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# FEDERALISM, VARIATION, AND STATE REGULATION OF FRANCHISE TERMINATION

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## Abstract

*This article discusses and expands on our recent work examining the effects of franchise-termination laws. In a prior article, we examined empirically the effect of franchise-termination laws on the level of franchise activity. Our analysis improved upon the prior literature in two major ways. First, our work exploited two new sources of panel data to provide new empirical evidence on the effect of franchise termination laws. Second, our analysis examined variation in states' restrictions on the ability of franchisors and franchisees to contract around a particular state's regulation. We found that the effects of termination laws on the overall level of franchise activity are negligible when states do not limit the parties' ability to contract around the laws, but become significant when states impose such limits. Our results show that contracting parties' ability to exit from a state's regulations is a significant factor in determining the effect of regulation, and should be taken into account by policy makers. It also demonstrates the importance of taking state variation into account when analyzing the effect of state regulation. This article further examines these issues. We discuss the policy issues related to contractual exit from state regulation. In addition, we present further evidence on the effects of variation in franchise regulation by examining the marginal effect of giving franchisees a right to cure violations.*

**JEL Codes:** D21; D23; D86; G38; K12; K22; L14; L15; L21; L22; L24; L25

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## I. INTRODUCTION

Economists have studied several fundamental franchising issues central to the theory of the firm.<sup>1</sup> These include the general nature of intra-versus inter-firm contracting and how contracts and incentives are used to reduce transactions and agency costs.<sup>2</sup> Economists have also studied how the regulation of the contractual relationship between franchisors and franchisees affects contracting, the organization of firms, and consumers.<sup>3</sup>

The franchisor's ability to terminate franchisees is a central focus of both the theoretical and empirical literature on franchise contracts and their regulation. The franchisor's ability to terminate shirking franchisees is an important self-enforcement mechanism for reducing monitoring and other agency costs. But broad termination powers may allow franchisors to opportunistically take over non-shirking franchisees. Responding to the latter possibility, some states and the federal government enacted various types of legislation aimed at regulating franchisor opportunism. State regulation varies in important ways.<sup>4</sup> Moreover, most states did not enact statutes, choosing instead to use state contract law and state common law to resolve such disputes.<sup>5</sup> The federal government acted only in the specific areas of gas stations and automobile dealers.<sup>6</sup> Thus, the regulation of franchise termination has remained largely a state law issue.

The variation in the states' regulatory response, as well as the federal government's partial regulation of the area, is important mainly for two reasons. First, the absence of broad federal regulation and the states' non-uniform approach to regulating the franchise contract has enabled

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<sup>1</sup> Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223 (1978).

<sup>2</sup> See generally, ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING*, (Cambridge 2005); Francine Lafontaine & Scott E. Masten, *Franchise Contracting, Organization, and Regulation: Introduction*, 2 J. CORP. FIN. 1 (1995); Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9 (1995).

<sup>3</sup> James A. Brickley, Frederick H. Dark & Michael S. Weisbach, *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101 (1991); J. Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157 (1995) (examining state regulation of the franchise contract); Howard P. Marvel, *Tying, Franchising, and Gasoline Service Stations*, 2 J. CORP. FIN. 199 (1995) (examining FTC regulation of gasoline franchising); Richard L. Smith II, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125 (1982); E. W. Eckard, Jr., *The Effects of State Automobile Dealer Entry Regulation on New Car Prices*, 23 ECON. INQ. 223 (1985) (examining state regulation of automobile dealers).

<sup>4</sup> See *infra* Section III.

<sup>5</sup> BLAIR AND LAFONTAINE, *supra* note 2 at 276-78; see Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981).

<sup>6</sup> See Federal Automotive Dealer Franchise Act ("FADFA"), 15 U.S.C.A. §§ 1221-25 (2000); Petroleum Marketing Practices Act ("PMPA"), 15 U.S.C.A. §§ 2801-06 (2000 & Supp. 2007).

economists to use this variation to measure the empirical effect of state regulations.<sup>7</sup> Second, state variation has allowed the forces of competitive federalism to operate in this area.<sup>8</sup> Franchisors have been able to use contractual choice-of-law and choice-of-forum clauses to select the law and courts of non-regulating states, thereby avoiding the effect of regulation.<sup>9</sup> If these regulations interfere with efficient contracting, the contracting parties' ability to avoid regulating jurisdictions can increase welfare. Variation in state treatment of contractual choice-of-law and choice-of-forum clauses also facilitates empirical measurement of the effect of these clauses.<sup>10</sup>

This article summarizes and extends our prior work on franchising and the economics of federalism. Specifically, this article examines the use of contractual choice-of-law and choice-of-forum clauses in franchise contracts to avoid regulating jurisdictions. We show that firms' ability to use contractual choice-of-law and choice-of-forum to avoid regulating states is an important theoretical consideration in predicting the effect of state franchise statutes.

The article also summarizes our prior empirical work on franchise regulation, which explicitly examines variation in states' approaches to regulating franchise contracts, including enforcement of choice-of-law and choice-of-forum clauses. Consistent with our theoretical work, we find that variations in states' treatment of choice-of-law and choice-of-forum clauses help explain the effects of state franchise regulation.

Finally, this article adds to the empirical literature on the effects of franchise regulation by further examining variation in the franchise statutes. Specifically, this article extends our prior work by showing the marginal effect of a statutory right to cure.

The analysis proceeds as follows. Section II provides a brief review of the theoretical and empirical literature on the economics of franchising. Section III examines variation in state franchise regulation statutes and prior empirical work on franchise regulation. Section IV discusses the economics of federalism and the use of contractual choice-of-law and choice-of-forum clauses in franchise contracts. Section V summarizes our prior empirical work on franchise regulation, and extends this analysis to examine the marginal effect of a statutory right to cure.

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<sup>7</sup>Jonathan Klick, Bruce H. Kobayashi, & Larry E. Ribstein, *The Effect of Contract Regulation: The Case of Franchising*, George Mason Univ. Law & Econ. Research, Paper No. 07-03, 2006, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=951464](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951464) (last visited Mar. 14, 2009).

