Principe v. McDonald's Corporation: The Separability Issue in Franchise Tying Arrangements

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INTRODUCTION

Despite the frequency of litigation involving tying arrangements,¹ no clear standards have emerged for determining if the allegedly tied items are separate and distinct as opposed to component parts of a single product.² This issue of separability poses a particularly difficult problem when tying arrangements are alleged in connection with franchising,³ because a franchise often represents a package of interrelated items.⁴ The recent case of Principe v. McDonald's Corp.,⁵ which involved an alleged tying arrangement in a franchise package, demonstrates the need for guidelines defining separability.

1. A tying arrangement is an agreement by a party to sell one product (the "tying product") only on the condition that the buyer also purchase a second, different product (the "tied product"). Northern Pac. Ry. v. United States, 356 U.S. 1, 5-6 (1958); The Impact of Franchising on Small Business, Hearings Before the Subcommittee on Urban and Rural Economic Development 23 (Washington, D.C., U.S. Government Printing Office, 1970).

2. Tying arrangements have been the subject of much litigation. Tying After Fortner, 46 ANTITRUST L.J. 603 (1977) (R. Rhodes Introductory Remarks). See also notes 7 & 8 infra and accompanying text. For a list of United States Supreme Court cases dealing with tying arrangements, see Bauer, A Simplified Approach to Tying Arrangements: A Legal and Economic Analysis, 33 Vand. L. Rev. 283, 283 n.1 (1980) [hereinafter cited as Bauer].

3. See Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 507 (1969), discussed at note 27, infra. This question is referred to as "the separability issue," "the single-product issue," or the "two-product issue." These terms will be used interchangeably in this article. A tying arrangement by definition involves more than one product.


5. 631 F.2d 303 (4th Cir. 1980).
In *Principe*, the Fourth Circuit faced the issue of whether a franchisor that requires its licensees to operate their franchises in premises leased from the franchisor is guilty of an illegal tying arrangement. Narrowly interpreted, the *Principe* decision establishes that sufficient business justifications render the leasing requirement reasonable. A broad reading of *Principe*, however, suggests that such a leasing requirement does not constitute an item separate and distinct from the franchise agreement. The shortcoming of the *Principe* decision is the court's failure to clarify whether the decision establishes a broad precedent upon which other courts may rely even in the absence of the factual basis which so heavily influenced the *Principe* court.

This article will explore the problems courts face in resolving the single product issue. First, this article will provide an overview of tying arrangements and franchises. Next, it will review the precedents that faced the Fourth Circuit in *Principe*. This article will then focus on *Principe* as illustrative of the current dilemma presented by the separability issue. Finally, this article will evaluate the impact of *Principe* on the field of tying arrangements in franchises.

**TYING ARRANGEMENTS AND FRANCHISES**

Tying arrangements often serve little purpose beyond suppressing competition. The anti-competitive effects of ties are two-fold. Ties foreclose competitors of the seller from the market for the tied item, not because the seller's product is of a better quality or is sold at a lower price, but because of the seller's market power over the tying item. Ties also limit the choices of the buyer, who might either prefer to take the tied product from another seller or not to purchase it at all. Due to these anti-competitive effects,
the courts often find tying arrangements violative of the antitrust laws.\textsuperscript{10}

Tie-ins represent \textit{per se} violations of the Sherman Act\textsuperscript{11} and the Clayton Act\textsuperscript{12} if three elements are satisfied.\textsuperscript{13} First, the tying arrangement must involve two or more separate products.\textsuperscript{14} Second, the seller must hold sufficient economic power in the market for the tying product to appreciably restrain competition in the market for the tied product.\textsuperscript{15} Finally, the tie must affect more than an insubstantial amount of interstate commerce.\textsuperscript{16} Even if a plaintiff

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\item \textsuperscript{13} Under the \textit{per se} approach, the court will presume that a tie-in violates the antitrust laws without examining its anti-competitive effects upon the particular industry or the reasons for its use. Northern Pacific Ry. v. United States, 356 U.S. 1, 5 (1958). However, because the court will look to the economic power of the tying party and the effect on interstate commerce, see text accompanying notes 15 & 16 infra, the judicial analysis resembles a modified \textit{per se} rule under which some inquiry into the economic effects of the tie is required. Moreover, there is evidence suggesting that the \textit{per se} approach has been overruled. See notes 47 & 120-22 infra and accompanying text.
\item \textsuperscript{14} Fortner Enterprises v. United States Steel Corp., 394 U.S. 495, 507 (1969). This element represents the separability issue, which is the focus of this article. See note 2 supra and accompanying text.
\item Some courts have required two additional elements to establish a \textit{per se} violation of the antitrust laws: individual coercion and damages. For an overview of the dispute over whether individual coercion is a separate element of a \textit{per se} tie-in violation, see Dore, supra note 15, at 411-12 n.15.1; Note, \textit{Tying Arrangements and the Individual Coercion Doctrine}, 30 VAND. L. REV. 755 (1977). In reference to the damages element, see Bogosian v. Gulf Oil Corp. 561 F.2d 434, 454 (3rd Cir. 1977), \textit{cert. denied}, 434 U.S. 1086 (1978); Response of
cannot establish the elements of a per se violation, a tie-in may still violate the antitrust laws if the arrangement unreasonably restrains competition. Moreover, a tie-in which does not violate either the Sherman or Clayton Acts may still be struck down if the arrangement constitutes an "unfair method of competition."  

In a franchise agreement, the tying product is the franchise and the tied products are typically the supplies that the franchisee must purchase to operate his business. An analytical obstacle in determining if a tie exists lies in distinguishing the items which constitute part of the franchise itself from those items which represent separate tied products. The difficulty in drawing this distinction depends upon whether the franchise consists merely of a trade name and the product which it identifies, or whether it consists of a pre-packaged business format.

Carolina, Inc. v. Leasco Response, Inc., 537 F.2d 1307 (5th Cir. 1976). See also note 133 infra and accompanying text.


20. See note 2 supra and accompanying text.

21. Trade name and product franchising, which is known as the traditional type of franchising, consists of an arrangement whereby the franchisee distributes the franchisor's product under the franchisor's label. U.S. DEPT. OF COMMERCE, FRANCHISING IN THE ECONOMY, 1978-1980, at 1 [hereinafter cited as FRANCHISING--1980]. This form of franchising, which accounted for over 75% of all franchise sales for 1980, includes gasoline service stations, retail automobile dealers, and soft drink bottlers. Id.

