination, hold up of products, and the like — that constitute “market power” under the regime established by *Kodak*.¹⁹² The argument also assumes that the threat of reputational losses and lost franchise sales does not deter the franchisor from embarking on such a strategy,¹⁹³ that “downstream competition” from competing franchise systems does not render such a strategy unprofitable,¹⁹⁴ and that the defendant has attempted to “impose” the purported tie at some point *after* the franchisee has made investments specific to the franchise relationship.¹⁹⁵ Yet, under the regime of *Kodak*, these arguments merely

threatened to terminate the franchisee, but reduced the franchisee’s allocation of vehicles), *revd.*, 858 F.2d 792 (1st Cir. 1988).

191. *Cf. supra* text accompanying notes 87-88. Such an upcharge does not, in and of itself, pose any danger of creating power in the market for the tied product. Yet, under the rationale of *Kodak*, no such danger is necessary. *See AREEDA & HOVENKAMP, supra* note 73, at ¶ 1709.1a (1995 Supp.); Kaplow, *supra* note 78, at 520-25 (arguing that antitrust policy should condemn the exploitation of monopoly power via leverage, even when there is no threat of competitive harm in the market for the tied product).

192. *See Lande, supra* note 73, at 200 (“Absent imperfect information this rent extraction would not be a concern, for no franchisee would sign a franchise arrangement that would enable the franchisor unfairly to extract its goodwill.”). In this vein, one scholar argues that the very absence of contractual protection against such opportunism suggests that purchasers have determined that such protection is unnecessary, with the result that no “lock-in” is present. *See Klein, supra* note 72, at 50-52.

193. *See* George A. Hay, *Is the Glass Half-Empty or Half-Full?: Reflections on the Kodak Case*, 62 ANTITRUST L.J. 177, 188-89 (1993).

194. *See id.* at 187; 9 AREEDA & HOVENKAMP, *supra* note 73, at ¶ 1709c2. Thus, if the downstream market is highly competitive and the strategy increases the price of a significant input, consumers will substitute away from the franchise’s products, reducing any franchise fees earned by the franchisor and rendering the scheme unprofitable. *See* International Telephone & Telegraph Co., 104 FTC 280, 410-11 (1984) (including “downstream competition” in the relevant market); AREEDA & HOVENKAMP, *supra* note 73, at ¶ 5201b1 (1996 Supp.); HORIZONTAL MERGER GUIDELINES, *supra* note 2, at § 1.11(3); *cf. United States v. Aluminum Co. of Am.*, 148 F.2d 416, 424-25 (2d Cir. 1945) (including within the relevant market both virgin ingot and ingot fabricated for sale downstream).

195. *See Lee v. Life Ins. Co. of N. Am.*, 23 F.3d 14, 20 (1st Cir. 1994) (finding no lock-in where plaintiffs knew of the challenged policy before making asset-specific investments); *Kenosha Liquor Co. v. Heublein, Inc.*, 895 F.2d 418, 420 (7th Cir. 1990)

raise questions of fact to be addressed by the tribunal in determining whether the franchisor possesses power over the tying product as a result of a lock-in.¹⁹⁶ Thus, any attempt to “filter” good ties from bad ties by focusing solely on procompetitive effects appears inconsistent with the current legal landscape, which requires courts in some cases to assume that these effects coexist with the exercise of market power and to engage in the required balancing analysis.

Closer scrutiny, however, suggests the existence of another condition that is necessary to evade the *prima facie* legality standard proposed here. To this point, we have assumed that a franchisor’s exercise of market power can only take the form of reducing the output of franchises, with the result that there can be no exercise of market power — aside from tying — once those awards have been made. Yet, even after franchises are awarded, there exists a separate outlet for a firm’s market power: namely, an increase in the price of products sold to the franchisee. Thus, if an automobile dealer has made investments specific to the dealership that lock the dealer into the relationship, the manufacturer may exercise its power simply by increasing the price of automobiles sold to the dealer.¹⁹⁷ When this option is present, the incentive to employ a tie for the purpose of exercising market power becomes more ambiguous, and we are drawn back to the general conclusion offered here — that any use of market power to impose such a tie would be an irrational waste of that power such that the presence of procompetitive benefits suggests that the arrangement is *prima facie* legal.¹⁹⁸