<sup>8</sup>Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom, in THE FALL AND RISE OF FREEDOM OF CONTRACT* 325, 348-49 (F.H. Buckley ed., 1999).

<sup>9</sup>*Id.*; see also *infra* Section IV.

<sup>10</sup>See Klick et al., *supra* note 7.

Section VI concludes this paper.

## II. THE ECONOMICS OF FRANCHISE CONTRACTS

Economists have applied the insights of transaction-cost economics to explain the use of franchising as a business form. Rubin argued that existing explanations for the franchise form based on capital constraints were implausible. He found more guidance in Coase's work on the theory of the firm,<sup>11</sup> which better explained the franchise form of contract and business decisions whether to franchise or own outlets.<sup>12</sup> Drawing on the agency cost insights of the economic literature,<sup>13</sup> Rubin's model of franchising explains the decision to use the franchise form and the structure of the franchise contract as a way to reduce monitoring costs and agency costs. Specifically, firms use franchising in situations where direct monitoring of the unit would be costly, as for units located far from the franchisor.<sup>14</sup>

Moreover, the structure of the franchise contract can be explained as an attempt by the contracting parties to generate joint surplus by encouraging the parties to invest optimally in the franchised establishment. The franchisee gets a share of the franchise revenues, thereby reducing the franchisor's need to monitor the franchisee. The franchisor is also motivated to provide on-going support, such as advertising, by receiving a share of revenues either directly or indirectly through contractual provisions requiring the franchisee to purchase its supplies from the franchisor, at above marginal cost.<sup>15</sup>

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<sup>11</sup> Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

<sup>12</sup> Rubin, *supra* note 1.

<sup>13</sup> Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976).

<sup>14</sup> James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 *J. FIN. ECON.* 401 (1987) (evidence supporting hypothesis that owning versus franchising decision reflects a trade-off among agency related problems).

<sup>15</sup> For a formal model of this "double sided moral hazard" problem, see Sugato Bhattacharyya & Francine Lafontaine, *Double-Sided Moral Hazard and the Nature of Share Contracts*, 26 *RAND. J. ECON.* 761, 771-73 (1995) (showing how the need for these incentive effects leads to linear revenue sharing formulas in franchise contracts). For empirical studies presenting evidence consistent with the double moral hazard model, see Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 *RAND J. ECON.* 263, 275-81 (1992) (finding that the observed degree of franchising among franchisors is consistent with this model); Francine Lafontaine & Kathryn Shaw, *The Dynamics of Franchise Contracting: Evidence from Panel Data*, 107 *J. POL. ECON.* 1041 (1999) (using panel data on franchise contract terms to show support for the double sided moral hazard model).

The franchise contract, like any long-term contract, still gives the parties room to act opportunistically.<sup>16</sup> In the absence of effective monitoring and incentives, franchisees will attempt to free ride on efforts by the franchisor and other franchisees to maintain the brand, because they do not bear a significant loss in the value of the franchise trademark when they fail to uphold the franchisor's quality standards.<sup>17</sup>

The contracting challenge this potential opportunism presents is that it is impossible to define the franchisees' performance standards in perfect detail under all contingencies and, therefore, impossible to enforce these standards in court. One way to deal with this problem is through self-enforcement mechanisms that give the franchisee a positive rent stream that will be taken away if he does not perform as expected and is terminated.<sup>18</sup> Thus, the franchisor's power to terminate shirking franchisees allows for better quality control and greater total surplus, thereby making the franchisor and franchisees collectively better off than they would be if the franchisee had more freedom to behave opportunistically.<sup>19</sup> Conversely, regulation of termination clauses that prevent or delay franchisors from disciplining underperforming franchisees by terminating their contract would weaken the effectiveness of this self-enforcement mechanism.

However, broad termination rights have the potential to generate a different kind of opportunism by allowing franchisors to take over

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<sup>16</sup>See generally, Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 52-56 (1985); Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships*, 34 ECON. INQ. 444 (1996).

<sup>17</sup> See Rubin, *supra* note 1; Klein, *supra* note 2; Benjamin Klein, *Transaction Costs Determinants of 'Unfair' Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980).

<sup>18</sup> See generally, Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) (empirical studies of franchise contracts are consistent with this incentive/agency model); Patrick J. Kaufmann & Francine Lafontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J.L. & ECON. 417 (1994) (showing that McDonald's franchisees retain ex-ante rents); James A. Brickley, Sanjog Misra & R. Lawrence Van Horn, *Contract Duration: Evidence from Franchising*, 49 J.L. & ECON. 173 (2006) (finding contract duration in franchise contracts is positively related to franchisee's level of specific investments); James A. Brickley, *Incentive Conflicts and Contractual Restraints: Evidence from Franchising*, 42 J.L. & ECON. 745 (1999) (examining incidence of specific contractual provisions in franchise contracts). See also Brickley & Dark, *supra* note 14; James A. Brickley, Frederick H. Dark & Michael S. Weisbach, *An Agency Perspective on Franchising*, 20 FIN. MGMT. 27 (1991); G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J.L. & ECON. 503 (1985); Seth W. Norton, *Franchising, Labor Productivity, and the New Institutional Economics*, 145 J. INST. & THEORETICAL ECON. 578 (1989).

<sup>19</sup> For an early exposition of this argument, see Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975).

profitable franchises, even where the franchisee is not shirking.<sup>20</sup> By exercising termination rights in markets that turn out to be unexpectedly profitable, the franchisor can expropriate returns from a non-shirking franchisee's investment in market discovery and development. In other words, the franchisor can "skim the cream" by taking the franchises that turn out to be the best. This denies the franchisee the benefits it expected under the contract by allowing the franchisor to serve the same market without having to split revenues with a franchisee or to profit from a resale of the franchise.

