

Reputation Life Cycle: The Case of Franchising

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Law-and-economics conventional analysis contends that franchise termination laws, prohibiting opportunistic termination by the franchisor, are superfluous. Well-rooted in traditional law-and-economics opposition to such legislation is the belief that the reputation mechanism serves as a sufficient control against opportunistic termination by franchisors. This article questions the idea that reputation concerns can be a substitute for regulation of franchise relationships.

The article argues that the reputation mechanism suffers from an inherent deficiency, which disqualifies it from serving as a substitute for franchise termination legislation. In short, the reputation mechanism often has a limited life cycle consisting of three stages: creation, erosion and collapse. At the early stages of the franchisor organizational life cycle, the reputation mechanism may have some deterring effects on the franchisor. At these stages, the incentive of the franchisor is normally to attract new franchisees and thus the franchisor attaches greater importance to being perceived as fair in the eyes of potential franchisees. As the franchisor's financial resources increase, the effectiveness of the reputation mechanism will be eroded. Particularly, the franchisor's incentive to attract new franchisees will decrease. Similarly, its incentive to maintain its present franchisees will decline. Instead, the franchisor, having greater financial resources, will gradually shift towards self-ownership of the units. Following the continuing decrease in the franchisor's financial constraints and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism may collapse. This may particularly occur when the reputation-related costs decrease to a minimum level, at which point they will be lower than the franchisor's benefits from opportunistic termination of the franchise contract.

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INTRODUCTION

Legal economists have long debated whether the reputation mechanism can serve as a substitute for regulating the behavior of legal entities bound to a contractual relationship.¹ If the importance of maintaining a good reputation in the market can effectively regulate or deter opportunistic behavior by the parties, legal regulation of the contractual relationship is a social waste. Conversely, if the market-based reputation mechanism cannot deter opportunism, regulation of the relationship is more justifiable. Traditional law-and-economics analysis, which has found its way into current legislative practices in the United States, tends to suggest that the reputation mechanism can indeed function as an effective substitute for costly regulation of contractual relationships.² One commercial relationship in particular—the franchise relationship—is well-positioned, say legal economists, to be governed by reputation rather than by regulation.

The franchise relationship involves two major legal entities: the franchisor provides its trademark or trade name and a business system, while the franchisee generally pays the franchisor an ongoing royalty and an initial fee.³ To date, the legal ties of franchise relationships are regulated by a minority of fifteen states in the United States. These states enacted termination laws requiring “good cause” for the termination of a franchise contract by a franchisor,⁴ generally defined as the

¹ See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 978 n.232 (1990).

² See, e.g., Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691, 703 (1983) (presenting a model in which “reputation will substitute perfectly for a damage rule”); DOUGLAS G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, *GAME THEORY AND THE LAW* 57, 159–87 (1994) (suggesting that the reputation mechanism “can bring about long-term cooperation even if there is no enforceable contract”). But see STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW*, 323–24 (2004) (arguing that the reputation mechanism is an imperfect substitute for courts).

³ The contract underlying the relationship between the two parties is the “franchise contract.” International Franchise Association, *Frequently Asked Questions About Franchising*, <http://www.franchise.org/industrysecondary.aspx?id=10008> (last visited Nov. 1, 2009). See generally Hadfield, *supra* note 1, at 931–32.

⁴ The fifteen “good cause” states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Virginia, Washington, and Wisconsin. See ARK. CODE ANN. § 4-72-204 (2001); CAL. BUS. & PROF. CODE § 20020 (Deering 2007); CONN. GEN. STAT. ANN. § 42-133f (West 2007); DEL. CODE ANN. tit. 6, § 2552(a) (2005); HAW. REV. STAT. ANN. § 482E-6(2)(H) (LexisNexis 2009); 815 ILL. COMP. STAT. ANN. 705/19 (West 2008); IND. CODE ANN. § 23-2-2.7-1(1)(7) (West 2005); IOWA CODE ANN. § 523H.7(1) (West 2007); MICH. COMP. LAWS ANN. § 445.1527(27)(c) (West 2002); MINN. STAT. ANN. § 80C.14(3)(b) (West 2009); NEB. REV. STAT. ANN. § 87-404 (LexisNexis 2007); N.J. STAT. ANN. § 56:10-5 (West 2001); VA. CODE ANN. § 13.1-564 (2006); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 1999); WIS. STAT. ANN. § 135.03 (West 2009).

franchisee's failure to obey the franchise contract.⁵ Under these laws, a franchisor who concludes the franchise contract without a show of good cause must pay the franchisee damages.⁶ These franchise termination laws aim to protect franchisees against opportunistic treatment by franchisors, who inherently enjoy greater bargaining power.⁷ They are designed to protect franchisees from franchisors, who may terminate the franchise contract and opportunistically appropriate the profitable outlet developed by the franchisee.⁸ More specifically, an opportunistic franchisor may terminate the contract of an efficient franchisee, who fully complies with the franchise contract, in order to sell the latter's profitable unit to a new franchisee for higher franchise fees.⁹ Alternatively, the franchisor can terminate the contract and manage the successful unit himself.¹⁰

Conventional law-and-economics analysis proposes that franchise termination laws, prohibiting opportunistic termination by the franchisor, are superfluous.¹¹ Deeply rooted in traditional law-and-economics opposition to such laws is the belief that the

⁵ See ARK. CODE ANN. § 4-72-202(7)(A) (2001); CAL. BUS. & PROF. CODE § 20020 (Deering 2007); CONN. GEN. STAT. ANN. § 42-133f(a) (West 2007); HAW. REV. STAT. ANN. § 482E-6(2)(H) (LexisNexis 2009); 815 ILL. COMP. STAT. ANN. 705/19(b) (West 2008); IND. CODE ANN. § 23-2-2.7-1(1)(7) (West 2005); IOWA CODE ANN. § 523H.7(1) (West 2007); MICH. COMP. LAWS ANN. § 445.1527(27)(c) (West 2002); MINN. STAT. ANN. § 80C.14(3)(3)(b) (West 2009); NEB. REV. STAT. ANN. § 87-402(8) (LexisNexis 2007); N.J. STAT. ANN. § 56:10-5 (West 2001); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 1999).

⁶ Recoverable damages may include the following: (1) a fraction of the franchisee's tangible assets used with respect to the terminated franchise, including sales outlets and facilities, offices, warehouses, trucks, furnishings, equipment, and accessories; (2) loss of goodwill; and (3) loss of profits. See generally ARK. CODE ANN. § 4-72-208(b) (2001); CONN. GEN. STAT. ANN. § 42-133g(a) (West 2007); DEL. CODE ANN. tit. 6, § 2553(c) (2005); 815 ILL. COMP. STAT. ANN. 705/26 (West 2008); IOWA CODE ANN. § 523H.13 (West 2007); MINN. STAT. ANN. § 80C.17(1), (3) (West 2009); NEB. REV. STAT. ANN. § 87-409 (LexisNexis 2007); N.J. STAT. ANN. § 56:10-10 (West 2001); VA. CODE ANN. § 13.1-571(a) (2006); WIS. STAT. ANN. § 135.06 (West 2009).

⁷ VA. CODE ANN. § 13.1-558 (2006); Geib v. Amoco Oil Co., 29 F.3d 1050, 1056 (6th Cir. 1994); Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 135 (7th Cir. 1990); Kubis & Perszyk Assocs. v. Sun Microsystems, Inc., 680 A.2d 618, 622 (N.J. 1996); Corp v. Atlantic Richfield Co., 860 P.2d 1015, 1018 (Wash. 1993); Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees*, 72 N.C. L. REV. 905, 926 (1994); Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1511 (1990).

⁸ Corp v. Atlantic Richfield, 860 P.2d at 1018; Robert W. Emerson, *Franchise Terminations: Legal Rights and Practical Effects When Franchisees Claim the Franchisor Discriminates*, 35 AM. BUS. L.J. 559, 564-65 (1998); Robert W. Emerson, *Franchise Selection and Retention: Discrimination Claims and Affirmative Action Programs*, 40 ARIZ. L. REV. 511, 519 (1998); Jean Wegman Burns, *Vertical Restraints, Efficiency, and the Real World*, 62 FORDHAM L. REV. 597, 620-21 (1993).

⁹ ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING* 271 (2005).

¹⁰ *Id.*

¹¹ See Michael J. Lockerby, *Franchise Termination Restrictions: A Guide for Practitioners and Policy Makers*, 30 ANTITRUST BULL. 791, 858-60, 866-71 (1985).

reputation mechanism can serve as a sufficient control against opportunistic termination by franchisors. Since the incentive of franchisors is to maintain and attract franchisees, their motivation is to uphold a reputation of fairness. Accordingly, out of concern for their reputation, franchisors are not likely to opportunistically terminate the franchise contract.¹²

This “conventional law-and-economics opposition to franchise termination laws has been significantly influential in the development of franchise law in general, as witnessed by state and federal policy making.”¹³ Most states to date have refused to regulate general franchise termination laws prohibiting opportunistic termination of the franchise contract by the franchisor.¹⁴ At the federal level, such statutes have also been rejected.¹⁵ Yet legislators may be surprised to discover that the theoretical basis for this law-and-economics opposition to franchise termination laws is not quite as solid as one would hope.