22. A dispute currently exists whether trademark licenses and the items which make up the trademarked product are separate and distinct. Compare Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972), and Susser v. Carvel Corp., 332 F.2d 505, 519 (2d Cir. 1964), cert: dismissed as improvidently granted, 381 U.S. 125 (1965) (trademark may be a separate and distinct product from the item it identifies), with Redd v. Shell Oil Co., 524 F.2d 1054 (10th Cir. 1975), cert. denied, 425 U.S. 912 (1976), and Carvel Corp., 68 F.T.C. 128 (1965) (trademark and product which it identifies constitute one item).

23. In business format franchising a franchisor offers a fully integrated relationship which includes not only the trademark, product, or service, but also a marketing strategy and plan, operating manuals and standards, quality control, and a communications system for information. FRANCHISING—1980, supra note 21, at 3. This type of franchising, which is also referred to as "pure" or "enterprise" franchising, is growing at a faster rate than the trade name franchising. Id. A form of the business format franchise, known as a "turn-key" operation, provides a completely outfitted store, which the franchisee can purchase and immediately begin business. See Zeidman, The Two Product Test in Franchising: If You Want to Get X, You Gotta Buy Y, 1980 ARIZ. ST. L.J. 433, 444 (1980) [hereinafter cited as Zeidman].
Hampering the formulation of a viable single product test is the courts' failure to distinguish between business format franchises and other types of franchises.\textsuperscript{24} Separating the franchise from the tied product is more complicated in the business format franchise, because it necessarily includes numerous interrelated items and services. The majority of franchise tie-ins occur in the business format franchise, due to the franchisor's need to protect his good will.\textsuperscript{25} Despite their aversion to tie-ins generally, potential franchisees are attracted to the business format franchise because of the unique advantages which it provides.\textsuperscript{26} Given the advantages to both the franchisor and franchisee, business format franchises should be accorded considerable attention in any court's formulation of a separability test.

**BACKGROUND**

*Non-franchising Cases*

The single product issue first arose in non-franchising cases. The separability standards developed in the non-franchising cases have subsequently formed the foundation of the courts' analyses of separability in franchising situations. Although the Supreme Court has specifically refused to set forth standards for determining sep-

\textsuperscript{24} See Note, *Chicken Delight "Per Se" Doctrine Extended to Distributorship Franchise*, 4 SETON HALL L. REV. 610, 621 (1973).

\textsuperscript{25} See note 38 infra. The success of any franchising system depends upon the maintenance of certain controls on the franchisee. J. RICE, THE FRANCHISING PHENOMENON 116-17 (1969) [hereinafter cited as RICE]. The owner of a trademark is required by law to protect the use of the trademark and ensure the quality of the goods the mark identifies. The Lanham Act, 15 U.S.C. § 1055 (1964). See generally Gilson, *Trademarks: Sine Qua Non of Franchising*, 52 Chi. B. Rev. 228 (1971). Moreover, controls are needed to maintain the public image developed by the franchisor. See RICE, supra at 116-17. The public image must be uniform, because consumers base their buying decisions on the basis of past satisfaction with a particular brand name. Comment, *Trademark Franchising and Antitrust Sanctions: The Need for a Limited Rule of Reason*, 52 B.U.L. REV. 463, 476 (1972). By requiring franchisees to purchase certain goods from the franchisor, the franchisor can assure uniform items in each store. In the case of trade name franchises, the franchisor need only supervise the trademarked product to insure uniformity. But in the business format franchise, the franchisor must supervise a multitude of items to assure uniformity. Another justification, besides good will, which franchisors offer for requiring franchisees to purchase certain goods from the franchisor, is that a franchisor can buy the supplies cheaper because of volume purchases. See Hunt & Nevin, supra note 19, at 22.

\textsuperscript{26} Franchises provide franchisees: the opportunity, as individuals, to become independent businessmen; low entry barriers and minimum capital requirements; a higher likelihood of success due to established products; and the opportunity to expand businesses. See Horwitz & Volpi, supra note 3, at 228-44. Additional benefits of a business format franchise may include market research, advertising, and real estate development. See, Note McDonald's Litigation, supra note 15, at 1 n.5.
arability, certain approaches to the single product issue have been utilized.

**Fungibility (Single Market)**

The Supreme Court first dealt with the issue of separability in a case involving a publisher who refused to sell separate advertising space in his two papers. The Court held the tying precedents in-

27. See Fortner Enterprises v. United States Steel Corp., 394 U.S. 495 (1969). Fortner involved a tying arrangement in which the credit subsidiary of U.S. Steel refused to extend credit for purchasing land unless the borrower agreed to erect prefabricated homes manufactured by U.S. Steel on each lot. The Court rejected defendant's argument that the credit and the homes represented a single product. The Court expressly refused to explain, however, which standards were to be used for determining whether a single product exists. Id. at 507. The Court did mention certain factors which may have influenced its decision, including the fact that the products were supplied by separate corporate entities and the tied products were sold at an artificially high price. Id. One critic terms the Court's failure to establish separability standards "an abrogation of judicial responsibility." Ross, The Single Product Issue in Antitrust Tying: A Functional Approach, 23 Emory L.J. 963, 1002 (1974) [hereinafter cited as Ross]. See also Bauer, supra note 1, at 306.


In Int'l Business Machines Corp. v. United States, 298 U.S. 131 (1936), the defendant leased its patented computing machine on the condition that it be used only with punch cards manufactured by IBM. Id. at 132. IBM contended that the patent of the machine granted a monopoly of the right to make and sell the cards used with the machine, Id. at 136, and that the tie-in was necessary to protect IBM's good will, because improperly made cards could damage the machines. Id. at 138. The Court disagreed, declaring that tie-ins are illegal even where the tying item is patented. Id. at 137. The Court also rejected the good will argument, noting that the less restrictive alternative of specifying standards for the cards would adequately protect IBM's good will. Id. 139-40.