Yet, even if a tie is the only method through which a franchisor could exercise market power conferred by a lock-in, the existence of procompetitive benefits still should render a tie *prima facie* lawful. Here it is important to distinguish between two possible sources of anticompetitive harm: the tying requirement itself, which forecloses the franchisee from purchasing the tied product elsewhere, and any upcharge on the tied product. Where a franchisor in such a position *could* obtain

(finding that the manufacturer need not terminate a distributor to exploit the value of the former’s brand when it can raise the price of the primary product). Of course, when a franchisor can terminate a franchise at will, it can effectively raise franchise fees at any time.

196. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 471-79 (1992). But cf. *Digital Equip. Corp. v. Uniq Digital Technologies, Inc.*, 73 F.3d 756, 762 (7th Cir. 1996) (suggesting that *Kodak* assumed, rather than decided, this question).

197. See Hay, *supra* note 193, at 185-87 (describing a hypothetical scheme whereby a fast food franchisee exploits locked-in franchisees by charging monopoly meat prices).

198. Cf. *Kenosha Liquor*, 895 F.2d at 420 (granting summary judgment for the manufacturer when the plaintiff alleged that the manufacturer had acted irrationally by exploiting the allure of the brand name via termination).

such an agreement through voluntary negotiation, it would not use any market power to impose the tie itself but instead only to enhance the price of the tied product. Thus, the existence of procompetitive benefits suggests that the tying requirement itself is not the result of forcing. Even when a lock-in confers market power, then, the presence of procompetitive effects should render the tying requirement *prima facie* legal, subject, of course, to the plaintiff's ability to prove an actual upcharge.¹⁹⁹

D. Price Discrimination

The analysis offered here assumes that franchisors that wish to exercise whatever market power they possess can do so simply by raising the price of the franchise.²⁰⁰ This assumption may not always describe entirely a franchisor's options, however. When different franchisees value the franchise opportunity differently, merely raising the price across the board will not capture the full profit available to a franchisor with market power.²⁰¹ In these circumstances, a franchisor can only realize the full potential of its power by discriminating in price among various purchasers.²⁰²

This realization is not itself an objection to the analysis offered here. A franchisor with information about the demand elasticities of potential franchisees simply could vary the prices charged to different franchisees accordingly.²⁰³ Thus the realization simply suggests that the approach offered here depends on the assumption that franchisors possess sufficient information about various franchisees to engage in price discrimination. Absent such information, the assumption that a franchisor necessarily would prefer to exercise whatever market power it possesses by increasing price collapses. Such a collapse leaves one to suspect that, at least in some circumstances, tying requirements that produce procompetitive benefits are in fact utilized by franchisors as

199. See *supra* text accompanying notes 142-43.

200. See *supra* text accompanying notes 124-34. Such an increase could take the form of higher up-front prices, franchise fees, or both.

201. See HOVENKAMP, *supra* note 126, at 342 ("Even the monopolist charging its nondiscriminatory profit-maximizing price does not make all the money theoretically possible from its position.").

202. See *id.* at 341-42; see also M.L. Burstein, *A Theory of Full-Line Forcing*, 55 Nw. U. L. REV. 62 (1960).

203. See JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 142-43 (1988).

devices for price discrimination.²⁰⁴ This conclusion, in turn, suggests a return to a sort of balancing test whereby the burdens of price discrimination are balanced against the benefits of eliminating free riding.²⁰⁵

Ultimately, however, the realization that imperfect information may lead a franchisor in some instances to utilize tying contracts to price discriminate does not require an approach different from that offered here.²⁰⁶ Such a strategy is only possible when purchases of the tied product are a strong indicator of a franchisee's elasticity of demand for the franchise opportunity, an elasticity that many assume is highly correlated with a franchisee's sale of the franchise product generally.²⁰⁷ Many franchise tying cases, however, involve instances in which the franchisee's purchases of the tied product are poorly correlated with its total revenues.²⁰⁸ Moreover, even when purchases of the tied product correspond with total sales, there is little guarantee that sales are a strong proxy for elasticity. Instead, such elasticity will more likely depend upon the competition to be faced by the franchisee in its territory, as well as the availability of substitute franchise opportunities.²⁰⁹

204. See HOVENKAMP, *supra* note 126, at 229-33 (discussing the conditions under which franchisors may use tying arrangements as vehicles for price discrimination).

205. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 373 n.14 (describing such an analysis).

206. Of course, the most potent response to such an objection may be to argue that price discrimination is itself of no concern of the Sherman Act absent some independent showing of anticompetitive effect. See Robinson-Patman Antidiscrimination Act, 15 U.S.C. § 13 (1994) (prohibiting price discrimination that lessens competition).

207. See HOVENKAMP, *supra* note 126, at 229-33; Burstein, *supra* note 202, at 72.

208. See, e.g., *Grappone, Inc. v. Subaru of New England, Inc.*, 858 F.2d 792, 793-96 (1st Cir. 1988) (addressing a tying requirement that the franchisee maintain an adequate supply of replacement parts); *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342, 1348-51 (9th Cir. 1987) (addressing a tying requirement that the dealer utilize Mercedes or Mercedes-approved replacement parts); *Southern Pines Chrysler-Plymouth v. Chrysler Corp.*, 826 F.2d 1360, 1362-63 (4th Cir. 1987) (addressing a tying requirement that the franchisee purchase automobiles that sold poorly); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1212-14 (W.D. Tenn. 1995) (addressing a tying requirement that the franchisee purchase replacement parts only from the franchisor). Also, when the franchise is of the "source" variety — when the franchisee purchases the franchise product from the franchisor — sales of the tied product are often directly proportional to sales of that main product, such that sales of the tied product are no better as a proxy for elasticity than sales of the main product itself. See, e.g., *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468, 472-73 (3rd Cir. 1992) (addressing a tying requirement that Chrysler's franchisees purchase sound systems from it).

209. Professor Hovenkamp, who views franchise tying contracts as presumptive vehicles for price discrimination, see HOVENKAMP, *supra* note 126, at 229-33, notes in a different context that "[t]here are no two identical firms in two different cities. Even two McDonald's franchises in identical buildings and traffic areas, and with equally ca-

At any rate, franchisors overcome such informational barriers by methods of price discrimination other than tying contracts. Imposition of a franchise fee, for instance, would seem to be an excellent vehicle for price discrimination; those franchisees with large revenues will ultimately pay more for the franchise than those who do poorly.²¹⁰ The availability of a less cumbersome method of price discrimination suggests that: (1) tying requirements often accomplish something different — that is to say, beneficial — from price discrimination, and (2) the elimination of price discrimination by prohibiting franchise tying contracts is largely a quixotic endeavor, the pursuit of which does not justify a departure from the general approach offered here. Indeed, when tying is the best method of price discrimination, prohibiting it will simply lead firms to adopt less effective measures, measures that may well lead to even lower output and larger allocative losses, as franchisors incur additional transaction costs in their quest to determine the demand elasticities of various franchisees.²¹¹ Antitrust policy would not be well served by such a result.²¹² Requiring franchisees actually to prove price discrimination by showing an unjustified upcharge on the tied product will vindicate whatever consumer interest is served by prohibiting tying as a means of price discrimination.

pable management, can show widely different rates of profitability.” Herbert Hovenkamp, *Antitrust's Protected Classes*, 88 MICH. L. REV. 1, 39 (1989). Both propositions, it seems, cannot be correct.

210. See Burstein, *supra* note 202, at 73-74 (arguing that a franchise fee is an “ancillary condition” that facilitates price discrimination); Kaplow, *supra* note 78, at 540-42 (claiming that the presence of alternative methods of price discrimination suggests that a tie is not a vehicle for such discrimination); Kaufmann & LaFontaine, *supra* note 28, at 438 (“[T]here are fairly costless mechanisms that McDonald’s could use to extract more rents from higher volume or promising restaurants.”). Indeed, to the extent that a franchisee’s revenues are a better proxy for its demand elasticity than are its purchases of the tied product, such a method of discrimination will be superior to a tying arrangement. Cf. Burstein, *supra* note 202, at 72 (arguing that the success of a tying scheme as a vehicle for price discrimination depends upon “the assumption that sales of the [tied product] will be highly correlated with sales of the [tying product] over time”).

211. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 11-13 (1975) (noting that monopolists are willing to incur transaction costs to realize the benefits of price discrimination); see also Basil Yamey, *Monopolistic Price Discrimination and Economic Welfare*, 17 J.L. & ECON. 377 (1974).

212. See *Business Elecs. Corp. v. Sharp*, 485 U.S. 717, 730 n.3 (1988) (refusing to adopt a per se rule because such a rule will lead parties to engage in inefficient practices as a means of evasion); see also *Continental T. V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 56 n.25 (1977) (rejecting a rule that will simply lead firms to accomplish anticompetitive objectives in other, more costly, ways).

E. *Recalcitrant Franchisees*

Of course, few franchisees challenge tying requirements at their inception — it is difficult to locate cases in which franchisees seek declaratory judgments that the contracts they are about to enter are illegal. Instead, most such challenges surface later, either in the midst of the relationship or in response to termination of the franchise.²¹³ One might ask: if franchise tying contracts are so beneficial to franchisees, why are they so often subject to challenge? Does not the presence of so many lawsuits challenging restrictions support the theory, outlined in *Standard Oil*, that such contracts are “forced” on franchisees?

This objection appears ill-founded in light of the economic characteristics of the franchise relationship, characteristics that suggest that such suits are often a symptom of free riding. By creating a strong reputation for quality associated with the franchise trademark, the enforcement of a tying requirement makes free riding all the more remunerative.²¹⁴ It should be no surprise then that some franchisees will attempt to “have their cake and eat it too” — pay a lower price for the franchise opportunity *and* free ride on other franchisees.²¹⁵ Of course, contractual remedies for such shirking are likely to be ineffective,²¹⁶ with the result that franchisors can only resort to self-help, namely, the termination of a franchise or the threat to do so, to obtain compliance with the tying requirement.²¹⁷ Termination may deprive the franchisee

213. See *Roy B. Taylor Sales, Inc. v. Hollymatic Corp.*, 28 F.3d 1379, 1382 (5th Cir. 1994) (addressing a claim filed after the termination of the franchise challenging certain tying terms contained in the initial agreement); *cert. denied*, 115 S. Ct. 779 (1995); *Yentsch v. Texaco, Inc.*, 630 F.2d 46, 49-50 (2d Cir. 1980) (same); *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 46 & n.1 (9th Cir. 1971) (evaluating tying requirements in place for nearly two decades before the suit). *But cf.* *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 894-95 (E.D. Mich. 1995) (addressing a tying requirement allegedly imposed after the award of the franchise); *Grappone, Inc. v. Subaru of New England, Inc.*, 534 F. Supp. at 1286-87 (D.N.H. 1982) (same), *revd.*, 858 F.2d 792 (1st Cir. 1988).

214. See Easterbrook, *supra* note 163, at 38-39 (discussing incentives for dealers to cheat on resale price maintenance schemes); Muris, *supra* note 34, at 575-80; *supra* text accompanying notes 29-44 (discussing franchisees' general incentives to shirk).

215. See WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 371 (observing that the desire to “have your cake (low price) and eat it too (no restrictions)” is inconsistent with “the theory and the practice of contract”); see also *supra* text accompanying notes 99-100 (noting that franchisees pay a lower price for franchise opportunity by promising not to free ride).