This article, therefore, calls into question the idea that reputation can be a substitute for franchise termination laws. The article argues that the reputation mechanism suffers from an inherent deficiency, which disqualifies it from serving as a substitute for franchise termination laws.

In short, the argument is as follows: The reputation mechanism often has a limited life cycle consisting of three stages: creation, erosion and collapse. At the earliest stage of the franchisor’s organizational life cycle, the reputation mechanism is created. Normally, in this initial phase, the franchisor’s incentive is to maintain its previous franchisees and attract new ones. The franchisor wishes to expand the market of its products as rapidly as possible, but is financially limited and cannot expand on its own. Given the initial need of the franchisor to attract and maintain franchisees, the franchisor will be compelled to act in a manner which appears fair to present and prospective franchisees. Opportunistic termination of the franchise contract is therefore less likely to occur, as legal

¹² See *infra* Part II.A.

¹³ Uri Benoliel, *The Expectation of Continuity Effect and Franchise Termination Laws: A Behavioral Perspective*, 46 AM. BUS. L.J. 139, 141 (2009).

¹⁴ Since 1992, about thirty states have refused to regulate general franchise termination laws. See James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511, 518 (2002).

¹⁵ For example, in 1998 and 1999 the federal government failed to pass two bills that would have made it unlawful for a franchisor to terminate a franchise contract without good cause. See H.R. 4841, 105th Cong. (2nd Sess. 1998); H.R. 3308, 106th Cong. (1st Sess. 1999).

economists suggest, at the early stages of the franchisor's organizational life cycle.

However, following the creation of the reputation mechanism, its effectiveness is likely to be eroded. Particularly, as the franchisor's financial condition improves, the effectiveness of the reputation mechanism will steadily deteriorate. As the franchisor's financial resources increase, the franchisor will gradually shift away from attracting and maintaining franchisees towards operating, on its own, the present and prospective outlets in its chain. This shift mainly derives from the fact that the franchisor normally gains more profits from a franchisor-owned unit than from a franchisee-owned unit. As a result of this shift, the franchisor will be less concerned about being perceived as fair by present and prospective franchisees, which leads to the conclusion that termination without good cause is more likely to occur at this stage.

Ultimately, the reputation mechanism may collapse. Following the gradual increase in the franchisor's financial resources and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism will malfunction. The reputation-related costs will reach a minimum level, which will be lower than the franchisor's benefits from the opportunistic termination of the franchise contract. When the franchisor accumulates enough financial resources to operate *the whole* franchise chain on its own, this outcome is to be expected. At this final stage—and herein lies the crux of the argument—the franchisor's reputation costs incurred from being perceived as unfair by present and prospective franchisees are likely to be lower than the benefits from opportunistic termination. Opportunistic termination therefore is likely to occur.

Part I of this article will provide theoretical context by briefly reviewing the debate over the effectiveness of reputation as a substitute for franchise termination laws. First, the arguments in favor of the reputation mechanism, which underlie the traditional law-and-economics disregard for franchise termination laws, will be introduced. Second, I shall review the scant manifestations of skepticism as to the effectiveness of reputation in preventing opportunistic termination by franchisors. Part II will demonstrate the intrinsic deficiency of the reputation mechanism in preventing opportunism by the franchisor, namely the reputation life-cycle. The three major stages of the reputation life cycle will be presented—creation, erosion and collapse—with an eye toward uncovering the Achilles heel of the reputation mechanism. While this article focuses predominantly on the (in)effectiveness of reputation in

preventing opportunism in franchise relationships, I will conclude by suggesting broader implications of my analysis for the legal administration of other long-term commercial relationships.

I. THE DEBATE OVER REPUTATION

A. Law-and-Economics Conventional Analysis

Legal economists oppose franchise laws that require franchisors to demonstrate good cause for termination of a franchise contract.¹⁶ Essential to legal economists' resistance to franchise termination laws is the argument that the market-based reputation mechanism can function as a substitute for regulation.¹⁷ More specifically, legal economists argue that the reputation mechanism can prevent contract termination without good cause, since such termination will impose reputation-related costs on the franchisor.¹⁸ As Charles Goetz and Robert Scott argue, franchisors will "incur substantial 'goodwill' losses if they attempt to exploit a discretionary termination authority."¹⁹

Legal economists furthermore specify the reputation-related costs which will prevent termination without good cause.²⁰ First, a franchisor who terminates the contract without good cause will encounter difficulties in retaining its other franchisees. The franchisor, as Richard Epstein explains, "has incentives to act in

¹⁶ See generally James A. Brickley et al., *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 103–09, 130 (1991); Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9, 30 (1995); Lockerby, *supra* note 11, at 858–71. Cf. Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 314–15 (1975).

¹⁷ Another important argument that underlies legal economists' resistance to franchise termination laws is that a statutory "good cause" requirement will increase franchisor termination costs and therefore tempt the franchisee to cheat or at least to free ride. See Brickley et al., *supra* note 16, at 104; Epstein, *supra* note 16, at 314; Matthew Ellman, *Specificity Revisited: The Role of Cross-Investments*, 22 J.L. ECON. & ORG. 234, 250 n.36 (2006); Richard L. Smith II, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125, 136 (1982). For a critical analysis of this argument, see generally Benoliel, *supra* note 13 (arguing that a statutory good cause requirement will enhance joint action, expression of trust, and fair treatment of both contractual parties).

¹⁸ Lockerby, *supra* note 11, at 860.

¹⁹ Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1148 (1981). See also James A. Brickley, Sanjog Misra & R. Lawrence Van Horn, *Contract Duration: Evidence from Franchising*, 49 J. L. & ECON. 173, 178 (2006); William L. Killion, *One Person's Sense of Justice Is Another's Sense of Injustice*, 24 FRANCHISE L.J. 3, 6 (2004); Alan J. Meese, *Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 131 n.96 (1996); Daniel Clough, *Law and Economics of Vertical Restraints in Australia*, 25 MELB U. L. REV. 551, 580 (2001).

²⁰ Epstein, *supra* note 16, at 314–15; Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. & ECON. 345, 356 (1985).

a manner which . . . appears to be fair if he wishes to retain his other franchisees.”²¹ Second, the franchisor will find it difficult to sell additional franchise units to new franchisees. As Benjamin Klein & Lester Saft explain, “[t]he franchisor is not likely to terminate franchisees merely to confiscate their sunk investments opportunistically because franchisors must be concerned about their reputations when attempting to sell additional franchise locations.”²²

Law-and-economics scholars, therefore, uniformly base their analysis upon the implicit assumption that franchisors have a *static* incentive: to retain their franchisees and to attract new ones. This assumption, however, is dubious, as will be demonstrated in this article.

B. Skepticism about Reputation Effectiveness

A handful of legal scholars manifest skepticism about the effectiveness of the reputation mechanism in controlling opportunistic termination by franchisors. David Charny posed one of the earlier challenges to the effectiveness of the reputation mechanism, in his innovative article of the early 1990s.²³ Charny argues that the reputation mechanism will not function if the

²¹ Epstein, *supra* note 16, at 315. See also Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289, 310 (1989); Smith, *supra* note 17, at 130; Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 577 (1981); Boyd Allan Byers, *Making a Case for Federal Regulation of Franchise Terminations—A Return-of-Equity Approach*, 19 J. CORP. L. 607, 651 (1994); Clough, *supra* note 19, at 580.

²² Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 356 (1985); Roger D. Blair & Francine Lafontaine, *Understanding the Economics of Franchising and the Laws That Regulate It*, 26 FRANCHISE L.J. 55, 64 (2006) (“There may be lurking concern that franchisors may abuse their ability to terminate franchise contracts in some opportunistic fashion. Although there is some possibility of such opportunism, there is scant empirical support for it. From an economic perspective, this is not surprising because most franchisors want to expand, and it is hard to attract new franchisees while abusing incumbent franchisees.”); See also Epstein, *supra* note 16, at 315; Lockerby, *supra* note 11, at 859–60; Pitegoff, *supra* note 21, at 310; Smith, *supra* note 17, at 130; Robert W. Emerson, *Franchise Terminations*, *supra* note 8, at 586; Alan J. Meese, *Regulation of Franchisor Opportunism and Production of the Institutional Framework: Federal Monopoly or Competition Between the States?*, 23 HARV. J.L. & PUB. POLY 61, 68 (1999); Jonathan Klick et al., *Incomplete Contracts and Opportunism in Franchising Arrangements: The Role of Termination Clauses* 16–17 (Am. L. & Econ. Ass’n Ann. Meetings, Working Paper No. 61, 2006), available at http://www.law.georgetown.edu/olin/papers/klick_paper.pdf; Jonathan Klick et al., *The Effect of Contract Regulation: The Case of Franchising* 33 (Geo. Mason L. & Econ. Res. Paper No. 07-03, 2006), available at <http://ssrn.com/abstract=951464>; Henry N. Butler & Barry D. Baysinger, *Vertical Restraints of Trade As Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction-Cost Economics, and Organization Theory*, 32 EMORY L.J. 1009, 1092 (1983); Byers, *supra* note 21, at 651; Clough, *supra* note 19, at 580; Muris, *supra* note 21, at 577; Killion, *supra* note 19, at 6.