The Court faced a similar situation in Int'l Salt Co. v. United States, 332 U.S. 392 (1947), where it held that leases of patented salt dispensing machines which required the lessee to use the machines only with salt purchased from the lessor created an illegal tying arrangement. The Court affirmed IBM and, using per se language for the first time, presumed sufficient market power solely from the possession of the patent.

In Times-Picayune Publishing Co. v. United States, 345 U.S. 594 (1953), the Court retreated somewhat from this position by suggesting that, at least in cases not involving patents or copyrights, proof of a dominant position in the tying product market would be required. The tie-in claim was dismissed because the defendant did not possess a dominant position in the relevant market. Id. at 611.

Times-Picayune's strict market dominance test proved to be a temporary standard, for it was relaxed in Northern Pac. Ry. v. United States, 356 U.S. 1 (1958). In Northern Pacific, the Court rejected the requirement of tying product dominance and adopted what has remained the present standard—sufficient economic power in the tying product to restrain competition in the market for the tied product, and a not insubstantial amount of interstate
applicable because the newspaper advertising arrangement involved only one product. Focusing on the market for the allegedly tied products, the Court found it significant that the advertisers considered the readers of both papers as "fungible customer potential." The Court failed, however, to weigh certain factors which later courts found persuasive as evidence of separability. These factors included the distinct features and format of the two papers which attracted separate reading groups, and the existence of separate pricing which was not eliminated until seventeen years after the paper was acquired.

Nine years later, the Supreme Court rejected a fungibility argument made by a defendant who maintained that the practice of conditioning the sale of successful movies to television stations on the stations' purchasing less successful movies did not constitute an illegal tie. The defendant argued that the relevant market was the television viewership, so that each movie became fungible with other movies and other forms of programming. The Court held that, regardless of the medium of exhibition, each film was a unique product due to its copyright. The Court's focus on the products themselves, rather than on the market for the products, suggests that the fungibility theory no longer represents a viable analysis of the single product issue.

commerce affected in the tied market. Id. at 6. See notes 13-16 supra and accompanying text. For a synopsis of the history of the tying doctrine, see generally L. SULLIVAN, HANDBOOK ON THE LAW OF ANTITRUST §152 (1977).

29. The Court also dismissed the case for lack of dominant economic power, another factor in the per se analysis. Times-Picayune Publishing Co. v. United States, 345 U.S. 504, 611 (1953). See text accompanying note 11.

30. Id. at 613.

31. See Ross, supra note 27, at 974 n.54.


33. Id.


37. Despite the Supreme Court's apparent dissatisfaction with the fungibility test, the Fourth Circuit utilized such an analysis as recently as 1971 in Washington Gas Light Co. v. Virginia Electric & Power Co., 438 F.2d 248 (4th Cir. 1971). The case involved an electric company which at first charged home developers for installing equipment necessary to deliver electricity, but then dropped the installation charge to those builders who went "all
Legitimate Business Reasons

The Supreme Court has severely limited the use of legitimate business reasons as a defense to tie-ins. Nonetheless, and even though such a defense may conflict with the per se rule against tying arrangements, lower courts continue to recognize legitimate business reasons in determining separability.

A landmark case using the legitimate business reasons test involved a defendant charged with illegally tying both ancillary components and service contracts to the sale of its newly-developed, specialized equipment. The court recognized that although a manufacturer cannot be forced to deal in the minimum product that usually would be sold, the manufacturer must have legitimate reasons for selling normally separate items in a combined form. The court then considered four factors to aid in the separability determination, and suggested that on the basis of these factors

electric.” Id. at 250. The gas company alleged that this arrangement illegally tied the purchase of electric power to the “credit” available for free installation, relying on the Supreme Court’s decision in Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495 (1969), which established that credit can be a separate tying product. See note 27 supra.

The Fourth Circuit found decisive the lack of dual markets for the installation of the equipment and electricity. 438 F.2d at 253. The court also determined that because the delivery equipment was ancillary to the electricity, it did not constitute separate products. Id. Cf. Crawford Transport Co. v. Chrysler Corp., 235 F. Supp. 751 (E.D. Ky. 1962), aff’d, 338 F.2d 934 (6th Cir. 1964), cert. denied, 380 U.S. 954 (1965) (delivery service ancillary to purchase of cars). But cf. Anderson Foreign Motors Co. v. New England Toyota, 475 F. Supp. 973 (D. Mass. 1979) (delivery of cars not ancillary to purchase of cars and thus are separate products). Rather, the court held that the defendant sold only one product, electricity, and that all electricity is physically fungible. 438 F.2d at 253. The court failed to distinguish the additional electricity used when the builders went “all electric” from the amount used by those who did not. See Ross, supra note 27, at 982, 983 & n.102, where the writer discusses this case more for its illogic than for its contribution to the problem.

38. In Standard Oil Co. v. United States, 337 U.S. 293, 306 (1949), the Supreme Court stated:

The justification most often advanced in [tying agreements'] defense—the protection of the good will of the manufacturer of the tying device—fails in the usual situation because specification of the type and quality of the product to be used in connection with the tying device is protection enough . . . The only situation, indeed, in which the protection of good will may necessitate the use of tying clauses is where specifications for a substitute would be so detailed that they could not practicably be supplied.

39. See note 13 supra and accompanying text.


41. 187 F. Supp. at 559.

42. Id. The court considered: (1) the practice of the seller’s competitors; (2) whether the number of components bought varied among buyers; (3) whether the buyers are charged on
alone the defendant’s practice constituted an illegal tying arrange-
ment.\textsuperscript{43} The court found, however, that the package deal was based
on legitimate business reasons, and thus did not constitute an ille-
gal tie.\textsuperscript{44} The court did note that as the legitimate business reasons
became less prevalent over time, the packaged sale would no longer
be an appropriate sales unit.\textsuperscript{45} Rather than hold that the defen-
dant justifiably sold separate products together, the court found
that no tie-in existed because the justifications evidenced a single
product.\textsuperscript{46}

Although commentators have widely criticized this analysis,\textsuperscript{47}
some courts have adopted similar reasoning.\textsuperscript{48} Yet, the legitimate
business reasons test has not become the final resolution of separa-
bility, particularly because the growth of franchising has added
new dimensions to the single product issue.

