Problematic Relations: Franchising and the Law of Incomplete Contracts

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Commitments to take or refrain from taking certain actions are indispensable elements in most forms of interaction and exchange. Even the purest form of spot-market transaction rests on commitments: the commitment of the state to value a piece of paper in future exchanges, and the commitment of the individual not to steal back what has been sold. As transactions spread out over time and become more complex, however, more is needed to ground the exchange than the mere stability of currency and property: The solidity of contract is also required.

In the case of the complete contract, which specifies in a manner immediately verifiable by a third party precisely what performances are required for all possible future conditions, classical notions of contract enforcement serve well to secure the commitment supporting the transaction. In this case, courts stand ready to examine the contract and, going no further than the balance reached in this private ordering, hold the parties to their commitments.[1]

In reality, few contracts can be complete. Accordingly, classic contract law has always provided for the accidental failure of completeness resulting from linguistic ambiguity, or from the absence of provisions specifying the performances required under certain, perhaps unanticipated, conditions. More recently, however, contract scholars have recognized that the failure of completeness is not always a mere stumble on the classical path.[2] Often, contracts are necessarily and intentionally incomplete because mutual desires for flexible, but bounded, responses to uncertain future conditions limit the scope and precision of verifiable terms. Moreover, incomplete contracts often exist deeply embedded in an ongoing relationship. The parties are not strangers; much of their interaction takes place “off the contract,” mediated not by visible terms enforceable by a court, but by a particular balance of cooperation and coercion, communication and strategy.

The confluence of contract and relation makes commitment problematic. Contracts modify an existing relational balance, incorporating the legal system into the relationship.[3] Yet precisely because the relational balance is difficult to alter privately, incompletely specified contractual commitments are vulnerable to unintended modifications; the private relational balance is there to insinuate itself back into place through the gaps in the incomplete contract. To the extent that courts cannot distinguish between the derogation of a commitment in an incomplete contract and an exercise of the flexibility which is a part of that commitment, incomplete contracts cannot fully function in their role as anchor for many complex transactions.

It is in this world of contractual incompleteness and relational complexity that franchising[4] exists. Franchise contracts are the basis of a unique organizational form, in use in the last forty years,[5] that now accounts for one-third of all retail sales.[6] The franchising structure combines elements of integration and delegation, control and independence. The franchise contract creates neither an employment relation nor an independent contracting relationship. It operates in markets subject to rapid change and high levels of uncertainty. It engenders multi-leveled relations: personal and economic, corporate and political. Finally, it poses enormous commitment problems. Although franchisees often make very large sunk investments in their franchises, an exercise of franchisor control may easily threaten a franchisee's investment. In turn, franchisees can reduce, sometimes significantly, the accumulated reputation capital of the franchisor by failing to maintain quality controls.

Such an odd-shaped beast tangles in many areas of the law. Franchising is a significant and problematic force in such areas as anti-trust, product liability, intellectual property, securities and agency law. Most importantly, however, franchising is problematic for contract law. Commentators have attacked franchise contracts as unconscionable and adhesive, and they have urged that exceptional standards of good faith and fiduciary duty should apply to such contracts.[7] Additionally, doctrinal and statutory efforts at both state and federal levels have sought to limit the contractual powers of termination and renewal.[8] Each of these approaches, addresses some aspect of the unusual nature of the franchise contract, yet none satisfactorily strikes at the heart of the problem: the incompleteness of the contracts that structure such a complex relationship, one which requires high levels of commitment to protect large sunk investments against opportunism.

This paper explores an alternative approach to the analysis of franchise contracts which takes seriously their unavoidable incompleteness. The point of departure is the fundamental insight of relational contracting theory, namely that when a contract is embedded within an identifiable relationship, such as the franchise relationship, contractual obligations are often modified, supplemented or completely supplanted by the norms of the ongoing relation.[9] Thus far, the explication of this insight has been along largely theoretical lines.[10] My objective in this article is to further develop the theoretical analysis of the importance of relational elements in order to fashion operational guidelines for courts faced with the difficult concrete task of resolving franchising disputes on the basis of incomplete contracts

I focus first on the economic dynamics created by uncertainty, sunk costs and the allocation of control within the franchise relationship. I argue that these dynamics structure the central commitment problems facing franchisee and franchisor as they endeavor to secure their exchange. Consequently, judicial efforts to identify the obligations created by the franchise contract should be directed at determining if and how these commitment problems have been addressed by the parties. It is at this juncture that the norms of the franchise relationship become important: Where there is no explicit contractual term supplying commitment, where the written contract appears incomplete, courts must look to the norms of the relation itself to see if they functioned to supply needed commitments. Relational norms should not be *imposed* on a particular relationship simply because such norms overcome commitment problems.[11] But the courts should determine the likelihood that the contracting parties *themselves* implicitly or explicitly relied on the relational norms to supply the commitments they could not reduce to written form. Thus relation becomes important because it contributes directly to the obligations exchanged by franchise and franchisor at the formation of their contract; respecting the parties' control over their relationship means that obligations must be understood to have arisen not only from the written document but also from the relation itself.

By integrating economic and relational analysis, this paper argues that courts systematically enforce franchise contracts in a manner that diminishes rather than augments their appropriate function as a means to overcome the central commitment problems that threaten the creation of franchise relationships. In particular, court enforcement systematically defeats the relationally reinforced expectations of franchisees as to what commitments they acquire from the franchisor in exchange for their own commitments. Courts can adequately promote the use of contracts to structure these relationships only by incorporating the relational and economic structure of the franchising arrangement directly into the interpretation and enforcement of contractual commitments.

The organization of the paper follows directly from this emphasis on the need to integrate the economic, relational and doctrinal features of franchising. Section I examines the institutional features of the franchising industry, answering the question, “What is franchising?” Section II analyzes the formal legal structure of franchising, focusing specifically on the contents of written franchise contracts. Section III then moves to the economics of franchising, elucidating the fundamental economic features of the relationship and its attendant bargaining and commitment problems. Section IV shifts to the informal content of the franchise relationship. Here, the paper extracts “relational” norms of franchising relevant to dispute resolution. Section V examines the nature of the franchising disputes that courts resolve, relying on the institutional, relational, and economic analyses of the previous sections to illuminate the problematic features of these disputes. Section VI critiques the current method of resolving these disputes and analyzes how a relational approach to contract interpretations can aid in their resolution.

I. THE FRANCHISING INDUSTRY

A. *Definition*

The threshold problem of defining “franchising” plunges us immediately into the complexity of this modern organizational form. Franchising is a method of structuring a productive relationship between two parties in which both contribute to the production or distribution of the product or service.[12] There are, of course, many such relationships. Here I consider the continuum of such relationships along two key dimensions: ownership and control.[13]

At one end of the continuum is the ordinary employment in relationship, representing a concentration of both ownership and control. In the typical employment relationship, the employer owns essentially all of the assets that produce the fruit of the relationship (except for the employee’s personal assets) as well as the products of the relationship, either tangible goods or revenues. In addition, the employer exercises complete control; she decides what actions both parities will take in the course of the relationship and how the assets of the relationship will be employed. At the other end of the continuum is the ordinary, independent contracting relationship, representing a diffusion of both ownership and control. In this relationship, the parties each own some of the assets that contribute to production. Both parties exercise control as independent decisionmakers with respect to their own assets and actions. The contract creating the relationship sets out concrete obligations on the part of both individuals, which will, of course, influence how each exercises authority.

As is readily apparent from the definition of these endpoints, relationships can quickly blend into a combination of the two. Sometimes an employment contract objectively defines specific employee obligations, making the employee more of an independent contractor along the control dimension: The employer is no longer free to determine employee actions. In comparison, the independent contractor becomes more like an employee along the ownership dimension when the only assets owned by the contractor are personal assets, such as a consultant’s know-how, or along the control dimension when the obligations created by the contract grant the other party significant discretion over the contractor’s actions.

Franchising relationships characteristically lie in the intermediate range between employment and independent contracting. With respect to control, franchising relationships are closest to the employment end of the continuum: the franchisor typically exercises significant amounts of relatively unrestricted decisionmaking authority.[14] With respect to ownership, however, franchising is much closer to the independent contracting model: the franchisee typically owns the bulk of the assets that contribute to producing the fruit of the relationship. Often the franchisor contributes nothing beyond the design for the product and relationship, perhaps represented by a trademark, and organizational capital.[15] A “pure” franchising relationship would be one in which ownership resided completely in the franchisee and control completely in the franchisor. This characteristic allocation of ownership and control is the key feature of franchising that a coherent legal framework must recognize.

B. *Background*

Firms engaged in franchising[16] made sales of $591 billion in 1987,[17] approximately one-third of all retail sales made that year in the United States.[18] The bulk of these sales occurred through the franchise system with the longest history: auto and truck dealerships, accounting for $306 billion.[19] The retail sale of gasoline, another long-standing franchise arrangement, accounted for $95 billion.[20] The type of franchise that most readily comes to mind for most people, fast-food, accounted for $58 billion when combined with other franchised restaurants.[21] Franchised convenient stores made $13 billion in sales; soft drink bottlers, $20 billion; franchised auto products stores, another $13 billion.[22]

What may be surprising is the size of the residual "other retailing" category: $87 billion in sales in 1987.[23] It is in this category that much of the growth in franchising now occurs.[24] While 2.5 percent of franchisors, mainly fast-food outlets, car dealerships, and gas stations, account for 48 percent of sales and 49 percent of outlets in franchising,[25] the adoption of franchising has spread to a wide variety of products and services.

Some observers, such as the U.S. Department of Commerce,[26] classify any relationship in which a retailer operates under its supplier's trademark as a franchise. Under this definition, many distributorships – of snack foods, beer or soft drinks, for example – are "franchises." In many of these cases, however, the distinctive separation of ownership and control that I identified above is missing. For example, a soft drink bottler who has acquired exclusive rights to distribute a given brand may retain almost total control over the distribution assets it owns: where to locate, how often to deliver, or how much to advertise. For the purposes of this article, such a relationship (often referred to as product or tradename franchising [27]) will not be considered a franchise.

The type of "franchising" that is characterized by a separation of ownership and control is known as "business-format" franchising.[28] As its name suggests, in this type of franchising the franchisee operates under a business format structured entirely by the franchisor. The franchisor provides the marketing concept, product ideas and design; it develops procedures for delivering the product; it creates operating manuals; and it sets quality standards.[29] The franchisor may or may not supply the actual product; the distinguishing characteristic is that the franchisee is under the control of the franchisor and thus is instructed how to run her business much as an employed manager would be.

At the same time, however, most franchisees are not simply managers; they are also owners and investors. While the bulk of franchisees own a single franchise outlet,[30] a small percentage[31] are master franchisees with rights to sub-franchise within their (normally larger) territory. Other franchisees own several outlets directly and hire managers to operate their outlets. Some may own multiple franchises, each with different partners and other investors.

Most notably, franchisors do not bear a significant share of the capital cost or risk setting up franchised outlets:

> Franchisees report that their own savings are the most frequently used source of funds for their first franchised unit. However, banks which are employed as a source of funds by 56% of franchisees are a source of a larger proportion of the total funds initially invested than are personal savings, 40.2% compared to 28.1%. Franchisors contributed, in the form of notes on equipment, signs, supplies, and so on, an unexpectedly low portion (8.7%).[32]

The franchisee purchases or leases virtually all of the franchised outlet's capital equipment. The franchisee also typically owns or leases both the land and the space from which the outlet operates,[33] although several franchise companies – notably some fast-food restaurants such as McDonald's – own the land on which the outlets sit and lease it to the franchisees. [34] Often, the franchisee also pays an up-front franchise fee to the franchisor for the privilege of operating under the franchise system. Altogether, the initial capital investment required to become a franchisee ranges form a few thousand dollars to set up a tax service to over half a million dollars for a fast-food outlet to several million dollars for a hotel. Table 1 sets out some estimates of initial capital requirements for a range of franchises:

TABLE 1
INITIAL CAPITAL REQUIREMENTS FOR VARIOUS FRANCHISES [35]

Franchise	Estimated Initial Capital
AAMCOTransmissions	$85,000
Dunkin' Donuts	$16,000–32,000
5 Minute Oil Change	$6,975
7-Eleven	$23,560
Western Auto	$50,000
Ernie's Wine and Liquor	$100,000
Dollar Rent-A-Car	$100,000
Old Uncle Gaylord's	$70,000-125,000
Kenneth of London	$60,000-95,000
Arthur Treacher's	$140,000
Best Resume Service	$5,000-25,000
Burger King	$150,000
H&R Block	$1,000-2,000
Domino's	$36,000-64,300
Telecheck Services	$195,000
My Pie International	$300,000
Ron's Krispy Fried Chicken	$350,000
Wendy's	$500,000
The Athlete's Foot	$77,500
Fat Fighters	$29,950
Modern Bridal Shoppes	$12,000-35,000
Nutri-System	$51,500
Kwik Kopy	$58,500
Snap-On Tools	$5,000
Century 21 Real Estate	$10,000
New England Log Homes	$100,000-125,000
Mary Moppet's Day Care	$45,000
Barbizon Schools of Modeling	$25,000-50,000
Acme Personnel Service	$9,000-19,500
Dootson Driving Schools	$20,000
Manpower	$50,000

While franchisors do not generally share in the investment in an outlet, they do share in its revenues in exchange for their contribution of a trademark and business format. The franchisor can collect revenues in several ways. If the franchise involves the outright sale of products to the franchisee, the wholesale price will ordinarily include a mark-up over cost representing the manufacturer's return. Often, the franchisor collects an up-front franchise fee from new and renewed franchisees. Many franchisees pay ongoing royalties to the franchisor, normally based on gross revenues. [36] Franchisors also can collect fees from franchisees for specific services, such as advertising, bookkeeping, management consultation, employee training, location selection, or providing the location itself. [37] In addition, franchisors may receive commissions from approved suppliers of their franchisees. [38]

Franchisors may also profit from franchising by directly owning and operating a fraction of the outlets in their system.[39] In 1987, the U.S. Department of Commerce counted 90,952 company-owned outlets out of a total of 498,495 outlets.[40] The percentage of company ownership varies considerably by industry, as may be seen in Table 2.

TABLE 2

COMPANY OWNERSHIP OF OUTLETS[41]

Industry	Percentage Company-Owned
Convenience Stores	58
Restaurants	30
Non-Food Retailing	23
Auto-Truck Rental	22
Hotels	14
Auto Products	13
Bottlers	10
Construction-Home Improvement	4
Auto & Truck Dealers	0

Additionally, company ownership of outlets has increased significantly over time. In the fast-food industry in 1960, franchisors owned only 1.2 percent of outlets; by 1968 the figure had grown to 6.6 percent. Franchisors owned 11.3 percent of outlets by 1971,[42] and fully 32 percent by 1986.[43] Interestingly, company-owned outlets may be more profitable than franchisee-owned outlets.[44]

Turning from the structure of the franchise relationship to its duration, most franchises are intended to be long-term arrangements. A large fraction of franchises are long-term by virtue of contractual length.[45] Contracts of shorter length often result in long-term arrangements through renewal.[46] Table 3 shows the duration of franchise contract in 1986.

TABLE 3
CONTRACT LENGTH[47]

Contract Term Length	Percentage of Franchise Contracts
1 year	1.8
3 years	2.1
5 years	16.3
10 years	31.7
15 years	10.9
20 years	21.1
25 years	1.1
Perpetual	12.9
Others	2.1

Actual duration is determined by how the relationship ends. The relationship may simply end with the expiration of a nonrenewable contract. More commonly, the relationship will end at the expiration of a renewable contract term with an explicit decision not to renew by one of the parties. In some cases, the franchisee's decision to transfer the franchise to another individual before the expiration of the contract with or without the required approval of the franchisor may terminate the relationship.[48] Franchises also commonly end before their term expires as a result of termination initiated by either party. One of the key legal issues in franchising is what constitutes cause for termination.[49]

Finally, franchise relationships end when either franchisor or franchisee fails. One of the most difficult characteristics to assess about franchising is the rate of business failure. The Department of Commerce consistently reports a failure rate within five years of start-up for franchise outlets of 5 percent, much below the over-50 percent failure rate of small businesses generally.[50] One would expect established franchise systems to exhibit a lower rate of failure than ordinary, single outlet small businesses because the business format of the franchise has already been subject to trial use in the market. Many writers, however, question the validity and significance of the 5 percent figure, pointing out that the Department of Commerce figure is developed from franchisor self-reporting,[51] and that the figure only accounts for total bankruptcy and not for failures to earn a normal rate of return on the franchise investment.[52] Moreover, among those franchisees who secure federal assistance from the Small Business Administration, the failure rate exceeds the average for all small businesses.[53] One congressional report found

> [b]etween 1969 and 1979, franchisees of the top 30 "major" franchisors, such as Shell Oil, Gulf Oil, Texaco, Subaru, Sheraton Inns, Tastee Freeze, and Mercedes Benz, had a failure rates between 11.6 and 33.3 percent on SBA loans, and loan guarantees. The failure rates for the 30 non-major franchisors, such as Crazy Horse Campground, American Speed Center, Chicken Delight, Mayflower Transit, El Taco, and Duraclean, varied from 35.7 to 100 percent.[54]

II. THE LEGAL STRUCTURE OF FRANCHISING

With this background in place, this section turns to the nature of the franchise contract. Before doing so, however, it is important to note that although franchising arrangements have traditionally been largely creatures of contract, they have become increasingly regulated. Efforts to introduce general legislation to regulate franchising continue.[55] The statutory scheme affecting franchising, however, is piecemeal. Separate legislation governs automobile dealerships as well as retail gasoline franchises.[56] Many states have their own general regulatory statutes that, like the federal automobile and gasoline legislation, focus primarily on controlling terminations and renewals.[57] But there is no comprehensive or uniform system of regulation.[58] Either because current regulation is piecemeal or, more fundamentally, because franchise relationships are too complex to reduce to precise statutory term,[59] the heart of franchising's legal structure is still contract. Indeed, as Section VI.A suggests, the statutes, even while ostensibly limiting contractual powers of termination or nonrenewal, in fact may have only a minimal impact on the legal treatment of franchising. Consequently, the legal structure of franchising is still largely determined by the nature of the contracts struck between franchisee and franchisor.

A. The Frequency of Contract Clauses

In order to illustrate the legal structure of the franchise organization, this section examines the common types and frequency of contract clauses. Unfortunately, empirical research on the content of franchise contracts is limited. The research that does exist generally dates back fifteen to twenty years, or is current but limited in scope.[60] One particular study of the fast-food industry, submitted as a report to the Senate Select Committee on Small Business in 1971, illuminates the frequency of various types of contract clauses.[61] While it is difficult to assess how these frequencies may have changed over the years, the types of clauses identified by this report continue to be used in many franchise contracts today.[62] Table 4 presents an overview of the contract clauses found in the fast-food industry in the 1971 study by Ozanne and Hunt.[63]

TABLE 4
CONTRACT CLAUSES[64]

Clause	% of Contracts	Comments
Termination any condition of	100	Franchisor has right to terminate. 76% require franchisee to agree that violation of contract is material breach. 68% give grace period for curing defaults (10 days); 79% indicate bankruptcy automatically terminates and all rights revert to franchisor.
	47	Franchisee must cease operations on termination. 33% require discontinued use of trademark; 47% require building alterations.
	44	Franchisor option to purchase equipment. 50% set depreciated value; 30% indicate market value.
Royalty Fees	90	75% require royalties monthly on gross receipts; median rate is 4%.
Insurance	88	Franchisee required to hold. 70% requiring full public liability insurance; 64% requiring indemnification of franchisor.