216. See Muris, *supra* note 34, at 575.

217. See Kaufmann & LaFontaine, *supra* note 28 (concluding that McDonald's leaves rents downstream for franchisees to create a “penalty” for termination); Klein, *supra* note 95, at 358-59 (claiming that the threat of termination of franchisees and the resulting loss of specific investment constitute a “performance bond” paid by the franchisee to assure quality); Richard L. Smith II, *Franchise Regulation: An Economic*

of franchise-specific investments or economic rents, thereby motivating a lawsuit seeking lucrative treble damages.²¹⁸

As a theoretical matter, such damages should be nonexistent in those cases where the challenged arrangement is efficient — where there is no upcharge on the tied product.²¹⁹ Yet, to the extent that courts award damages — as they often do — reflecting the lost value of the franchise opportunity itself, no such upcharge must be proven.²²⁰ Even when no such franchise-specific investments are present, a franchisee still may bring suit, insofar as the remedy for termination is not limited to the economic rents lost as a result of termination, but in some circumstances may include injunctive relief as well.²²¹ The threat to seek such an injunction — to impose significant externalities on the franchise system — may allow a plaintiff to obtain a lucrative settlement. Thus, current law against tying, combined with the possibility of treble damages, provides a mechanism whereby franchisees can obtain a franchise for a lower price by promising not to free ride, all the while planning to do so, knowing full well that, if caught, they will have the “insurance policy” of a treble damage action.²²² The presence of so many suits simply suggests that franchisees are acting opportunistically,

Analysis of State Restrictions on Automobile Distribution, 25 J.L. & ECON. 125, 129 (1982) (same).

218. See *Jack Kahn Music Co. v. Baldwin Piano & Organ Co.*, 604 F.2d 755, 757 (2d Cir. 1979) (discussing the propensity of terminated distributors to file treble damage actions).

219. See *Siegel v. Chicken Delight, Inc.*, 448 F.2d 43, 52-53 (9th Cir. 1971); see also *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977) (limiting treble damage remedies to those injuries that flow from anticompetitive conduct).

220. See *Yentsch v. Texaco, Inc.*, 630 F.2d 46, 59 n.19 (2d Cir. 1980) (describing a method of calculating damages based on termination); *Hovenkamp*, *supra* note 209, at 5; see also *supra* text accompanying notes 148-49; cf. *Fishman v. Estate of Wirtz*, 807 F.2d 520, 556-560 (7th Cir. 1986) (holding that normal profits were not available given the duty to mitigate damages).

221. See, e.g., *Semmes Motors, Inc. v. Ford Motor Co.*, 429 F.2d 1197 (2d Cir. 1970) (Friendly, J.) (observing that equitable relief is available when the plaintiff had a contractual expectation to remain a distributor).

222. See ELZINGA & BREIT, *supra* note 140, at 84-90. Indeed, some scholars have gone so far as to suggest that the existence of treble damages provides dealers with the incentive to breach their contracts purposely in the hope of being terminated. See WILLIAM BREIT & KENNETH G. ELZINGA, *ANTITRUST PENALTY REFORM* 36-38 (1986); Henry N. Butler, *Restricted Distribution Contracts and the Opportunistic Pursuit of Treble Damages*, 59 WASH. L. REV. 27 (1983). But cf. Robert H. Lande, *Are Antitrust “Treble” Damages Really Single Damages?*, 54 OHIO ST. L.J. 115 (1993) (arguing that treble damages do not overcompensate plaintiffs). Similarly, one could argue that present tying law presents distributors with the lucrative option of benefiting from a tying arrangement for several years only to challenge it thereafter, reaping treble damages or an injunction.

and tells us nothing about the efficacy or origin of franchise tying contracts.

F. *Bypassing the Coercion Element?*

At bottom, this article concludes that ties that produce substantial procompetitive benefits which are internalized by the parties are most probably not forced on franchisees through the exercise of market power, but instead are examples of voluntary contractual integration about which the antitrust laws should not be concerned. This suggestion that "voluntariness" — however determined — ought to save an otherwise per se illegal tie may ring hollow to the practitioner familiar with the formal elements of tying analysis, specifically, the tying requirement that "conditioning," which generally includes "coercion" or "forcing," be present.²²³ Does the present proposal add to the coercion analysis already required, or is it a call for a second bite at the coercion apple?