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\item a \begin{tabular}{l}component basis or by the product; and (4) whether all the necessary components must be\end{tabular} bought from the seller. One writer has developed these factors into separate tests. Note, \textit{Product Separability: A Workable Standard to Identify Tie-In Arrangements Under the Antitrust Laws}, 46 S. CAL. L. REV. 160, 165-75 (1972) [hereinafter cited as Note, \textit{Product Separability}].

\item 43. 187 F. Supp. at 560.

\item 44. \textit{Id.} The court found that Jerrold’s packaged product was necessary to protect the company's good will, because the equipment was newly-developed and highly specialized, thus requiring special care. If Jerrold could not maintain the system, malfunctioning equipment would hinder acceptance of the product. \textit{Id.} Nevertheless, the court rejected Jerrold's justification that the extra income from the package would help the company recoup the time and effort spent in developing the system. \textit{Id.} at 560-61.

\item 45. \textit{Id.} at 560. As the product established a dependable reputation, and as others became familiar with maintaining the system, Jerrold's legitimate business reasons would disappear. \textit{Id.} Thus, separability may change at different points in time. See Wheeler, \textit{Some Observations on Tie-Ins, the Single-Product Defense, Exclusive Dealing and Regulated Industries}, 60 CALIF. L. REV. 1557, 1561 (1972) [hereinafter cited as Wheeler]. This is often termed the “New Entrance Defense.” See, e.g., Bauer, \textit{supra} note 1, at 326.

\item 46. 187 F. Supp. at 560.

\item 47. One writer terms the \textit{Jerrold} court's insertion of justifications into the separability issue “unfortunate.” See Ross, \textit{supra} note 27, at 991. Another commentator refers to the court's analysis as “conceptual gymnastics,” and asserts that it overturns the per se rule. See Wheeler, \textit{supra} note 45, at 1561. See also note 120 infra and accompanying text. \textit{But cf.} Note, \textit{Antitrust: Tying Arrangements: Tying of Goods and Service Justified by a “Sound Business Reason”}, 49 CALIF. L. REV. 746, 749 (1961) (court only meant that under the circumstances a full systems sales policy was reasonable).

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The Franchising Cases
The Traditional Franchises

Although the Supreme Court has never dealt with tying arrangements in franchises, the lower courts have attempted to formulate standards for determining if a single product exists. The doctrine governing tying arrangements in franchises arose out of a challenge to a traditional franchise tie of supplies to a franchise license. Taking the first major step toward outlawing such arrangements, the Second Circuit found that a trademark could constitute a separate tying item under the antitrust laws. The court, holding that separate products existed, rejected the franchisor’s argument that the trademarked items represented a single “end” product sold to the public.

The determination that a trademark can be a tying item set the stage for the landmark case of Siegel v. Chicken Delight. In Chicken Delight, the franchisor did not charge a franchise fee or royalties; rather, it required licensees to purchase cooking equipment, package supplies, and mixes directly from the franchisor at a higher price than other sellers charged. The defendant contended that the trademark and franchise licenses were not separate and distinct items from the packaging, mixes, and equipment, because all were essential components of the franchise. Reasoning that a trademark forms the tying item in a franchise, the Ninth Circuit held that the determination of whether the trademark and supplies

49. Susser v. Carvel Corp., 206 F. Supp. 636 (S.D.N.Y. 1962), aff’d, 332 F.2d 505 (2d Cir. 1964), cert. dismissed as improvidently granted, 381 U.S. 125 (1965). Among the items allegedly tied were the ice cream mix, cones, toppings, patented freezes, and paper goods. 206 F. Supp. at 638.
50. 332 F.2d at 513. The Second Circuit disagreed with the district court’s holding that a trademark could not be a tying item. 206 F. Supp. at 640. The Second Circuit’s conclusion also conflicted with the FTC’s determination in an independent proceeding involving the Carvel franchise system. See Carvel Corp. 68 F.T.C. 128 (1965). However, the agency has since changed its opinion, now holding that trademarks can be tying items. See In re Chock Full O’Nuts Corp., [1973-1976 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 20,441 (FTC 1973). See also note 22 supra.
51. 332 F.2d at 514. The court rejected the defendant’s contention that the public buys one product—a sundae or an ice cream cone. Rather, the court noted that the defendant sold the items separately to its franchisees. Id. The court of appeals, however, did affirm the lower court’s finding that the tie of the ice cream mix was justified because it involved a secret formula and thus came within the Supreme Court’s limited acceptance of the good will defense. See note 38 supra.
52. 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972).
53. Id. at 46-47.
54. Id. at 47-48.
were separate and distinct depended upon the "function of the aggregation." The court added that relevant considerations in ascertaining this function included whether any cost savings resulted from the amalgamation other than the savings normally associated with any tie-in, and whether the items are normally sold or used as a unit with fixed proportions.

After determining that the trademark and supplies were separable, the court of appeals looked not to whether the items were essential to the franchise, but to whether it was essential to the franchise that the items be purchased from the franchisor. Despite acknowledging good will as a legitimate business justification, the court held that such justification could not be upheld where less restrictive alternatives existed. Because specifying the type and quality of the product to be used in conjunction with the tying item presented a less restrictive means of protecting good will, the court declared the tie illegal.

Packaged Franchises

The recent increase in packaged, turn-key franchises has compounded the single product issue. The turn-key operation emphasizes one of the primary attractions of the franchise system to franchisees: a package deal including many, if not all, of the items necessary to operate the business. Although some turn-key franchises have survived judicial scrutiny, most courts carefully

55. Id. at 48.
56. Id.
57. Id. at 49 ("[T]he goodwill of the Chicken Delight trademark does not attach to the multitude of separate articles").
58. Id.
59. Id. at 51. The court rejected the defenses that the arrangement was necessary to collect revenue and that the new business justification applied. Id. at 50-51. See note 46 supra.
60. Id. at 51.
61. Id. at 51-52. The Fifth Circuit has applied the function of the aggregation analysis in several franchising cases. See, e.g., Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d. 368 (5th Cir. 1977); Warriner Hermetics, Inc. v. Copeland Refrigeration Corp., 463 F.2d 1002 (5th Cir. 1972). The Ninth Circuit has extended the function of the aggregation analysis to non-franchising cases. See, e.g., Moore v. Jas. H. Matthews & Co., 550 F.2d 1207 (9th Cir. 1977); In re Data General Corp. Antitrust Litigation, 1980-1 Trade Cas. ¶ 63, 219 (N.D. Cal. 1980).
62. See note 23 supra.
limit these operations to prevent circumvention of the antitrust laws. Some courts allow only those elements which are integral or essential to the franchise to escape tie-in claims. Until recently, only one court had unconditionally accepted a lease as an integral component of a franchise package.