Duration	88	Specifying fixed duration. 59% make the contract renewable at expiration
conditional on		
		absence of franchisee default.
Franchise Fee	83	Required up-front. 35% specify sole consideration is license to operate; 48% require nonrefundable deposit before execution.
Transfer	83	Franchisor approval required. 75% do not indicate basis for refusal.
	46	Franchisor right of first refusal in sale of outlet.
Training	77	Formal start-up training at headquarters or outlet. 47% report receiving.
	34	On-the-job training. 71% report receiving.
	45	Franchisor will provide assistance in opening. Franchisor bears expense in 62%; 99% of franchisees report receiving start-up supervision Median Length of all training is 2 weeks.
Standards	82	Food quality.
	76	Operations.
	61	Cleanliness; product line control.
	56	Maintenance.
	27	Franchisor right to control inventory.
Inspection	79	Franchisor right to inspect premises.
Trademark	77	Franchisee has no ownership rights in trademark.
Audit	76	Franchisor right to audit books.
	62	Franchisor approval of bookkeeping method.
	30	Franchisor right to order certified audit.
	79	Require periodic reports; 25% require submission of tax return.
	40	Franchisee required to pay for audit if underreporting discovered. 5% pay bookkeeping fee to franchisor.
Enforcement	74	Franchisor's failure to enforce is not waiver.
Separability	73	Invalid clauses separable from remainder.
Noncompetition	67	Covenant not to compete with franchisor after termination or expiration. Time (60%)
and		
		area (52%) restrictions. 38% prohibit franchisee from hiring franchisor personnel.
Physical Layout	64	Approval of layout. 96% of franchisors report they retain right of approval/control.
Trade Secret	64	Franchisee agrees operation/procedures are trade secret.
Inheritance	64	Transfer to heirs possible on assumption of franchisee obligations.
Agency Status	64	No agency relationship created by contract.
Operating Manual	61	Franchisee to receive. 35% of contracts distribute on loan/trade secret basis only;
16%		
		specify compliance with manual at all times. 38% give franchisor right to revise at
	any time.	
Territory	60	86% of franchisors report assigning some kind of exclusive territory.
Venue	60	Specification of venue for litigation.
Hours	55	Days outlet to be open.
	63	Hours to be kept.
Advertising	53	Franchisor right of control over franchisee advertising (ad approval).
	29	Franchisor required to advertise. 38% require contribution but no control for
franchisee;		
		62% administered jointly.
	42	Contribution of percentage of gross sales to advertising fund required. Franchisors
report		
		57% require contribution to national ad fund; 47% require minimum local
	advertising; 81%	
		reserve right to approve ads.
Supplies	58	Franchisor approval of suppliers required.
	43	Operating supplies equipment to be purchased from franchisor.
	33	Paper goods to be purchased from franchisor.
	33	Sign to be purchased from franchisor.
Building	47	Franchisor builds, leases to franchisee in 60% of these: franchisee constructs in
40%.		
Construction		
Site Selection	45	66% give franchisor right to select location; 33% allow franchisee to select subject
to		
		franchisor approval; 54% of franchisors select location and then offer to franchisees; 97% reserve right to approve location.
Management Consultation	45	75% of these "require" advice only when franchisor judges it necessary; 25% at franchisee's request.
Start-up Date	39	Required date of operation.
Alteration	36	Approval required for changes to building or layout.
Lease	35	Specifying rental base for lease from franchisor; 50% based on dollar amount plus

		percentage sales; 20% on dollar amount only; 33% percentage-only sales.
	18	Approval of third-party lease required.
Sign	34	Specifying dimensions.
Employees	32	Conduct requirements. 39% specify employee uniforms.
Arbitration	23	Disputes to be arbitrated.
Pricing	14	Franchisor right to control prices. 13% restrict prices that franchisors can charge franchisees; 50% of franchisors report specifying retail prices.
Performance Deposit	12	Franchisee posts performance deposit.
Self-Employment	12	Require franchisee to manage full time. 9% require approval of manager.
Renewal Fee	7	Additional fee on renewal.

This overview exhibits a number of features. First, note the breadth of coverage: The contracts contain clauses pertaining to nearly every detail of operation. Indeed, the franchisor's operations manual itself will ordinarily carry an extensive set of requirements on small details of operation.[65] Second, consider the great weighting of the clauses towards the obligations of the franchisee. Nearly all of the clauses pertain to commitments made by the franchisee: to build or to lease buildings, equipment, or supplies; to maintain standards; to meet layout requirements; to maintain hours; to contribute to advertising funds; to pay royalties; and to adhere to bookkeeping guidelines. When one incorporates the operations manual into the contract, the franchisee's obligations increase dramatically. On the other hand, the franchisor's contractual obligations extend only to training, to advertising, and to the provision of an exclusive territory. Ongoing management support, promised in about half the contracts, is normally discretionary. Few franchisors undertake firm obligations with regard to the nature, extent, and quality of advertising.

Third, observe the number of clauses pertaining to the trademark and licensing aspects of the relationship. Trademark and licensing clauses include: ownership of the trademark; cessation of operations on termination; royalty fees and franchise fees; audit authority; and trade-secret status for procedures and operations manual. Thus, the property rights of the franchisor are often a primary interest of the contract.

Fourth, note the nature of the provisions regarding a cessation of the relationship. Franchisees generally must agree that any violation of any term of the contract, including, in many cases, the details of the operations manual, constitutes material breach and is a basis for termination. Several conditions or events may arise upon termination. The franchisor often has an option to purchase all equipment at a depreciated value. The franchisee must cease operations and perhaps alter the building. Franchise contracts often prohibit the franchisee from continuing in a line of business in competition with the franchisor for a period of time – two years is common – and over a distance often measured as a radius from any outlet operated by the franchise system. If the relationship ends with a decision to transfer the franchise, the franchisor typically retains the right to approve the transfer; rarely does the contract place restrictions on the exercise of that right. Nearly half of franchisors retain a right of first refusal should the franchisee wish to sell the outlet.

Finally, observe that there are essentially no clauses creating any obligation for the franchisor to develop the system, to continue in operation, to continue to advertise, or to maintain the trademark. Outside the exclusive territory for the trademark, the franchisor is free to compete with the franchisee through the development of another system or through the establishment of competing outlets. The franchisor may withdraw its system from a region or the entire market. There are no restrictions on what operating procedures the franchisor may adopt, what layout or building alterations it may require, or what forms of promotion it may require the franchisee to undertake.

B. *A McDonald's Contract: 1959-1977*

An examination of the evolution of the basic elements of the contract – the quality standards and termination provisions – for a particularly visible franchise organization provides another perspective on the legal structure of the franchise contract.[66]

In 1959 the McDonald's Corporation provided for contract termination in the event that a franchisee violated the following: provisions requiring operation at maximum capacity and efficiency over specified days and hours "in accordance with the standards and business practices and policies presently in force and, from time to time, promulgated by Licensor"; provisions on employee uniform and behavior; provisions on the use of specified packaging materials, flavorings, and garnishments and on approved suppliers; and provisions regarding the approval of local advertising.[67] Notably, upon termination, the contract required McDonald's to buy out the franchisee's interest in the equipment and furnishing of the outlet for a specified depreciated sum.[68] Moreover, the contract, while requiring the franchisee to acknowledge the general importance of uniformity and compliance with the entire McDonald's "system," set out explicitly the standards on which termination could turn.

In contrast, by 1964 McDonald's had converted the required buyout term into an option to be exercised by McDonald's[69] and introduced a clause requiring franchisees to supply "best efforts" in complying with the franchise system.[70] Termination could, as in 1959, turn on the violation of any explicit contract provision, and now it could also result from a failure to supply the undefined level of "best effort." By 1970 McDonald's had explicitly incorporated the entire Operations Manual into the contract,[71] thereby extending the scope of franchisor control. The 1970 contract reiterated the vaguely defined requirement that "operation shall at all times be conducted in accordance with the standards and business practices and policies presently in force and from time to time promulgated by Licensor"; violation of this provision "shall be deemed to be a substantial breach of this Agreement and shall give the Licensor the right to terminate this Agreement." [72]

By 1977, the obligations of McDonald's franchisees were even more detailed. This contract ostensibly limited the parties' intent to ensuring the franchisee's compliance with those obligations, rather than to creating a set of mutual commitments. The contract stated:

> The foundation of the McDonald's System and the essence of this License is the adherence by the Licensee to standards and policies of Licensor….
> The provisions of this License shall be interpreted to give effect to the intent of the parties stated in this paragraph…so that the restaurant specified in this license shall be operated in conformity to the McDonald's System through strict adherence to Licensor's standards and policies as they exist now and as they may be from time to time modified. [73]

In contrast, the contract left the franchisor's duties relatively undefined, a difficult-to-quantify duty to "advise and consult." [74] Thus the franchisee paid fees for a service that the service-provider retained full discretion to define in content and duration.[75] In the McDonald's contract, as in many franchise contracts, the contract frames franchisor obligations in terms such as "reasonable," "periodic," and "from time to time." The franchisor had no contractual duty to employ prudence or consideration in the making of decisions that directly affect the profitability of the franchisee.[76]

C. Incompleteness and the Content of the Franchise Contract

Ideally, one would like to have a full-fledged empirical survey of franchise contracts, drawn from several industries and franchisors, as the basis for general conclusions about the nature of these contracts. Unfortunately, such a survey does not appear to exist. Nonetheless, the evidence produced by the McDonald's contracts, sample franchise contracts,[77] franchise buyers' guides,[78] and a general overview of franchise cases in the courts,[79] does permit some basic generalizations. A court must of course ultimately interpret and enforce a particular contract; my objective in looking at generalizations is to lay the groundwork for a set of theoretical guidelines to aid a court in that task.

The basic picture that emerges is that franchise contracts are long-term, standard form contracts. They grant the franchisee the right to operate under the franchisor's trademark and to use a system designed by the franchisor, often in an exclusive territory, in exchange for the payment of a franchisee fee and royalties. The contract does not specify the details of the many transactions that will take place within the framework of the basic exchange. Rather, it structures the long-term relationship, much as a constitution does, by delineating the basic function of each party. In short, franchisors are responsible for making decisions about details such as inventory, outlet and product design, location, uniforms, hours and bookkeeping; franchisees are responsible for complying with the franchisor's decisions. Franchisors have some responsibility to provide training, advertising, and management advice, but franchisees do not possess the authority to determine the quantity or quality of these services. Franchise contracts focus almost exclusively on setting out the range of franchisee obligations and protecting the franchisor's ownership of its trademark.

For purpose of the theoretical analysis I will develop, the key characteristic of the franchise contract is its incompleteness. While roles and areas of responsibility are laid out, a court has little concrete guidance from the contract in deciding issues such as whether a franchisee's failure to build a new showroom,[80] or a franchisor's decision to discontinue marketing its product in a franchise's territory,[81] violates the terms of the contract. All that will be clear from the written contract is that the franchisor has discretion over decisions regarding showrooms or marketing; the typical contract will be silent about how this discretion is to be exercised. Moreover, the subject of franchisor discretion will often be undefined. Franchisors are responsible for developing the franchise system as they see fit over time.

Thus many of the standards with which a franchisee must comply will not even be articulated until well after the contract has been signed. As a result, in many cases there will be no language in the written document to assist the court in determining whether a particular franchisor demand is legitimate and whether the franchisee's behavior is in compliance or in violation of that demand. It is the absence of contract terms answering these questions that identifies the franchise as incomplete.

The significance of incompleteness is not merely that any particular franchise dispute will be complex to resolve. Rather, from a long-term perspective, what is important is whether incompleteness can be avoided, and therefore ultimately cured, by an appropriate rule. Many traditional rules of contract interpretation, such as the parol evidence rule, can be understood as forward-looking judicial efforts to discourage incomplete contracting. But if incompleteness is unavoidable, then such efforts will prove futile. In such a case it becomes important to approach the problem of incompleteness as a basic characteristic that must be addressed directly.

The franchise contract presents such a case. While contracts could be drafted more completely than they are now, ultimately they will still be incomplete.[82] Few contracts are called upon, as is the franchise contract, to accomplish so complex a task as to structure an entire ten-to-twenty year productive relationship, especially under the conditions of significant uncertainty displayed in retail markets. To write a complete contract for this purpose would be to attempt to reduce to written form a complete listing of all the different business decisions that the franchisor could undertake under all possible future circumstances, and also to specify the range of compliance responses available to the franchise in each case. Franchisee and franchisor would have to negotiate today over how best to respond to the long-term vagaries of the automobile industry, or the fast-food market, or the demand for tax services.

Because this is an essentially impossible, task, the franchise contract that we see in use is necessarily an incomplete one. Rather than spelling out every decision *ex ante*, it designs a decisionmaking structure and assigns to the franchisor responsibility for responding to market conditions as they arise and to the franchisee responsibility for compliance. A court must recognize, however, that this allocation of roles does not necessarily reflect a desire to assign unfettered authority to franchisors and unquestioning compliance to franchisees. Given the impossibility of substantially more precise contracting, broadly defined responsibilities are the only alternative available short of abandoning the relationship entirely. Consequently, a court called upon to "interpret" a franchise contract and determine whether it has been breached must look more deeply into the entire structure of the contracting relationship. As I will demonstrate in the next section, an understanding of the nature of the economics of franchising and the commitment problems involved can, as a first step, guide a court in this deeper analysis.[83] As I will also demonstrate,[84] however, ultimately it is necessary for a court to examine the nature of the franchising relationship itself to interpret and enforce the incomplete franchise contract.

III. THE ECONOMIC STRUCTURE OF FRANCHISING

This section examines the economic dynamics of the franchise relationship to elucidate the nature of the planning and commitment problems that it poses. These are problems that the franchisee and franchisor must overcome to make their arrangement an economically sensible one. Isolating these problems provides a basic analytical framework for examining the franchise contract. Within this framework the incompleteness of the contract is seen more vividly. Furthermore, we can identify the "missing links" of commitment that we would expect to find within the structure of the relationship itself.[85]

There are two major difficulties inherent in the franchising relationship. Both flow from the basic structure of franchising.[86] First, because the franchisor owns the basic franchise system and its trademark and the franchisee owns and operates the retail outlets that deliver the system and display this trademark, the franchisor faces problems of controlling the quality of the franchisee service. Conversely, also because of this structure, the franchisee faces problems related to a franchisor's opportunistic use of this control power. As a result, the franchise relationship is structurally centered on conflicts of interest. Overcoming these conflicts is the primary challenge of franchising.

A. The Franchisor's Problem: Quality Control

From the franchisor's perspective, the franchising relationship poses a substantial problem with respect to quality control. The franchisor has normally created a differentiated product or service or system with the expectation that consumers will be willing to pay for the added benefits of this creation. If the franchisor is to fulfill this expectation, that product or service or system must be implemented at the retail level as designed by the franchisor. A formula for a soft drink must be mixed correctly; a method of losing weight must be taught correctly; a procedure for serving food quickly must be followed correctly. The trademark encapsulates these concerns of the franchisor. The value of the trademark gauges the success of the franchisor in assuring that franchisees provide an otherwise valuable product or service or system according to the franchisor's plan. The more valuable the trademark, the greater the price at which franchises can be sold and the greater the royalties collected.

The value of the trademark is, however, vulnerable to franchise free-riding. This is a problem that has already received considerable attention from scholars and the courts.[87] A franchisee is inclined to make decisions about how much effort to put into the business based on the profits that will accrue directly to her in her own outlet. She is not inclined to take into account that, because customers will make judgements about the quality of the entire franchise system based on their experience at an outlet, cost-saving reductions in quality at her outlet will affect the overall value of the trademark and thus the profits of other franchisees and the franchisor. If all franchisees, facing the same incentives, act in this way, the value of this trademark will suffer dramatically.[88]

Free-riding is an example of the problem of control, known as the principal-agent problem in the economics literature.[89] It pervades almost all organizational forms to a greater or lesser extent. If, for example, the franchisor decided to operate as a vertically integrated firm, owning the outlets itself, it would still face the problem of controlling its managers. The franchise arrangement changes the nature of the control problem but it does not eliminate it. To some extent, franchising simply trades one control problem- overcoming the incentives to “shirk” that face the salaried employee but not the profit-collecting entrepreneur- for another- overcoming the incentives to minimize cost that face the entrepreneur but not the employee.

At the heart of the control problem is a divergence in interest between franchisee and franchisor. A franchisee wants to maximize her profits from the operation of the outlet; she does not wish to undertake any efforts or expenditures that will not compensate the undertaking. On the other hand, once a franchisor establishes a particular franchise, it aspires to sell more franchises and increase royalty revenues. These objectives make the franchisor less sensitive to the costs of operating an outlet and prompt the franchisor toward maximizing revenues rather than profits.[90] The greater the volume of sales under the trademark, the greater the likelihood that a consumer has had direct or indirect contact with the trademark, increasing its value. The greater the revenues of outlets, the greater are the royalties collected as a percentage of sales.

This divergence in interest goes beyond the basic free-riding problem to touch almost every aspect of the operation of the franchise. Franchisees, seeking to exploit their trademark license, want to limit the number of franchises granted: franchisors, having sold the first round of franchises, may want to saturate the market with franchises. Franchisees want to locate outlets in profitable area: franchisors, seeking to advertise the trademark and create the image of being on every street corner, may want to license additional franchisees in areas that will contribute to this reputation, even if a particular outlet may not be profitable. Franchisors may wish to have stores operate twenty-four hours per day in order to develop the trademark’s reputation for consumer convenience; franchisees, making few sales at night, may wish to save operating costs and close for a number of hours. From the franchisor’s perspective, bringing the franchisee’s interests in line with its own is the central difficulty of this method of doing business.

B. *The Franchisee’s Problem: Opportunism*

If controlling franchisee interests were the only problem within the franchising relationship, its solution would be relatively straightforward, albeit costly. Franchisors could, for example, retain the authority to dictate required behavior for franchisees and hire squadrons of field people to monitor compliance daily. However, the problem of divergent interests cuts both ways. An unrestricted exercise of control by the franchisor will favor the franchisor’s interests over the franchisee’s and create an equally significant problem for the franchisee: risk of opportunism.[91]

For the franchisee, the most significant economic feature of franchising is the allocation of capital investments. Franchisees are distinct from ordinary employees because they have made capital investments in the business.[92] These investments, however, are normally highly idiosyncratic, meaning that a large fraction of the franchise assets often have a greatly diminished value if employed in another line of business. Consequently, the costs of establishing a franchise are effectively sunk costs, which, once expended, are not easily recovered if the franchise goes out of business.[93]

Sunk costs play an important role in creating the incentives that operate within an established relationship.[94] This is best understood by considering the difference between fixed costs (overhead or up-front costs) that are sunk and those that are recoverable.[95] For example, consider a business in which a variable cost of production has increased dramatically, so that the highest price in the business can charge for its product covers only the marginal cost of producing it, leaving nothing to contribute to fixed costs. Although the business can cover its variable expenses, such as wages and ingredients, it is making negative profits because it has nothing left over on its investment in overhead assets. If the business can resell these assets to recover its fixed costs, then the business can raise its profits to zero by shutting down and selling off the assets. If, however, these assets are sunk assets, then, by definition, their sale will not recover their full cost; shutting down will still leave the business with negative profits. If the business has any revenue left after paying variable costs to defray the cost of these assets, the profit-maximizing decision is to continue to operate, instead of junking the assets entirely and losing the whole investment. The key difference is that a business with recoverable fixed costs will shut down as soon as it shows losses, employing its capital more profitably elsewhere. A business with sunk costs, on the other hand, will continue to operate even though it has never recovered its investments in fixed costs, and it will not shut down until the amount it is losing exceeds what it would lose by simply abandoning the investment.[96]

The incentive that causes a business with sunk costs to stay in operation despite losses makes franchisees vulnerable to franchisor behavior known as "opportunism." [97] Because the franchisee will continue to operate even if it is not recovering its sunk investment, the franchisor can make decisions that induce such losses without the franchisee going out of business. When these decisions benefit the franchisor at the expense of the franchisee, the franchisor opportunistically extracts a portion of the franchisee's sunk costs. A franchisor can potentially extract this value from the franchise directly in a number of ways: it can raise the price of goods sold to franchisees, increase rent, boost royalties through an increase in the required volume of a franchise, levy fees, or divert advertising funds to general corporate uses. Extractions can occur indirectly as well. To increase the price of new franchises, a franchisor could require franchisees to make excessive advertising investments, to participate in promotional programs which are not cost-effective, or to undertake unnecessary renovations.

Just as the risk of free-riding makes control a central concern for the franchisor, the risk that franchisors will extract sunk costs makes opportunism a central concern for franchisees. These concerns meet head on: Where franchisors seek to expand their control, franchisees seek to erect boundaries. In some circumstances a franchisor's decision to require increased advertising by franchisees, for example will reflect a legitimate exercise of franchisor control to overcome free-riding. But in other circumstances, it will reflect only opportunism.

The difficulty of distinguishing between a legitimate exercise of control and an opportunistic one provides another perspective on why franchise contracts are necessarily incomplete. It is this distinction that must be drawn, in writing, to complete the franchise contract. Clearly this is an enormous task, one requiring the franchisee and franchisor to anticipate every detail of the long course of their relationship in a highly uncertain environment. As a result of the enormity of this task, franchise contracts leave many of the problems at the interface between legitimate quality control and opportunism unsolved.[98]

C. *The Normative Consequences of Unsolved Problems of Quality Control and Opportunism*

Determining whether the consequences that flow from the failure of the incomplete franchise contract to control free-riding and opportunism justify particular rules of contract interpretation and enforcement first requires that a court adopt a normative framework for analyzing those consequences. I will briefly mention two possible frameworks before turning to the one on which my own analysis rests.