The proposal offered here would constitute a second bite if, in fact, the current law governing the conditioning element and the subsidiary inquiry into coercion reflected a rational method of sorting "coercive" ties from those that are "voluntary" in the sense employed here. Present law generally makes no such attempt. A few courts do not even require a showing of coercion.²²⁴ Moreover, in some other courts, a finding of coercion can be based simply on a showing that a form contract contained the tying requirement, and that there was no chance for negotiation over the provision.²²⁵ As one court recently held in the franchise context:

Where the tying arrangement is admitted or . . . imposed as part of a contract, there is no further need to demonstrate the forcing element. Because of the very nature of a binding contract, coercion and forcing can be implied since the victim of the tying arrangement has no other choice

223. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 16-18 (1984) (defining a per se violation with reference to the possibility of "forcing"); *Paul E. Volpp Tractor Parts, Inc. v. Caterpillar, Inc.*, 917 F. Supp. 1208, 1231-32 (W.D. Tenn. 1995); *Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 895 (E.D. Mich. 1995) (noting that "forcing" is a necessary element of a franchise tying claim).

224. See *Bell v. Cherokee Aviation Corp.*, 660 F.2d 1123, 1130-32 (6th Cir. 1981); *Bogosian v. Gulf Oil Corp.*, 561 F.2d 434, 450 (3d Cir. 1977).

225. See, e.g., *Tic-X-Press, Inc. v. Omni Promotions, Co.*, 815 F.2d 1407, 1416-17 (11th Cir. 1987), modified by *Thomson v. Metropolitan Multi List, Inc.*, 934 F.2d 1566 (11th Cir. 1991); *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 593 F. Supp. 1506, 1517 (N.D. Cal. 1984), *affd.*, 833 F.2d 1342 (9th Cir. 1987). *Contra* *Capital Temporaies, Inc. v. Olsten Corp.*, 506 F.2d 658, 666 (2d Cir. 1974) (holding that the mere fact that a franchisee signed a standard franchise contract does not establish coercion).

but to comply with the arrangement or face litigation to enforce the contract.²²⁶

Indeed, in some courts, a showing that an appreciable number of buyers accepted a "burdensome" term establishes by itself the element of coercion.²²⁷ Finally, at least one court has held that threatening to terminate a dealer for failure to abide by a tying requirement in the original contract is sufficient to establish coercion.²²⁸

Obviously, the present tests governing "coercion" or "conditioning" are not up to the task of distinguishing procompetitive ties from those that are anticompetitive on the grounds offered here. The mere fact that a provision appears "burdensome" *after* the contract has been entered does not require the conclusion that the provision has been "imposed" at all.²²⁹ Instead, the franchisee simply may have accepted the term in return for a different, favorable term or a lower price.²³⁰ Moreover, courts that deem the mere presence of a condition in a binding contract to be "coercive" confuse the process of contract enforcement — which necessarily involves public or private coercion — with that of contract formation.²³¹ The test offered here avoids this confusion and allows courts to sort agreements that have been "imposed" from those that are freely bargained for.

IV. IMPLICATIONS OUTSIDE THE FRANCHISE CONTEXT

The analysis offered here has significant possible application in other contexts, where the presence of low transaction costs suggests that

226. *Little Caesar*, 895 F. Supp. at 896; *see also Volpp Tractor*, 917 F. Supp. at 1232; *Anderson Foreign Motors, Inc. v. New England Toyota Dist., Inc.*, 475 F. Supp. 973, 979-88 (D. Mass. 1979).

227. *See Moore v. Jas. H. Matthews & Co.*, 550 F.2d 1207, 1217 (9th Cir. 1977); *Hill v. A-T-O Inc.*, 535 F.2d 1349, 1355 (2d Cir. 1976).

228. *See Osborn v. Sinclair Ref. Co.*, 286 F.2d 832, 839-41 (4th Cir. 1960).

229. *Cf. RESTATEMENT (SECOND) OF CONTRACTS* § 208 (stating that a court may refuse to enforce a contractual term that is unconscionable "*at the time the contract is made*") (emphasis added).

230. As Professor Williamson explains:

It is easy to conclude, upon examining a contract at a point in time, that one of the parties to the exchange is disadvantaged by the restraint

Such a myopic conception fails to recognize that the terms under which the original franchise was struck reflect the associated restraints. It is understandably attractive to have your cake (low price) and eat it too (no restrictions). But both the theory and the practice of contract preclude that.