**PRINCIPE v. MCDONALD'S CORPORATION**

**Factual Background**

The *Principe* case arose out of a McDonald's Corporation policy requiring its franchisees to operate their restaurants on premises leased from McDonald's. McDonald's does not consider itself a fast food retailer, but rather considers its business as developing a system of fast food restaurants. Accordingly, McDonald's does

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65. In *Beefy Trail, Inc. v. Beefy King Int'l, Inc.*, 348 F. Supp. 799 (M.D. Fla. 1972), a district court in the Fifth Circuit allowed the franchising of a fully equipped restaurant which had been in operation for more than six months as a company-owned restaurant. The franchisee claimed that the equipment which was already in place in the store included items which were tied to the franchise. The court ruled that such a sale in isolation did not constitute a tying arrangement, because the equipment had become fixtures in the restaurant. *Id.* at 806-07. The court added, however, that "a different situation might exist under the circumstances where the franchisor by an intentional course of conduct seeks to circumvent the antitrust laws concerning tying arrangements by requiring a franchisee to purchase a restaurant and its equipment previously established. . . ." *Id.* at 807.

The Court of Appeals for the Fifth Circuit had an opportunity to examine the *Beefy Trail* reasoning in *Carpa, Inc. v. Ward Foods, Inc.*, 536 F.2d 39 (5th Cir. 1976). *Carpa* involved a franchisor who built seafood restaurants, including the interior design and equipment, before leasing the restaurants to franchisees. The franchisor argued that his practice was acceptable under *Beefy Trail*, because construction often began without knowing if the restaurant would be franchised or company-owned. The court ruled that the franchisor's practice came within the *Beefy Trail* caveat and limited *Beefy Trail* to isolated instances. *Id.* at 46.

66. The Eighth Circuit has held that although advertising is not a product separable from the franchise license, since advertising is essential to the value of the license, Kugler v. AAMCO Automatic Transmission, Inc., 460 F.2d 1214 (8th Cir. 1972), a lease agreement is separable. Northern v. McGraw-Edison Co., 542 F.2d 1336 (8th Cir. 1976), *cert. denied*, 429 U.S. 1097 (1977). Similarly, the Seventh Circuit has found an illegal tying arrangement in a franchisor's requirement that its franchisees lease their kiosks from the franchisor. Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980). The franchisor could have offered a complete package without the lease agreement and still have satisfied the franchisee's desire to obtain a packaged franchise. *Id.* at 725.

67. *See In re 7-11 Franchise Antitrust Litigation*, 1974-2 Trade Cas. ¶ 75,429 (N.D. Calif. 1974), (advertising, merchandising service, and lease agreement are integral to franchise).

68. McDonald's Corporation was founded in 1954 when Ray Kroc entered into an agreement with the McDonald brothers to license McDonald's franchises. Note, *McDonald's Litigation*, supra note 15, at 610.

69. 631 F.2d at 305. McDonald's is the nation's leading fast food franchisor. At the time of trial, more than 4,700 McDonald's restaurants existed, of which some 3,500 were franchised. Appellant's Brief at 6.
not sell any equipment or supplies to its franchisees. At the time the Principes filed suit, the McDonald's enterprise consisted of McDonald's Corporation and its three subsidiaries. McDonald's Systems, Inc. controls franchise rights and licenses franchisees to sell fast food under the McDonald's name. Franchise Realty Corp. purchases or leases real estate, builds McDonald's restaurants, and leases them to either franchisees or a third corporation, McOpCo. McOpCo operates approximately one-fourth of the McDonald's restaurants in the United States as company-operated stores.

McDonald's systematically plans a pattern of new restaurant placement for different locales based on the company's detailed research and analysis of marketing information. Once McDonald's decides to locate a new restaurant in an area, it makes arrangements for the acquisition and development of a specific site without regard to who will operate the proposed restaurant. After deciding to build a restaurant on a particular site, McDonald's makes a separate, independent decision whether the restaurant will be company-operated or franchised. When it decides to franchise, McDonald's often does not determine a specific franchisee until

70. 631 F.2d at 305. When a franchisee leases a McDonald's restaurant, the restaurant contains no kitchen or dining room equipment. Id. at 306.

71. The three subsidiaries are McDonald's Systems, Inc., Franchise Realty Corp., and McOpCo. These corporations will hereinafter be referred to collectively as "McDonald's," except as otherwise noted.

72. 631 F.2d at 305. By the time the Principe case was decided, McDonald's Systems had merged into McDonald's Corporation, the parent. Id., n.3.

73. Franchise Realty Corp. was formed two years after the McDonald's Corporation began, because profits from the franchise fees alone had proven insufficient. Note, McDonald's Litigation, supra note 15, at 610. McDonald's devised a system whereby it leases the land from the property owners on a subordinate basis: the lessor takes back a second mortgage so that McDonald's can obtain a first mortgage, with the land being subordinated to the building. The first mortgage is usually for no more than a ten-year period, while the leases by McDonald's are for twenty years. The franchisees pay McDonald's monthly payments which cover McDonald's mortgage and other expenses and provide a profit. After the initial ten-year period, McDonald's mortgage is paid off and the remainder of the franchisee's payments represent pure profit. Id. See R. Kroc, GRINDING IT OUT, THE MAKING OF McDoN-ALD's 83-103 (1977). Furthermore, the franchisees must maintain the building and pay for improvements and taxes. 631 F.2d at 307. Until 1961, approximately 25 franchisees neither leased nor subleased from Franchise Realty Corp. Soon after, McDonald's decided that there would be no more exceptions to its leasing policy. Note, McDonald's Litigation at 610 n.22.

74. 631 F.2d at 305.