²³ David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373 (1990).

franchisor ceases to use franchisees altogether.²⁴ He suggests that this may occur once the franchisor “has established a market niche” or when the acquirer in a takeover puts in place a new management team that decides to terminate existing franchises.²⁵

Skepticism about the potential for reputation to control opportunistic termination by franchisors was also manifested in a seminal article on franchise contracts by Gilliland Hadfield.²⁶ First, Hadfield, similar to Charny, argues that the reputation mechanism will not function if the franchisor stops selling franchisees.²⁷ She furthermore suggests that this may happen if the franchisor reaches a limit on the number of the franchise units it is able to sell.²⁸ This limitation may often exist, she maintains, as franchisors provide their franchisees with territorial exclusivity.²⁹ Hadfield’s second argument highlights the problematic fact that the reputation mechanism depends upon inferences, drawn by potential franchisees, about the franchisor’s past behavior.³⁰ She claims, “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.”³¹

Over the next few years, other scholars joined in the dispute over the effectiveness of the reputation mechanism in the context of franchising. Warren Grimes, for instance,³² argues that a franchisor is likely to be less constrained by reputation concerns in several circumstances. First, a franchisor is likely to be less constrained by reputation concerns if a myth of high profitability surrounds franchising or certain types of franchising.³³ Second, the reputation mechanism will be less effective if the franchisor can counter reputation damage by lowering the franchise fee.³⁴ Third, the reputation mechanism is less likely to operate as expected if the franchisor can make less-informed franchisees the target of opportunism.³⁵ Fourth, the reputation mechanism’s effectiveness is dubious if the franchisor has a short-term

²⁴ *Id.* at 434.

²⁵ *Id.* at 435.

²⁶ Hadfield, *supra* note 1.

²⁷ *Id.* at 978 n.232.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² Warren S. Grimes, *When Do Franchisors Have Market Power? Antitrust Remedies for Franchisor Opportunism*, 65 ANTITRUST L.J. 105 (1996).

³³ *Id.* at 130–31.

³⁴ *Id.* at 131–33.

³⁵ *Id.* at 133–34.

perspective.³⁶ Finally, the reputation mechanism will be less effective if the franchisor misapprehends the extent of reputation damage.³⁷

While I agree with many of the scholarly objections leveled at the reputation mechanism in the past, the next part of this article contends that the reputation mechanism also suffers from an inherent deficiency: its limited life cycle. The three major stages of the reputation life cycle will be presented in chronological order: creation, erosion and collapse. A detailed analysis of the life cycle will reveal that the reputation mechanism is often, by its very nature, doomed to failure.

II. REPUTATION LIFE CYCLE

A. Stage One: Creation

At the early stages of the franchisor organizational life cycle, the reputation mechanism may have some deterring effects on the franchisor; the franchisor may be particularly discouraged from terminating a franchise contract without good cause. At these early stages, the incentive of the franchisor is normally to attract new franchisees (or other types of intermediaries, such as dealers and distributors) and thus the franchisor attaches greater importance on being perceived as fair in the eyes of potential franchisees.³⁸ The initial incentive to attract new franchisees derives from three cumulative factors, which will be explained in greater detail below. First, franchisors ordinarily wish to rapidly expand the market for their products by opening many pioneering outlets in various locations.³⁹ Second, a young franchisor normally lacks the significant financial resources necessary to promptly expand the market on its own.⁴⁰ Third, new franchisees, attracted by the young franchisor, can effectively support the franchisor in overcoming its initial financial constraints.⁴¹

³⁶ *Id.* at 134–35.

³⁷ *Id.* at 135.

³⁸ See *supra* note 22 and accompanying text.

³⁹ Alfred R. Oxenfeldt & Anthony O. Kelly, *Will Successful Franchise Systems Ultimately Become Wholly-Owned Chains?*, 44 J. RETAILING 69, 74 (1968–69). For a detailed discussion on this first factor see *infra* notes 42–59.

⁴⁰ Rajiv P. Dant et al., *Ownership Redirection in Franchised Channels*, 11 J. PUB. POLY. & MKTG. 33, 34 (1992). For a detailed discussion on this second factor see *infra* notes 60–72.

⁴¹ Scott A. Shane, *Hybrid Organizational Arrangements and Their Implications for Firm Growth and Survival: A Study of New Franchisors*, 39 ACAD. MGMT. J. 216, 220 (1996) (describing the types of costs saved by the franchisor). For a detailed discussion on this third factor see *infra* notes 73–105.

Franchisors generally hope to quickly expand the market for their products by opening many pioneering outlets in various locations.⁴² Swift expansion generates several benefits for franchisors. First, a franchisor, entering the market early can snag superior geographic locations before the market becomes saturated by competitors.⁴³ A franchisor who quickly develops its franchise system, on valuable real estate, may preempt its competitors;⁴⁴ followers will face difficulties in gaining possession of the same valuable real estate, already held by the fast franchisor.⁴⁵ McDonald's, for example, effectively preempted precious real estate from its competitors, through favorable leases.⁴⁶ Through its early expansion in the relatively novel sector of fast food, McDonald's benefited from a first-move advantage.⁴⁷ In addition, a franchisor who quickly develops its franchise system, may be able to lease or acquire assets in the early stages of the market at prices below those that will prevail in later stages, after the market has evolved.⁴⁸

Rapid expansion not only gives franchisors an edge over competitors, but also allows the franchisor to shape the market.⁴⁹ A franchisor that promptly expands the market for its products may influence customer preferences.⁵⁰ In the early stages of many markets, consumers may not have a strong and precise opinion about their preferred value of the new product ingredients.⁵¹ They may also not have a strong inclination about their preferred combination of the product features.⁵² For example, when Coca Cola first penetrated the market, not many customers had a predetermined preference for how carbonated or sweet a cola should be.⁵³ A successful early franchisor is likely to have a seminal influence on the customers' preferences regarding

⁴² Oxenfeldt & Kelly, *supra* note 39, at 74.

⁴³ Victoria Bordonaba Juste et al., *Franchise Firm Entry Time Influence on Long-term Survival*, 37 INT'L J. RETAIL & DISTRIBUTION MGMT. 106, 109 (2009).

⁴⁴ Oxenfeldt & Kelly, *supra* note 39, at 74; Steven C. Michael, *First Mover Advantage Through Franchising*, 18 J. BUS. VENTURING 61, 65 (2003). *See generally* Marvin B. Lieberman & David B. Montgomery, *First-Mover Advantages*, 9 STRAT. MGMT. J. 41, 44 (1988).

⁴⁵ Michael, *supra* note 44, at 65. *See generally* Birger Wernerfelt, *A Resource-based View of the Firm*, 5 STRAT. MGMT. J. 171, 173 (1984).

⁴⁶ JOHN F. LOVE, MCDONALD'S: BEHIND THE ARCHES 164-65 (1986).

⁴⁷ Michael, *supra* note 44, at 65.

⁴⁸ Lieberman & Montgomery, *supra* note 44, at 44; Michael, *supra* note 44, at 65.

⁴⁹ Gregory S. Carpenter & Kent Nakamoto, *Consumer Preference Formation and Pioneering Advantage*, 26 J. MARK. RES. 285, 286 (1989).

⁵⁰ Michael, *supra* note 44, at 66.

⁵¹ Carpenter & Nakamoto, *supra* note 49, at 286; Lieberman & Montgomery, *supra* note 44, at 46.

⁵² Carpenter & Nakamoto, *supra* note 49, at 286.

⁵³ *Id.*

the value of the product features.⁵⁴ A franchisor may also influence customer preferences as to the combination of the product features.⁵⁵ Coca Cola, for example, may have critically impacted the development of customers' preferences for colas.⁵⁶ The influence on customers' preferences may ultimately shift customers to favor the pioneer franchisor over later competitors,⁵⁷ leading to a market share benefit. Rapid expansion, therefore, is quite beneficial for franchisors. Empirical studies confirm that swift expansion is advantageous. Examining 137 U.S. franchisors in the restaurant industry, Steven Michael found that a rapid expansion strategy of franchisors leads to superior outlet share and ultimately to higher profitability.⁵⁸ Similarly, data covering 188 Spanish franchise chains for an eight-year period show that an early entry strategy of franchisors leads to lower failure risk.⁵⁹

Nonetheless, despite the advantages, maneuvering an early entrance into the franchise market is difficult. A young franchisor, wishing to rapidly expand the market for its products on its own, normally lacks the significant financial resources needed to fulfill its desire.⁶⁰ Opening new outlets is often too costly for a financially immature franchisor.⁶¹ Three significant costs must normally be incurred by the young franchisor: information costs, start-up costs, and management costs.⁶²

To begin with, financial resources are required to gather information regarding the local market in which the franchisor may potentially expand.⁶³ When a young franchisor system expands beyond its original geographic location, it generally

⁵⁴ *Id.*; Lieberman & Montgomery, *supra* note 44, at 46.