Franchisors' incentives to engage in opportunistic "cream skimming" behavior can be tempered by reputational penalties. Opportunistic franchisors will face increased costs of selling new franchises unless the price of the franchise is lowered to reflect the increased "cream skimming" risk. Indeed, these penalties help explain why franchise contracts contain termination-at-will and other mechanisms for constraining franchisee opportunism, despite the risk of opportunism by franchisors.<sup>21</sup>

Empirical evidence on franchise operations and termination suggest that while franchisors may act opportunistically, that is not likely to be the main reason they terminate or decide not to renew franchises.<sup>22</sup> The "cream skimming" theory suggests that franchisors would tend to terminate units that become profitable unexpectedly. Yet there is evidence that one-third of contract terminations resulted in the outlet being closed, and that contract termination actions were likely to involve underperforming outlets.<sup>23</sup> Moreover, since the unprofitable units cannot be sustained, the "cream skimming" hypothesis predicts that established franchises would tend to become company-owned over time. Yet the data show no such tendency.<sup>24</sup>

### III. STATE FRANCHISE REGULATION

Concerns about franchisor opportunism led many states to limit franchisor termination rights by statute beginning in the early 1970s.<sup>25</sup> Between 1971 and 1992, nineteen jurisdictions enacted laws regulating

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<sup>20</sup> See, e.g., Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990).

<sup>21</sup> See Klein, *supra* note 17, at 360.

<sup>22</sup> See Blair & Lafontaine, *supra*, note 2, at 271-75.

<sup>23</sup> Darrell L. Williams, *Franchise Contract Termination: Is There Evidence of Franchisor Abuse?*, in TENTH ANNUAL PROCEEDINGS OF THE INTERNATIONAL SOCIETY OF FRANCHISING (A. Dugan, ed., 1996). See also BLAIR & LAFONTAINE, *supra* note 2, at 271-75.

<sup>24</sup> *Id.* at 273; Lafontaine & Shaw, *supra* note 15.

<sup>25</sup> Kobayashi & Ribstein, *supra* note 8; Jason Stover, *No Cure, No Problem: State Franchise Laws and Termination for Incurable Defaults*, 23 FRANCHISE L. J. 217 (2004).

franchisors' ability to terminate franchise contracts.<sup>26</sup> Table 1 lists the states that have enacted general statutory restrictions on franchise termination, non-renewal of franchise contracts, and these statutes' substantive provisions. The states' regulatory response varied in several important ways. First, while nineteen jurisdictions passed general franchise-protection statutes that regulated termination, most jurisdictions did not do so. Second, while most statutes require good cause for a franchisor to terminate its contract, such as violation of specific contract terms or fraud on the part of the franchisee, two statutes require only notice.<sup>27</sup> Third, eleven statutes give the franchisee a right to cure any cause for termination raised by the franchisor. Giving franchisees a right to cure removes the threat of immediate termination and may further erode the potential disciplinary effect of the termination threat; in addition, there are other sources of variation. Fourth, some statutes protect franchisees from potential encroachment of new franchises on their territory.<sup>28</sup> Fifth, some statutes restrict enforcement of contractual provisions waiving franchisee protection and contracting for the applicable law and forum.<sup>29</sup>

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<sup>26</sup> Rhode Island recently enacted a statute that regulated termination of franchisees. *See* R.I. GEN. LAWS § 6-50-4 (2007). In addition, Federal law regulates specific types of franchise relationships—automobile franchises under FADFA (15 U.S.C. §§ 1221-1225), which imposes a general duty of good faith, and gasoline franchises under the Petroleum Marketing Practices Act (“PMPA”) (15 U.S.C. §§ 2801-2806). These laws may primarily benefit franchisors to the extent that they preempt state law and thereby protect franchisors from more onerous state regulation. However, states can enact significant regulations beyond those contained in the federal statutes. For example, state regulation of automobile dealerships is far more extensive than those contained in the FADFA or the states' general regulation of franchises enacted in almost every jurisdiction. The PMPA did not preempt a preexisting law in Maryland that prohibits refiner control of retail gasoline stations (MD. CODE ANN., [BUS. REG.] § 10-311 (LexisNexis 2004)), and would not prevent the enactment of similar laws in other states (Delaware and the District of Columbia have enacted similar laws (DEL. CODE ANN., tit. 6, § 2905(a) (1974), D.C. CODE ANN. § 36-302.02 (2001))).

<sup>27</sup> All of the statutes require that notice be given to the franchisee up to 180 days before the relationship is terminated. In addition, the vast majority of these statutes (i.e., all states with termination statutes except IL, MI, VA, and WA) apply to a franchisor's decision not to renew a franchisee's contract as well. *See supra* Table 1.

<sup>28</sup> A very restrictive encroachment provision was a unique feature of the Iowa statute, passed in 1992. However, this provision was relaxed 1995. *See* IOWA CODE § 523H.6 (2007). Analyses of anti-encroachment provisions contained in state automobile dealer regulations show that these provisions operate to prevent manufacturers from solving the successive monopoly problem, and result in higher prices to consumers. *See* Smith, *supra* note 3; Eckard, *supra* note 3.

<sup>29</sup> These variations are discussed in detail below, and are listed *infra* in Table 2.