75. Id.

76. Id. at 306.

77. Id.
the store is nearly completed, because the franchise might be offered to and rejected by several different applicants.\textsuperscript{78} Regardless of who will operate the restaurant, every building is constructed with the same distinctive features (golden arches, brick and glass construction, and unique roofline) which identify it as a McDonald's, even where zoning restrictions preclude signs.\textsuperscript{79}

Frank and Ann Principe became McDonald's franchisees in 1970\textsuperscript{80} by executing a twenty-year franchise license agreement with McDonald's Systems, Inc., and a separate twenty-year lease agreement with FRIC.\textsuperscript{81} The Principes became franchisees of a second McDonald's restaurant in 1974 under terms similar to those of the first franchise agreement and lease.\textsuperscript{82} Although the Principes sought a third franchise, McDonald's, after extended corporate review, refused their request.\textsuperscript{83}

A few days after denial of their request, the Principes filed suit, alleging that McDonald's violated antitrust laws by tying the store leases to the franchise rights.\textsuperscript{84} The district court directed a verdict for McDonald's on the tie-in claim.\textsuperscript{85} The Court of Appeals for the
Fourth Circuit affirmed the district court, holding that the lease did not constitute an item separate and distinct from the franchise license. 86

**The Fourth Circuit's Decision**

The Fourt Circuit began its analysis with a thorough review of McDonald's method of doing business. 87 The court then distinguished two previous cases which had examined leases as part of franchise packages and found illegal ties. 88 According to the court, neither case decided the right to conduct a business in a specific company-owned store; nor did either case involve superior expertise, elaborate market research, or substantial investment on the part of the franchisor. 89 The court further discounted these cases because they failed to elaborate on the separability issue. 90

Moreover, the court rejected Siegal v. Chicken Delight91 as controlling. 92 Because Chicken Delight emphasized the trademark as the essence of the franchise 93 the court limited Chicken Delight's potential relevance to situations in which a franchisor merely licenses franchisees to sell products under a tradename, as opposed to a modern franchisor who offers a complete method of doing business. 94

The Fourth Circuit declined to examine the alleged tie from the public's point of view, but instead viewed the issue as whether the items were "integral components of the business method being franchised." 95 Applying this standard, the court held that the lease does not constitute an item separate from the franchise, because the company-owned restaurants are an integral part of what makes

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86. Id. at 304.
87. Id. at 305-07.
88. Id. at 309 n.6. See note 66 supra.
89. Id.
90. Id.
91. 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972).
92. 631 F.2d at 309.
93. See text accompanying note 55 supra.
94. See notes 21-26 supra and accompanying text. The court found that McDonald's method of doing business left nothing to chance and virtually guaranteed a franchisee's success. 631 F.2d at 309.
95. Id.
a McDonald's franchise uniquely attractive.96 The court then examined the reasons for the unique attractiveness of the McDonald's real estate policy, enumerating four benefits embodied in this policy. First, McDonald's expertise enables it to obtain better sites than the franchisees could select, which benefits the franchisees.97 In a footnote, the court rejected the less restrictive alternative of requiring corporate approval of franchisees' site selections, based on testimony that McDonald's planning and acquisition experts would not remain with McDonald's if their roles became advisory.98 Second, McDonald's policy of owning its own restaurants ensures that the stores remain part of the McDonald's system.99 The good will of the entire system is thereby protected, because McDonald's can maintain the stores' patronage even during management changes and avoid the negative publicity of having its food stores used for other purposes.100 Third, McDonald's practice of investing its own money in acquiring the sites and building the restaurants allows it to select franchisees on the basis of management potential rather than wealth.101 This practice greatly benefits the franchisees by lowering their initial investment.102 Finally, since both McDonald's and the franchisee have a substantial financial stake in the success of the restaurant, their relationship becomes a partnership that might be impossible under another arrangement.103

In conclusion, the Fourth Circuit found that because these four factors contribute significantly to the overall success of the McDonald's system, they are part of the formula which McDonald's sells. Thus, the court held that there was no illegal tie because there was only one product.104

**ANALYSIS**

Although the *Principe* decision appears to be a major victory for
franchisors, its value as precedent is questionable. Not only did the Fourth Circuit dismiss the precedential value of cases which found that leases were not integral components of a franchise package, it also ignored factors which other courts have found indicative of separate products.

The court further departed from precedent in defining an integral component of the franchise as one which is advantageous to the franchise. Applying this standard to McDonald's real estate policy, the court found that the policy's substantial benefits rendered the lease agreement an integral component of the franchise. Rather than recognize that the leasing policy, although perhaps justified, constituted a separate product, the court ruled that the policy's contribution to the success of the franchise indicated a single product.

The court failed to consider that most ties contribute to the success of a business. Regardless, tying arrangements have been declared illegal because they limit choices and impair competition. The *Principe* decision justifies a tie on the basis of its advantages to a franchise system without considering the anticompetitive ef-

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105. See Davis & Poole, *Courts Retreat from “Per Se” Rule in Franchising*, *Legal Times of Washington*, October 27, 1980, at 15, col. 4 (hereinafter cited as Davis & Poole).
106. See text accompanying note 89 *supra*. The court suggested that a franchisor may avoid the prohibition against tying arrangements by developing great expertise on the tied item, performing elaborate market research, and investing substantial sums of money in the tied item. 631 F.2d at 309 n.6.
107. The court never accounted for McDonald's not requiring the lease agreement when it first began its franchising business, but later developing the real estate policy to increase corporate profits. See note 73 *supra*. See generally Ross, *supra* note 27 at 974 n.54. Nor did the court consider that the franchise agreement and the lease were provided for by separate corporate entities, see notes 72 & 73 *supra* and accompanying text, and that McDonald's continued to use separate franchise and lease agreements for 15 years after the restriction on changing the original franchise agreement ended. See note 80 *supra*. See generally Fortner Enterprises, Inc. v. United States Steel Corp., 394 U.S. 495, 507 (1969); Washington Gas Light Co. v. Virginia Elec. & Power Co., 438 F.2d 248, 253 (4th Cir. 1971). Many of the factors ignored by the *Principe* court are emphasized as evidence of separate products in *Washington Gas Light Co.*, which, like *Principe*, was decided by the Fourth Circuit. The *Principe* court also failed to compare McDonald's real estate policy with that of its competitors. See note 42 *supra*. But see Zeidman, *supra* note 23, at 446-47 (each franchise system is so unique that the courts cannot reliably look to industry practice).
108. 631 F.2d at 309-10. Previous courts have interpreted an integral component as one which is necessary or essential to the offering of a franchise package. See note 66 *supra* and accompanying text.
109. See text accompanying notes 97-103 *supra*.
110. 631 F.2d at 311.
111. See Davis & Poole, *supra* note 105, at 15, col. 3.
112. See notes 7 & 8 *supra*.
fects of the tie.