⁵⁵ Carpenter & Nakamoto, *supra* note 49, at 286.

⁵⁶ *Id.*; Lieberman & Montgomery, *supra* note 44, at 46.

⁵⁷ For empirical support, see Carpenter & Nakamoto, *supra* note 49, at 286, 294; Frank H. Alpert & Michael A. Kamins, *An Empirical Investigation of Consumer Memory, Attitude, and Perceptions toward Pioneer and Follower Brands*, 59 J. MKTG. 34, 36-37, 41 (1995).

⁵⁸ Michael, *supra* note 44, at 66-67, 69-71, 74. See also Regis Coeurderoy & Rodolphe Durand, *Leveraging the Advantage of Early Entry: Proprietary Technologies Versus Cost Leadership*, 57 J. BUS. RES. 583, 584, 587, 589 (2004).

⁵⁹ Juste et al., *supra* note 43, at 109, 112, 115.

⁶⁰ Rajiv P. Dant et al., *Ownership Redirection in Franchised Channels*, 11 J. PUB. POL'Y & MKTG. 33, 34 (1992); Richard E. Caves & William F. Murphy II, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 581 (1976); Francine Lafontaine & Patrick J. Kaufmann, *The Evolution of Ownership Patterns in Franchise Systems*, 70 J. RETAILING 97, 99 (1994).

⁶¹ Lafontaine & Kaufmann, *supra* note 60, at 99.

⁶² Rajiv P. Dant & Audhesh K. Paswan, *The Effect of Financial Resource Availability and System Size on Ownership Redirection in Franchised Channels of Distribution*, 10 ASIA PAC. J. MKTG & LOGISTICS 85, 86 (1998).

⁶³ Lafontaine & Kaufmann, *supra* note 60, at 99.

lacks information regarding other local markets.⁶⁴ Therefore, the franchisor needs to invest capital in searching for and identifying suitable locations.⁶⁵ It should ideally also evaluate the local market conditions of each potential location.⁶⁶ More specifically, the franchisor will have to invest resources in learning about local marketing strategies, input suppliers, and customer preferences, at each potential location.⁶⁷ These information-gathering costs are likely to augment with increases in the unfamiliarity, diversity, and uncertainty of local markets.⁶⁸

The franchisor, wishing to expand on its own, will furthermore incur considerable start-up costs in establishing each outlet. The total start-up costs of each outlet can range from \$20,000, at a minimum, to over \$1,000,000, depending on the franchise chosen.⁶⁹ Costs may involve renting or building an outlet, stocking it with inventory and equipment, and advertising it.⁷⁰ Finally, a franchisor, ready and willing to promptly expand on its own, will incur significant management costs. These costs include the necessary capital needed to select skilled managers to operate each outlet (*selection costs*).⁷¹ They also include expenditures for monitoring the managers' performance (*monitoring costs*).⁷²

Since expanding rapidly is usually too costly for a young franchisor, its initial incentive will be to attract new franchisees.⁷³ New franchisees will normally be able to

⁶⁴ Thomas Bürkle & Thorsten Posselt, *Franchising as a Plural System: A Risk-Based Explanation*, 84 J. RETAILING 39, 41 (2008).

⁶⁵ James G. Combs et al., *A Strategic Groups Approach to the Franchising-Performance Relationship*, 19 J. BUS. VENTURING 877, 880 (2004).

⁶⁶ *Id.*

⁶⁷ Alanson P. Minkler, *Why Firms Franchise: A Search Cost Theory*, 148 J. INST. THEORETICAL ECON. 240, 242 (1992).

⁶⁸ *Id.* at 242-43.

⁶⁹ International Franchise Association, *Frequently Asked Questions About Franchising*, <http://www.franchise.org/industrysecondary.aspx?id=10008> (last visited Nov. 12, 2009).

⁷⁰ Justin G. Longenecker et al., *SMALL BUSINESS MANAGEMENT: LAUNCHING AND GROWING ENTREPRENEURIAL VENTURES* 99-101 (14th ed. 2007).

⁷¹ See Shane, *supra* note 41, at 219; Seth W. Norton, *An Empirical Look at Franchising as an Organizational Form*, 61 J. BUS. 197, 204 (1988); Combs et al., *supra* note 65, at 880.

⁷² See Shane, *supra* note 41, at 219-20; Seth W. Norton, *Franchising, Brand Name Capital, and the Entrepreneurial Capacity Problem*, 9 STRAT. MGMT. J. 105, 106 (1988); James A. Brickley & Fredrick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401, 403 (1987).

⁷³ Rajiv P. Dant et al., *supra* note 60, at 34; Brent L. Baker & Rajiv P. Dant, *Stable Plural Forms in Franchise Systems: An Examination of the Evolution of Ownership Redirection Research*, in STRATEGY AND GOVERNANCE OF NETWORKS: COOPERATIVES, FRANCHISING, AND STRATEGIC ALLIANCES 87, 92 (George Hendrikse et al. eds. 2008); Shelby D. Hunt, *The Trend Toward Company-Operated Units in Franchise Chains*, 49 J.

effectively assist the financially immature franchisor in overcoming its initial economic constraints. To begin with, franchisees often incur the information costs needed to find suitable locations for expansion in locations which are unfamiliar to the franchisor.⁷⁴ Notably, franchisees are likely to have valuable information regarding potential local markets, which the youthful franchisor lacks.⁷⁵ This is mainly because they usually reside in the community in which the new unit is planned to be established.⁷⁶

In addition, franchisees will commonly incur the start-up costs involved in establishing new outlets, including equipment, inventory building, and real estate costs.⁷⁷ Franchisees furthermore reduce the management costs needed to operate an outlet.⁷⁸ First, they reduce the selection costs needed to recruit qualified managers.⁷⁹ Franchisees typically agree to invest heavily in the outlet and to receive a residual claim on the outlet's uncertain profits.⁸⁰ By doing so, franchisees signal their management capabilities, compared to salaried managers, who are willing to take the job.⁸¹ Second, franchisees reduce the monitoring costs needed to scrutinize the performance of managers.⁸² Since franchisees invest significant resources in the outlet and have a residual claim on the outlet's profit, they are less likely than salaried managers, to put forth a suboptimal effort level.⁸³

Franchisees support the franchisor in overcoming its initial financial constraints, not only by incurring and reducing significant costs, but also by directly providing the franchisor significant capital.⁸⁴ First, if the franchise involves the sale of products by the franchisor to the franchisee, the sale price will usually comprise a mark-up over cost representing the

RETAILING 3, 4 (1973); Oxenfeldt & Kelly, *supra* note 39, at 71; Caves & Murphy, *supra* note 60, at 581.

⁷⁴ Combs et al., *supra* note 65, at 880. Sometimes, franchisors select the location, but then they collect fees from franchisees for this service. Hadfield, *supra* note 1, at 936.

⁷⁵ Bürkle & Posselt, *supra* note 64, at 41; Minkler, *supra* note 67, at 243; Anna Watson et al., *Retail Franchising: An Intellectual Capital Perspective*, 12 J. RETAILING CONSUMER SERVICES 25, 28 (2005).

⁷⁶ Bürkle & Posselt, *supra* note 64, at 41; Combs et al., *supra* note 65, at 880; Lafontaine & Kaufmann, *supra* note 60, at 99.

⁷⁷ Lafontaine & Kaufmann, *supra* note 60, at 99.

⁷⁸ Combs et al., *supra* note 65, at 880.

⁷⁹ Shane, *supra* note 41, at 220.

⁸⁰ *Id.* at 220; Norton, *supra* note 71, at 205; Combs et al., *supra* note 65, at 880.

⁸¹ Shane, *supra* note 41, at 220.

⁸² *Id.* at 219–21.

⁸³ Brickley & Dark, *supra* note 72, at 404–05; Shane, *supra* note 41, at 221; Combs et al., *supra* note 65, at 880; Watson et al., *supra* note 75, at 28.