**Table 1 - State Regulation of the Franchisor/Franchisee Relationship**

STATE	STATUTE	CAUSE REQUIRED FOR TERMINA- TION	RIGHT TO CURE	CAUSE REQUIRED FOR NON- RENEWAL	NOTICE	OTHER STATU- TORY RESTRIC- TIONS
1. AR (eff. 3/4/77)	AR STAT. ANN 4-72-204	YES	30 days. 10 Days if a, b. None if c, d, e, f, g, h.	YES*	90 days - R/T	
2. CA (eff. 10/1/80; Op. 1/1/81)	CA BUS. & PROF. CODE @ 20020	YES	30 days None if a, c, d, e, f, g, h.	NONE**, ***-	180 days R	
3. CT (eff. 10/1/72)	CT GEN. STAT. @ 42-133f	YES	NONE	YES	60 days T/R 30 days if c None if d 6 mo R if g	
4. DC (eff. 4/16/89; repealed 4/29/98)	D.C. CODE @ 29-1201	YES	60 days	YES	60 days T/R 15 days if c. None if d.	
5. DE**/ (1970)	6 DEL C. @ 2552	YES	NONE	YES	90 days	
6. HI**/ (1974)	HRS @ 482E-6	YES	Reasonable Period	YES*	Reason- able Period	
7. IA**/ (1992)	ICA s 523H.7	YES	Reasonable Period None if a, c, d, f.	YES	Reason- able Period	Indepen- dent Sourcing, Liability for Encroach- ment
8. IL (eff. 1/1/98)*/**	815 ILCS 705/19	YES	30 days, None if a, c, d, f.	NONE	30 days T 60 days R	
9. IN (eff. 7/1/76)	IN ST. 23- 2-2.7	YES	NONE	YES*	90 days R/T	Indepen- dent Sourcing, Liability for Encroach- ment.
10. MI (eff. 10/15 /84)	MCLA 445.1527	YES	30 days	NONE	30 days T	
11. MN (eff. 7/1/81)	MSA s80C.14	YES	60 days None if a, c, d.	NONE**	90 days T 180 days R	
12. MO (1974)	MO ST 407.405	NONE	NONE	NONE	90 days - R/T	

13. MS (eff. 7/1/75)	MS ST s75-24	NONE	NONE	NONE	None if c, d, f, h. 90 days - R/T	
14. NE (1978)	RRS Neb @ 87-404	YES	NONE	YES	None if c, d, f, h. 60 days - R/T 15 days if c	
15. NJ (eff. 12/21/71)	NJSA 56:10-5	YES	NONE	YES	None if d, f, g, h. 60 days - R/T 15 days if c.	
16. TN (1989)	TCA 47- 25-150B	YES	30 days, non if c, d, f.	YES	None if d 60 days	
17. VA (1972)	VA ST s 13.1-564	YES	NONE	NONE	NONE	
18. WA (1971)	RCWA 19.100.180	YES	30 days or substantial & continuing action to cure. None if a, c, d, f.	NONE	30 days	
19. WI (eff. 4/5/74)	WSA 135.03	YES	60 days, 10 days if h	YES	90 days R/T None if f	Cause applies to "substan- tial change in competi- tive circum- stances."

## NOTES:

## Exceptions:

a - Repeated failure to comply with non-discriminatory or reasonable requirements

b - Repeated failure to act in good faith/commercially reasonable manner

c - Abandonment

d - Criminal Conduct/fraud

e - Impairs Franchisor's Trademark

f - Insolvency/Bankruptcy

g - Loss of right to occupy premises

h - Failure to pay/insufficient funds/ no account check

\* Not required for non-renewal reflecting reasonable/standard policies or practices of franchisor.

\*\* Non-Renewal cannot be for the purpose of converting franchise to franchisor operated outlet

\*\*\* Must give franchisee opportunity to sell &amp; franchisor has right of first refusal.

\*/ DE and HI statutes were amended, but do not know if substantive or technical. DE amended 62 Laws 1980, ch. 352 Section 4, HI amended 1978). IA statute applies different but similar section to franchise contracts entered into after 7/1/2000 (Section 523H.2A).

\*/\*\* Prior IL law reflecting termination, Public Act 81-426, renumbered Public Act 81-1509, effective 1980.

There is a significant question regarding the net effect of these regulations on franchisors and franchisees. If the costs of franchisor opportunism are likely to outweigh those of franchisee opportunism, laws restricting termination rights could make both franchisors and franchisees better off. For example, the law could encourage franchisees to invest more in market discovery and development by helping franchisors make commitments not to skim off the best franchises. However, as discussed above, such regulations may not be necessary because of the availability of reputational and other market forces to police franchisor opportunism. Thus, the benefits of the laws in reducing “cream skimming” may be outweighed by their costs in preventing franchisors from disciplining shirking franchisees.

Given these questions regarding the net benefits of regulations, policymakers and scholars have been interested in measuring the actual effects of franchise regulation. Notably, Brickley et al. used the variation in the states’ choices on whether to enact franchise protection statutes that restrict termination to test competing hypotheses regarding the effects of these regulations.<sup>30</sup> Using cross-sectional regression analyses, they estimated the effect of these regulations by comparing the rate of franchising in states with and without such franchise protection statutes. The authors hypothesize that if termination clauses primarily discipline franchisee cheating, the effect of termination limit laws on the rate of franchising will be most pronounced in industries characterized by transient, non-repeat business. Franchisors may not need the threat of termination in industries with significant repeat business because in this situation a franchisee that cheats on quality will lose local customers. By contrast, franchisees that rely on the franchise itself rather than on local reputation can impose costs on other outlets in the chain by shirking on quality, thereby making the potential for termination more important. On the other hand, Brickley et al. hypothesize that if termination clauses primarily allow the franchisor to exploit the franchisee, restrictions on termination should not have different effects across industries.<sup>31</sup>

Brickley et al. show that the effect of termination restrictions is, in fact, greater in the industries they classify as particularly subject to non-repeat customers (e.g., restaurants, hotels, and auto-rental agencies) than in

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<sup>30</sup> Brickley, *supra* note 3, at 117-126.

<sup>31</sup> *Id.* at 111.

other industries.<sup>32</sup> Although their regressions do not show significant differences in the fraction of franchised units to total units between regulating and non-regulating states when all industries are included, the effect of regulation is negative and statistically significant when only non-repeat industries are included.<sup>33</sup> The authors conclude that their findings are consistent with the view that termination laws increase the costs of franchising, and reduce efficiency by preventing the contracting parties from optimally contracting regarding termination.<sup>34</sup>

The Brickley et al. results are consistent with a large number of studies that have empirically demonstrated the negative effects of franchise and dealer regulation in other contexts.<sup>35</sup> However, there are several limitations to the Brickley et al. empirical analysis. First, the absence of widely available data has hindered the empirical study of the effects of varying levels of state regulation across different chains or industries. It may be difficult to obtain data showing the effect of the regulation on the firm in any particular jurisdiction because neither firms nor the government produce widely available data that show how effects vary by industry, jurisdiction, and over time. Brickley et al.'s data, collected by the U.S. Department of Commerce,<sup>36</sup> did not allow them to isolate the shock of legal changes or remove the effects of differences between industries in states with termination restrictions and those without. Moreover, the most recent

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<sup>32</sup> *Id.* at 123-26.