The court also failed to consider whether legitimate business reasons justify the alleged tie of the two items, and instead allowed the real estate policy's advantages to evidence a single product. This commingling of the separability issue with possible defenses renders the separability issue dependent upon the substantiality of the alleged tie-in's advantages. The Supreme Court has suggested that business justifications be determined independently of the single product issue. The confusion of issues also creates difficulties in distinguishing questions of law from questions of fact.

In addition, because the legitimate business reasons test requires a factual determination in each case, its commingling with the separability issue offers no guide by which franchisors may conduct future business.

The advantage of considering the business justifications defense as part of the initial separability issue is that such consideration leaves intact the per se approach to tying arrangements and avoids the necessity of undertaking an examination of their economic effects. Nevertheless, the widespread acceptance of busi-

113. Ross, supra note 27 at 992. Furthermore, a distortion of the burdens of pleading and proof results. Ross, supra note 27 at 992. The plaintiff has the burden of proof on all issues constituting the single product determination, whereas the defendant has the burden of proof with respect to establishing business justifications. See Carpa, Inc. v. Ward Foods, Inc., 536 F.2d 39, 46 (5th Cir. 1976); Anderson Foreign Motors, Inc. v. New England Toyota Distributor, Inc., 475 F. Supp. 973, 981 (D. Mass. 1979); Dore, supra note 15, at 413 n.20; Comment, Tying and Exclusive Dealing Agreements: Protection for Franchise Trademark Licensors, 45 Tul. L. Rev. 1016, 1023 (1971) [hereinafter cited as Comment, Tying and Exclusive Dealing].


115. Dore, supra note 13 at 416. Another problem with the legitimate business reasons test is that it views the arrangement solely from the seller's point of view. Id. at 417. Cf. note 51 supra and accompanying text.

116. See note 13 supra. Advantages of the per se approach are that it is easier, quicker, surer, and has a greater deterrent effect than the rule of reason approach. Bauer, supra note 1 at 286; Wheeler, supra note 45 at 557. See generally Osborn v. Sinclair Refining Co., 286 F.2d 832 (4th Cir. 1960), cert. denied, 366 U.S. 963 (1961); Bauer, Per Se Illegality of Concerted Refusals to Deal: A Rule Ripe for Reexamination, 79 Colum. L. Rev. 685, 694 (1979); Bork, The Rule of Reason and the Per Se Concept, 74 Yale L. J. 775 (1965).

117. See Dore, supra note 15 at 412; Note, Trademark Franchising and Antitrust Law: The Two Product Rule for Tying Arrangements, 27 Syracuse L. Rev. 953, 964 (1976). But see Recent Cases, 84 Harv. L. Rev. 1717, 1719 (1971) (a court must not end consideration of an alleged tie by ruling that the items are not separate unless it is clear that no economic
ness justifications for franchise tying arrangements, coupled with
the confusion caused by attempting to force these justifications
into the separability analysis, may indicate the need to abandon
the per se approach and adopt a rule of reason.\textsuperscript{118} In fact, it has
been widely recognized that the legitimate business reasons test
has in substance overruled the per se approach to tie-ins.\textsuperscript{119} Some
antitrust observers have also suggested that \textit{Principe} actually over-
ruled the per se analysis and adopted the rule of reason approach
to franchise tying claims.\textsuperscript{120}

\textit{Principe} also demonstrates that, as business justifications con-
tinue to be a decisive factor in franchise tying arrangements, courts
must determine which justifications will vindicate an otherwise il-
legal tying arrangement. Although the Supreme Court has limited
acceptable justifications to good will situations requiring specifica-
tions too intricate to be reasonably provided, the lower courts have
considerably expanded the good will defense.\textsuperscript{121} \textit{Principe}, in fact,
accepted three justifications unrelated to good will.\textsuperscript{122}

Although the Fourth Circuit characterized these business justifi-
cations as unique benefits, it remains doubtful that McDonald’s
real estate policy is totally responsible for these benefits. For in-
stance, the court’s finding that the real estate policy allows Mc-
Donald’s to select franchisees on the basis of management poten-
tial rather than wealth\textsuperscript{123} ignores the fact that McDonald’s must
choose franchisees with good management potential in order to

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\item \textsuperscript{118} See Garlick, \textit{Pure Franchising, Control and the Antitrust Laws: Friends or Foes?}, 48 J. Uls. L. 835, 881 (1971) (hereinafter cited as Garlick) (at least, the per se rule should not apply to pure franchises); but see, Bauer, supra note 1, at 297-98.
\item \textsuperscript{119} See note 47 supra; Garlick, supra note 118, at 854; Hunt & Nevin, supra note 19 at 23; Comment, Siegel v. Chicken Delight, Inc.: Clarification of the Legality of Franchise Tying Arrangements, 5 Ga. L. Rev. 151, 152 (1970). It has been suggested that neither Congress nor the Supreme Court intended tying arrangements to be per se violations. See Comment, \textit{Antitrust Barriers to Franchising}, 61 Geo. L.J. 189, 199-200.
\item \textsuperscript{120} See Davis & Poole, supra note 108, at 14 col. 1. Another recent franchise case, State v. Lawn King, Inc., 1980-2 Trad. Cas. ¶ 63,488 (N.J. 1980), also represents a departure from the traditional per se approach to franchise tying claims.\textit{Lawn King} arose out of a requirement that franchisees of lawn care products purchase these products from a distributor who, in turn, purchased them from the franchisor. The New Jersey Supreme Court held that the purchasing requirements should be reviewed under a rule of reason rather than a per se analysis because of the unique nature of franchising.\textit{Cf. Continental T.V., Inc. v. GTE Sylvania, Inc.}, 433 U.S. 36 (1977) (rule of reason approach to territorial restraints in franchising).
\item \textsuperscript{121} See note 38 supra and accompanying text.
\item \textsuperscript{122} See text accompanying notes 97-103 supra.
\item \textsuperscript{123} See text accompanying note 101 supra.
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protect McDonald's good will, irrespective of the real estate policy. Also, the claim that the leasing arrangement creates a partnership between McDonald's and its franchisees, due to their mutual stake in the business,\textsuperscript{124} disregards McDonald's substantial stake in the franchise independent of the leasing arrangement. Even assuming the legitimacy of these justifications,\textsuperscript{125} the court clearly departed from the substantial weight of precedent by failing to seriously consider whether less restrictive alternatives would achieve the purposes of McDonald's real estate policy.\textsuperscript{126} The factors present in a case involving McDonald's may not apply to other franchisors, due to McDonald's unique formula for success.\textsuperscript{127} Some observers even maintain that real estate is not essential to a successful McDonald's franchise.\textsuperscript{128} Even so, a tie-in involving real estate