⁸⁴ Hadfield, *supra* note 1, at 935.

franchisor's return.⁸⁵ In addition, each franchisee ordinarily pays the franchisor an initial lump-sum fee, called a franchise fee⁸⁶—generally ranging between \$10,000 and \$30,000.⁸⁷ Moreover, each franchisee provides a constant and on-going stream of capital to the franchisor, via royalty rates.⁸⁸ Normally, royalty rates are calculated as a percentage of sales revenues.⁸⁹ The average royalty rate paid in 2001 was 5.2%, which in real terms translates to about \$500 per month.⁹⁰ Many franchisees also pay the franchisor advertising fees,⁹¹ to support franchisors in advertising their product or service regionally or nationally.⁹² These fees are most often a steady percentage, usually one to two percent,⁹³ of the franchisee's monthly sales revenue.⁹⁴ Finally, franchisees occasionally pay fees to franchisors for bookkeeping and management consultation services.⁹⁵

Given the significant capital that franchisees provide to the youthful franchisor, and their ability to support him in overcoming its financial constraints,⁹⁶ one would posit that the initial incentive of the franchisor will be to attract franchisees. This theoretical contention is, in fact, empirically supported. Francine Lafontaine conducted a survey of, among other things, franchisors' motivation for using franchisees.⁹⁷ The survey was

⁸⁵ *Id.*

⁸⁶ James G. Combs & David J. Ketchen, Jr., *Can Capital Scarcity Help Agency Theory Explain Franchising? Revisiting the Capital Scarcity Hypothesis*, 42 *ACAD. MGMT. J.* 196, 199 (1999); Lafontaine & Kaufmann, *supra* note 60, at 99; Hadfield, *supra* note 1, at 935.

⁸⁷ International Franchise Association, *Frequently Asked Questions About Franchising*, <http://www.franchise.org/industrysecondary.aspx?id=10008> (last visited Nov. 12, 2009). For statistics on the variation in franchise fees, see generally BLAIR & LAFONTAINE, *supra* note 9, at 56–61.

⁸⁸ Hadfield, *supra* note 1, at 935; Watson, *supra* note 75, at 25.

⁸⁹ BLAIR & LAFONTAINE, *supra* note 9, at 62.

⁹⁰ *Id.* at 67, 69.

⁹¹ *Id.* at 69.

⁹² *Id.*

⁹³ Longenecker et al., *supra* note 70, at 100.

⁹⁴ BLAIR & LAFONTAINE, *supra* note 9, at 69.

⁹⁵ Hadfield, *supra* note 1, at 936. Notably, franchisors sometimes also obtain a commission from approved suppliers of their new franchisees. *Id.*

⁹⁶ *But see* P. H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 *J. L. & ECON.* 223, 225–26 (1978) (suggesting that passive investors, such as stockholders, are a superior source of capital than franchisees). However, for explanations of why franchisees are in fact a superior source of capital than passive investors, see, for example, Robert E. Martin & Robert T. Justis, *Franchising, Liquidity Constraints and Entry*, 25 *APPLIED ECON.* 1269, 1271–72 (1993); Lafontaine & Kaufmann, *supra* note 60, at 99; Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 *RAND J. ECON.* 263, 267 (1992).

⁹⁷ Francine Lafontaine, *How and Why do Franchisors Do What They Do: A Survey Report*, in *FRANCHISING: PASSPORT FOR GROWTH & WORLD OF OPPORTUNITY, PROCEEDINGS OF THE SIXTH CONFERENCE OF THE SOCIETY OF FRANCHISING* (Patrick Kaufmann ed. 1992).

based on the answers given by 130 franchisors, all members of the International Franchise Association, and involved in a variety of businesses.⁹⁸ The majority of the respondents began franchising only recently.⁹⁹ Franchisors participating in the survey explained that they became involved in franchising mainly because it allowed them to expand rapidly, especially because franchisees provide capital to franchisors.¹⁰⁰ In another survey, conducted by Rajiv Dant, of 79 founders and representatives of franchisors, similar results were found.¹⁰¹ Respondents were primarily drawn from the following franchising sectors: fast food and restaurants, gifts and home decorations, hospitality, convenience stores, and services.¹⁰² The majority of respondents classified their business in the introduction or growth stages of its life cycle,¹⁰³ indicating the relative youthfulness of the franchisors.¹⁰⁴ According to the survey, the most cited motivations for attracting franchisees were “market entry and growth” and “capital access and profits.”¹⁰⁵

B. Stage Two: Erosion

As the franchisor’s financial resources increase, the effectiveness of the reputation mechanism will erode. Particularly, the franchisor’s incentive to attract new franchisees will decrease.¹⁰⁶ Similarly, its incentive to maintain its present franchisees will decline.¹⁰⁷ Instead, the franchisor, having greater financial resources, will gradually shift towards owning

⁹⁸ *Id.* at 2, 4.

⁹⁹ *Id.* at 3.

¹⁰⁰ *Id.* at 11.

¹⁰¹ Rajiv P. Dant, *Motivation for Franchising: Rhetoric Versus Reality*, 14 INT’L SMALL BUS. J. 10 (1995).

¹⁰² *Id.* at 15.

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 16.

¹⁰⁵ *Id.* at 23. For further empirical support to the hypothesis that the initial incentive of franchisors is to attract new franchisees due to financial constraints, see Lorelle Frazer, *Why Franchisors Discontinue Franchising but Continue Operating*, 19 INT’L SMALL BUS. J. 29, 32 (2001); David A. Kirby & Anna Watson, *Overcoming the Financial Constraints on Small Firm Growth: The Case of Franchising*, 6 J. OF PRIVATE EQUITY 61, 63 (2003); Anne Marie Doherty, *The Internationalization of Retailing: Factors Influencing the Choice of Franchising as a Market Entry Strategy*, 18 INT’L J. SERV. INDUS. MGMT. 184, 194 (2007); Scott Weaven & Carmel Herington, *Factors Influencing Governance Choice and Human Resource Management Within Services Franchising Networks*, J. MGMT. & ORG. 126, 132 (2007). For indirect empirical support, see Lafontaine & Kaufmann, *supra* note 60, at 110 (“the fact that franchisors [examined in the study] that were subsidiaries of larger corporations owned more of their own units, point toward the idea that access to resources might constrain some firms to operate less units than they would like.”).

¹⁰⁶ Oxenfeldt & Kelly, *supra* note 39, at 75.

¹⁰⁷ *Id.*

the units himself.¹⁰⁸ The franchisor will specifically want to progressively open new outlets under franchisor-ownership, which would have been opened as a franchisee-owned outlet, when the franchisor lacked financial resources. In addition, the franchisor's motivation will be to gradually transform the existing franchisee-owned outlets in his chain into franchisor-owned outlets.

The shift in the franchisor's incentive stems from the fact that the profits that a franchisor can make, by owning a unit, are normally greater than the profits it can amass through a franchisee-owned unit.¹⁰⁹ True, establishing and maintaining a franchisor-owned unit is costly for the franchisor since it involves information, start-up, and management costs. In addition, a franchisee-owned unit provides the franchisor capital through a lump-sum fee, franchise fees, and other fees.¹¹⁰ However, in the long-run, a franchisor-owned unit is more profitable for the franchisor than a franchisee-owned unit.¹¹¹ With its company-owned and operated units, the franchisor continually keeps all of the profits of the unit, whereas with franchised units its chief source of profit is a lump-sum fee and ongoing fees computed as a small percentage of the gross revenue.¹¹²

The superiority of franchisor-owned units over franchisee-owned units in generating franchisor's profits is empirically supported. For example, Thomas Ehrmann and Georg Spranger examine the financials of seven large public U.S. restaurant retail chains through their annual 10-k filings with the U.S. Securities and Exchange Commission.¹¹³ They examine each franchisor's gross margin ratios as well as the operating income ratios for franchisor-owned to franchisee-owned units.¹¹⁴ For each franchisor analyzed in the study, the single franchisor-

¹⁰⁸ *Id.*; Rajiv P. Dant et al., *What We Know About Ownership Redirection in Franchising: A Meta-Analysis*, 72 *J. Retailing* 429, 434 (1996); Caves & Murphy, *supra* note 60, at 581; Gary J. Castrogiovanni et al., *Shifting Imperatives: An Integrative View of Resource Scarcity and Agency Reasons for Franchising*, 30 *ENTREPRENEURSHIP THEORY & PRAC.* 23, 25 (2006); Baker & Dant, *supra* note 73, at 92.

¹⁰⁹ Baker & Dant, *supra* note 73, at 92.

¹¹⁰ *See supra* Part II.A.

¹¹¹ Hunt, *supra* note 73, at 6–7; Hadfield, *supra* note 1, at 936–37; Paul Tracey & Owen Jarvis, *Toward a Theory of Social Venture Franchising*, 31 *ENTREPRENEURSHIP THEORY & PRAC.* 667, 669 (2007); James G. Combs et al., *Franchising: A Review and Avenues to Greater Theoretical Diversity*, 30 *J. MGMT.* 907, 909–10 (2004).

¹¹² Baker & Dant, *supra* note 73, at 92; James G. Combs & Gary J. Castrogiovanni, *Franchisor Strategy: A Proposed Model and Empirical Test of Franchise Versus Company Ownership*, 32 *J. SMALL BUS. MGMT.* 37, 38–39 (1994).

¹¹³ Thomas Ehrmann and Georg Spranger, *Franchisee Versus Company Ownership—An Empirical Analysis of Franchisor Profit*, in *ECONOMICS AND MANAGEMENT OF NETWORKS* 31, 39–40 (Gérard Cliquet et al., eds. 2007).