<sup>33</sup> *Id.* at 125.

<sup>34</sup> *Id.* at 125-26. In addition, Brickley et al. perform an event study analysis of the stock price reaction of publicly traded franchisors to passage of the California Franchisee Protection Statutes. They find that the passage of the Act was associated with significant negative abnormal returns for these firms. They conclude that these results are consistent with termination regulations that serve to increase the costs of franchising. *Id.* at 126-30. However, while the stock market event study captures losses to franchisors that result from the imposition of regulation, it cannot adequately distinguish losses resulting from reduced opportunism profits from those resulting from higher agency costs and deadweight losses from regulation.

<sup>35</sup> These include state regulation of automobile franchises and gasoline divorcement statutes. *See, e.g.,* Smith, *supra* note 3; Eckard, *supra* note 3 (finding that auto dealer regulations had anti-consumer effects); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000); John M. Barron & John R. Umbeck, *The Effects of Different Contractual Arrangements: The Case of Retail Gasoline Markets*, 27 J.L. & ECON. 313 (1984); Asher A. Blass & Dennis W. Carlton, *The Choice of Organization Form in Gasoline Retailing and the Cost of Laws That Limit That Choice*, 44 J.L. & ECON. 511 (2001) (noting the anticompetitive effects of gasoline divorcement regulations).

<sup>36</sup> *See* Beales & Muris, *supra* note 3; Brickley et al., *supra* note 3 (discussing the U.S. Department of Commerce's publication, *Franchising in the Economy*, which collected data on franchising between 1979 and 1986).

data from this source is now over 20 years old because the federal government's publication of the data ended in 1988.<sup>37</sup>

Second, the authors' analysis does not take into account significant differences in the regulating states' approaches to regulation of franchise termination, such as whether the franchisee is given a right to cure violations and the states' differential treatment of contractual waiver.<sup>38</sup> The relevant statute may allow contracts between the parties to waive the regulation,<sup>39</sup> apply a more permissive law to the interpretation or enforcement of the contract,<sup>40</sup> or to have cases arising out of the contract adjudicated in a jurisdiction other than the one that imposes the regulation, where the court may apply its own or a third jurisdiction's more permissive law.<sup>41</sup> The potential for such bargaining and variation in states' treatment of such bargaining can be a significant factor in determining how state regulations affect the franchisee-franchisor relationship.

#### IV. FEDERALISM AND CONTRACTUAL AVOIDANCE OF REGULATION

Even if state franchise termination regulation can harm contracting parties, they may not do so because contracting parties have several ways to minimize or even completely negate the effect of costly regulations,<sup>42</sup> thereby achieving beneficial flexibility.<sup>43</sup> Thus, the actual effect of states' regulations on contracting parties can be trivial.<sup>44</sup>

States' enforcement of contracts also has implications for the effectiveness of competitive federalism. Effective regulatory competition between states can improve the efficiency of state regulation by improving legislators' incentives to produce efficient law and deterring legislative

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<sup>37</sup> See, e.g., Brickley et al., *supra* note 3.

<sup>38</sup> Existing studies have explicitly analyzed how bargaining between the parties affects the terms of the franchise contract. See, e.g., Seth W. Norton, *The Coase Theorem and Suboptimization in Marketing Channels*, 6 *MARKETING SCI.* 268 (1987). However, these analyses generally have not considered bargaining over whether or not a given state's franchise regulations apply. For exceptions, see Kobayashi & Ribstein, *supra* note 8 (discussing the effect of contractual choice of law and forum on the applicability of state franchise regulation); Klick et al., *supra* note 7 (empirical evidence on the effect of contractual waivers, choice of forum and choice of law). See also Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 *J. LEG. STUD.* 549 (2003) (discussing use of arbitration clauses).

<sup>39</sup> See *infra* Table 2.

<sup>40</sup> See *infra* Section IV.

<sup>41</sup> *Id.*

<sup>42</sup> See Kobayashi & Ribstein, *supra* note 8. See generally, Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 *GA. L. REV.* 363 (2003).

<sup>43</sup> See generally, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *YALE L.J.* 541 (2003).

<sup>44</sup> Kobayashi & Ribstein, *supra* note 8.

wealth transfers from out of state to in state parties.<sup>45</sup> Whether such regulatory competition is effective depends significantly on the parties' cost-of-exit from a given state,<sup>46</sup> which, in turn, depends on whether the states allow the parties to contract for the applicable court or law.

It follows that there is an important question as to how and to what extent states allow parties to exercise contractual exit from franchise statutes. Most obviously, the states could explicitly allow the contracting parties to enter into an enforceable agreement waiving the statute. This is unlikely for franchise regulation, however, because the whole purpose of the regulation is to protect franchisees from contract provisions favorable to franchisors. Indeed, many of the state statutes contain explicit anti-waiver provisions.<sup>47</sup>

Still, the parties can skirt such anti-waiver provisions through alternative contract clauses.<sup>48</sup> In particular, the parties can provide that the contract is to be interpreted and enforced under the law of a state that does not regulate franchise termination. It may not be clear whether these provisions are prohibited by statutory anti-waiver provisions, even if they have a similar effect.