WILLIAMSON, *ECONOMIC INSTITUTIONS*, *supra* note 8, at 371; *see also supra* text accompanying notes 98-100 (explaining that franchisees will not be willing to pay a sufficiently high price for the right to choose inputs).

231. *See, e.g., Little Caesar Enters. v. Smith*, 895 F. Supp. 884, 896 (E.D. Mich. 1995).

a partial equilibrium tradeoff analysis is inappropriate. Consider the so-called "false attribution" justification for tying contracts. Here, the seller asserts that it must require the purchaser to take from it a complement of the tying product to ensure that use of a lower quality complement does not cause the tying product to break down, improperly undermining its reputation.²³² Under current law, courts assume that such a tying requirement, while possibly beneficial, must be forced on an unwilling purchaser by means of the exercise of market power.²³³ The analysis offered here, however, suggests that the seller, who internalizes the benefits of eliminating the "false attribution" problem, will charge a lower price to those customers who accept the tying requirement and a higher price to those who do not.²³⁴ Such price differentials, of course, are cost-justified and thus unrelated to the exercise of market power, suggesting that, when a tying requirement does eliminate a "false attribution" problem, no forcing is present, even when a less restrictive alternative is available.

A recent decision involving a horizontal restraint provides another possible application of the analysis offered here. In *United States v. Brown University*,²³⁵ MIT argued, *inter alia*, that an agreement limiting competition between it and other elite colleges and universities with respect to financial aid awards to non-needy students was necessary to improve the quality of education at the respective schools, by diverting the increased profits associated with reduced competition to scholarships for students of diverse socio-economic backgrounds.²³⁶ The Third Circuit held that a rule of reason balancing test was appropriate — that the fact finder should balance the benefits of an improved education against the harms resulting from the limitation on competition imposed by the challenged agreement.²³⁷ Such an approach, of course, constituted a classic partial equilibrium welfare analysis: the fact finder was required to compare the harm flowing from the exercise of market

232. See *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 483-84 (1992). The classic example is IBM's tying requirement that customers purchase from it "punch cards" for use in its tabulating machines, purportedly to insure that use of inferior cards did not cause the machines to malfunction. See *IBM v. United States*, 298 U.S. 131, 138-40 (1936); see also *International Salt Co. v. United States*, 332 U.S. 392, 397-98 (1947); *United States v. Jerrold Elecs. Corp.*, 187 F. Supp. 545 (E.D. Penn. 1960), *aff'd.*, 365 U.S. 567 (1961) (per curiam).

233. See *Standard Oil Co. v. United States*, 337 U.S. 293, 306 (1949).

234. See *supra* text accompanying notes 98-104.

235. 5 F.3d 658 (3d Cir. 1993).

236. See 5 F.3d at 674.

237. See 5 F.3d at 676-79.

power with the benefit associated with the enhanced demand for the schools' respective products.

Here again, the transaction cost approach has powerful implications. If, in fact, the benefit of enhancing socio-economic diversity at a college or university improves the quality of the education, and thus outweighs the resulting harm to other students, we would expect that a school could, absent transaction costs, unilaterally adopt policies enhancing such diversity and, as a result, realize a higher demand for its services. More precisely, a school could differentiate its product from others and thus command a higher price in the form of less attractive scholarship awards to non-needy students. In such circumstances, a "less restrictive alternative" — no restraint at all — *would* be called for, insofar as each institution could achieve the very same procompetitive objective without acting collectively. Thus, litigation resources currently spent balancing one effect against another would be better employed determining the magnitude of transaction costs attending the relationship between schools and prospective students.