¹¹⁴ *Id.* at 40.

owned unit added far more to both the gross margin and to the total operating income than the single franchisee-owned unit.¹¹⁵ Similarly, Urban Ozanne and Shelby Hunt found that sales in franchisor-owned outlets in the fast food industry are on average significantly higher than those in franchisee-owned outlets.¹¹⁶

Anecdotal evidence bolsters the contention that franchisor-owned units are superior to franchisee-owned units in generating franchisor profits, as expressed in several classic statements by franchisors. For example, John Jay Hooker famously stated:

As all of you know, the name of the game is not really franchising. The name of the game is company stores. I was looking at some figures not too long ago and saw where a big company in America has 1,600–1,700 units, and only two hundred of those were company-owned, but the two hundred company-owned units were producing sixty percent of the net after taxes. . . the real name of the game is owning the stores yourself.¹¹⁷

Similarly, Lawrence E. Singer, who was the president of Royal Castle System Inc. has noted: “We make more profit, per unit, than we could possibly make in franchising. This fact has been acknowledged by many of the franchise operators.”¹¹⁸

Given the superiority of franchisor-owned units over franchisee-owned units, the effectiveness of the reputation mechanism is likely to be eroded when the franchisor’s financial constraints decrease. As the resources needed for establishing and operating units become more attainable by the franchisor, forgoing the higher levels of profit attained through franchisor ownership ceases to be necessary.¹¹⁹ Indeed, empirical studies indicate that as the franchisor’s financial resources increase, the reputation mechanism erodes. These studies particularly

¹¹⁵ *Id.* at 41.

¹¹⁶ S. Select Comm. on Small Business, 92d Cong., 1st Sess., Report on the Economic Effects of Franchising 87 (Comm. Print 1971) (written by Urban B. Ozanne & Shelby D. Hunt); Hunt, *supra* note 73, at 7.

¹¹⁷ 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 164, 171 (Charles L. Vaughn ed. 1970).

¹¹⁸ Lawrence E. Singer, *To Franchise or Not—How to Decide: Con—Why Company-Owned Units*, in FRANCHISING TODAY: 1966–1967 23, 24 (Charles L. Vaughn & David B. Slater eds. 1967). Likewise, William Ware of PKI Foods, Inc., stated:

More profits can be gained from company-owned stores. A break-even analysis of operations in the \$225,000 to \$300,000 range shows this fact to be very true. Since our stores average \$270,000 per unit per year and some clear between \$50,000 and \$100,000, it becomes evident that our stores are more profitable than if franchised.

William Ware, *To Franchise or Not—How to Decide: Con—Why Company-Owned Units*, in FRANCHISING TODAY: 1966–1967 27, 29 (Charles L. Vaughn & David B. Slater eds. 1967).

¹¹⁹ Baker & Dant, *supra* note 73, at 92.

confirm that as the financial availability of the franchisor increases, its incentive will gradually shift away from attracting new franchisees and maintaining the present ones, towards owning prospective and present outlets.¹²⁰ For example, Rajiv Dant and Patrick Kaufmann examine the changes in ownership patterns of franchise systems as the franchisor financially matures.¹²¹ They utilize a national mail survey of the franchised fast food restaurant industry franchisors, and analyze a total of 152 questionnaires filled out by franchisors.¹²² The questionnaire asks the franchisor respondent to provide details of ownership patterns, unit reacquisition activity, new units sale activity, and franchisor's resource availability position.¹²³ The questionnaires were most frequently completed by presidents, CEOs, or founders of the franchise.¹²⁴ The typical franchisor commenced its operation in 1966, sold its first franchise in 1974, and had about 200 outlets.¹²⁵ Dant and Kaufmann's study confirms the validity of the hypothesis that the greater the franchisor's internal access to financial, informational, and managerial resources, the more likely the strategic tendency toward company ownership of outlets.¹²⁶ The strategic tendency toward company ownership of outlets is measured by two factors. First, the inclination of franchisors to substitute *existing* franchisee-owned outlets with franchisor-owned outlets (*retrospective substitution*), was considered.¹²⁷ This inclination is captured mainly by comparing (a) the number of franchisee-owned units reported by the franchisor to have been permanently converted into franchisor-owned units and (b) the number of franchisor-owned units

¹²⁰ Notably, other contradicting empirical studies also examine the relationship between the size and age of the franchisor and its ownership patterns. See, for example, Hunt, *supra* note 73, at 9; Scott Shane, *Explaining the Distribution of Franchised and Company-Owned Outlets in Franchise Systems*, 24 J. MGMT. 717, 724–25, 730, 735 (1998); Gary J. Castrogiovanni et al., *Resource Scarcity and Agency Theory Predictions Concerning the Continued Use of Franchising in Multi-Outlet Networks*, 44 J. SMALL BUS. MGMT. 27, 30, 36–37 (2006); Lorelle Frazer, *Causes of Disruption to Franchise Operations*, 54 J. BUS. RES. 227, 229–30, 232 (2001); Lafontaine & Kaufmann, *supra* note 60, at 110; Ilan Alon, *The Use of Franchising by U.S.-Based Retailers*, 39 J. SMALL BUS. MGMT. 111, 117 (2001); Combs & Castrogiovanni, *supra* note 112, at 45.

¹²¹ Rajiv P. Dant & Patrick J. Kaufmann, *Structural and Strategic Dynamics in Franchising*, 79 J. RETAILING 63 (2003).

¹²² *Id.* at 67.

¹²³ *Id.*

¹²⁴ *Id.* at 68.

¹²⁵ *Id.*

¹²⁶ *Id.* at 72. For similar results and dataset, see Patrick J. Kaufmann & Rajiv P. Dant, *Multi-Unit Franchising: Growth and Management Issues*, 11 J. BUS. VENTURING 343, 351, 354 (1996); Rajiv P. Dant & Patrick J. Kaufmann, Robert A. Robicheaux, *Changes in the Mix of Company-Owned and Franchised Outlets: Ownership Redirection Revisited*, in PROCEEDINGS OF THE INTERNATIONAL SOCIETY OF FRANCHISING CONFERENCE 4, 13 (1998).

¹²⁷ Dant & Kaufmann, *supra* note 121, at 67.

reported by the franchisor to have been permanently converted into franchisee-owned units.¹²⁸ The strategic tendency toward company ownership is furthermore measured by the propensity of franchisors to open *new* outlets under franchisor-ownership which would have been opened as a franchisee-owned outlet earlier in the franchisor's history (*prospective substitution*).¹²⁹ This tendency is calculated by comparing (a) the current year's pattern of new units opening activity to (b) the pattern of ownership as established by previous year's composition of franchisor-owned units versus franchisee-owned units.¹³⁰

Empirical support for the erosion of the reputation mechanism in several key industries was also established in a study by Rajiv Dant and Audhesh Paswan. Dant and Paswan culled data from successive volumes of *Franchising in the Economy* to test, among other things, the shifts in ownership patterns of franchise systems as the franchisor financially matures,¹³¹ spanning the period of 1977 through 1986.¹³² They find in the rentals (equipment) industry, as well as in the hotels, motels and campground industry, that as the financial resource availability of franchisor increases there will be greater incidence of ownership redirection favoring the franchisor.¹³³ Ownership redirection, in this context, was captured by the inclination of franchisors to substitute existing franchisee-owned outlets with franchisor-owned outlets. This inclination is measured mainly by comparing the number of franchisee-owned units converted to franchisor-owned units with the number of franchisor-owned units converted to franchisee-owned units.¹³⁴

Another empirical study, conducted by James Combs and David Ketchen, indicates that as the financial resources of the franchisor increase, the reputation mechanism erodes.¹³⁵ Combs and Ketchen's sample is drawn from the restaurant industry during the years 1989 through 1993.¹³⁶ Their study relies mainly on franchisor's annual reports and Compact Disclosure, a comprehensive database of public firms.¹³⁷ Examining data from 91 restaurant chains, Combs and Ketchen empirically confirm the hypothesis that the less a franchisor encounters difficulties

¹²⁸ *Id.*

¹²⁹ *Id.* at 67–68.

¹³⁰ *Id.* at 68.

¹³¹ Dant & Paswan, *supra* note 62, at 90.

¹³² *Id.*

¹³³ *Id.* at 93, 96, 99.

¹³⁴ *Id.* at 93.

¹³⁵ Combs et al., *supra* note 86, at 199.

¹³⁶ *Id.*

¹³⁷ *Id.* at 199, 201.

stemming from a lack of capital, the less the franchisor will rely on expansion through franchising as opposed to franchisor ownership.¹³⁸

C. Stage Three: Collapse

Following the continuing decrease in the franchisor's financial constraints and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism may collapse. This may particularly occur when the reputation-related costs decrease to a minimum level, at which they will be lower than the franchisor benefits from opportunistic termination of the franchise contract. Such a low level is reached when the franchisor accrues sufficient capital to manage the whole franchise chain on its own. At this stage, the franchisor's reputation costs from being perceived as unjust by present and prospective franchisees are likely to be lower than the benefits from opportunistic termination. Termination without good cause therefore is likely to occur.