Fairness is one potential normative stance. This is the stance adopted by those who seek franchise regulation because they perceive franchisor opportunism as unfair action that uses superior bargaining power to take advantage of a franchisee's vulnerability.[99] Judicial reliance on doctrines of unconscionability or adhesion[100] to regulate franchisor behavior also stems from fairness concerns. The duty to avoid defeating the reasonable expectations of one's contracting partners is another possible fairness justification for contract rules that control free-riding and opportunism.

Economic efficiency, the stance adopted by most adherents of the law and economics movement,[101] is another normative framework that courts could use to justify contract rules. The inefficiencies created by failures to control the divergent interests of two interdependent agents are well documented in the economic literature.[102] The use of franchisor control to overcome free-riding improves efficiency as franchisees are forced to provide a level of quality that takes account of the effect of their action on other franchisees and the franchisor.[103] Judicial action to prevent opportunism promotes efficiency by lowering the transaction costs associated with it: the private resources expended "perpetrating and protecting against opportunism."[104]

The possibility of unrestrained opportunism can diminish efficiency as franchisees choose not to enter into otherwise profitable franchise arrangements for fear of losing their investment in sunk assets;[105] alternatively, if franchisees fail to foresee the danger of opportunism, they may be led to invest in essentially unprofitable schemes that merely operate as devices to transfer wealth to franchisors. Even with efficiently formed franchising relationships, there may still be *ex post* inefficiencies because of opportunism. During the course of the relationship, the franchisor makes hundreds of investment decisions, most of which are shouldered by franchisees.[106] If the franchisor opportunistically fails to take into account the cost of these decisions for franchisees, it will be led to make too many of these investments relative to the efficient level.[107]

Despite their wide appeal, both the fairness and the efficiency rationales remain problematic. What is fairness? Why should courts pursue economic efficiency? While these are essential questions to explore, this normative task is not one that I undertake here. Instead, since my immediate objective is to improve the resolution of current franchise disputes, I choose to rest my analysis on a narrower normative rationale, that which undergirds traditional contract doctrine.

As most judges today would see it, the traditional function of contract law is to enforce the private commitments reached by contracting parties in structuring their exchanges.[108] From this normative stance, the central issue is the actual content of the commitments reached by the franchisee and franchisor. If courts mistakenly interpret gaps in the incomplete franchise contract as absences of commitment about either free-riding or opportunistic conduct, then either franchisees or franchisors may find the franchise arrangement a less attractive one. Consequently, they will tend to eschew a voluntary exchange that they would otherwise adopt, and the courts will have failed to facilitate their decision to form a franchise. Alternatively, if franchisees and franchisors do not anticipate that courts will fail to enforce their implicit commitments to refrain from free-riding or opportunistic behavior, then franchising may indeed arise as a choice but the exchange enforced will no longer be the one voluntarily entered into by the parties.

The analysis of the franchise relationship by a court interested in performing the traditional function of facilitating exchanges by enforcing private commitments must focus on identifying those commitments in the absence of a feasibly complete contract. The twin problems of control and opportunism structure this analysis. By beginning with the hypothesis that neither franchisee nor franchisor would choose voluntarily to form a franchise relationship in the absence of legally enforceable commitments preventing free-riding and opportunism,[109] a court can examine the details of a particular franchise relationship to determine if the hypothesis holds. If so, then these commitments must be counted among those that the court should enforce.

Some of these commitments will indeed by found in the written contract; others may be inexplicably absents. My main objective, however, is to demonstrate that many of these commitments arise within the franchise relationship itself, as that relationship is understood by its participants. Developing this analysis requires an examination of the "relational" structure of franchising, to which I now turn.

IV. THE RELATIONAL STRUCTURE OF FRANCHISING

Contract literature has made much of the importance of "relational elements" in franchising.[110] It is difficult, however, to define precisely what is meant by the term "relation", since "relation" exists at many levels. It can encompass the actual exchanges or bargains that occur within the arrangement, that is, exchanges that could be made the subject of separate, simple, short-term contracts. "Relation" can also be understood as the balance of economic power within the arrangement, the bargaining positions of the parties and their respective vulnerabilities to exchanges they do not like but cannot prevent. "Relation" can embrace the set of perceived obligations and rights of the various parties in the relationship, as the objectives and options of the parties and the boundaries they face or must respect. It can entail the balance of elements more relevant to analyses of individual personality or class structure than modern economic theory: balances of power and autonomy, and of dignity and exploitation.[111]

My purpose in exploring the "relational" aspects of franchising is to demonstrate that economic tools can elucidate an understanding of "relationship" grounded in particular attributes of exchange, bargaining, control and sunk costs. Guided by the commitment problems illuminated by the economic analysis of control and opportunism, relational analysis can focus on identifying those features of the relation between franchisor and franchisee that address these problems. Such an application of relational analysis, consonant with the private commitment model of contact ostensibly employed by the courts, provides an avenue for introducing the analysis of relation into the resolution of current contract disputes in the courts.[112]

Relation enters the examination of franchising through the incompleteness in the franchise contract. Classical contract doctrine claims to look only to the "four corners of the document" in identifying the content of the contractual relationship between the parties.[113] Doing so in the franchise context would define a relationship almost exclusively in terms of the franchisor's interest in protecting its trademark and the broad range of control that it assumes to pursue that interest.[114] As Stewart Macaulay has documented, [115] however, the real life of the franchise is found not in the contract but in its operation.

We should nonetheless be clear about the importance of the contract in structuring the "real life" of the franchise. The contract supplies starting points: the frequency of payments, expected training levels, and advertising responsibilities. It also applies boundaries: some supplies must be forthcoming, some sales must be made and royalties paid, and some distances must be preserved between outlets. However, the incompleteness of franchise contracts consists in either the absence or the intense ambiguity of these starting points and boundaries: How expensive can promotions be? How often can outlet refurbishing be required? What measures to boost sales can be required? The franchise contract sketches only a bare outline, one which is then filled in by the ongoing balance- the beliefs, powers, and incentives that comprise the relationship.

The incomplete contract that courts see is precisely that: incomplete. A rational decisionmaker, aware of the problems of control and opportunism, simply would not enter into a contract so incomplete if it represented the entirety of expected obligations and commitments. Instead, I argue, franchisee and franchisor enter into a "franchise relationship" in reliance on commonly understood features of that relationship which fill in the gaps of the written contract and create an understanding of the full range of commitments involved. Thus the importance of the relational elements is not merely of descriptive interest. These are not merely details that are irrelevant for the basic economic issues of planning, incentives, and commitment.

Getting at the “relationship,” however, is a slippery task. What I report here are only general comments about the relationship – perceived obligations, limitations, bargains and abuses- accessible from popular books and trade journals on franchises.[116] Nevertheless, the comments capture a view of the norms, beliefs and exploits of franchising[117] and paint a different picture of franchising than that accessible from a mere examination of contract structure.

A. The Nature of the Exchange

One of the first issues to explore is the perception within the industry of the content of the franchising exchange. What, in other words, do the participants expect “franchising” to be? One franchise consultant offers the following definition:

> Franchising is a continuing relationship in which a franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising, and management, in return for a consideration from the franchisee.
>
> ..A franchisor then is fulfilling his obligations to his franchisee only when he provides *continuing* assistance toward the solution of his franchisee’s many problems- to their mutual benefit and profit.[118]

This perspective reflects the view that franchising is fundamentally about the purchase of a trademark license and a management consulting service, making the obligations of the franchisor vital to the exchange. As another franchisor describes it, “the basic concept of franchising revolves around the franchisor’s ability to satisfy the desires of the franchisee. [The manager] must understand that the franchise company sells service to the franchisee and that the franchisee represents the cornerstone upon which the industry rests.”[119] This view stands in sharp contrast to the de-emphasis of franchisor obligations in the standard franchise contract.[120]

Another definition of franchising emphasizes the mutuality of the relationship. The mutuality perspective understands franchise contracts as “any contract under which interdependent retailers or wholesalers are organized to act in concert with each other or with manufacturers to distribute given products or services.”[121] This view again contrasts with the contractual view that emphasizes the franchisor’s interest.

Most definitions emphasize that franchisors are in the business of figuring out how to build a better mousetrap while franchisees are in the business of building it:

> Franchising is now an industry in its own right and as such is based largely on the concept that there is money to be made by creating and perpetuating business opportunities for others.[122]

But in these definitions it is nonetheless clear that the franchisee is expected to do as he or she is told:

> Franchising is a chain of small businesses bound by the image and policies of a parent company. The person buying a franchise does not buy his own business. He buys a success package from a company who shows him how to use it.[123]

More bluntly:

> Running a franchised business means giving up your independence and playing by someone else’s rules.[124]
>
> You are the “manager-owner” of the franchise, but the emphasis is always on the “manager.” You must take orders from headquarters. Will you be able to do this?[125]
>
> It’s your business [says one franchisor], but I control what you do.[126]

But despite the fact that franchisees are expected to act as if they were only managers, franchisees repeatedly assert that they entered franchising because they wanted to own their own businesses:

> The franchise merely gives the individual one major right, that of owning his own business and having that pride of independence which accompanies being his own boss to a greater rather than lesser extent. In exchange, he must give up certain things - such as the inalienable right to mismanage his own business.[127]

Franchisors direct their advertising campaigns to this point:

> OWN YOUR OWN BUSINESS….No boss…no clock to punch…just a great sense of independence.[128]
>
> IF NOT NOW, WHEN….are you going to be your own boss?[129]

Franchisees and franchisors alike also seem to view the exchange as a low-risk alternative to an independent small business:

> [T]he prospective franchisee visualizes the "franchise package" as a group of devices which contribute to reducing his risk of failure…rather intensive fears of failure were evident among franchisees who had seriously considered an independent business venture versus a franchised business.[130]
>
> The very fact that the successful franchise is "packaged success" lies at the very heart of the franchise boom. "If we know a man is on his way down…we'll do everything possible to bail him out. We don't want a bankruptcy."[131]

As industry observers have recently begun to recognize, however, the risks of franchising go beyond the reduced likelihood of bankruptcy. One observer suggests that the 5 percent failure rate reported by the Department of Commerce[132] "may be moot, because troubled franchised outlets rarely go out of existence. They are often sold back to the franchisor or to another operator at fire-sale prices."[133] As one buyer's guide cautions:

> We hear success rates of 95 percent to 99 percent being thrown around. The government seems to support these figures.
>
> We're not sure where they get their statistics from but we can't agree with them. The figures don't tell you about the franchisee in Des Moines who invested $100,000 in his business and then had to sell it to someone else for $15,000 because that was all he could get. The business is still operational, as the "statistics" indicate; the $85,000 loss, however, is not reflected anywhere.[134]

Modern buyers' guides, in contrast to earlier guides that portrayed franchising as "fail-safe,"[135] now start off by immediately debunking the "myth" of financial security.[136]

As the above comments demonstrate, the precise exchange taking place in franchising is ambiguous. Nonetheless, certain characteristics can be identified. For example, the franchise relationship is clearly no merely an arm's length trademark license between a passive trademark owner and an essentially independent small business operator. Nor is the franchisor's power exercised merely to protect its trademark. The relationship is, instead, a much more active mutual exchange. Franchisees purchase more than trademark rights: They purchase the franchisor's expertise and management advice. Franchisor control not only protects the trademark; it must also provide these basic risk-reducing services to the franchisee. Franchisees are expected to act as if they are employed managers strictly following franchisor direction. But at the same time they are clearly operating "their own" businesses in the sense that, despite franchisor advice, they run the ultimate risk of bankruptcy or poor performance. Thus, as I will explore further below, the exchange involves obligations on both sides.

B. *The Reliance Relationship: Superiority and Inexperience*

The mutuality of the exchange in franchising does not mean that it is an exchange between equals. Instead, the reliance relationship created by the franchisor's relative superiority and the franchisee's relative inexperience is an essential component of the typical franchise exchange.

One way in which the franchisor's necessary superiority is expressed is in the perception of the importance of the standard form nature of the franchise contract. There is a strong perception in franchising that the standard form contract, designed by the franchisor, is a necessary part of the peculiar nature of the franchise relationship:

> The reputable company will not change its contract; it will rarely let it be examined until the prospective purchaser has made a deposit towards the purchase. It will not compromise or negotiate any part of it. The attorney representing a prospective purchaser need only determine with him if the client can live within the framework of the franchise agreement. If it is oppressive or confiscatory, the client is best advised not to sign. If the franchise company offers to negotiate away any of its requirements to make the sale, it can only be an indication of the weakness of the company. The intangible that the purchaser seeks in joining the franchise network is the organization and power of a professional management group; if that group is willing to give away any part of its basic contract it can only indicate a fatal weakness in the structure and philosophy of the company.[137]

This advice represents a clear ethic of non-negotiation, not merely to boost the bargaining power of the franchisor, [138] but also to define what, fundamentally, it is that the franchisee is purchasing. In other words, franchisors use the standard form contract to signal aspects of the relationship that the franchisee can expect- the relational elements of company structure and philosophy. Buyers' guide authors echo this same norm.[139] The clear message is that the refusal of the franchisor to negotiate- the superior position of the franchisor- is a hallmark of the relationship that the franchisee is purchasing.

On the other side of the scale is the franchisee's inexperience. Both franchise participants and observers note that the typical franchise relationship is aimed at those who "don't have a product or the skills to establish [their] own company."[140]

> The franchisee whom the Colonel knew in the beginning had been a man without funds. All the prospect had was the spirit and the emotion and the guts. The prospect knew he wanted to be in business and he intended to sell Kentucky Fried Chicken. The Colonel never looked at the prospect's financial statement. As a matter of fact, many prospects did not even know what the word meant.[141]
>
> It should be remembered that despite the fact…that more and more franchisees are professionals, the nature of the franchising industry continues to attract the individual of modest means and limited business experience. Franchising still offers the uninitiated and inexperienced their first opportunity to establish businesses of their own.[142]
>
> [T]he majority of franchisors [63%] say that they prefer to enroll a franchisee with no experience in their line of business. This preference exists in spite of our finding…that experienced franchisees operate more profitable units.[143]

An advertising directory published in 1985 by franchisors notes "previous self-employment is not necessarily an advantage when considering a franchise… The problems concern your sense of business autonomy."[144] And despite the fact that "franchises are growing in size and sophistication,"[145] a recent article still notes that "[f]ranchising has always attracted mom-and-pop operators because it offers a relatively cheap way to own a business. And franchisees have always been at the mercy of franchisors whose decisions about new products, markets, and capital spending can determine whether the franchisee's life savings go up in smoke."[146]

The presumed, and preferred, inexperience of the franchisee introduces the reliance of the franchisee on the franchisor into the very heart of the franchise relationship. This imbalance is not just a consequence of imperfections in bargaining. Rather, it is in the very nature of what is being exchanged. Franchising centers on the franchisee following the franchisor's rules, while the franchisor advises and assists the fledging small business operator. Those services on the part of the franchisor are what the franchisee purchases and what makes the imbalance in the relationship appropriate and valuable. As one franchisor assured its franchisees: "Remember, everything we do is calculated to make your store more profitable, make you more successful."[147]

As a generally inexperienced businessperson in a reliance relationship, the franchisee's commitment is often simply to work hard.[148] In exchange for hard work, the franchisor relieves the franchisee of responsibility for the types of mistakes that cause most small business failures:

> Our quota clause is designed mainly to prevent someone from buying a Chicken Delight business for the sake of running the business into the ground in order to destroy the company's good name, or in order to make it possible for a competitive operation to get a start in one of our areas while they tool up to move into that area. But if you

[prospective applicant] were making every conscientious effort and consistently failed to meet your quota, we try to find out why and do everything possible to help you, even to the point of moving you to a new location if we should deem it necessary.[149]

True, you must be on solid financial ground to begin with. But if you make up for lack of financial assets with drive and stamina, and if you are hungry enough, and we recognize that, we reach for you. We'll help you get started.[150]

Franchisors often characterize those who fail as lazy, cavalier about quality, or lax about exercising the good sense of a diligent worker. Success or failure is within the direct control of the individual franchisee:

Many who started and grew with the industry, franchisor and franchisee alike, have prospered beyond imagination, beyond dreams of dreams. Some whose dedication, determination, character or imagination was not real enough, have not achieved.[151]

The emphasis on the franchisee's obligation to work hard underscores the basic reliance relationship between an inexperienced but diligent small businessperson and a superior, experienced franchisor responsible for making the remaining business decisions that will determine the success of the venture.

C. Intimacy and Interdependence

Not only is franchising a relationship between unequals, it is a highly intimate and interdependent one. The franchise contract hints at the extent of this intimacy. The norms and beliefs of the relationship go much deeper. In the early days of franchising, franchisors were surprisingly unabashed in their use of family metaphors to describe the relationship:

Being a franchisor is pretty much like being a parent. If there's a squabble amongst the kids you try to get in there and solve it. You have to handle it with diplomacy.[152]

His [the franchisee's] responsibility to you is to perform like you say to. When you sell the franchise, the franchisee is buying your leadership. You are not buying his. The function of the franchisee is to follow the wisdom and system of the franchisor….[T]ell him, 'Look, partner, we are both playing a role, and the role I've got is the Daddy, and the role you've got is the son, and I'm going to tell you how to do it. If you do it right *we're* going to do it better.'[153]

For one franchisor the parental metaphor was insufficient. At one time, the then-president of Kentucky Fried Chicken noted that

franchising has been described many different ways, but actually what it is, is a wedding. Lots of music, lots of flowers, money exchanging hands and lots of kisses. The couple is from the best of two worlds; one of the partners is experienced, with plenty of good know-how, and the other partner is a virgin, who hopefully has never been in business before. The vows they exchange are almost the same as you exchanged when you married your wife. The virgin bride must have a burning desire to be "his" own boss and to run "his" own business.[154]

Even today, modern franchising guides caution: "Are you a 'confirmed bachelor' who is on the verge of a 'business marriage?'" [155]

Other franchisors and industry observers echo the intimacy of the relationship and its extension, like a marriage, beyond the recognized legal form, but do so without the use of marriage or family metaphors: "In the relationships of franchisors and franchisee- in fact, in any relationships- we are talking about human relationships…And these relationships are not merely contractual; they do not begin or end with signed agreements, or with legal limitations."[156]

Sometimes the intimacy of the relationship is perceived as a windfall for the franchise company:

When you sell this gentleman the license, and he gives you $10,000, it is like sitting around a poker table. There are seven or eight of you, and he puts down $10,000 for his seat. He does not put his name in the ante, he won't get that back. He is giving that to the house. Marvelous industry, this franchising! Can you imagine a fellow paying you $10,000 for the right to pay you royalties for the rest of his life? And that is what the franchising industry is all about! He, the franchisee, pays you $10,000 for the right to pay you for the rest of his life! And sometimes in perpetuality?[157]

For others, however, the intimacy of the relationship is seen as a foundation for the responsibility that accompanies interdependence within an unequal relationship:

> In analyzing the relationship, I would suggest to you that the time has passed where any franchising company can operate on a "take it or leave it" basis, I believe a franchisee, having a substantial investment in his business, is entitled to an increased amount of Tender Loving Care. He has every right to expect empathy and a genuine understanding reciprocated by the franchising company to whom he is paying substantial fees.[158]

D. Conflict

These portrayals indicate that the franchise relationship is set of mutual obligations embedded in an intimate interdependence between unequals. And is often the case with intimate relationships, observers can subscribe to the view that the relation is inherently harmonious.[159] But more realistically- and as evidenced by litigation, popular observation, and efforts to obtain regulation- the intimacy and inequality inherent in the relationship make it vulnerable to conflict and abuse. Increasingly observers have recognized the fundamental divergence of interest within the relationship and the need for ongoing efforts to control such divergence.

Franchisors have for some time recognized the ways in which franchisee interests can diverge from their own. The basic quality control problem is well recognized,[160] as is the broader problem of free-riding.