Finally, it should be noted that the approach offered here has implications for the scope of available remedies to redress restraints that the law otherwise might deem unreasonable. It is well settled that private plaintiffs may obtain legal or equitable relief only upon proof of "antitrust injury" — when the alleged injury flows from the aspect of a restraint or practice that renders it unlawful and is the type of injury that the antitrust laws seek to prevent.²³⁸ The analysis advanced here suggests that many of the injuries alleged by private plaintiffs — for instance, foreclosure from competing in the market as the result of an exclusive dealing or tying contract²³⁹ — might not be related to any exercise of market power, but might instead be the natural result of contractual integration that produces procompetitive benefits. Thus, even where a contract might be, on balance, anticompetitive, a plaintiff would not suffer antitrust injury when the presence of significant procompetitive effects suggests that the parties would have entered the very same contract absent any prospect of obtaining or exercising mar-

238. See *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 334 (1990); *Cargill, Inc. v. Monfort of Colo., Inc.* 479 U.S. 104, 109-13 (1986).

239. See, e.g., *Town Sound and Custom Tops, Inc., v. Chrysler Motors Corp.*, 959 F.2d 468, 481-85 (3rd Cir. 1992) (en banc) (addressing the claim that foreclosure resulted from a tying contract); *Interface Group v. Massachusetts Port Auth.*, 816 F.2d 9, 11-12 (1st Cir. 1987) (addressing the allegation that foreclosure from the market resulted from an exclusive dealing contract).

ket power. In these circumstances, challenges to such contracts would be left to public agencies, or, perhaps, consumers.²⁴⁰

CONCLUSION

Economists have demonstrated that franchise tying contracts can reduce free riding by franchisees and thus increase output. The partial equilibrium tradeoff framework that governs the analysis of tying arrangements and trade restraints, however, is premised upon the presence of high transaction costs. Under this approach, any beneficial effects of a challenged restraint must be weighed against anticompetitive effects that are presumed once the plaintiff proves the elements of a *per se* violation. Moreover, as in other antitrust contexts, the presence of a less restrictive means of achieving the tie's objectives is fatal to the arrangement regardless whether it is on balance procompetitive.

This article has demonstrated that the balancing framework so thoroughly developed and rigorously applied in a variety of antitrust contexts is simply ill-suited to the evaluation of tying contracts that reduce the agency costs associated with the separation of the ownership of a trademark from its control — a separation inherent in the franchise system. In particular, once the plaintiff makes a showing of market power, the ordinary framework assumes that any procompetitive benefits associated with the reduction in agency costs are “forced” on franchisees and thus necessarily coexist with anticompetitive effects. As shown here, however, this assumption is ill-founded in the tying context, where transaction costs are very low. Instead, in such cases, parties are in a position to order their relationship voluntarily in a manner that produces procompetitive benefits internalized by each. The presence of such benefits strongly suggests that the defendant need not exercise market power to achieve them — that no “forcing” is present.

Insofar as the exercise of market power involves the sacrifice of monopoly profits, the presence of such benefits strongly suggests that the franchisor would not “impose” a tying contract through the exercise of market power, but would negotiate for the voluntary inclusion of such a provision. Thus, the existence of such benefits requires a conclusion that the arrangement is *prima facie* unrelated to the exercise of market power or any hope of obtaining it, with the result that the ar-

240. Cf. *Alberta Gas Chems. Ltd. v. E.I. DuPont De Nemours and Co.*, 826 F.2d 1235, 1246 (3d Cir. 1987) (finding no antitrust injury when the same harm would have occurred in the absence of an anticompetitive effect); *Bayou Bottling, Inc. v. Dr. Pepper Co.*, 725 F.2d 300 (5th Cir. 1984) (same); see also *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 487-88 (1977) (observing that antitrust laws are not designed to remedy those harms that result from procompetitive practices).

rangement should be presumed legal, regardless of whether a less restrictive alternative is available.

This is not to say that any arrangement that produces procompetitive benefits should be deemed *per se* legal: the test proposed here would still allow a plaintiff to show that a tying contract is unreasonable by proving that there is an unjustified "upcharge" on the tied product. However, once the defendant has shown that the challenged contract creates substantial procompetitive benefits, such proof must proceed without the benefit of either the presumption that arises upon the proof of market power or the "less restrictive alternative" test.

Finally, the implications of this approach apply beyond the franchise tying context to other situations in which the parties enjoy low transaction costs. In these circumstances a partial equilibrium trade-off analysis is simply inappropriate. The test that is normally applied, and the standards governing the available remedies for unreasonable restraints, must be adjusted accordingly.