An analysis of case law on dealership and distributorship relationships, which are often governed by franchise termination laws, arguably reveals the collapse of the reputation mechanism that follows a gradual improvement in a franchisor's financial position. An early illustrative case is *Kealey Pharmacy & Home Care Servs. Inc. v. Walgreen Co.*¹³⁹ Between 1972 and 1979, Walgreen sold a wide variety of drugs, beauty aids, and household commodities to consumers through a nation-wide system of both Walgreen-owned stores and dealers using the Walgreen brand-name.¹⁴⁰ The dealers independently owned drugstores pursuant to a standard dealership agreement with Walgreen.¹⁴¹ Throughout the contractual relationship between Walgreen and its dealers, the dealers provided capital to Walgreen in two chief ways. First, the dealers paid for merchandise which they purchased from Walgreen.¹⁴² In addition, the dealers provided capital to Walgreen indirectly by

¹³⁸ Combs et al., *supra* note 86, at 199, 202. For similar results and dataset, see Vera L. Hoover, David J. Ketchen, Jr. & James G. Combs, *Why Restaurant Firms Franchise: An Analysis of Two Possible Explanations*, 44 CORNELL HOTEL AND REST. ADMIN. Q. 9, 14 (2003); see also James G. Combs & David J. Ketchen, Jr., *Explaining Interfirm Cooperation and Performance: Toward a Reconciliation of Predictions from the Resource-Based View and Organizational Economics*, 20 STRAT. MGMT. J. 867, 872, 880 (1999).

¹³⁹ *Kealey Pharmacy & Home Care Servs., Inc. v. Walgreen Co.*, 761 F.2d 345, 347 (7th Cir. 1985).

¹⁴⁰ *Kealey Pharmacy & Home Care Serv., Inc. v. Walgreen Co.*, 539 F. Supp. 1357, 1360-1361 (W.D. Wis. 1982), *aff'd*, 761 F.2d 345 (7th Cir. 1985).

¹⁴¹ *Kealey Pharmacy & Home Care Servs., Inc.*, 761 F.2d, at 347.

¹⁴² *Kealey Pharmacy & Home Care Serv., Inc. v. Walgreen Co.*, 607 F. Supp. 155, 158 (W.D. Wis. 1984), *aff'd in part, vacated in part*, 761 F.2d 345 (7th Cir. 1985).

promoting the Walgreen name, image, and reputation in their local communities.¹⁴³ Arguably, Walgreen relied on these dealers to provide the significant financial resources needed to promote Walgreen products, which Walgreen lacked at that stage. During the contractual relationships of Walgreen with its dealers, Walgreen's net sales were almost constantly increasing.¹⁴⁴ For example, Walgreen's net sales in 1972 were \$863,334,000;¹⁴⁵ whereas by 1979, Walgreen's net sales had jumped to \$1,344,542,000.¹⁴⁶ Figure 1 outlines Walgreen's increase in net sales between 1972 and 1979.

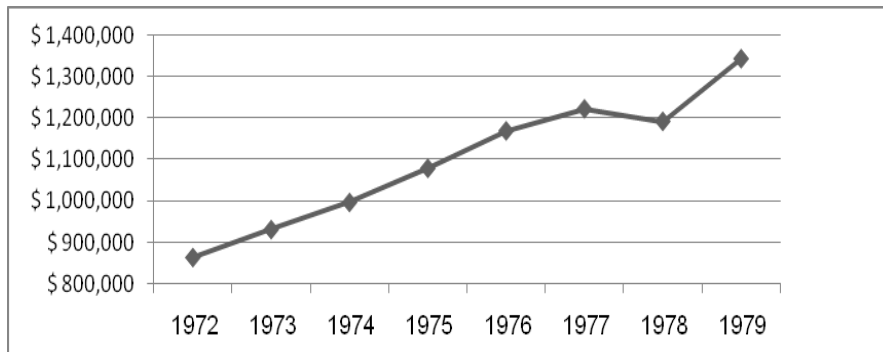


Figure 1: Walgreen's Net Sales: 1972–1979 (in thousands)

In 1980, following the constant increase in Walgreen's annual net sales, it arguably reached a stage in its organizational life cycle in which it had enough financial resources at its disposal to operate all the stores on its own.¹⁴⁷ Indeed, in that year, Walgreen decided to adjust its marketing strategy. In particular, Walgreen made a decision to cease its reliance on dealers.¹⁴⁸ Instead, Walgreen chose to maintain and increase its own stores in the same geographic areas where the dealers had already helped build up Walgreen's reputation and image.¹⁴⁹ At this stage, the reputation mechanism collapsed. Walgreen was no longer interested in relying on the financial resources

¹⁴³ *Kealey Pharmacy & Home Care Serv. Inc.*, 607 F. Supp. at 159. For example, all of the prescription drugs that the dealers sold included the words "Walgreen Agency." *Id.*

¹⁴⁴ These are the annual net sales of Walgreen during 1972 and 1979 (in thousands): \$863,334 (1972), \$930,898 (1973), \$996,616 (1974), \$1,079,143 (1975), \$1,169,779 (1976), \$1,223,249 (1977), \$1,192,855 (1978), \$1,344,542 (1979). See WALGREEN CO., ANNUAL REPORTS (1972–1979).

¹⁴⁵ WALGREEN CO., 1972 ANNUAL REPORT (1972).

¹⁴⁶ WALGREEN CO., 1979 ANNUAL REPORT (1979).

¹⁴⁷ See generally WALGREEN CO., ANNUAL REPORTS (1972–1979); *Kealey Pharmacy & Home Care Servs., Inc. v. Walgreen Co.*, 761 F.2d 345, 347 (7th Cir. 1985).

¹⁴⁸ *Kealey Pharmacy & Home Care Servs.* 761 F.2d at 350.

¹⁴⁹ *Id.*

provided by the dealers, and thus had no reason to fear a blow to its reputation.¹⁵⁰ Termination without good cause was likely to occur. In fact, Walgreen terminated its dealership agreements absent any showing that the dealers failed to comply with the requirements imposed by Walgreen.¹⁵¹

Another important case which reveals the collapse of the reputation mechanism following a gradual improvement in the franchisor's resource availability is *Atlantic City Coin & Slot Serv. Co. v. IGT*.¹⁵² International Game Technology (IGT) designs and manufactures electronic gaming devices.¹⁵³ During 1983 and 1997 IGT expanded its products in New Jersey, Maryland, and the Caribbeans using an exclusive distributor.¹⁵⁴ Throughout the contractual relationship between the IGT and the distributor, the latter provided significant financial assistance to IGT.¹⁵⁵ More specifically, the exclusive distributor invested significant financial resources in promoting the IGT name, expanding a sales force, expanding a marketing facility, expanding a storage area for IGT products, and leasing warehousing devoted to storing, testing, and servicing of IGT gaming devices.¹⁵⁶ Arguably, IGT relied on its exclusive distributor since it could provide the significant resources necessary to promote IGT products—resources which IGT lacked at that early stage. Throughout its contractual relationship with the exclusive distributor, IGT's annual total revenues were almost constantly increasing.¹⁵⁷ For example, in 1983 IGT total revenues were \$60,032,000;¹⁵⁸ whereas by 1997, IGT total revenues had jumped to \$743,970,000.¹⁵⁹ Figure 2 demonstrates graphically IGT's increase in total revenues between 1983 and 1997.

¹⁵⁰ See generally Combs et al., *supra* note 86 (discussing the deterioration of the reputation mechanism that corresponds with an increase in financial resources).

¹⁵¹ *Kealey Pharmacy & Home Care Servs., Inc.* 761 F.2d at 350.

¹⁵² *Atlantic City Coin & Slot Serv. Co. v. IGT*, 14 F. Supp. 2d 644 (D.N.J. 1998).

¹⁵³ *Id.* at 647.

¹⁵⁴ *Id.* at 647, 649.

¹⁵⁵ *Id.* at 654.

¹⁵⁶ *Id.* at 646, 653–54.

¹⁵⁷ These are the annual total revenues of IGT during 1983 and 1997 (in thousands): \$60,032 (1983), \$73,262 (1984), \$56,564 (1985), \$41,574 (1986), \$83,522 (1987), \$98,694 (1988), \$151,152 (1989), \$210,257 (1990), \$237,363 (1991), \$399,443 (1992), \$478,030 (1993), \$674,461 (1994), \$620,786 (1995), \$733,452 (1996), \$743,970 (1997). See INTERNATIONAL GAME TECHNOLOGY, ANNUAL REPORTS (1983–1993); INTERNATIONAL GAME TECHNOLOGY; FORMS 10-K (1994–1997).

¹⁵⁸ INTERNATIONAL GAME TECHNOLOGY, ANNUAL REPORT (1983).