> [H]ow do you control your hostility toward the franchisee- usually the well-established, old-friend sort of franchisee-who has made it so well he could not care less about making it even better? You sit in your office and hunger for that unrealized potential - while he is out on his yacht, on a sea of complacency and self-satisfaction![161]
>
> [T]here is the problem that many franchisees have reached a comfort index and are saying , in effect, "I don't want to expand. I've got enough. My taxes are so high that there is no reason for me to make additional investments." This may leave us with territories that are not fully developed- with markets where we have a substantial untapped potential. Again, this is a gap we must close by finding means to encourage existing franchisees to go beyond their comfort index or to sell off a part of the territory they have not developed.[162]

However, the extensive powers specified in the contract, as well as the understanding within the relationship that quality control is a key feature that justifies constraints on franchisee behavior, seem to enable the franchisor to control the franchisee's divergent interests. Franchisors have not been among those lobbying for change or regulation.[163]

Franchisees, on the other hand, have long seen a need to control franchisor abuses.[164] Franchisees and industry observers have recognized the essential problems of franchisee sunk costs and franchisor opportunism.

> There have been instances of franchisees who, having invested their life savings in building-up a business, find upon termination, that all they can take out (if they are lucky) is their original franchise fee. The plight of the franchise may be especially pitiful when he is subject to a restrictive covenant which prohibits his reentry into the only business he knows. He may be left with a "distinctive" piece of real estate – say a hamburger stand shaped like a donut which may not be used to sell hamburgers (or donuts). Under these conditions, the sale of equipment and real estate at a "fire-sale" evaluation (perhaps, back to the franchisor) may be the only alternative for the franchisee…. The assumption seems to be that all goodwill is solely traceable to the franchisor's trademark.[165]
>
> The right to approve the sale of the franchise or to approve the incoming franchisee can be a potential weapon against the franchisee. The franchisor can withhold approval in order to obtain concessions or in order to force the introduction of his new, often more stringent, franchise agreement.[166]
>
> More than one person has learned very expensively that the "unreasonable withheld" clause [for transfer or location approval] is largely meaningless and offers not protection to the franchisee whatever. In fact, it is a universal escape hatch for the franchisor.[167]

Franchisees also find that "[t]he most common cause of conflict comes under the catchall term lack of support [:] …failure to provide promised or necessary expertise."[168] Complaints concerning the quality of operational and financial guides and the knowledge of franchise field people are common.[169] Aware of the potential for lack of support, one franchising guide counsels prospective franchisees to ask:

[W]hat happens if I'm not successful due to my efforts? Suppose it's your fault – introducing products that don't sell, or picking the wrong location?

…[O]bserve carefully for your obligations couched in terms like "shall", "must," "will refrain from," "will be required to maintain, to pay, and to do" versus a franchisor bound only by "might's" and "maybe's." [170]

Franchisors can abuse the relationship most directly through manipulation of the price or quantity of products or services sold to the franchisee.[171] A buyer's guide cautions prospective franchisees to "[b]e aware that a franchisor may create additional fees or require additional purchases when it has excessive inventories or needs a quick infusion of cash for any reason."[172] Similar abuses occur in connection with the allocation of the advertising fees collected from franchisees. Observers note that it is "tempting for franchise companies to use these advertising dollars to boost their profit margins." [173] Many franchisees complain that "they do not receive advertising support commensurate with their payments of advertising fees." [174] Franchisors can also directly extract the franchisee's capital value by forcing the franchisee to forfeit either the capital equipment – sometimes purchased from the franchisor – or the initial franchise fee.[175] Franchisors are also accused of extracting profits by attempting to buy out (perhaps by finding "cause" for termination) successful franchisees.[176]

More subtle forms of extraction occur when the franchisor pursues its own otherwise legitimate interest at the expense of the franchisee. Examples of this type of behavior include increasing the exposure of the franchise name or changing the franchise image for the purposes of increasing the value of the franchise system overall without taking into account the cost to franchisees.[177] In addition, franchisors may make subtle use of franchisee investments, in the franchise itself or in on going supply purchases, to experiment with locations and products. By encouraging franchisees to take on products or locations with which it wishes to experiment, franchisors can shift the cost of the experiment to franchisees. One critic suggests that

> For many chain builders franchisees serve as cannon fodder, foot soldiers to be expended in battle. If the company thinks there might be a market for a product in a certain area it can find operators who will invade the community. If the experiment fails and the franchisees go bankrupt, well, that's too bad – in business there are always risks. In this way tens of thousands of individuals have lost their investments. As long as some outlets survive, they can continue trying new areas. It is out of the trial and error financed by many franchisees that a few successful chains and franchisees emerge.[178]

Over time, as the litany of franchisor abuses has mounted, franchising observers have come to recognize that the danger of abuse is inherent in the structure of franchising. The degree of franchisor control, coupled with the presence of franchisee investments, sets the stage for conflict.[179] As one buyers' guide notes, "as long as your interests do not conflict with their best interest, franchisors will indeed help you….Should your interests fail to converge with theirs, however, any franchisor will look out for itself first." [180] Asked, "Can't I trust the franchisor to do right by me," this guide answers, "Most franchisors will do right by you, according to their definition. However, their definition is not likely to coincide with your definition of what is 'right''.[181]

V. CONTRACT DISPUTES IN FRANCHISING

As both the economic and relational analyses of the previous two sections make clear, franchising is structurally vulnerable to conflicts. In this section I will present a basic overview of the variety of the contract disputes that are brought into the courts.[182] Section VI will then develop a general analysis of the interpretation and enforcement of franchise contract.

Most franchise disputes appear in court as wrongful termination suits. Terminations follow from two different types of events: franchisee violation of an established operating requirement or franchisor modification of the operational environment.[183] I will deal with these types of disputes separately.

A. *Franchisee Violations of Established Standards*

The most straightforward termination cases involve the franchisor's central concern – a franchisee's unambiguous failure to maintain quality standards – and a contract clearly providing for termination upon a finding of such failure. Cases of this type involve such questions as whether the contract justifies terminating a fast-food franchisee whose failure to comply with detailed requirements from an operations manual ("cover all food items" and "control pests")[184] resulted in health citations, or terminating a hotel franchisee who received successive "unacceptable" ratings in routine quality inspections governed by a detailed list of standards.[185] In such situations, courts must inevitably apply broad contract terms to particular facts. Photographically documented exhibits of rotting food, uncleaned equipment, improperly stored ingredients, and stray animals in the kitchen weigh against general contract requirements to maintain cleanliness.[186] Courts call upon generalized "best efforts" and possibly implied "good faith" standards to justify termination when franchisees mislead highway motorists about gasoline prices,[187] sell a generic brand of ice cream in trademark containers,[188] or pump substitute gas from trademarked pumps.[189] Such termination cases present the paradigm of franchise disputes.

An otherwise paradigmatic termination case becomes problematic when the franchisor apparently had an opportunistic reason for terminating the franchisee, indicating that the seeming violation merely provided a pretext for termination. In one such case, a franchisee ostensibly violated a 24-hour clause in this franchise contract by shutting down overnight during a period of federal gasoline rations. During that period the franchisor had attempted to induce the franchisee into the unprofitable position of posting a "no gas" sign during the day and taking it down when a competing gas station closed at night.[190] In another case, a franchisor sought termination upon a franchisee's default of less than 2 percent in royalties; the franchisor planned to transfer the franchise to a new franchisee able to distribute goods more profitably without compensating the original franchisee for its lost investment.[191] In another example, a franchisee failed to meet sales quotas devised by its franchisor while also threatening the success of a competing franchisor-owned oulet.[192] General "inadequate performance" leads to termination in some cases where the franchisor's true complaint appears to be the franchisee's failure to maintain suggested resale prices.[193] A final example of this type of dispute includes the case in which a fast-food franchisee bought into a fledgling system and agreed to open ten outlets in ten years. When the franchisee had only nine in place after ten years, the now highly successful franchisor terminated all nine, thereby allowing the franchisor to resell the franchises at higher prices, and depriving the franchisee of the upside of its earlier gamble.[194] In all of these more problematic cases, the franchisor appears to be "enforcing" a minor or curable contract violation not to promote the quality of its franchises but to achieve some other, opportunistic goal at the franchisee's expense.

The hardest cases of franchisor opportunism involve ambiguous motives on the franchisor's part. In one such case, the franchisor terminated the franchisee after the franchisee sold below his quota and refused to comply with the franchisor's demands for additional salespeople and increased inventory.[195] On the one hand, the franchisee had a clear obligation to meet the quota; on the other, the franchisor, perhaps facing region-or nation-wide declines in sales as well, had a potentially opportunistic interest in shifting inventory and the cost of boosting sales to the franchisee.[196] Another example involves the termination of a franchisee who had failed to disclose, as required by contract, the identity of franchise shareholders. The franchisee, ailing financially, contracted to sell the franchise to a new franchisee. The franchisor disapproved the transfer, committed the franchise to a third franchisee in settlement of an extraneous dispute, and terminated the franchise.[197] The potential for opportunism here rests in the franchisor's interest in transferring the franchise at a low price to the third franchisee as consideration for settlement of another dispute. Again, however, an otherwise legitimate ground exists that might ordinarily prompt termination, and identifying the franchisor's true motive is often complex.

In all of the above cases, courts face the question of whether the franchisee's violation of an established obligation justifies termination. The importance of a franchisor's more or less ambiguous ulterior motives depends on the court's resolution of a relational question: Are there limits on the use of the power to terminate, the power of quality control?

B. *Changing the Franchise Environment*

The second type of dispute raises a slightly different relational question: What are the limits on the franchisor's power to structure the franchisee's obligations in the first place, the power of design? When the franchisor exercises this power and modifies the franchise system in some way, litigation arises after the franchisee's refusal to comply results in termination or when the franchisee alleges that the franchisor has breached its obligations by abusing the design power.

A large number of cases of this type involve franchisor efforts to induce franchisees to terminate voluntarily in order to transfer the franchises to more profitable franchisees or to convert the outlets to company ownership. In one such case, the franchisee had taken on a Mazda automobile dealership when the company was selling only the GLC, a relatively unpopular model.[198] When Mazda introduced its successful RX-7 model, it sought to reduce its inventories of the less popular GLC by allocating RX-7's to old franchisees on the basis of GLC sales. Mazda then adopted a policy of "drastic action" to achieve the voluntary termination of existing franchisees. Under this scheme, new franchisees received RX-7s on the basis of RX-7 sales. Because older franchisees held GLC inventories, which Mazda would not repurchase after termination, older franchisees were unable to compete effectively with the new dealerships which could count on the availability of RX-7s to attract new customers.

In other cases, the franchisor will take steps in response to a changing market environment that raise the possibility that the franchisor is attempting to reduce the value of the franchise in order to bring about voluntary termination. Modifications such as delays in delivery, price and credit-rate increases, and required retail discounting may reflect such an effort.[199] In one extreme case, a franchisee purchased Fotomat film distribution franchises from the franchisor at an early stage in the development of the system, paying a relatively low franchise fee.[200] Discovering that the franchises were more profitable than expected and that profits from company-owned stores were higher than those from franchised stores, the franchisor began setting up competing outlets close to particularly successful franchises and ceased providing contractually required pick-up and delivery services thereby cutting the profits of the franchisees in half. These and other steps drastically reduced the price at which the franchisor could buy back the outlets.

In a related set of cases, the franchisor limits the profitability of a franchisee by preventing it from competing effectively with the franchisor's own nearby location. In one such case the franchisor refused to increase fuel supplies to a franchisee seeking to expand, designating the franchise as a "no-growth" distributor.[201] In another, the franchisor allegedly manipulated the franchisee's territory in order to take over its successful distribution network.[202]

The *Fotomat* case demonstrates another opportunistic use of the design power: franchisor experimentation. Many franchises, like the Fotomat franchise, involve new products or processes, the success of which is still uncertain; all franchises involve uncertainty about the potential success of a particular location. This uncertainty creates the danger that the franchisor may use its power to terminate or devalue a franchise in order to seize the upside of the franchisee's gamble, leaving the franchisee only the downside. *Burger King*[203] is another example in which the franchisor attempted to terminate a franchisee who had been with the system since its early days, possibly to resell the franchises at higher prices. The franchisor might also seek to take advantage of a successful location gamble by invading a franchisee's territory.[204] When a location is not successful, the franchisee bears all of the costs of the failure.[205] Franchisors may also experiment with operational changes, such as staying open twenty-four hours,[206] or introducing limited-offer menu items.

Franchisees bear the costs of these marketing experiments, distorting the franchisor's assessment of whether an experiment is cost-effective.

The franchisor often makes explicit changes in the franchise system when presenting the franchisee with a new contract containing modifications in terms. The facts of *Arnott v. American Oil Company* [207] provide an example of how contract modification may be employed opportunistically. Amoco persuaded Arnott, a service station franchisee, to purchase a carwash from Amoco for installation at his station. In exchange for the installation, Amoco attached a rider to franchise contract which entitled Arnott to a minimum monthly rebate on the car wash, provided he met a prescribed level of sales. Four months after Arnott installed the car wash, Amoco cancelled the existing contract and presented Arnott with a new contract which essentially cut the rebate in half.

Less blatant examples of opportunistic contract modification also occur. In one case, the franchisee refused to sign a new agreement giving the franchisor new powers to relocate to franchise and set hours and transferring to the franchisee utility costs previously borne by the franchisor.[208] In another case, the new contract would have created more onerous sales, price, and hours requirements and established new grounds for termination.[209] Other cases involve modifications which require the franchisee to convert traditional gasoline service stations into streamlined "gas & snack" operations without repair services,[210] or to implement formulaic increases of as much as 300 percent in the rent charged to gasoline franchisees.[211] The complexity in these cases derives from the conflict between the franchisor's legitimate interest in responding to a changing market and its illegitimate interest in shifting the costs of change onto franchisees or in masking purely opportunistic changes as market-induced.

"Dual-distributor" cases often raise this issue. In one such case, an automobile franchisor selling a fairly popular model adopted a formula whereby franchisees could only obtain this model if they agreed to take on a less popular model the franchisor was promoting.[212] In this case the franchisee refused, citing competition with another existing line in its showroom, and was terminated. In another case, a franchisor terminated a franchisee for selling a second, unrelated line of automobiles.[213] The contract nowhere proscribed such dual distribution – a standard and easily specified clause. The franchisor rationalized that decision by virtue of its contractual right to establish standards for the showroom layout, but the facts did not indicate whether the showroom had been detrimentally affected by the new line. The franchisor's interest in the decision is clear enough, but so is the cost to the franchisee. A case involving the removal of a long-standing leasing component of a truck dealership, in order to create space for display of the franchisor's products and to create additional amenities for customers,[214] raises the same issue of whether franchisors are entitled to make design decisions solely in the franchisor's interest, regardless of the cost to franchisees.

These questions, which require the evaluation of the contractual status of apparently legitimate but divergent interests between franchisor and franchisee, arise prominently in the context of the franchisor's exercise of its authority to approve a franchisee's transfer of the franchise to a new franchisee. On the one hand, this approval authority reflects a strong, legitimate interest on the part of the franchisor to choose with whom it will enter into the franchise relationship. In order to ensure the financial success of the new franchise, the franchisor has an interest in overseeing the details of the transfer. On the other hand, prospective franchisees are the only purchasers for whom the otherwise idiosyncratic assets of the franchise – the trademarked signs, inventory, and building design – have full value. Thus, the franchisor may reduce competition for the outlet and thereby reduce the purchase price by restricting the pool of potential franchisees available to the departing franchisee. Often it appears that the franchisor has a single buyer in mind and consequently will not consent to transfer to any other buyers with whom the departing franchisee may be negotiating;[215] this potential franchisee is then in a good position to bargain for a low price from the departing franchisee. Many franchisors also exercise their control to reduce the transfer price by refusing to approve a sale at a price above a certain value.[216] Other conflicts arise when the franchisor either requires the franchisee to obtain written consent from the franchisor prior to consideration of potential transferees, leaving the franchisee in a poor bargaining position,[217] or refuses to waive a right of first purchase which the franchisor has declined to exercise, thereby leaving a cloud over the franchisee's negotiations with potential buyers.[218]

The above cases all deal with franchisor efforts to "tinker" with franchisee obligations. Beyond these are issues that arise in connection with basic restructuring of the franchise system. What, if any, obligations to recent franchisees does the franchisor have to continue to invest in and support the franchise system? In one example, Holiday Inn decided to withdraw entirely from the business of promoting its TravL-Park system in which franchisees had recently invested.[219] In such a case, resolution of the franchise dispute requires the court to determine whether it is sufficient that withdrawal is in the franchisor's interest, or whether the franchisor is obligated to support the system so long as the franchisee could remain successful. Other such cases turn on the question of what responsibility lies with the franchisor to disclose to new or continuing franchisees its future plans for the system. Is a fast-food franchisor required to disclose to prospective franchisees viability studies that indicate that the system is in financial trouble?[220] If the franchisor does not disclose the studies, is the franchisor entitled to tell franchisees that it remains committed to a strategy to do "whatever it takes" to support system growth?[221]

Questions about the franchisor's power to restructure the entire franchise system can reach a high water mark when the franchisor decides to sell the system to a new franchisor.[222] Attempts to alter the franchise relationship, in an effort to achieve a level of profitability that eluded the previous franchisor, can accompany the change in franchisor. The new franchisor may wish to terminate franchisees it determines are "unprofitable,"[223] which compete with the new franchisor's own distribution,[224] or which it determines are in any way "dissatisfactory."[225] The new franchisor may seek to alter the terms of the franchise by changing the formula for computing wholesale prices[226] or by altering the duration and royalty rates that had governed the franchise in the past.[227] The new franchisor may also attempt to modify advertising policy and require renovations in existing outlets.[228] Finally, the franchisor may change the product by substituting pre-packed ice cream for "ice-cream made fresh daily on the premises,"[229] or frozen fishcakes for fresh fillets.[230] These cases present particularly difficult questions of identifying the contractual balance between the interests of the new franchisor and the franchisee.

In sum, there are two basic types of contract disputes in franchising. First, there are those that involve a clear failure on the part of the franchisee to comply with an established operating requirement. Second, there are disputes that involve the franchisor's efforts to change the franchise system's operating requirements or design. In the first type of dispute, courts must establish the relevance of a franchisor's ulterior or additional, and potentially opportunistic, motives for termination. In relational terms, the question is, what are the limits on the use of the power to terminate for quality control violations? In the second type of dispute, courts must delineate the franchisee's obligations to comply with new franchisor directives. Put relationally, what are the limits on the power to redesign the franchise system? In the next section, I turn to a general approach to analyzing these questions.

VI. RESOLVING FRANCHISE DISPUTES

A. *Interpreting an Incomplete Contract*

Recalling the analysis of the central commitment dilemma of franchising,[231] we can see why the two types of questions identified in the previous section emerge as the fundamentals of franchise disputes. It is along these dimensions that the franchisor's interest in quality control and design comes into direct conflict with the franchisee's interest in preventing opportunism. Only by defining the limits of franchisor control and discretion can the two interests reconcile in a way that provides each party with the commitment necessary to justify entering into the franchise relationship.[232]

In a world of complete contracting- the classical world envisioned by standard contact law- the fundamental questions in franchise disputes would be easy to resolve. The franchise contract would define explicit limits on the quality control and design powers, using written terms to correspond to the particular facts of each potential set of circumstances. For example, the contract would specify what actions Amoco could and could not require from a 24-hour gasoline franchisee in the event of gasoline rationing,[233] it would specify the market conditions under which Holiday Inn could decide to withdraw permanently from its Trav-L-Park system.[234] It would specify how much and what kind of advertising the franchisor had to do, given the various possible changes in the competitive franchise environment. The contract would also specify whether a new franchisor could switch from handmade to pre-packaged ice cream[235] or require alterations in outlet design or equipment long before existing capital wears out.[236] In this classical world there might be the occasional definitional difficulty,[237] but by and large the courts could resolve franchise disputes passively, employing standard tools of contract interpretation.

The reality, as demonstrated in Section II, however, is that franchise contracts are extraordinarily and necessarily incomplete. Rarely do they, nor can they, spell out the details of the myriad transactions between the franchisee and franchisor. Instead these agreements read like miniature constitutions, setting out the parameters of each party's duties in general terms. Franchisors are to design and maintain the system. Nowhere does the contract specify whether the franchisor may terminate the franchise simply because a better franchisee appears.[238] For an automobile dealership franchise, the contract may be silent on the question of whether the franchisee is entitled to receive the franchisor's popular new model of automobile in the same quantity as new franchisees.[239] Nor do fast-food restaurant franchise contracts typically mention whether the franchisee can refuse to participate in a promotional "free fries with every burger" program which costs the franchisee far more than it brings in the way of new customers.[240] In the absence of even poorly drafted terms covering such situation, courts are faced with non-classical contract interpretation.