The standards the courts apply to these issues are summarized in Restatement (Second) of Conflict of Laws § 187(2). It provides that a choice-of-law clause will not be enforced as to issues such as validity (when the choice of law matters most) if there is no "substantial relationship" between the chosen law and the parties or transaction or other "reasonable basis" for the parties' choice, or application of the chosen law would contravene a "fundamental policy" of a state with a materially greater interest whose law would apply in the absence of an effective choice of law by the parties.<sup>49</sup> Thus, whether a court will enforce a choice-of-law clause depends on the contacts between the parties and the transaction, on one hand, and the chosen jurisdiction on the other, whether a state with closer contacts seeks to regulate the transaction, and on the nature of the regulation.<sup>50</sup>

The flexibility of these tests leaves the forum court significant leeway in deciding whether to enforce the choice-of-law clause. These rules suggest that the parties might maximize the chance that the clause will be enforced by adding a forum-selection clause to the agreement providing that the dispute will be decided in a particular court that has a general rule

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<sup>45</sup> *Id.*

<sup>46</sup> See generally, Richard A. Epstein, *Exit Rights Under Federalism*, 55 LAW & CONTEMP. PROB. 147 (1992); Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956); BRUCE H. KOBAYASHI AND LARRY E. RIBSTEIN, *ECONOMICS OF FEDERALISM* (Edward Elgar 2007).

<sup>47</sup> See *infra* Table 2.

<sup>48</sup> Kobayashi & Ribstein, *supra* note 8.

<sup>49</sup> RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (2008).

<sup>50</sup> Kobayashi & Ribstein, *supra* note 8.

favoring enforcement or that is otherwise inclined to enforce the parties' choice-of-law clause.<sup>51</sup> The vast majority of jurisdictions have a general policy favoring enforcement of choice-of-forum clauses.<sup>52</sup> Enforceability also has been supported by the U.S. Supreme Court,<sup>53</sup> although these opinions on federal issues are not necessarily binding in state courts on state issues. One reason for the somewhat different judicial approaches to choice-of-forum and choice-of-law clauses is that a court does not have to clearly disregard local law or the law of another regulating state to hold simply that the case should be brought in the designated forum.<sup>54</sup> Another is that enforcing a choice-of-law clause might force a court to apply the law of another jurisdiction with which it may be unfamiliar and on which its decision would not have precedential value.<sup>55</sup> The parties' might further enhance the chance of enforcing the forum-selection clause with a clause providing that the parties' consent to jurisdiction in the designated forum.<sup>56</sup>

Because courts' flexibility is limited, enforcing the parties' choice-of-forum clause does not necessarily mean that the chosen forum will enforce the parties' contractual choice of law. Thus, a state law recognizing enforcement of choice-of-law clauses is more permissive than a state law recognizing enforcement only of choice-of-forum clauses.

Finally, the parties can enhance enforcement of the choice-of-law clause by establishing connections with the designated state. As noted above, under the general rules on enforcement of contractual choice of law, enforcement is more likely where the parties and transaction have a "substantial relationship" with the designated state, and where a regulating state does not have a "materially greater interest" than the designated state.<sup>57</sup>

Applying these rules to franchise cases, an important impetus to the enforcement of choice-of-forum and choice-of-law clauses in franchise contracts was the Supreme Court's decision in *Burger King* enforcing a clause in a franchise agreement by which the franchisee consented to jurisdiction in Florida.<sup>58</sup> The court held that the franchisee had established "minimum contacts" with Florida, and had agreed to a contract that had "substantial connections with the forum state," including a provision that provided for application of Florida law. As a result, the Michigan Franchise Investment Law, which required cause for termination and gave

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<sup>51</sup> *Id.*

<sup>52</sup> Michael E. Solimine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L. REV. 49 (1989).

<sup>53</sup> *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991).

<sup>54</sup> Ribstein, *supra* note 42.

<sup>55</sup> *Id.*

<sup>56</sup> *Burger King v. Rudzewicz*, 471 U.S. 462 (1985).

<sup>57</sup> Ribstein, *supra* note 42.

<sup>58</sup> *Burger King*, *supra* note 53.

the franchisee thirty days to cure any defects, did not govern the relationship.<sup>59</sup>

Following this decision were two cases in the late 1980's that enforced choice-of-law clauses. *Tele-Save*, decided by the U.S. Court of Appeals for the Sixth Circuit, upheld a contractual choice-of-law provision choosing New Jersey Law despite a non-waiver provision found in the Ohio Business Opportunity Plans Act.<sup>60</sup> *Modern Computer Systems*, decided by the U.S. Court of Appeals for the Eighth Circuit, held that a choice-of-forum clause requiring "exclusive venue in Douglas County Nebraska in any litigation between them concerning this contract" precluded application of the Minnesota Franchise Act in spite of the existence of an anti-waiver provision in the statute.<sup>61</sup>

These holdings effectively enabled a franchisor to avoid franchise regulation if it included a choice-of-law clause in the franchise contract and established significant contacts with the designated state, or avoided contacts with the regulating state, or both. These opinions established legal rules for fourteen of the state statutes that existed as of the late 1980's, which included a large percentage of the states that have enacted franchise regulations, including the particularly oppressive laws in Iowa, Minnesota and Arkansas in the Eighth Circuit, and Michigan in the Sixth Circuit.

On the other hand, some courts have voided contractual choice-of-law clauses even where the relevant statute did not specifically bar the clause. Examples include *Electrical & Magneto* in the Eighth Circuit<sup>62</sup> and *Wright-Moore* in the Seventh Circuit,<sup>63</sup> which directly cover franchise statutes in Illinois, Wisconsin and Indiana. *Wright-Moore* failed to find a substantial relationship to the forum state, noting that although Ricoh was incorporated in New York, its principal place of business was New Jersey. Also, in contrast to the holding in *Modern* that the franchisee's domicile (Minnesota) had expressed a strong preference for upholding contractual choice of law, the court in *Wright-Moore* did not find such an expression by Indiana.