¹⁵⁹ INTERNATIONAL GAME TECHNOLOGY, Form 10-K (1997).

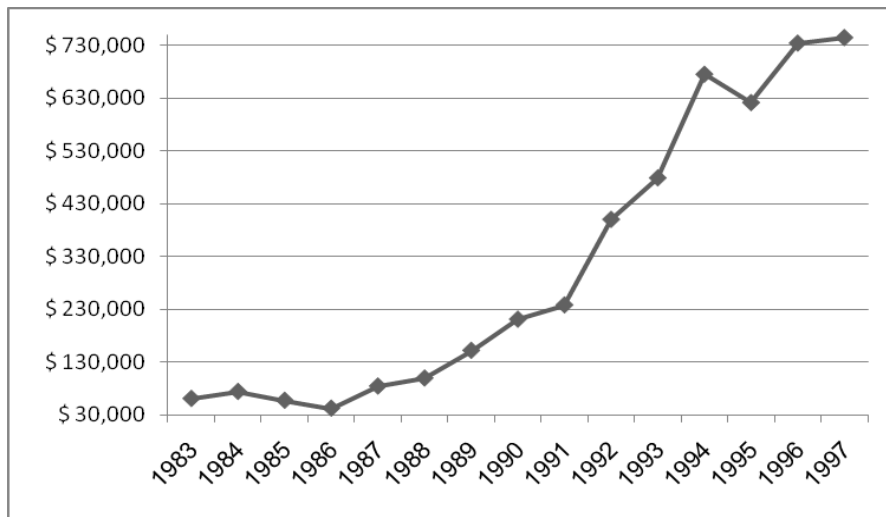


Figure 2: IGT Annual Total Revenue: 1983-1997 (in thousands)

In 1997, following the constant increase in IGT annual total revenues, it arguably reached a stage in its organizational life cycle in which it had access to enough financial resources to replace its exclusive distributor with an IGT-owned distribution system. Predictably in that year, IGT decided to discontinue its relationship with its exclusive distributor.¹⁶⁰ Instead, IGT chose to promote and sell its product on its own.¹⁶¹ At this stage the reputation mechanism collapsed because IGT was no longer interested in relying on distributors.¹⁶² Termination without good cause was likely to occur. Indeed, IGT terminated its distribution agreement with its exclusive distributor in 1998, without any allegations of wrongdoing to justify the termination.¹⁶³ Rather, IGT praised the exclusive distributor's performance just prior to terminating the relationship.¹⁶⁴ Good cause supporting the contract termination was noticeably absent.¹⁶⁵

The collapse of the reputation mechanism is likewise evidenced by the case of *Day Distrib. Co. v. Nantucket Allserve*,

¹⁶⁰ *Atlantic City Coin & Slot Serv. Co. v. IGT*, 14 F. Supp. 2d 644, 658–59 (D.N.J. 1998).

¹⁶¹ *Id.* at 659.

¹⁶² *Id.* at 646.

¹⁶³ *Id.* at 658–59.

¹⁶⁴ *Id.* at 658.

¹⁶⁵ *Id.*

*Inc.*¹⁶⁶ Nantucket Allserve, Inc. (Nantucket) produces a line of upscale sodas known as Stewart's.¹⁶⁷ At the early stages of the organizational life cycle of Nantucket, its resource availability was apparently limited.¹⁶⁸ One of Nantucket's founders, Mr. Scott, was so financially strapped that he slept in his car during the summer of 1991.¹⁶⁹ At that early stage, Nantucket sold its products through distributors¹⁷⁰ who provided financial resources to Nantucket by purchasing high volumes of Nantucket sodas.¹⁷¹ Arguably, Nantucket chose such a marketing strategy due to its financial inability to distribute its products on its own. At this stage in Nantucket's organizational life cycle, the reputation mechanism was relatively effective. Nantucket had to rely on distributors, and therefore was restrained from acting opportunistically towards its distributors.¹⁷²

Nantucket's financial situation improved dramatically over the years. Revenues soared from \$200,000 in 1991 to about \$30 million in 1996.¹⁷³ In addition, the successful Nantucket group was purchased in 2002 by Cadbury Schweppes Plc, a British beverage giant,¹⁷⁴ for an undisclosed sum that was estimated at \$100 million.¹⁷⁵

Following the acquisition of Nantucket by Cadbury, Nantucket presumably reached a stage in its organizational life cycle in which it had enough financial resources to discontinue its reliance on distributors and perform all the distribution functions on its own. In fact, one year following the acquisition of Nantucket by Cadbury, they both began exploring the possibility of discontinuing distributors.¹⁷⁶ Instead, Nantucket and Cadbury

¹⁶⁶ *Day Distrib. Co. v. Nantucket Allserve, Inc.*, 2008 U.S. Dist. LEXIS 57334 (D. Minn. July 25, 2008).

¹⁶⁷ *Id.* at *1.

¹⁶⁸ Robert Halasz, *Company History: Nantucket Allserve, Inc.*, available at <http://www.answers.com/topic/nantucket-allserve-inc> (last visited Nov. 1, 2009).

¹⁶⁹ *Id.*

¹⁷⁰ *Day Distrib. Co.*, 2008 U.S. Dist. at *2. Two of the distributors began as sub-distributors of Nantucket but later became distributors of Nantucket. *Id.*

¹⁷¹ *Id.* at *3.

¹⁷² Halasz, *supra* note 168.

¹⁷³ *Id.* In 1996, Nantucket was ranked 13th in *Inc.*'s fastest-growing U.S. private company list. *Id.*

¹⁷⁴ Corpfin Worldwide, Deal No. 171893 (June 19, 2009) (providing a summary of Snapple Beverage Group's acquisition of Nantucket Allserve Inc.). Notably, Cadbury bought Nantucket through Snapple Beverage Group, a wholly-owned subsidiary of Cadbury. *Id.*

¹⁷⁵ *Cadbury Schweppes PLC: Nantucket Nectars Purchase Will Build Snapple Beverages*, WALL ST. J., Mar. 26, 2002, at B.6.

¹⁷⁶ *Day Distrib. Co.* 2008 U.S. Dist. at *5. Two clarifying notes: Firstly, Cadbury Schweppes Americas Beverages, one of the defendants in the Nantucket case, was a subsidiary division of Cadbury in the United States. Secondly, the court referred to

decided to distribute Stewart's directly rather than to rely on distributors.¹⁷⁷ At this stage, the reputation mechanism collapsed and termination without good cause was likely to occur. Unsurprisingly, Nantucket took its distribution operations in-house and terminated the agreements with its distributors.¹⁷⁸ Apparently, Nantucket did not terminate the agreement due to the distributors' failure to comply with their contractual requirements.¹⁷⁹ Good cause supporting a termination was presumably absent.¹⁸⁰

CONCLUSION

This article questioned the effectiveness of the reputation mechanism in deterring opportunistic termination by franchisors. It also cast doubt upon the traditional law-and-economics assumption that reputation can be a substitute for franchise termination laws.

While this article focuses on franchise relationships, its conclusions can have broader implications. The assumption that reputation can serve as a substitute for regulation of long-term commercial relationships must be re-examined. As we have demonstrated, the concern for one's reputation in long-term commercial relations often has a limited life cycle. A firm in the early stages of its organizational life cycle usually lacks internal financial resources needed to achieve its business goals; therefore, it is spurred on to enter into contractual relationships with other firms that can assist it in overcoming its financial constraints.¹⁸¹ To illustrate, a financially immature firm, wishing to erect a factory, may have an initial incentive to enter into a partnership or a joint venture agreement with other firms, in order to recruit necessary capital. At this stage the reputation mechanism has some deterring effects, since the young firm is economically dependent upon its contractual partners. However, as the financial availability of the immature firm improves, it becomes less dependent on its contractual partners. The firm's

Nantucket Allserve and Cadbury Schweppes Americas Beverages as "Cadbury," following the practice of the parties. *Id.* at *1-2.

¹⁷⁷ *Id.* at *5.

¹⁷⁸ *Id.* at *1.

¹⁷⁹ It seems unlikely that all distributors concurrently failed to comply with Nantucket and Cadbury's requirements.

¹⁸⁰ For more cases which potentially reveal the collapse of the reputation mechanism in the context of franchise termination laws see *C. C. Hauff Hardware, Inc. v. Long Mfg. Co.*, 148 N.W.2d 425 (Iowa 1967); *Volvo Constr. Equip. N. Am., Inc. v. CLM Equip. Co.*, 386 F.3d 581 (4th Cir. 2004); *Sims Wholesale Co. v. Brown-Forman Corp.*, 468 S.E.2d 905 (Va. 1996); *Cooper Distrib. Co. v. Amana Refrigeration*, 63 F.3d 262 (3d Cir. 1995).

¹⁸¹ *See supra* Part II.A.

incentive will shift towards owning and operating the business on its own, which will increase its profits. At this inevitable stage, the effectiveness of reputation in preventing opportunism will decline and the reputation mechanism may ultimately collapse.