To properly "interpret" the franchise contract one must read the written document in the context of the franchise "relation." Faced with the silence of the agreement, a court has only two options: Either it can refuse to decided the dispute, finding the contract invalid and unenforceable, or it can resolve the case, filling in the contract's silences. Early in the development of franchising, courts routinely took the first, "classical," route. Today, however, almost all courts choose the second.

Having taken this second route, a court has no choice but to look beyond the document and identify a configuration of commitments patterned not in the words of the contract but in the underlying relation itself. If a court is to decide that an auto dealership warrants termination by refusing to build a new showroom, it can only do so by discerning in the relationship and obligation on the part of the dealer to comply with a manufacturer'' request for a new showroom. In deciding that a fast-food franchisor incurs no liability to potential franchisees when it fails to disclose its plans to dismantle the system, it must see within the franchise relationship no franchisor obligation to share with franchisee relevant available information necessary to make successful business decisions. Courts, in resolving franchising disputes, do exactly this: they supply a theory of the relationship in order to identify the commitments they must enforce. But the theory they supply is, I will argue, inappropriate.

B. *The Business Judgement Approach*

Essentially, the courts get half of the story right. They understand well the franchisor's interests in quality control and design and the vulnerability of these interests in franchisee failures.[241] Thus, they see the franchisor's problem in enforcing the franchisee's commitment to maintain quality and adhere to the franchisor's system. Consequently, in the paradigmatic franchise dispute in which the franchisee has, for example, failed to observe practices set out in an operations manual, and where there is no evidence of improper franchisor motive, the courts easily find the obligation that makes such behavior a contract violation and basis for termination.[242]

Where the courts go astray, however, is in treating the franchisor's interest as if it represented the entirety of the relation. As one court expressed this view:

> [T]he substantiality of a franchisee's noncompliance, as a legal concept, must be gauged in light of its effect upon or potential to affect the franchisor's trade name, trademark, good will and image which, after all, is the heart and substance of the franchising method of doing business.[243]

Although correctly recognizing the effect of franchisee and noncompliance on the franchisor's trademark, the court quoted above errs in adopting the view that this effect constitutes the "heart and substance" of the franchise. Even calling franchising a "method of doing business," and thus portraying it as the franchisor's choice of a distribution method, obscures the basic exchange aspects of the arrangement. Franchisors and franchisees alike perceive franchises as packages of services that promote the profitability of the fledgling small businessperson.[244] It would be just as erroneous to portray this aspect of franchising as the entirely of franchising. The point remains, however, that both franchisor and franchisee perspectives reflect components of the exchange.

The theory that the franchise relation centers exclusively on protecting the integrity of the franchisor's system and the value of the trademark leads to what I call a rule of "business judgment" in resolving cases that go beyond the simple paradigm of a franchisee violating a standard operating requirement. Facing the more problematic cases in which a franchisor terminates a franchisee,[245] the courts routinely adopt the view that since the franchise relationship is a "business" relation the franchisor needs only to articulate a plausible business justification.

For example, when Holiday Inn eliminated its Trav-L-Pack system after the plaintiffs had entered into a long-term franchise arrangement, the court refused to impose any liability on the franchisor. The court simply stated that the "franchise relationship is inherently a business relationship."[246] In another example, when the Burger Chef system went into decline, franchisees who had relied on the franchisor's brochures and assurances to do "whatever it takes" to build the system into an industry leader sued on the basis of Burger Chef's failure to disclose the viability studies that foretold the decline of the system even as the franchisor made the assurances and sold new franchises. The court, however, held that the statements about the future growth of the system "could only be characterized as 'puffing' " and that "although [the franchisees] may in *fact* have relied on the representations of the defendants, they had no *right* to rely on them."[247] And in a final example, when Leyland Motors terminated a franchisee for refusing to take on an additional line of motor vehicles because the new line would compete unfavorably with another of the franchisee's existing lines, the court upheld the franchisor because the termination was

> based upon a rational business decision… The evidence clearly demonstrates that it was in the best interests of Leyland to market its Triumph and Rover lines in the United States through dual dealerships…When [the franchisee] declined to accept such a dual dealership Leyland had a perfectly legitimate reason to refuse to renew its Triumph franchise.[248]

The "business judgment" theory evidenced in these cases amounts to filling in the gaps in the incomplete contract by according the franchisor unfettered discretion, much as it would enjoy if it were a vertically integrated corporation. According to this view, if Holiday Inn does the calculation and finds it would be better off withdrawing from the Trav-L-Park market, it can do so; Burger Chef is not required to disclose its business judgements to anyone; Leyland Motors is free to select whatever distribution scheme it decides will serve its interests best.

But Holiday Inn, Burger Chef, and Leyland Motors are not vertically integrated firms. Rather, they have chosen to have independent franchisees make all or most of the sunk capital investments in the retailing end of the business. In exchange they have to be understood to have taken on an obligation not to make “business judgements” that take advantage of those investments. Would Holiday Inn or Burger Chef invest in new outlets knowing what they did about the future of the system? Would they have chosen to withdraw when they did if their own investments were at risk? Would Leyland Motors have established a Triumph dealership standing alone or invested in another line to increase the customer base, only to have that investment wiped out by the introduction of another untried model?

It is simply not sufficient to look for a plausible story about why a particular franchisor decision is the result of the franchisor’s “business judgement.” As the courts employ this rule, any franchisor decision which does not appear “vindictive”[249] or the product of “improper motive”[250] is a legitimate business judgement. The business judgement rule does indeed protect franchisees against “arbitrary”[251] decisions or blatant fraud. Thus the courts will reject efforts to terminate a franchisee when it is evident that the franchisor is simply trying to transfer the rights to a franchisee better placed to maximize sales.[252] Stereotypical antitrust violations - such as resale price maintenance[253] or predatory behavior to achieve a low-cost buy-out of the franchisee[254] - also fail the “business judgement” test. So do obviously opportunistic efforts to change contractual terms to capture the value of a franchisee’s specialized investments,[255] or to exact higher prices and sales requirements.[256] But inside these limits, under the business judgement rule the franchisor possesses unrestricted discretion in making decisions about quality control and the design of the franchise system.

Essentially, this view frees the franchisor to behave opportunistically in making those decisions. The business judgement approach rejects any scrutiny of whether the decision results in the extraction of sunk costs from the franchisee, or of whether the franchisor’s decision is one that is profitable to the franchisor only at the expense of the franchisee’s investments. The problem with this approach should now be clear: By enforcing the franchise contract in this way, courts fail to protect fully one half of the interests necessary to support the franchise relationship.

What are the consequences of this failure by the courts? There are a number of ways to approach this question. It seems clear that franchisees generally enter the franchising relation expecting to exchange conscientiousness, investment, and hard work for a successful management package. Thus, from a relational perspective, courts undermine the exchange by routinely ignoring this expectation in resolving contract disputes. Courts fail to appreciate that franchisees did not enter into the exchange as if they were purchasing stock in the franchisor’s company, that is, putting up their money and taking all risks short of fraud, self-dealing, or other failures of corporate responsibility. Franchisees make large, undiversified, long-term investments; normally there is no “meeting of the minds” granting the franchisor power to issue directives that profit the franchisor only at the direct expense of the franchisee despite covenants which require the franchisee to obey *all* directives. Treating franchisees as if they made deals they did not in fact make offends the traditional rationale for contract enforcement.[257]

Under this rationale, contract law should provide a contracting instrument that enables parties to devise their own arrangements privately and enforces the commitments underlying those arrangements.[258] In the world of classical complete contracting, courts read the contract and compare it with what has occurred. In franchising’s world of incomplete contracting the courts must strive to identify the entirety of the commitment structure that underlies the franchise arrangement and then to enforce those commitments.[259]

The incompleteness of franchise contracts is neither an accident nor a failure of adequate draftsmanship. Given this, parties, and courts cannot merely pursue rules of interpretation intended to spur better drafting and competition among franchisors in designing a standard form contract. They must instead grapple with the difficult issues of relational interpretation.

C. *A Relational Approach to Interpreting Franchise Contracts*

The business judgment approach relies on a flawed theory of what the franchise relation is about; it thus inevitably generates flawed contract enforcement. How can the courts use enforcement to create an incomplete contracting instrument that better serves the needs of franchising? The answer lies not in a change in doctrine but in a change in approach.

The doctrinal tool necessary to bring the resolution of franchise contract disputes into line with the realities of the franchise relation is the convenant of good faith and fair dealing. Already, the covenant of good faith and/or a requirement of good cause for termination is implied in most franchise contracts.[260] "Good faith" and "good cause," however, are extremely open terms. Ironically, it is in stating the content of such terms that courts have been most explicit about their appreciation of the business judgement approach.[261] Although the doctrinal tools necessary to introduce relational considerations into the interpretation and enforcement of franchise contract disputes exist, they have been essentially buried by the business judgment theory.[262]

Relying on the good faith doctrine as a method of introducing more accurate relational considerations requires that courts routinely look beyond the written franchise contract and examine the relationship in which that contract is embedded. A relational interpretation should first determine the significance of the written terms. For example, particular and explicit clauses setting out franchisee obligaitons[263] should receive presumptive force, since normally the franchisee and franchisor both know and understand their respective roles: the franchisor sets out such obligations and the franchisee complies with them.[264] Vague general clauses or clauses that attempt to transfer broad sweeping powers to the franchisor,[265] on the other hand, should not be enforced so as to free franchisors to behave opportunistically, absent evidence that the franchisee truly negotiated and understood the full implications of the terms, or that, unlike typical franchisees, the franchisee is neither inexperienced nor reliant on the franchisor.[266] Such terms simply do not accord with the typical structure of the franchise relationship: more evidence is needed about a particular relationship to demonstrate a true intent to leave the franchisee, as these terms literally would, with no protection against franchisor opportunism. General "interpretation guides,"[267] declaring that the contract is only concerned with ensuring franchisee compliance with quality control provisions and, by implication, not with controlling franchisor opportunism, should be treated with similar skepticism.

Courts should stop conceiving of the franchise relation as one solely dedicated to protecting the franchisor's trademark and goodwill. The franchise relation is a mutual exchange. Franchisees make large, sunk investments in operating outlets- investments the franchisor would otherwise have to make in order to retail its product or service in the franchisee's area- to reduce the risks of operating their own small business. In turn, franchisors obligate themselves to promote the profitability of franchisees. Franchisors risk the value of their trademarks in exchange for shifting sunk investments to franchises. Franchisees commit themselves to complying with franchisor directives in anticipation that they will receive sound products, sound business advice, and support. The relation makes little sense unless the "contract" between franchisor and franchisee balances these mutual arrangements, establishing commitments on the part of both franchisee and franchisor.

The relational approach to contract interpretation requires sensitivity to the particularities of any one relation. The features of the abstract franchise relation should only be used as a guide to identify the features of a concrete franchise relation. In some cases, a "franchise" relation may differ in important respects from an abstract franchising relation. Using the abstract model as a guide, however, a court can distinguish those arrangements in which the typical franchising problems of control and opportunism are potential problems from those in which they are not.[268]

Courts facing a dispute between a "franchisor" and a "franchisee" should first determine whether the arrangement includes sunk investments, a necessary prerequisite for opportunism. Many distributorship arrangements, for example, lack sunk investments: distributors may take on a manufacturer's product but make very few investments in distribution facilities and equipment specific to the product. In other cases, the franchisor agrees to purchase all of the franchisee's assets at market prices- that is, prices that included a component for the franchisee's future profits as a franchisee- in the event of termination. In these two types of cases, the franchisee needs little protection against opportunistic behavior which reduces the value of sunk investments. Therefore, there is no reason to believe that the relationship includes limits on manufacturer behavior other than those explicitly set out in the contract. If the court finds sunk investments, however, it must determine whether the challenged action falls within the scope of the relationship.

There are no hard-and-fast rules for accomplishing this end. Relational interpretation is a fact-specific exercise of attention, insight and judgment. Consider a recent case in which Volkswagen terminated a franchisee after it distributed Fords in the same dealership.[269] The written contract contained a provision giving Volkswagen the right to prescribe standards for the showroom layout, but it did not prohibit a dual dealership. Manifesting a business judgement approach, the court upheld the termination, suggesting that the Ford line affected the showroom layout and finding that Volkswagen had made a valid business judgement that it was not in its interest to have dual dealerships.[270] From a relational perspective, this resolution is troublesome. *Volkswagen* involves the typical scenario in which the franchisee has made large sunk investments in capital with the attendant danger that the franchisor will make "business judgements" that fail to take these investments into account. The court needs to ask: What prompted the franchisee to take on the Ford line? Is it possible that sales of Volkswagens had declined to such a level that the scale of business no longer generated a reasonable return on the franchisee's investment in showroom space. Why was there no explicit clause prohibiting a dual dealership? It is possible that Volkswagen was unable to get franchisees to take on dealerships with such a prohibition at the time the contract was formulated, because of uncertainty about the popularity of the automaker's models and thus the wisdom of making sunk investments. Did the additional Ford line in fact substantially affect the showroom layout? Did the franchisee have an opportunity to make changes to the showroom in order to maintain the amount of space previously devoted to Volkswagens? Did the prohibition of a dual dealership benefit only the franchisor's interests, such as by promoting tangential trademark concerns at substantial cost to the franchisee, without promoting the franchisee's interest in selling more cars or creating a more profitable dealership? The court should have attempted to determine, in light of the particular relationship at hand, whether the franchisor's judgment took advantage of the franchisee's commitment of sunk resources.

Finding that the franchisor does not have a unilateral contract right to prevent a dual dealership does not forever doom the franchisor to this unhappy course. The point is that, like any other business, it may have to pay for achieving this result. The franchisor could have renegotiated with the franchisee, compensating the franchisee for giving up the Ford Line, or it could terminate the franchise and pay damages calculated to compensate the franchisee for its loss, including repurchase of inventory and showroom and damages for lost future profits.[271]

Looking more closely into the franchising relationship, courts should be sensitive to the ways in which franchisor and franchisee interests diverge.[272] Only then can they assess whether the franchisor's interests should trump the franchisee's. Franchisor policies or promotional programs that produce a profit for the franchisor, but only because franchisees must bear the cost, are an example. There are numerous others. A franchisor may prefer a particular location because its high visibility promotes consumer recognition of the trademark, but a franchisee might find that the same location's inaccessibility fails to generate a profitable volume of customers. Franchisor image advertising of the trademark may generate revenue from secondary licensing (such as T-shirts and movie releases) but produce very little in the way of business for the franchisees. Franchisors generally seek to increase gross volume per outlet because they receive royalties based on volume and because volume generates consumer recognition. On the other hand, franchisees, who must bear the cost of increasing volume, seek to increase profits, which requires operating at a volume somewhere below the maximum possible. When deciding whether to sell their franchise systems, franchisors have an interest in maintaining high sales and trademark value by keeping such plans quiet, whereas potential and existing franchisees can make better investment decisions and evaluate the risks if they have access to the franchisor's plans. In a declining franchise system, large corporate franchisors with alternative uses for resources may have an interest in withdrawing those resources at a time when franchisees with sunk investments are still able to earn a reasonable return from the system. A franchisor has an interest in transferring the assets of an existing franchise to a new franchisee at a low price or to a particular candidate, but the outgoing franchisee has an interest in recouping as much of its sunk investment as possible.

Accompanying these divergent interests is the franchisor's control power. This power allows the franchisor to pursue its interest at the expense of the franchisees. When a franchisor decides to terminate and buy out a successful franchisee, is it taking advantage of a gamble that turned out well but not compensating the franchisee for the loss of future profits? When a franchisor withholds approval of the transfer of a franchise, does it do so in order to grant the franchise to a specific transferee it prefers, who will pay a lower price for the franchise? If a franchisor disapproves of the transfer price, does it do so because it reasonably fears that the proposed transfer price will overburden the new franchisee? By keeping future plans for the franchise system a secret, has the franchisor induced franchisees to make decisions, such as putting up investments or foregoing alternative arrangements that a reasonable businessperson with the information would not have made? Are plans to alter the system in an effort to bolster a declining organization overly risky in light of the cost to franchisees? Is the decision to terminate old franchisees or to seek, voluntary termination by changing the terms of the franchise an effort to take over the franchises at low cost or an effort to eliminate obsolete inventory?

Proponents of a business judgment approach to resolving franchise contract disputes are likely to protest that the courts are not competent to ask, much less answer, these types of questions. First, I believe courts are capable of answering these types of questions; for the most part the questions simply involve widening the judicial lens to include the full landscape of events. Courts can guide their inquiry with a relatively simple analytical structure, one developed from an understanding of the nature of commitment, sunk costs, and opportunism.[273] Second, even conceding that the courts will make mistakes in carrying out this inquiry, courts should be at least as competent in understanding franchise disputes as they are in analyzing medical malpractice cases, product liability issues, and antitrust suits, or in reviewing the decisions of modern administrative agencies, assessing the employment decisions of public and private organizations, or making determinations about the deals struck between large, equally sophisticated firms. Although the courts may be more or less flawed in performing many of their functions, the relative competence of the courts is a fixed feature of the modern judicial system and one of the costs of administering that system.

Third, while courts may err and see opportunism where it does not exist or fail to see it where it does, these errors should be largely random. Any bias resulting from the relational approach is likely to be far smaller than the bias we would expect to emerge if the franchisor were handed the judge's gavel. But a business judgment approach, by deferring to the franchisor's assessment of the decision to terminate a franchisee, does essentially this. Given the inherent difficulty of writing incomplete contracts and the central difficulty of balancing franchisors' interests like quality control against franchisees' interests in protection against opportunism, the franchise relationship needs an unbiased dispute resolution mechanism. The business judgment approach, because it will always be more biased than even a flawed relational approach, fails to provide this mechanism.

Finally, unless the courts wish to abandon their traditional role in enforcing the exchanges actually reached by contracting parties, there is no escaping relational interpretation in a world of incomplete contracts. The business judgment approach does not respect the basic franchising exchange and thus undermines it. Complete contacting is simply not feasible. Consequently, despite the difficulties of administering incomplete contracts, the judicial system must either grapple with this task or else deny accurate contract enforcement to arrangements such as franchising.

VII. CONCLUSION

In a complex economy the judicial system faces increasingly complex tasks of developing and enforcing the various legal rules and instruments that structure the economy's relationships. Enforcing the incomplete franchise contract is such a complex task because it requires coming to terms with the unique attributes of the franchise relationship.

Although the franchise relationship may appear unremarkable on the surface, it has in fact a highly distinctive structure. Unlike either an employment relation or an ordinary independent contracting relation, the franchise relationship is characterized by the fact that franchisees own the bulk of the capital assets of the franchise and franchisors retain he right to determine how franchisees will use those assets.

This distinctive separation between the ownership of the franchise assets and the control over those assets has enormous consequences for the nature of the exchange in franchising. It structures the central commitment dilemma of franchising: On the one hand, the franchisor has a strong interest in exercising control over the product quality decisions and over the design of the overall system; on the other hand, the franchisee has a strong interest in ensuring that the franchisor's exercise of control is not opportunistic. Understanding the economic dynamics of the relationship identifies this basic commitment problem and provides some insight into the types of disputes that arise between franchisor and franchisee.

In classical contracting settings, such commitment problems are addressed in a written contract. The writing serves to guide courts in resolving disputes. But an examination of the written franchise contract uncovers an important non-classical feature: The contract is highly incomplete. While broad in scope, it is short on detail, necessarily so, given the uncertain and long-term nature of the relationship. The written contract defines general powers and responsibilities, but it does not, and probably cannot, specify how the parties are to exercise those powers. Moreover, the written contract appears to address only one half of the underlying commitment problem in the relationship – specifically, the franchisor's problem of quality control. It fails to address the franchisee's problem of controlling franchisor opportunism. Instead, the contract leaves to the franchisor's discretion the exercise of both the powers of quality control and design.

The necessary incompleteness of the franchise contract prompts examination of the norms and practices – the relational structure of franchising – to identify the complete content of the franchisor and franchisee's exchange. Guided by the commitment problems elucidated by economic analysis, this examination reveals that the exchange in franchising is a mutual one. The typical franchisee is an inexperienced businessperson, seeking to set up a small business but seeking also to reduce the risks of that enterprise. The franchisor, usually an experienced and sophisticated business entity, provides the franchisee with a package of corporate services, a product with a proven track record, and the advantages of a common trademark. As a result, the relationship is essentially a reliance relationship between unequal parties. The franchisee relies on the franchisor's superior business knowledge and perceives its obligations as following the franchisor's directives. The franchisor, in a sense burdened by its superior position in a nonetheless mutual exchange, is obligated to develop a successful system and to share its expertise with the franchisee. Even the drafting of the standard form written contract is, because of the relational imbalance, almost necessarily left to the expertise of the franchisor.