Some state legislators swiftly reacted to these federal decisions. Soon after the Eighth Circuit's decision in *Modern Computer Systems*, the Minnesota legislature passed a provision explicitly voiding choice-of-law provisions in franchise contracts by adding the phrase "including any choice of law provision" to the section voiding waivers.<sup>64</sup> However, there is

<sup>59</sup> *Id.* For a description of the Michigan Franchise Investment Law, see Table 1, *supra*.

<sup>60</sup> *Tele-Save Merchandising Co. v. Consumers Distributing Company, Ltd.*, 814 F.2d 1120 (6th Cir. 1987).

<sup>61</sup> *Modern Computer Systems, Inc. v. Modern Banking Systems, Inc.*, 871 F.2d 734 (8th Cir. 1989).

<sup>62</sup> *Electrical & Magneto Service Co. Inc. v. AMBAC Intern. Corp.*, 941 F.2d 660 (8th Cir. 1991).

<sup>63</sup> *Wright-Moore v. Ricoh*, 908 F.2d 128 (7th Cir. 1991).

<sup>64</sup> MINN. STAT. § 80C.21 (2008).



significant variation in the states' responses. Since 1988, six states have explicitly voided choice-of-forum or choice-of-law clauses. Only two, Washington and Iowa, void both types of provisions. The California, Illinois and Michigan statutes have provisions voiding choice-of-forum provisions but not choice-of-law provisions. Meanwhile, the Minnesota statute explicitly voids choice-of-law provisions but does not explicitly void choice-of-forum provisions.

**Table 2 - Statutory Restrictions on Waiver, Choice of Forum, Choice of Law, and Applicability**  
States that Regulate the Franchisor/Franchisee Relationship

<i>JURISDICTION</i>	<i>RESTRICTION ON WAIVER</i>	<i>RESTRICTION ON CHOICE OF FORUM</i>	<i>RESTRICTION ON CHOICE OF LAW</i>	<i>RESTRICTION ON APPLICABILITY</i>
CT (2 <sup>nd</sup> Circuit)	GEN. STAT. @ 42-133f (f) 1975	NONE	NONE	GEN. ST @ 42.133h FRANCHISE IN-STATE
NJ (3 <sup>rd</sup> Circuit)	NJSA @ 56:10-7(A) 1971	NONE	NONE	NJSA @ 56:10-4 FRANCHISE IN-STATE
DE (3 <sup>rd</sup> Circuit)	NONE	NONE	NONE	6 DEL. C. @ 2551 FRANCHISE IN-STATE
VA (4 <sup>th</sup> Circuit)	VA ST @ 13.1-571 1972	NONE	NONE	VA ST. s 13.1-559 FRANCHISE IN-STATE
MI (6 <sup>th</sup> Circuit)	MCLA @ 445.1527 (27b) 1974	MCLA @ 445.1527 (27f) 1988	NONE	MCLA @ 445.1504 OFFER ORIGINATES OR RECEIVED IN STATE OR FRANCHISE IN STATE
TN (6 <sup>th</sup> Circuit)	TCA 47-25-1507 1989	NONE	TCA 47-25-1510 1989	NONE
IN (7 <sup>th</sup> Circuit)	IN. ST. @ 23-2-2.7-1(5) 1976	NONE	NONE	IN. ST. 23-2-2.7-1 FRANCHISE IN-STATE OR RESIDENT OF IN
WI (7 <sup>th</sup> Circuit)	WSA @ 135.025 Effective 11/24/77	NONE	NONE	WSA @ 135.02 FRANCHISE IN-STATE
IL (7 <sup>th</sup> Circuit)	815 ILCS @ 705/41 1988	815 ILCS @ 705/4 1988	NONE	815 ILCS @ 7-5/19-20 FRANCHISE IN-STATE
AR (8 <sup>th</sup> Circuit)	ASA @ 4-72-206(1) 1977	NONE	NONE	ASA @ 4-72-203 FRANCHISEE IN-STATE
MN (8 <sup>th</sup> Circuit)	MSA @ 80C.21 1973	NONE	MSA @ 80C.21 1989	MSA @ 80C.19 OFFER ORIGINATES OR RECEIVED IN STATE OR FRANCHISE IN STATE
MO (8 <sup>th</sup> Circuit)	NONE	NONE	NONE	MO. ST. 407.400 FRANCHISE IN-STATE

IA (8 <sup>th</sup> Circuit)	ICA @ 523H.4 1992	ICA @ 523H.3(1) 1992	ICA @523H.14 1992	ICA @ 523H.2 FRANCHISE IN STATE
WA (9 <sup>th</sup> Circuit)	RWCA @ 19.100.220 1971	RWCA @ 19.100.220 1991	RWCA @ 19.100.220 1991	RWCA 19.100.160 ANY PERSON ENGAGED IN OFFER TO SELL OR IN BUSINESS DEALINGS
CA (9 <sup>th</sup> Circuit)	BUS. & PROF. CODE @ 20010 1980, (operative 1/1/1981)	BUS & PROF. CODE @ 20040.5 1994	NONE	BUS & PROF. CODE @ 20015 FRANCHISEE DOMICILED OR FRANCHISE OPERATED IN- STATE
HI (9 <sup>th</sup> Circuit)	HRS @ 482E- 6(F)1974	NONE	NONE	NONE
NE (10 <sup>th</sup> Circuit)	RRS NEB. @ 87-406 1978	NONE	NONE	RRS NEB. @ 87.403 FRANCHISE IN- STATE
MS (11 <sup>th</sup> Circuit)	NONE	NONE	NONE	NONE
DC (DC Circuit)	NONE	NONE	NONE	NONE

Moreover, the state legislative response still permits enforcement of contractual choice-of-law clauses even in the states that have enacted specific anti-choice provisions. This is because the application of these statutes depends on the places of business of the franchisee and franchisor. For example, in *JRT* the Eighth Circuit held valid the contractual choice of Arkansas law, and affirmed the district court's judgment, which dismissed or granted summary judgment on the plaintiff's claims based on the Michigan Franchise Investment Law.<sup>65</sup> The Arkansas Franchise Law can be used only by a franchisee that maintains a place of business in Arkansas. Even without this statutory provision, the regulation might not apply to a franchisor because of a lack of a "substantial relationship" between the regulating state and the parties or transaction under the standards of Restatement (Second) of Conflicts §187(2).<sup>66</sup> Franchisors, therefore, can minimize the impact of state franchise regulations by locating franchises only in non-regulating states and by locating headquarters either in non-regulating states or in regulating states that apply their provisions only to in-state franchisees.