\textsuperscript{124} See text accompanying note 103 supra.

\textsuperscript{125} No court had previously accepted as a legitimate business reason the lowering of the franchisee's initial investment as a result of the alleged tying arrangement. Moreover, this justification ignores the fact that franchisees are denied the opportunity to build equity and depreciate their property when the franchise is company-owned. Furthermore, the justification that the mutual stake of McDonald's and the franchisee in the success of the restaurant creates a better relationship between the parties appears doubtful when balanced against the restraint of competition.

\textsuperscript{126} See Note, Antitrust Law Tie-ins—Chicken Delight and the "Per Se" Doctrine, 4 S\textsc{etton} H\textsc{all} 610, 627 (1973); Comment, Tying and Exclusive Dealing, supra note 113 at 1022. But see Note, Trademark Franchising and Antitrust Sanctions: The Need for a Limited Rule of Reason, 52 B.U.L. Rev. 463, 477 (1972). The Princepe court touched briefly on the less restrictive alternative of allowing McDonald's personnel to approve locations selected by the franchisee, but dismissed this as an unworkable approach because McDonald's presented testimony that their planning and acquisition personnel would leave the company if they become merely advisory. See text accompanying note 98 supra. Whether another court would so summarily dismiss what one writer has termed "the obvious alternative" is doubtful. See H. Brown, Franchising: Realities and Remedies, 174 (1973). The court did not even touch on the less restrictive alternative of protecting the franchisor's good will by requiring that the franchisee offer to sell the premises or assign the lease for the premises upon termination of the franchise.

\textsuperscript{127} McDonald's business methods virtually guarantee a franchisee's success. See note 94 supra. It is questionable, however, whether another franchisor, adopting similar business methods, could make the same claim. This poses the question of whether only a very successful franchisor can employ business methods similar to McDonald's without violating the antitrust laws, or whether even a failing franchisor may employ such business methods, arguing they are necessary for future success. This success factor also raises the issue of whether a franchisor's poor business judgment in implementing an arrangement which fails to guarantee success results in an illegal tie, whereas a fortunate guess insulates the franchisor from tying charges. See Davis & Poole, supra note 105 at 15, col.3.

\textsuperscript{128} See H. Brown, Franchising: Realities and Remedies, 173 (1973); Note McDonald's Litigation, supra note 15 at 619 and 635-36; Davis & Poole, supra note 105, at 15, col. 3; cf. Wolfstone, Antitrust Tying Arrangements: Fortner, FTC, and Statutory Remedies for Automobile Franchise Abuses, 52 O\textsc{reg}on L. Rev. 237, 244 (1973) (leasing arrangements in automobile franchises clearly not essential to the franchisee's success). But cf. McCarthy,
presents problems to a franchisee beyond the question of separability.\textsuperscript{129} Thus, by determining that the lease was not separable from the franchise, the \textit{Principe} court avoided the need to wade through a multitude of other issues before reaching an ultimate decision.

\textbf{CONCLUSION}

As the \textit{Principe} case demonstrates, the current trend in pure franchising compounds the issues surrounding separability. Yet these issues must be resolved to provide a measure of predictability by which pure franchisors can conduct their business. The courts' resolution cannot invalidate a franchisor's way of doing business;\textsuperscript{130} however, a franchisor's way of doing business cannot violate the antitrust laws. Although \textit{Principe} might be inadequate as a precedent for determining if a violation of the antitrust laws exists, the case is invaluable for presenting the issues which any standard of separability must take into account.

\textit{Trademark Franchising and Antitrust: The Trouble with Tie-ins}, 58 Calif. L. Rev. 1085, 1092 (1970) (exterior of a building may be associated with the end product sold to the public and is therefore essential to the franchise).

\textsuperscript{129} See note 16 supra. Because real estate is unique, it is often difficult for a franchisee to prove damages, especially since courts require a plaintiff to establish damages by demonstrating that he could have obtained an equally profitable alternative site. \textit{See}, e.g., Martino v. McDonald's Corp., 1980-1 Trade Cas. ¶ 63,217 (N.D. Ill. 1980) (uniqueness of each real estate parcel also prevents class actions); Kypta v. McDonald's Corp., 1980-1 Trade Cas. ¶ 63,267. Furthermore, it is difficult to establish damages when the franchisor sets the franchisee's rent at fair market value, for the tie-in does not impose upon the franchisee a price above the competitive level. \textit{See} \textit{Note, McDonald's Litigation, supra} note 15 at 633. Even if the franchisor receives a profit on a sublease, the franchisee may not incur damages if the franchisor procured the lease at a rate which is lower than current market rental. It is doubtful whether franchisees should gain from the franchisor's foresight or superior bargaining power without being required to share in potential losses when market rental falls below the rate paid by the franchisor. \textit{But see} Comment, \textit{Franchise Tie-Ins and Antitrust: A Critical Analysis}, Wis. L. Rev. 847, 871 n.180 (1973) (courts are not so much concerned with the economic injury a franchisee may suffer in the form of higher prices as a result of the tie-in as with restricting the business decisions of the franchisees).

\textsuperscript{130} According to McDonald's, the appellants were asking the court to invalidate the way McDonald's does business. \textit{Principe} v. McDonald's Corp., 631 F.2d at 307-08; \textit{See} Appellee's Brief at 16.