Predictably, the franchise disputes that appear in court center on the franchisor's exercise of its significant, relationally constrained but formally unfettered powers. And unfortunately, drawn to the model of the complete contract, courts tend to view the formal written contract as representing the entirety of the commitments structuring the franchise relationship. In practice, this approach amounts to a "business judgment" rule of enforcement: Provided that franchisor articulates some plausible business rationale for its actions, courts will not interfere. In doing so, however, the courts fail in their traditional task of enforcing the true exchanges reached by the contracting parties.

Courts can remedy this failure by bringing an understanding of the true relational structure of franchising to bear on their task, and by developing an alternative, relational approach to the interpretation of franchise contracts and the resolution of franchise disputes. The highly incomplete franchise contract requires analysis in a manner distinct from the ordinary, complete contracting approach of classical contract law. Franchise contracts are embedded within an identifiable, discoverable relation. The commitments that support the relationship stem not only from the written document, but from a common understanding of this relation. As a consequence, to interpret the franchise contract is to read it in the context of this relationship, to test the written terms against the basic sense of the relationship and the commitment problems facing both franchisee and franchisor. Only by so doing can courts ensure that the exchanges they enforce are indeed the exchanges that constitute a franchise.

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Endnotes

[1] The courts may also face a commitment problem in carrying out the sanctions that contract law requires. Courts may be tempted to relieve the parties of their *ex ante* obligations. I will not deal directly here with this aspect of commitment.
[2] *See, e.g.,* Oliver E. Williamson, *Transachon Cost Economics: The Governance of Contractual Relations.* 22 J.L & ECON. 233, 235-38 (1979).
[3] That is, even beyond the legal system's unavoidable elements (regulation, tort, property, etc).
[4] Franchising is generally characterized by an arrangement between a franchisee, who owns and operates a retail outlet identified by franchisor's trademark, and a franchisor, who may supply a product, such as automobiles, gasoline, or clothing, to the franchisee. Alternatively, the franchisor may provide a complete business plan with which franchisees must comply. See text accompanying notes 12-54 infra for a more in-depth discussion of the identifying features of franchising.
[5] *See* Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors.* 45 BUS. LAW. 289, 290 (1989).
[6] U.S. DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY 1985-87., at 14 (1987) [hereinafter FRANCHISING IN THE ECONOMY].
7 *See, e.g.,* Harold Brown, *Franchising – A Fiduciary Relationship.* 49 TEX. L. REV. 650 (1971).
8 See. e.g. Arnott v. American Oil Co., 609 F.2d 873 (8th Cir. 1979) (franchisor has fiduciary duty to franchisee at termination); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973) (termination-at-will clause unconscionable); 15 U.S.C. 1221-1225 (1988) (Automobile Dealer's Day in Court Act); 15 U.S.C. 2801-2806 (1988) (Petroleum Marketing Practices Act); CAL. BUS. & PROF. CODE 20020-20026 (1981) (California Franchise Relations Act); N.J. REV. STAT. 56:10-1-52 (1971) (Franchise Practice Act); WIS. STAT. 135.03-04 (1985) (Wisconsin Fair Dealership Law).
[9] Relational contracting involves those contracts found in relations that

> take[ ] on the properties of "a minisociety with a vast array of norms beyond those centrered on the exchange and its immediate processes." By contrast with the neoclassical system, where the referrence point for effecting adaptations remains the original agreement, the reference point under a truly relational approach is the "entire relation as it has developed…[through] time. This may or may not include an 'original agreement'; and if it does, may or may not result in great deference being given it."

Williamson, *supra* note 2, at 238 (citations omitted).
10 Stewart Macaulay has demonstrated how disputes in automobile franchisers are often resolved on the basis of relational norms instead of contractual terms. STEWART MACAULAY, LAW AND THE BALANCE OF POWER (1966). Ian Macneil has explored many of the theoretical implications of recognizing the relational aspects of contracts. *See* Ian R. Macneil, *Values in Contract: Internal and External.* 78 Nw. U.L. REV. 340 (1983): Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus."* 75 Nw. U.L. REV. 1018 (1981): Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law.* 72 Nw. U.L. REV. 854 (1978): Ian R. Macneil, *The Many Futures of Contract.* 47 S. CAL. REV. 691 (1974).
[11] Nor do I adopt here the view of others who have used economic analysis to argue that efficiency norms should guide courts in supplying the missing terms of incomplete contracts. *See, e.g.* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts.* 67 VA. L. REV. 1089 (1981); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts,* 65 MINN. L. REV. 521 (1981).
[12] I have chosen to focus on the bilateral aspects of franchising because this is the relationship that appears in the franchise contract: as a system, however, franchising is characterized by the hub-and –spoke

interdependence created when several bilateral relationships are interlocked by a common agent, the franchisor.

[13] By "control," I mean the authority to determine how an asset (including labour efforts) will be used and/or disposed of. While we often think of ownership as implying control, this need not be the case. Indeed, I argue below that the distinguishing feature of franchising is that franchisees own assets that are subject to the franchisor's control.

[14] *See* text accompanying notes 65-76 *infra.*

[15] Of course, these are highly important contributions.

[16] The U.S. Department of Commerce identifies two types of "franchising": product and tradename franchising represents "an independent sales relationship between supplier and dealer in which the dealer acquire(s) some of the identity of the supplier." FRANCHISING IN THE ECONMY, *supra* note 6, at 1. Business-format franchising, on the other hand, is "characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service, and trademark, but then entire business format itself- a marketing strategy and plan, operating manuals and standards, quality control, and continuing two-way communications." *Id.* At 3.

[17] *Id.* at 1 (estimate).

[18] *Id.* at 14.

[19] *Id.* at 54

[20] *Id.* at 77.

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.* at 3. For example, "other retailing" franchising entities include The Hair Performers; Kenneth of London; Audit Control Inc.; Best Resume Service; Contacts Influential; The Maids; H&R Block; Telecheck Services; Jellystone Campgrounds; Holiday Inn; The Athlete's Foot; Gingiss International; Just Pants; Modern Bridal Shoppes; New England Log Homes; Redi-Strip; Barbizon Schools of Modelling; Child Enrichment Centers, International Travel and Training Courses; Mary Moppet's Day Care Schools; Mind Power Inc; Manpower; Smelling and Smelling: United Rent-All; Ernie's Wine and Liquor. Playboy Clubs International; Diet-Control Centers; Fat Fighters; Nutri-System; Culligan International; Snap-On Tools; Roto-Rooter; Century 21 Real Estate; American Vision Center; Kwik-Copy; Speedy Printing Centers; and FotoMat.

[25] *Id.* at 4-5. Of these, 25% are testaments and about 17% are suppliers of automotive products and services. *Id.*

[26] *See* note 16 *supra.*

[27] *Id.*

[28] *Id.*

[29] Details set by the franchisor include store layout, operating hours and procedures., approved suppliers and materials, employee training and uniforms, advertising, bookkeeping, location, equipment, inventory, maintenance, and insurance.

[30] Franchisees owning a single outlet accounted for 72% of franchisees in 1970. SENATE SELECT COMM. ON SMALL BUSINESS, 92 CONG., 1ST SESS., REPORT PREPARED FOR THE SMALL BUSINESS ADMINISTRATION: THE ECONOMIC EFFECTS OF FRANCHISING (Comm. Print 1971) (written by Urban B. Ozanne and Shelby D. Hunt) [hereinafter 1971 SENATE REPORT]. Unfortunately, the U.S. Department of Commerce does not provide a more recent report. While this statistic is undoubtedly lower today, the circumstantial evidence provided by buyers' guides and franchisor advertising suggests that most franchisees are still single-outlet owners.

[31] Master franchises accounted for 4% of franchises in 1970. *Id.* at 102-03.

[32] *Id.* at 123 (citation omitted); see *also* BRIAN R. SMITH & THOMAS L. WEST, BUYING A FRANCHISE 43 (1986) (noting that the majority of franchisors do not provide or help secure financing).

[33] "In nearly 60% of the cases [in the fast-food industry], the franchisee controls his own land [and buildings] through ownership or by holding the master lease." 1971 SENATE REPORT, *supra* note 30, at 129-30.

[34] BRYCE WEBSTER, THE INSIDER'S GUIDE TO FRANCHISING 4 (1986).

[35] PETER G. NORBACK & CRAIG T. NORBACK, THE DOW JONES-IRWIN GUIDE TO FRANCHISES (rev. ed. 1982) [hereinafter DOW JONES GUIDE].
[36] 1971 SENATE REPORT, *supra* note 30, at 215.
[37] *Id*. at 119-258.
[38] In the fast-food industry in 1970, 41% of franchisees reported that their franchisors received commissions from the franchisor's approved suppliers. *Id*. at 162.
[39] As one franchisor explains, " If [as for Minnie Pearl] 200 company-owned units out of 1,600 or 1,700 overall units produce 60% of the net after tax profits, the real name of the game is owning the stores yourself….After you sell franchises, you need to take your stock public that is raise public money, and build company-owned units, but the first thing you do is sell franchises." John Jay Hooker, *The Story of Minnie Pearl – A Case History of One New Company's Trials, Tribulations and Triumphs,* in FRANCHISING TODAY: REPORT ON THE FIFTH INTERNATIONAL MANAGEMENT CONFERENCE ON FRANCHISING 172-76 (C. Vaughn ed. 1970) [hereinafter FRANCHISING TODAY].
[40] FRANCHISING IN THE ECONOMY, *supra* note 6, at 27.
[41] *Id.* at 26 (figures for 1986).
[42] 1971 SENATE REPORT, *supra* note at 30, at 79 (projection).
[43] FRANCHISING IN THE ECONOMY *supra* note 6, at 27. This growth has important implications for any assessment of the nature and benefits of franchising. Most importantly, any explanation of why franchising occurs and whether it is a necessary or desirable economic arrangement for the courts to support must confront the fact that company-owned outlets are common and profitable. *See* note 44 *infra.* Company takeover of a franchised outlet also raises important legal issues directly. The risk is that franchisees will invest in a new franchise only to have the franchisor take it away on pretense of termination if and when it proves profitable. *See, e.g.,* Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979) *cert denied,* 445 U.S. 917 (1980).
[44] In 1970, sales in company-owned outlets in the fast-food industry were on average 81% higher than those in franchised outlets. 1971 SENATE REPORT, *supra* note 30, at 87.
[45] In 1985 the Commerce Department estimated that over 36% of franchise contracts stipulated a term of at least 20 years. FRANCHISING IN THE ECONOMY, *supra* note 6, at 13.
[46] In 1985 franchisors reported that 91% of contracts up for renewal were renewed. *Id.* This statistic is somewhat difficult to interpret, as it is not clear what qualifies a contract as being "up for renewal". Moreover, the statistics are questionable because they are based on self-reporting by franchisors.
[47] *Id.* at 13.
[48] The withholding of approval is often a source of legal conflict. *See* text accompanying notes 197 & 215-218 *infra.*
[49] *See* text accompanying notes 181-197 *infra.*
[50] Philip F. Zeidman, *Franchising: Who Needs It? The Role of Small and Medium-Sized Companies,* FRANCHISING, Winter 1984, at 11.
[51] *The Proposed Uniform Franchise Act: Questions & Answers,* FRANCHISE L.J., Spring 1986, at 17 (suggestions that the 5% figure reflects franchisors' underreporting).
[52] Thomas O'Donnell, *No Entrepreneurs Need Apply,* FORBES, Dec. 3, 1984, at 124, 128 (5% figure "moot" because troubled franchises are often sold back to franchisor or another operator at "fire-sale" prices): B. SMITH & T. WEST, *supra* note 32, at 1 (arguing that franchisors hide failed outlets by converting to company ownership or reporting closed outlets as operating outlets); Zeidman, *supra* note 50, at 11.
[53] STAN LUXENBERG, ROADSIDE EMPIRES 257 (1985) (reporting on Government Accounting Office determination that 10% of franchisees, but only 4% of independent businesses, defaulted on SBA loans).
[54] HOUSE COMM. ON GOVERNMENT OPERATIONS, PROBLEMS WITH SMALL BUSINESS ADMINISTRATION FINANCIAL ASSISTANCE TO FRANCHISES, H.R. REP. No. 916, 97th Cong., 2d Sess. (1982) [hereinafter 1982 HOUSE REPORT]
[55] Introduced in 1977 were bills entitled Fair Franchise Practices and Distribution Practices Reform Act (H.R. 9144) AND Franchising Termination Practices Reform Act (H.R. 5016) 95th Cong., 1sr Sess. (1977). As recently as 1986 the National Conference of Commissioners on Uniform State Laws proposed the Uniform Franchise and Business Opportunities Act. Pitegoff, *supra* note 5, at 292.

[56] Automobile Dealer's Day in Court Act, 15 U.S.C. ~~1221-1225 (1988); Petroleum Marketing Practices Act (PMPA), 15 U.S.C. ~~2801-2806 (1988).
[57] *See* note 8 *supra*.
[58] One observer has criticized the "patchwork of inconsistent state legislation." Pitegoff, *supra* note 5, at 291. He notes that no state has elected to adopt the Uniform Franchise Business Opportunities Act crafted by the National Conference on Uniform State Law author of the Uniform Commercial Code. *Id.* at 292.
[59] *See id.* at 317 (difficulty of capturing variety of franchise relationships in a single law).
[60] Data collected by the Commerce Department are of a limited nature, as they only pertain to the number of outlets, sales, outlet ownership, and contract duration.
[61] *See* 1971 SENATE REPORT, *supra* note 30, at 199-283.
[62] Compare the clauses examined in the text with the following list of clauses found in a "Sample Franchise Contract," prepared by a franchising directory, EDWARD L. DIXON JR., THE 1985 FRANCHISE ANNUAL 11-45: (1) Term and Renewal; (2) Site Selection; (3) Franchisor Approval of Lease; (4) Exclusive Territory; (5) Trademark Restriction; (6) Training by Approval of Lease; (7) Franchisor Help with Opening; (8) Operating Manual: (9) Advertising by Franchisor; (10) Advertising by Franchisee; (11) Advertising Controlled by Committee; (12) Royalty; (13) Franchisor- Right to Inspect; (14) Standard of Cleanliness; (15) Standard Operations; (16) Franchisor- right to Audit; (17) Noncompetition; (18) Confidential Information; (19) Permitted Incorporation of Franchisee; (20) Termination by Franchisor; (21) Termination by Franchisee; (22) Right of First Refusal in Franchisor; (23) Approval of Sale by Franchisor; (24) Sale of Equipment to Franchisor.
[63] 1971 SENATE REPORT, *supra* note 30, at 199-258.
[64] *Id.* at 199-256. Percentages given refer to the number of franchise contracts that contain written clauses pertaining to the subject: when these figures differ from those reported by franchisors (indicating perhaps informal commitments), this is noted in the comments. Clauses are listed in descending order of frequency.
[65] Breadth, however, should not be confused with specificity. As will be seen from the language of the McDonald's franchise contract, the franchisor may have broad authority to set requirements without explicitly delineating these requirements. *See* text accompanying notes 66-76 *infra.*
[66] The excerpts that follow are from exhibits included in *Franchise Practices Reform Act: Hearings* on H.R. 8319, H.R. 8982 [and all identical bills] *Before the Subcomm. On Consumer Protection and Finance of the House Comm. On Interstate and Foreign Commerce,* 94 Cong., 2d Sess. 78 (1976).
[67] *Id.* at 79-80 (Exhibit A).
[68] *Id.* at 80.
[69] *Id.* at 91 (Exhibit B).
[70] *Id.* at 87.
[71] *Id.* at 94-95 (Exhibit C).
[72] *Id.* at 95-96.
[73] *Id.* at 111.
[74] *Id.* at 112.
[75] This type of arrangement raises an issue known in economics as "moral hazard." *See generally* ROBERT S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 602-05 (1989). The franchisor in this case obligates itself to provide the services for which the "system" calls: the system, however, cannot really be defined other than by what the franchisor in fact does. The franchisor has full authority over the content of the system.
[76] For example, a decision to adopt a promotional program that involved advertised price-reductions, to alter outlet décor or product line, or to withdraw from a regional market would be unrestricted by the contract. It should be recognized, however, that although there are few, if any, contractual duties on the part of the franchisor, that is not to say there are no market incentives which might ensure certain behavior on the part of the franchisor, such as reputation or multilateral commitments. *See* note 232 *infra.*
[77] *See* note 62 *supra.*
[78] *See,* e.g., B. SMITH & T. WEST, *supra* note 32, at 42-43.
[79] *See* notes 184-230 *infra* and accompanying text.
[80] *See* Empire Volkswagen, Inc. v. World Wide Volkswagen Corp., 814 F. 2d 90 (2d Cir. 1987).
[81] *See* Consumers Petroleum Co. v. Texaco, 804 F. 2d 907 (6th Cir. 1986).

[82] Benjamin Klein has also argued that contracts such as the franchise contract will be necessarily incomplete. *See* Benjamin Klein, *Transaction Cost Determinants of 'Unfair' Contractual Arrangements.* 70 AM. ECON. REV., May 1980, at 356 (papers and proceedings).
[83] Economic analysis will also further illustrate why franchise contracts are necessarily incomplete. *See* text accompanying note 98 *infra.*
[84] *See* note 109 *infra* and accompanying text.
[85] This second step takes us into the relational analysis I develop in Section IV, I want to emphasize that my objective in analyzing the economics of commitment in franchising is to provide an analytical tool that will be useful to a court faced with a concrete franchise dispute on the one hand, and with an incomplete franchise contract on the other. My objective is not normative. I do not intend to suggest that because franchisees and franchisors would, if rational in the economic sense, overcome the commitment problems I identify, courts should impose this rationality on their arrangement if they have failed to do so themselves. My starting point is descriptive. We should expect franchisee and franchisor to overcome these problems, and consequently it makes sense to look more closely to see whether they have. The economics I consider should be understood as an analytical hypothesis to be tested against what the relationship reveals on closer examination.
[86] *See* text accompanying notes 12-15 *supra.*
[87] *See* Victor P. Goldberg, *The Law and Economics of Vertical Restrictions: A Relational Perspective.* 58 TEX. L. REV. 91 (1979) (analyzing problem of free-riding and discussing court cases).
[88] More formally, free-riding is an example of an economic externality. A profit-maximizing franchisee will choose quality levels at which the marginal revenue at her outlet equals her marginal cost. The franchisee's effort, however, will also affect marginal revenues for other franchisees and the franchisor. This external effect is ignored by the franchisee, leading her to choose too little effort relative to the level that would maximize joint profits for the entire franchise system. *See generally* R. PINDYCK & D. RUBINFELD, *supra* note 75, at 617-23.
[89] *See generally id.* at 605-11.
[90] The franchisor will place some weight on franchisee profits because new franchisees will be more likely to purchase profitable outlets. The point is that revenues will also figure significantly in the franchisor's decisions.
[91] *See generally* Benjamin Klein, Robert G. Crawford & Armen A. Alchian. *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process,* 21 J.L. & ECON. 297 (1978): Williamson, *supra* note 2.
[92] *See* text accompanying notes 14-15 *supra.*
[93] The magnitude of these sunk costs depends on the types of contract provisions governing the resale of equipment and furnishings to the franchisor when the relationship terminates.
[94] Economists refer to these as *ex post* incentives, because they arise after the investment in sunk costs has occurred.
[95] A fixed cost is an up-front cost which must be incurred in order to produce any amount of goods or services. A variable cost is one that varies with the quantity of goods or services provided. A marginal cost is the variable cost of producing additional amounts of goods or services. *See* WILLIAM SAMUELSON, ECONOMICS 427-31 (11th ed. 1980). A profit-maximizing franchisee will decide how much to produce and therefore what price to charge based on marginal cost. Ordinarily, a franchisee will be able to charge a price above its marginal cost as a result of the market power it derives from its exclusive territory. This price is, however, limited by what consumers are willing to pay, given the availability of substitute goods. If marginal costs increase but consumer willingness to pay does not, the price may only cover marginal costs and not total ……
[96] I have simplified this argument. More formally, the business will compare the present value of the income stream form continued operation less variable costs, A. with the income that could be earned by shutting down and reselling the fixed assets. B. If A exceeds B, the firm will stay in operation. When fixed costs are sunk, the resale price of the assets will be low relative to their depreciated value; when they are fully recoverable, resale price will equal depreciated value. Thus the firm with sunk costs is more likely to find that A exceeds B than is the firm with fully recoverable costs.
[97] *See generally* Klein, Crawford, & Alchian, *supra* note 91 (analysis of sunk costs and opportunism).

[98] While most economists have focused on the use of specified vertical restraints such as quotas or resale price maintenance to control franchisee free-riding, *see e.g.* G.F. Mathewson & R.A. Winter, *An Economic Theory of Vertical Restraints.* RAND J. ECON. 27 (1984), other writers have essentially argued that the incompleteness of the franchise contract is necessary in order to solve the franchisor's control problem, *see e.g.* Goetz & Scott, *supra* note 11: Klein *supra* note 82. The argument is that the problems of specifying up-front the innumerable details of quality performance for franchisees make it necessary for the franchisor to retain broad discretion to enforce compliance with "the system." Enforcement is achieved, it is argued, through the use of the franchisor's power to terminate franchisees "at-will," that is, whenever the franchisor independently judges that a franchisee has failed to comply with quality standards. The threat of termination, and the consequent loss of franchise profits, deters free-riding. *See generally* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms,* 31 J.L. & ECON. 265 (1988) (discussing role of franchisee profits in operation of termination mechanism).

[99] *See* Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors,* 45 BUS. LAW. 289 (1989) (stating that regulatory statutes were designed to correct abuses due to bargaining inequalities).

[100] …….

[101] *See, e.g.,* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 9 (1983).

[102] *See, e.g.,* Mathewson & Winter, *supra* note 98.

[103] *Id.L see also* Goetz & Scott, *supra* note 11, at 1130-50; Goldberg, *supra* note 87, at 177-28.

[104] Muris, *supra* note 11, at 524.

[105] *See* Klein, Crawford & Alchian, *supra* note 91, at 301. Recently observed "shortages" of willing franchisees may be a consequence of an emerging understanding that franchisor opportunism may go unchecked by either the market or the courts. *See* Jeffrey A. Tannenbaum, *Franchise Pool Is Drying Up for Some Firms,* Wall St. J., Nov. 14, 1989, at B1, col.6.

[106] These decisions may include promotional coupon redemption plans outlet renovations, local advertising campaigns, or variations in product offerings or hours of service. *See* notes 118-136 *infra* and accompanying text.

[107] This is an application of straightforward externality theory: If franchisors ignore the costs to franchisees, they perceive investments to be cheaper than they are and consequently overinvest.

108 As one scholar has described it,

[the] conventional classification of the law of contract, which has dominated legal discourse during the last century, views the purpose of contract law as the creation of a facility for individuals to pursue their voluntary choices. Its latent social ideal embodies a liberal state in which the law maximizes the liberty of individual citizens, encourages self-reliance, and adopts a more or less neutral stance with regard to permissible patterns of social life. It secures these goals by facilitating the creation of legal obligations on any terms which individual freely choose.

HUGH COLLINS, THE LAW OF CONTRACT 1 (1986).

[109] Some authors have argued that commitment mechanisms other than the legal system could justify the relationship. *See* note 232 *infra.*

[110] *See, e.g.,* S. MACAULAY, *supra* note 10; Goetz & Scott, *supra* note 11: Klein, *supra* note 82; Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus."supra* note 10, at 1023; Macneil. *Values in Contract: Internal and External, supra* note 10, at 362-66; Muris, *supra* note 11.

[111] For discussions of the dimensions of relational contracting, see Ian R. Macneil, *Relational Contract: What We Do and do Not Know,* 1985 WIS. L REV. 483; Robert W. Gordon, *Macualay, Macneil, and the Discovery of Solidarity and Power in Contract Law, 1985* WIS. L . REV. 565.

[112] To date the focus of much of the work that takes seriously the particular norms and practices of contracting relationships has been descriptive or of general theoretical interest. *See generally* Godon, *supra* note 111; Macneil, *supra* note 111. My objective here is to operationalize relational contracting principles in a manner useful to practicing attorneys and courts.

[113] " [It] may be said without qualification that if the parties have a memorial of their bargain…their actual intent unless expressed in some way in the writing is ineffective…" 3 WILLISTON ON CONTRACTS 1751 (1936). "Judicial construction of a contract requires a determination of the meaning of the language used, not

the ascertainment of some possible but unexpressed intent of the parties." Hunt v. Triplex Safety Glass Co., 60 F.2d 92, 94 (6th Cir. 1932).
[114] *See* text accompanying notes 231-237 *infra.*
[115] *See generally* S. MACAULAY, *supra* note 10
[116] Many of these sources reflect views from the earlier days of franchising and further study of the continuity and precision of these views is necessary. Further examination would be particularly difficult to conduct, however because the views expressed below reveal a kind of naivete on the part of some franchisors (some of whom ultimately failed spectacularly) that would be considered today as impolite accounts of their business. The absence of similar studies and viewpoints today may reflect fundamental changes in views: it may also reflect increased political savvy on the part of franchisors. Nonetheless these earlier views are valuable, because they coincide with the time period over which the statistics on contracts, above, were collected and over which many of the cases we will examine later arose.
[117] As described by Robert Gordon, the "method" of relational contracting as practiced by its leading architects. Ian Macneil and Stewart Macaulay. "l[ies] in the close inspection of the norms and practices of the commercial users of contract law, the contracting parties themselves." Gordon, *supra* note 111, at 568.
[118] HARRY KURCH, THE FRANCHISE BOOM 22 (REV. ED. 1968) (quoting M.M. (Montie) Brohard, Jr.).
[119] Robert J. Emmons, *The Second Generation Franchise Executive,* in FRANCHISING TODAY *supra* note 39, at 39.
[120] Indeed I found no definition in the popular literature that matched the contractual language in minimizing franchisor obligations or contributions; the view that the franchise relationship is solely about protecting the franchisor's trademark did not emerge in my survey.
[121] Leonard J. Konopa, *What Is Meant by Franchise Selling?,* J. MARKETING, Apr. 1963, at 35,37.
[122] H. KURSH, *supra* note 118, at 32 (emphasis omitted).
[123] *Id.* At 47 (emphasis omitted).
[124] O'Donnell, *supra* note 52, at 124.
[125] E. DIXON, *supra* note 62, at 11-43
[126] B. SMITH & T. WEST, *supra* note 32, at 3.
[127] 1971 SENATE REPORT, *supra* note 30, at 149 (emphasis omitted).
[128] Advertisement, MinuteMan Press, *reprinted in* E. DIXON, *supra* note 62, at 112.
[129] Advertisement, PIP Printers, *reprinted in* E. DIXON, *supra* note 62, at 113.
[130] EDWIN H. LEWIS & ROBERT S. HANCOCK, THE FRANCHISE SYSTEM OF DISTRIBUTION 69 (1963).
[131] H. KURSH, *supra* note 118, at 51, 50.
[132] *See* text accompanying note 50 *supra.*
[133] O'Donnell, *supra* note 52, at 128.
[134] B. SMITH & T. WEST, *supra* note 32, at 1.
[135] *See, e.g.,* H. KURSH, *supra* note118, at 14-18.
[136] *See, e.g.,* B. WEBSTER, *supra* note 34. A recent report indicates that "franchise frauds and failures [have] taken a toll. The public used to think that franchising was a gold mine…Now the public is somewhat leery…there's no longer a sense of guaranteed success." Tannenbaum, *supra* note 105, at B2, col. 5 (quoting Robert T. Justis, Director of the International Franchise Center at Louisiana State University).
[137] Coleman R. Rosenfield, *Franchising and the Lawyer.* 42 FLA. B.J. 17 (1968). Mr. Rosenfield is the author of a well-known treatise in the area. COLEMAN R. ROSENFIELD, THE LAW OF FRANCHSIING (1970).
[138] The standard form franchise contract is often analyzed in terms of bargaining power. This is what leads other writers to suggest that the contract be considered adhesive and presumptively unenforceable. *See* Todd D. Rakoll, *Contracts of Adhesion: An Essay in Reconstruction,* 96 HARV. L. REV. 1173, 1176-80 (1983).
[139] "[I]f a franchisor is sound and ethical, he or she will not bargain away major essential points of the system. If the franchisor is willing to do so, why were they included in the first place?" DOW JONES GUIDE, *supra* note 35, at 22.
[140] O'Donnell, *supra,* note 52, at 124.

[141] Ken Coomer, *Three Recurrent and Acute Major Problems in Franchising,* in FRANCHISING TODAY, *supra* note 39, at 185 (story of Colonel Sanders).
[142] Irving Scher, *Recruiting, Selecting, and Training Franchisees as Franchisor Firms Multiply- Legal Comments,* in FRANCHISING TODAY, *supra* note 39, at 220.
[143] 1971 SENATE REPORT, *supra* note 30, at 125.
[144] E. DIXON, *supra* note 62, at 11-43.
[145] Gail DeGeorge, *Fed-Up Franchisees: They're Mad as Hell,* BUS. WK., Nov. 13, 1989, at 83
[146] *Id.* Recently, franchisors have experienced a shortage of qualified franchisees, due in part to "growing sophistication among franchise investors… 'People who have money generally don't want to run a restaurant hands on' " Tannenbaum, *supra* note 105, at B2, cols. 3, 5 (quoting William Spiers, President of a Baton Rouge franchise).
[147] H. KURSH, *supra* note 18, at 124.
[148] "Many dealers say that they never read their franchise contract because 'if I do the job, I will be alright.' " S. MACAULAY, *supra* note 10, at 78. "We look for a man who might be earning $5,000 and wants to make it $12,000 or more and doesn't mind working for it." H. KURSH, *supra* note 118, at 121. "In the long run the most important ingredient in franchising, either for the franchisor or the franchisee, is hard work." E. DIXON, *supra* note 62, at 11-31.
[149] H. KURSH, *supra* note 118, at 116.
[150] *Id.* At 13 (quoting A.L. Tunick, first president of the International Franchise Association).
[151] David Slater , *Opening Statement,* in FRANCHISING TODAY, *supra* note 39, at 6.
[152] H. KURSH, *supra* note 118, at 118-19.
[153] Hooker, *supra* note 39, at 176.
[154] Coomer, *supra* note 141, at 184.
[155] DOW JONES GUIDE, *supra* note 35, at 5.
[156] Daryl W. Motte, *Franchisor-Franchisee Relations to Prevent a Hostile Environment,* in FRANCHISING TODAY, *supra* note 39, at 264.
[157] Hooker, *supra* note 39, at 174-75.
[158] Elmer L. winter, *Franchise Facts of Life in the 1970s,* in FRANCHISING TODAY, *supra note 39, at 390-391.*
[159] "Conflict can and does arise between franchisors and franchisees because one or both parties fail to appreciate that they are in business for a common end." E. LEWIS & R. HANCOCK, *supra* note 130, at 75.
160 It is not enough to have central administration of only those activities which contribute to the joint effort. It becomes essential to have close coordination and some degree of control over those activities delegated to the dealers as well. Without this, the dealers, by virtue of their independent status, are likely to exert their individual prerogatives to the detriment of the joint effort.

Id. at 76.
[161] Motte, *supra* note 156, at 266.
[162] Winter, *supra* note 158, at 399.
[163] *See* Pitegoff, *supra* note 99, at 289 (stating that franchise relationships law were designed to protect franchisees against franchisor abuses).
164 A 1971 Senate report noted that 35.6% of franchisees surveyed felt that legislation restricting termination to only substantial noncompliance was necessary, while another 41.1% felt such legislation was very necessary. 1971 SENATE REPORT, *supra* not 30, at 277. This same report noted that: franchisees, legislators and critics of franchising suggest that the franchisor can and frequently does hold the threat of termination or nonrenewal over the franchisee's head in order to exact concessions from the franchisee not in the latter's best interest.

Id. At 269.
[165] James. N. Nicholson, *Some Observations and Reservations about Franchising*. In FRANCHISING: SECOND GENERATION PROBLEMS 128, 148-49 (Practicing Law Institute 1969).
[166] …….
[167] B. WEBSTER, *supra* note 34, at 99.
[168] *Id*. at 188. Another observer cites several franchisor induced problems:

> To be sure, "hostile environments" arise not only because of poor franchisee selection but also because of poor performance on the part of frnachisors; first in original agreements that offer unproductive locations or phony exclusives or that fail to be based on full, mutual understanding between the parties; or secondly, in failures of service – advertising programs that do not drive in the customers, promotions that do not promote, training that does not train, operational and marketing supports that do not support; or, thirdly, in burdensome equipment purchases that place marketing at the mercy of finance; and finally, in know-it-all, heavy-handed franchisor management methods.

Motte, *supra* note 156, at 268.

[169] See E. LEWIS & R. HANCOCK, *supra* note 130, at 82-83.

[170] B. SMITH & E. WEST, *supra* note 32, at 43, 55.

[171] Observers have collected a long list of examples:

> In the food industry, for example, the franchisor usually has a commissary and requires the franchisee to purchase from it all food and supplies sold by the franchisor…. Unfortunately for the franchisee it frequently develops that such prices run from 25% to 200% above those for identical products on the open market.

Harold Brown, *Equitable Protection for Franchisees*, in FRANCHISING TODAY, *supra* note 39, at 318. The mere act of consulting with the franchisor may be costly also. "You may have to pay an hourly rate or flat fee every time you ask the company to send a representative to help you solve a problem." B. WEBSTER, *supra* note 34, at 120. Charges by franchisors, however, are not limited to tangible assets or services. "An additional cost, sometimes levied once a year or at the beginning of a new franchise agreement, for the privilege of benefiting from the franchisor's good name and reputation in the community [may be incurred as a 'business goodwill fee']." *Id*. at 119. Oftentimes hidden fees make it hard to get a franchise off the ground. "One franchisee had to pay an unanticipated $28,000 build-to-suit chagre for a small outlet, more than doubling the planned start-up budget." *Id.* at 120. The aggregate effect is that franchisees typically end up with less than they bargain for: "Another common problem occurs when a franchisor sells or leases to the franchisee used or refurbished equipment at…. *Id.* at 187.

[172] B. WEBSTER, *supra* note 34, at 189.

[173] *Id.* at 186.

[174] *Id.* at 103.

[175] There have been some blatant examples of such behavior.

> There are franchisors who use their ownership of lease or land to wipe out a franchisee's investment, for payments for one reason or another: Perhaps they have borrowed too heavily to open their franchise and are using the fees to pay back loans instead; or they are using them to meet operating expenses during a cash-flow crunch; or any of a number of other reasons. In these cases, franchisors who own the land, building, or lease have been known to bring "unlawful detainer" actions that force the franchisees to forfeit huge sums of prepaid capital expenses and fees. The franchisee loses the business and his up-front captial investmet
>
> … [T]here have been reports that some less scrupulous franchisors have sold franchises for the same location as many as 15 times [by immediately terminating for default on rent or royalties].

Id. at 80-81. The 1971 Senate Report included the following excerpt from a letter from a franchisee with "one of the largest and best known franchise systems in the country: 'I have been told that they have a new policy, if I sign agreement and give them all equipment (and fixtures), they will let me out of contract, if I agree not to sue them.'" 1971 SENATE REPORT, supra note 30, at 167-68.

[176] One critic noted that '[I]n the late 1970s some franchisees accused McDonald's of harrassing them, by trying to take over units that were operating in profitable areas." S. LUXENBERG, *supra* note 53, at 270-71.

[177] The cost of many promotional programs, for example, is borne disproportionately by the franchisees, who may find themselves unable to refuse participation. As discussed earlier, *see* text accompanying notes 106-107 *supra*, such programs may well be used excessively because they are cheap for the franchisor. "Franchisors may force you to accept large numbers of discount coupons. The discounts may reduce or eliminate your profit margin, but you will still have to pay royalties to the franchisor based on the increased gross sales figures that including the value of the coupons." B. WEBSTER, *supra* note 34, at 16. "We've all heard the phrase, 'At *participating* --- restaurants." While it's quite true that participation is voluntary for whatever's being touted (free french fries with every double cheeseburger, for example) some franchisees

who didn't 'volunteer,' found the truck delivering supplies from the franchisor suddenly breaking down and arriving later and later." B. SMITH & T. WEST, *supra* note 32, at 15.

> Some contracts also force you to replace older, depreciated equipment with new equipment that meets the franchisor's most recent or current specifications. This means that you could be faced with replacing equipment in good working condition every three to five years…
>
> Other contracts can force you to renovate or refurbish your franchise as the franchisor dictates to keep up or improve the appearance of the franchise outlet.

B. WEBSTER, *supra* note 34, at 107.

[178] S.LUXEMBERG, *supra* note 58, at 259.

[179] Buyers' guides now emphasize the potential for abuse of the quality control power:

> Quality control remains one of the least understood and most perilous issues a potential franchisee has to face…For at least twenty years, many franchisees have contended that a company's quality-control clauses are often used to force a franchisee to buy supplies, equipment, appliances, signs, "secret" ingredients, and so forth from the parent company.

B. WEBSTER, *supra* note 34, at 190 This guide counsels franchises to avoid any franchise that dictates quality-

> control standards with a heavy hand. These strictures could be used to take a new, thriving franchise away from a franchisee so the parent company could reap the benefits of his toil and trouble…If the franchisor's quality-control behavior changes significantly after you are in business, find out why. If it suddenly gets lax, the franchisor may be in trouble – you'll need to protect yourself from its demise. If it becomes onerous, the franchisor may be trying to force out the franchisees in favor of company-owned outlets. Or it many simply be trying to upgrade the franchise's image for all concerned. Find out.

Id. at 192.

[180] *Id.* at 98.

[181] *Id.*

[182] Franchising gives rise to litigation in numerous areas of the law: antitrust, securities, products liability and intellectual propety, as well as contract. I focus on contract disputes because I believe that at the heart of most franchise litigation is a basic contract difficulty which, rebuffed by contract doctrine, seeks solution elsewhere in the law. Statutory regulation of franchising, such as state franchise acts, the Dealer's Day in Court Act and the Petroleum Marketing Practices Act, also rests ultimately on contract interpretation and enforcement.

[183] This latter event also results, although less frequently, in a breach-of –contract action by a continuing franchisee.

[184] Bonanza Int'l v. Restaurant Management Consultants, 625 F. Supp. 1431, 1436 (E.D. La. 1986).

[185] Chia-Hsin (Charles) Huang v. Holiday Inns, 594 F. Supp. 352 (C.D. Cal 1984).

[186] Dayan v. McDonald's Corp., 162 Ill. App. 3d 11, N.E.2d 945 (1984).

[187] Robertson v. Mobile Oil Corp.,……

[188] Baskin-Robbins Ice Cream Co. v. D. & L. Ice Cream Co., 576 F. Supp. 1055 (E.D.N.Y. 1983)

[189] Wisser Co. v. Mobil Oil Corp., 730 F.2d 54 (2nd Cir. 1984).

[190] Arnott v. American Oil Co., 609 F.2d 873 (8th Cir, 1979), *cert. denied*, 446 U.S. 918 (1980).

[191] Univeral Computers Ltd. v. Datamedia Corp., 653 F. Supp 518 (D.N.J. 1987), aff'd 838 F.2d 1208 (3rd Cir. 1988).

[192] Marquis v. Chrysler Corp., 577 F.2d 624 (9th Cir. 1978); *see also* York Chrysler-Plymouth, Inc. v. Chrysler Credit Corp., 477 F.2d 786 (5th Cir. 1971).

[193] *See, e.g.* Autowest, Inc. v. Peugeot, Inc., 434 F.2d 556 (2d. Cir. 1970); *Arnott,* 609 F.2d at 873-74.

[194] Burger King Corp. v. Family Dining, 426 F. Supp. 485 (E.D. Pa.), aff'd, 566 F.2d (2d Cir. 1977).

[195] The quota was sent according to a national formula unadjusted for local market conditions. Carroll Kenworth Truck Sales v. Kenworth Truck Co., 781 F.2d 1520 (11th Cir. 1986).

[196] A similar case involved the termination of an auto-parts franchisee who failed to make any substantial sales in the 19-month life of the franchise. Glaesner v. Beck/Arnley Corp., 790 F.2d 384 (4th Cir. 1986). The franchisee, who also operated an auto repair shop, claimed that the franchisor-selected inventory was unsalable and in fact the franchisor refused to exercise its contract option to repurchase the inventory upon termination. The franchisor countered that the franchisee had failed to make necessary investments in the

business, and that the franchisee was simply using his franchise membership to obtain parts for his repair business at wholesale prices.

[197] Newfield v. General Motors Corp., 84 A.D. 548, 443 N.Y.S.2d 239 (1981), *aff'd,*56 N.Y.2d 818, 438 N.E.2d 103, 452 N.Y.S.2d 570 (1982).

[198] Fox Motors, Inc. v. Mazda Distribs. (Gulf), Inc. 806 F.2d 953 (10th Cir. 1986)

[199] *See, e.g.,* Diehl & Sons, Inc. v. International Harvester Co., 426 F. Supp 110 (E.D.N.Y. 1976).

[200] Photovest Corp. v. Fotomat Cope., 606 F.2d 704 (7th Cir. 1979) *cert. denied,* 445 U.S. 917 (1980).

[201] L.C. Williams Oil Co. V. Exxon Corp., 625 F. Supp. 477 (M.D.N.C. 1985).

[202] Copy-Date Sys., Inc. v. Toshiba Am., Inc., 663 F. 2d 405 (2d Cir. 1981), *cert, denied,* 474 U.S. 825 (1985).

[203] Burger King v. Family Dining, 426 F. Supp. 485 (E.D. Pa.), *aff'd,* 566 f. 2d 1168 (3d Cir. 1977).

[204] *See e.g.,* Domed Stadium Hotel v. Holiday Inns, 732 F. 2d 480 (5th Cir. 1984); *Copy-Data Sys.,* 663 F. 2d at 405.

[205] A 1982 congressional report considering the abnormally high rate of default on Small Business Administration (SBA) loans to franchisees noted the case of Burger King Corporation which:

> sold land and a building to an SBA New York guaranteed franchisee for $398,004. This figure included a price of $140,000 for the land, a price based on an appraisal done by the Burger King Corp…When the franchise went bankrupt (due primarily to poor location), an independent appraisal valued the land at only $30,00. Burger King Corp. then offered to repurchase the land and the building from SBA for $50,000.

1982 HOUSE REPORT, *supra* note 54, at 33 (citations omitted). A commentator observed that the Congressional committee staff had "prepared a memo noting that the franchises failed because of poor location chosen by Burger King which was 'experimenting'…The congressional staff noted that Burger King 'made no attempt to save these businesses or help them once it was realized that there was a problem. Instead, the company tried to "shop in the bargain basement" for the used equipment once the franchises failed.' " . S. LUXENBERG, *supra* note 53, at 258-259.

[206] *See e.g.,* White Hen Pantry V. Johnson, 599 F. Supp. 718 (E.D. Wis. 1984).

[207] 609 F.3d 873 (8th Cir. 1979). *Cert, denied,* 446 U.S. 918 (1980).

[208] Zapatha v. Dairy Mart, 381 Mass. 284, 408 N.E. 2d 1370 (1980).

[209] Eden V. Texaco Ref. & Mktg., 644 F. Supp. 1573 (D. Md. 1986).

[210] *See* Valentine v. Mobil Oil Corp., 789 F.2d 1388 (9th Cir. 1986); Radecki v. Amoco Oil Co., 634 F. Supp. 1393 (D. Minn. 1986); Gruber v. Mobil Oil Corp., 570 F. Supp. 1088 (E.D. Mich. 1983).

[211] *See* Siecko v. Amerada Hess Corp., 569 F. Supp. 768 (E.D. Pa. 1983); Munno v. Amoco Oil Co., 488 F. Supp. 1114 (D. Conn. 1980).

[212] David. R. McGeorge Car Co. v. Leyland Motor Sales, 504 F. 2d 52 (4th Cir. 1974), *cert, denied,* 420 U.S. 992 (1975).

[213] Empire Volkswagen v. World Wide Volkswagen Corp., 814 F.2d 90 (2d Cir. 1987).

[214] Dunne Leases Cars & Trucks v. Kenworth Truck Co., 466 A.2d 1153 (R.I. 1983).

[215] *See* Kestenbaum v. Falstaff Brewing Corp., 575 F.2d 564, 573 (5th Cir. 1978); Fray Chevrolet Sales v. General Motors Corp., 536 F.2d 683, 684-85 (6th Cir. 1976); McDaniel v. General Motors Corp., 480 F. Supp. 666 (E.D.N.Y. 1979); Mogul v. General Motors Corp., 391 F. Supp 1305, 1311-12 (E.D. Pa. 1975).

[216] *See* Kestenbaum v. Falstaff Brewing Corp., 514 F.2d 690, 696 (5th Cir. 1975); Frank Coulson, Inc.-Buick v. General Motors Corp., 488 F.2d 202 (5th Cir. 1974); Pierce Ford v. Ford Motor Co., 299 F.2d 425, 429-30 (2d Cir. 1962).

[217] *See* Prestin v. Mobil Oil Corp., 741 F.2d 268, 272 (9th Cir. 1984).

[218] *See* Schultze v. Chevron Oil Co., 579 F.2d 776, 777-80 (3rd Cir. 1978).

[219] Picture Lake Campground, Inc. v. Holiday Inns, 497 F. Supp. 858 (E.D. Va. 1980).

[220] *See*, e.g. Vaughn v. General Foods Corp., 797 F.2d 1403 (7th Cir. 1986) (characterizing statements regarding system's viability as "puffing," and therefore not fraudulent under Indiana law).

[221] *Id.* Similar questions arise in Consumers Petroleum Co. v. Texaco, Inc., 804 F.2d 907 (6th Cir. 1986) Here, a gasoline franchisee, on hearing rumors that the franchisor had plans to withdraw from distribution in its territory, met with the franchisor to confirm the rumor. The franchisor told the franchisee that the territory

was an integral part of the franchisor's marketing area and that the franchisor would never withdraw. In fact, the franchisor already had received a report suggesting that it withdraw from the territory, a step it later took.

222 This problem has taken on importance in recent years. *See Franchisees Are Fighting Back*, N.Y. Times, Dec. 4, 1988, δ 3, at 1, col. 4.

223 *See* Brach v. Amoco Oil Co., 677 F.2d 1213 (7th Dir. 1982).

224 *See* Estey & Assocs. V. McCulloch Corp., 663 F. Supp. 167, 167-70 (D. Or. 1986).

225 *See* Barnes v. Gulf Oil, 795 F.2d 358 (4th Cir. 1982).

226 *See id*. at 361.

227 *See* William C. Cornitius, Inc. v. Wheeler, 276 Or. 747, 556 P.2d 666 (1976).

228 *See* Bresler's 33 Flavors Ice Cream v. Wokosin, 591 F. Supp. 1533, 133, 1534-36 (E.D. Wis. 1984).

229 *See* Nassau-Suffolk Ice Cream v. Integrated Resources, 662 F. Supp. 1499, 1501 (S.D .N.Y. 1987).

230 *See* B. SMITH & T. WEST, *supra* note 32, at 2.

231 *See* notes 86-98 *supra* and accompanying text.

232 Other writers have suggested that the franchisor's interest in maint writers have suggested that the franchisor's interest in maintaining its reputation and selling more franchises is all that is necessary to control franchisor opportunism. *See, e.g.,* Klein, *supra* note 82. While reputation is certainly a factor in franchise markets, there are a number of reasons why one should be skeptical about the potential for reputation to completely control opportunism. First, in order for the reputation mechanism to work, the franchisor must always anticipate selling at least one more franchise. Many franchisors, however will reach a limit on the number they can sell, particularly since franchises usually come with an exclusive territory. More importantly, the reputation mechanism depends on the inferences about the franchisors past behavior drawn by potential franchisees. But the interdependence, the uncertainty, and the length of the relationship, as well as the inexperience of the franchisee all make the identification of franchisor opportunism very difficult. Terminations rarely result without a hint of cause, pretext or otherwise. Potential franchisees, already burdened by their lack of market experience, will face great difficulties distinguishing opportunistic behavior from the plausible justifications franchisors can offer: that the actions were necessary for the good of the system as a whole; that they were a short-term response to unusual conditions: or that the complaining franchisee is simply a bad manager, is in a bad location, or is simply a victim of bad luck. And indeed, they will even face great difficulty gaining access to any information on which to base an inference. Franchisors need not steer prospective franchisees to speak with unsuccessful franchisees; existing franchisees seeking to sell have no incentive to discourage prospective buyers.

Ultimately, whether reputation is a sufficient mechanism to deter franchisor opportunism is an empirical question. Franchisee efforts to obtain regulation and, perhaps more telling, the lengths to which authors of modern franchise buyers' guides go to warn potential franchisees about the opportunism they have observed in the industry indicate that opportunism does in fact take place. Finally, even if the reputation mechanism does protect some franchisees, such as those in large, visible franchise systems, that fact does not alter the problems faced by those for whom it fails- those that end up in court.

233 *See* note 190 *supra* and accompanying text.

234 *See* note 219 *supra* and accompanying text.

235 *See* note 229 *supra* and accompanying text.

236 *See, e.g.,* notes 177 & 228 *supra.* B.WEBSTER, *supra* note 34.

237 For example, does "handmade" ice cream refer to the ingredients used, or to the equipment used, or to the frequency of production?

238 *See* note 191 *supra* and accompanying text.

239 *See* note 198 *supra* and accompanying text.

240 *See* note 177 *supra.*

241 Amerada Hess Corp. v. Quinn, 142 N.J. Super. 237, 252, 362 A.2d 1258, 1266 (N.J. 1976).

242 *See* notes 184-189 *supra* and accompanying text.

243 *Amerada Hess.* 142 N.J. Super. at 251, 362 A 2d at 1266.

244 *See* notes 118-136 *supra* and accompanying text.

245 *See* notes 190-218 *supra* and accompanying text.

[246] Picture Lake Campground v. Holiday Inns, 497 F. Supp. 858, 869 (e.D. Va. 1980).
[247] Vaughn v. General Foods Corp., 797 F.2d 1403, 1411, 1415 (7th Cir. 1986).
[248] David R. McGeorge Car Co., v. Leyland Motor Sales, 504 F. 2d 52, 56 (4th Cir. 1974), *cert, denied,* 420 U.S. 992 (1975).
[249] *See* American Mart Corp. v. Joseph E. Seagram & Sons, 824 F.2d 733, 734 (9th Cir. 1987).
[250] *Id.*
[251] Moody v. Amoco Oil co., 734 F.2d 1200, 1217 (7th Cir. 1984).
[252] *See* Universal Computer, Ltd. v. Datamedia Corp., 653 F. Supp. 518 (D.N.J. 1987), *aff'd.* 838 F.2d 1208 (3rd Cir. 1988).
[253] Arnott v. American Oil Co., 609 F.2d 873, 88.-84, (8th Cir. 1979), *cert. denied,* 446 U.S. 918 (1980); Autowest, Inc. v. Peugeot, Inc., 434 F.2d 556, 561-63 (2d Cir. 1970).
[254] Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 727-28 (7th Cir. 1979), *cert. denied* 445 U.S. 917 (1980).
[255] *Arnott,* 609 F.2d at 873.
[256] …….
[257] *See* note 108 *supra* and accompanying text.
[258] There will of course be numerous contexts in which we will want to assess and regulate private arrangements, but I choose to leave that as a separate matter; my effort here is to bring franchise contract enforcement into line with the traditional passive contracting model employed by the courts.
[259] This conclusion can also be justified under a fairness rationale, if fairness is understood to mean avoiding the defeat of reasonable expectation, or an efficiency rationale, if one adopts the view that the traditional model of passive contract enforcement of voluntary exchanges serves to enable market forces to sort efficient from inefficient arrangements. *See* ANTHONY T. KRONMAN & RICHARD A. POSNER. THE ECONOMICS OF CONTRACT LAW 1-5 (1979).
[260] The convenant of good faith and fair dealing is implied through the operation of statutes such as state franchise laws, the Automobile Dealer's Day in Court Act and the Petroleum Marketing Practices Act. Requirements of good faith have also been implied in franchise contracts, by analogy to ~~1-203 of the Uniform Commercial Code, which provides, "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." *See* Phillips v. Chevron U.S.A. 792 F. 2d 521 (5th Cir. 1986); Larese v. Creamland Dairies, 767 F.2d 716, 717 (10th Cir. 1985) (franchise relationship requires good faith and commercially reasonable dealings); Randolph v. New Eng. Mut. Life Ins. Co., 526 F.2d 1383, 1386-87 (6th Cir. 1975) (imposing duty of good faith on exercise of facially unrestricted termination clause): deTreville v. Outboard Marine Corp., 439 F.2d 1099 (4th Cir. 1971) (express unilateral termination agreements must conform to equity and good conscience); Tele-Controls, Inc. v. Ford Indus., 388 F.2d 48 (7th Cir. 1967) (termination of dealership contract must be in good faith); ABA Distribs. V. Adolph Coors Co., 542 F. Supp. 1272 (W.D. Mo. 1982) (franchise agreements subject to covenant of good faith); Zapatha v. Dairy Mart 381 Mass. 281, 408 N.E.2d 1370 (1980) (unconscionability and covenant of good faith apply to franchise contracts through operation of the Uniform Commercial Code); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973) (public policy requires good cause for termination of franchise); Atlantic Richfield Co. v. Razumic, 480 Pa. 366, 390 A.2s 736 (1978) (franchisor under duty not to act arbitrarily in terminating franchise agreement); Seegmiller v. Western Men, Inc., 20 Utah 2d 352, 437 P.2d 892 (1968) (same); Ashland Oil v. Donahue, 159 W. Va. 463, 474, 223 S.E. 2d 433, 440 (1976) (franchise agreement subject to implied covenant of good faith as expressed in Uniform Commercial Code); *see also* Ernest Gellhorn, *Limitations on Contract Termination Rights – Franchise Cancellations,* 1967 DUKE L.J. 465.
261 In one case, the court stated:

> We interpret the good faith and good cause requirement [of a state franchise law] as embodying both an objective and a subjective element. In order to show that there was good cause for termination, the franchisor must establish the existence of a sufficient business justification for its actions: specifically, it must demonstrate the existence of a well founded objective ground for the termination based upon compelling business reasons. The subjective requirement of good faith calls for the additional showing that the termination was in fact based on such ground and that it was not undertaken with a vindictive or otherwise improper motive.

American Mart Corp. v. Joseph E. Seagram & sons, 824 F.2d 733, 734 (9th Cir. 1987). Another courts interpretation of the Petroleum Marketing Practices Act's good faith and good cause requirements is even more explicit. *See, e.g.,* Moody v. Amoco Oil Co., 734 F.2d 1200, 1217 (7th Cir. 1984) (citing Branch v. Amoco Oil Co., 677 F.2d 1213 (7th Cir. 1982)):

> ….Congress, in enacting the [Petroleum Marketing Practices Act], sought to protect franchisees from arbitrary terminations and nonrenewals while allowing franchisors to exercise reasonable business judgement…Amoco's decision to terminate the contracts was an exercise of its business judgement. We cannot substitute our business judgement for that of the franchisor.

The standard interpretation of the Automobile Dealer's Day in Court Act's good faith requirement is implicitly a business judgement interpretation. *See, e.g.,* Empire Volkswagen v. Worldwide Volkswagen Corp., 627 F. Supp. 1202, 1210 (S.D.N.Y 1986) ("In order to lack good faith [under the Dealer's Day in Court Act] a manufacturer must exercise coercion and intimidation and makes threats against the dealer.")

262 Courts have experimented with a number of other doctrinal tools. Doctrines of adhesion, unconscionability, and fiduciary duty have all had brief lives in the franchising context. See Carter Equip. V. John Deere Indus. Equip. Co., 681 F.2d 386 (5th Cir. 1982) (franchisor's power to control franchisee can give rise to fiduciary duty); Arnott v. American Oil Co., 609 F.2d 873 (8th Cir., 1979) (fiduciary duty inherent in franchise relationship); Corenswet, Inc. v. Amana Refrigeration, 594 F.2d 129 (5th Cir. 1979) (termination-at-will clauses should be subject to unconscionability test, not good faith); Tulowitzki v. Atlantic Richfield Co.,396 A.2d 956 (Del. 1978) (applying unconscionability test to franchisor demand of renewal); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973) (termination-at-will clause adhesive and unconscionable); Ashland Oil v. Donahue, 159 W. Va. 463, 223 S.F. 2d 433 (1976) (termination-at-will clause unconscionable). Most courts, however, have rejected all of these approaches to resolving franchise disputes, largely because these doctrines appear overly protective outside of the consumer context and because they cut too broadly, often resulting in an unenforceable contract. The essential element of inequality in franchising highlights another reason why these doctrines are inappropriate: They operate from the premise that the problem arises from the unequal bargaining power between franchisor and franchisee at the time the contract is "negotiated." However, the difficulties in franchising arise in the ongoing exercise of power in the gaps of the incomplete contract. While contracts could certainly be less one-sided, they could not be significantly less incomplete. The doctrine of fiduciary duty seems to provide a more tailored approach than the adhesion and unconscionability approaches, and indeed has been championed as the proper approach by one well-known critic of franchising. *See* Harold Brown, *Franchising: A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971) (gross disparity in the power to control another creates a fiduciary obligation). However, it too is ultimately inappropriate. Traditional fiduciaries are bound to pursue only the interest of the other party. This clearly conflicts with the mutual nature of the relationship between franchisee and franchisor. Most courts now interpret the fiduciary duty to be no more than the ordinary duty of good faith and fair dealing. *See* Cambee's Furniture v. Doughboy Recreational, 825 F.2d 167, 171 (8th Cir. 1987) (interpreting fiduciary duty of *Arnott* to rest on implied covenant of good faith and fair dealing); Phillips v. Chevron U.S.A., Inc., 792 F.2d 521, 524 (5th Cir. 1986) (fiduciary has generalized obligation of dealing fairly and in good faith); Domed Stadium Hotel v. Holiday Inns, 732 F.2d 480, 485 (5th Ci. 1984) (interpreting Arnott's fiduciary duty also more than basic contract principle of good faith and fair dealing); Picuture Lake Campground v. Holdiay Inns, 497 F. Supp. 858, 869 (E.D. Va 1980) (same).

263 For example, "franchisee must seek franchisor's approval for showroom layout" or "franchisee will purchase menu ingredients only form the following approved suppliers".

264 Not every exercise of the control power, however, is entitled to deference. *See* text accompanying notes 269-270 *infra.*

265 For example, at-will termination clauses or clauses requiring compliance with any franchisor demand.

266 In Boat & Motor v. Sea Ray Boats, 825 F.2d 1285 (9th Cir. 1987), the franchisee made significant sunk investments in advertising, capital, and the provision of below cost warranty work to purchasers. The standard form contract presented to the franchisee included a thirty-day-at-will termination clause. When the franchisee objected to the term, the franchisor responded that it was non-negotiable, but it reassured the franchisee that he had nothing to worry about, that he would "always be a Sea Ray dealer." *Id.* at 1288. This

case illustrates the difficulty of according substantial force to a term that poses significant potential for unrestrained opportunism when it is never the subject of negotiation and when it is undermined by other aspects of the relationship between the parties, such as reassurances that the term is unimportant. Another writer has suggested that while franchisees do in fact "understand the termination-at-will clause…to mean nonopportunistic franchisor termination" they should realize that they are relying on a reputation mechanism and not the courts for protection. Klein, *supra* note 82, at360. In my view, this amounts to flawed contract enforcement for it enforces deals that franchisees did not in fact make. Klein also suggests that the presence of broad power that can be employed opportunistically is evidence that reputation enforcement is cheaper than court enforcement; if it was not, franchisors would write more explicit contracts. I believe this argument overlooks the very high (possibly infinite) cost of writing a complete contract that protects both franchisors from free-riding and franchisees from opportunism.

[267] ……

[268] In what follows, I focus on the problem of opportunism because the problem of controlling free-riding is already largely understood by the courts.

[269] Empire Volkswagen v. World-Wide Volkswagen Corp., 814 F.2d 90, 92 (2d Cir. 1987).

[270] ……

[271] If the franchisor's desired objective – for example, avoiding consumer association of Volkswagen with Detroit – was worth the cost of giving up the Ford line, then either renegotiation or payment of full damages for termination should not prevent this ultimate outcome. If, on the other hand, the policy is one that costs more than it produces in terms of increased profitability (i.e. one that is only worth pursuing if someone else is bearing the cost), then the fact that the franchisor is frustrated in this objective is the efficient outcome and the one the franchisor would choose if it owned the outlet itself.

[272] *See* note 159 …..

[273] *See, e.g.* Marquis v. Chrysler Corp., 577 F.2d 624 (9th Cir. 1978) (good faith determined by circumstances and inferred from course of conduct); Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir 1985) (franchisee has right to cure default under court's interpretation of termination clause).