<sup>65</sup> *JRT v. TCBY Yogurt*, 52 F.3d 734 (8th. Cir. 1995).

<sup>66</sup> RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (2008).

**Table 3 - Applicable State Franchise Termination Laws**  
by Franchisor's Principal Place of Business and Franchisee's State

*Franchisor's Principal Place of Business and Contractual Choice of Law*

Franchisee's State (Circuit):	Non-Reg. State	AR (8)	CA (9)	CT (2)	DE (3)	HI (9)	IA (8)	IL (7)	IN (7)	MI (6)	MN (8)	NE (8)	NJ (3)	TN (6)	VA (4)	WA (9)	WI (7)
Non Reg. State:	N (6)	N (1)	N (1)	N	N	N	N (1)	N	N	N/y (4,5)	N/y	N (1)	N (1)	N/y	N	N/y	N
AR(8)	N (2,8)	<b>AR</b>	N	N	N	N	N (1,2)	S	S	N/y (2)	N/y	N	N	N	N	N/y	S
CA(9)	N (2,C)	N (2,B)	<b>CA</b>	-	-	-/y	N (2,B)	Y (6)	Y	N/y	N/y	N (2,B)	-	N/y	-/y	-/y	Y
CT (2)	N	N	-	<b>CT</b>	-	-	N	Y	Y	N	N	N	-	N	-	-	Y
DE (3)	N	N	-	-	<b>DE</b>	-	N	Y	Y	N	N	N	-	N	-	-	Y
HI (9)	N	N	-	-	-	<b>HI</b>	N	S	S	N	N	N	-	N	-	-	Y
IA(8)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	<b>IA</b>	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)
IL(7)	S	S	Y	Y	Y	Y	S	<b>IL</b>	Y	S/y (3,6)	S/y	S	Y	S	Y	Y	Y
IN(7)	S (3,F)	S	Y	Y	Y	Y	S	Y	<b>IN</b>	S/y	S/y	S	Y	S/y	Y	Y	Y
MI(6)	N (6)	N (1,2,E)	N	N	N	N	N (1,2)	S	S	<b>MI</b>	N/y	N (1,2)	N	N	N	N/y	S
MN(8)	Y (4,L)	Y (4,L)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	<b>MN</b>	Y (4,E)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)
NE(8)	N (2,B)	N (2,B)	N	N	N	N	N (2,B)	S	S	N/y (2)	N/y	<b>NE</b>	N	N	N	N/y	S
NJ(3)	N	N	-/y	-/y	-/y	-/y	N	Y	Y	N/y	N/y	N	<b>NJ</b>	N/y	-/y	-/y	Y
TN(6)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	<b>TN</b>	Y (4)	Y (4)	Y (4)
VA (4)	N	N	-	-	-	-	N	Y	Y	N	N	N	-	N	<b>VA</b>	-	Y
WA(9)	Y (4)	Y (4)	Y (4,K)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	Y (4)	<b>WA</b>	Y (4)
WI(7)	S (3,F)	S	Y	Y	Y	Y	S	Y	Y	S	S	S	Y	S	Y	Y	<b>WI</b>

Table Entries:

- Y - Franchise Law of Franchisee's State applies.
- Y - One Circuit has voided Choice of Law Clause
- N - Both Circuits have Enforced Choice of Law Clause, or No Franchise Law Exists in Franchisee State
- N - One Circuit has Enforced Choice of Law Clause.
- S - One Circuit has Enforced Choice of Law, Other has not.
- /y - Franchise Law of *Franchisor's* State may apply to out of state franchisee.

Notes:

- <sup>1</sup> Franchise statute does not apply to out-of-state franchisee by statute (See Table 3)
- <sup>2</sup> Contractual choice of law enforced over general waiver in the absence of explicit anti-choice of law clause
- <sup>3</sup> General waiver voids contractual choice of law or forum
- <sup>4</sup> Explicit anti-choice of law clause voids contractual choice of law
- <sup>5</sup> No regulations apply in either state.

Specific Cases:

<sup>A</sup> *Modern Computer Systems v. Modern Banking*, 871 F.2d 734 (8<sup>th</sup> Cir. 1989) (applied contractual choice of NE law over Minnesota Franchise Act (MFA), but prior to amendment adding explicit anti-COL clause to MFA). *DeLaria v. KFC Corp.*, 1995 U.S. Dist. LEXIS 21516 at \*17 (D. Minn) (interpreting amendment to MFA as legislative response to *Modern*).

<sup>B</sup> Following Eighth Circuit holdings in *Modern Computer* and *JRT* upholding contractual choice absent specific provisions in statute.

<sup>C</sup> *Cottman Transmission System v. Melody*, 869 F. Supp. 1180 (E.D. Pa. 1994) (upholding contractual choice of Pennsylvania Law over California Franchise Regulation).

<sup>D</sup> *Hengel, Inc. v. Hot N' Now*, 825 F. Supp. 1311 (N.D. Ill. 1993) (Franchisor successfully argues that its choice of MI law is void to avoid application of Michigan Franchise Investment Law (MFIL) by a IL franchisee – waiver provision in ILCS invalidates contractual choice of MI law); See also *To-Am Equipment Co., Inc. v. Mitsubishi Caterpillar Forklift America, Inc.*, 152 F.3d 658 (C.A.7 (Ill.) 1998); *Bixby's Food Systems, Inc. v. McKay* 193 F.Supp.2d 1053 (N.D. Ill. 2002); *Healy v. Carlson Travel Network Associates, Inc.* 227 F.Supp.2d 1080 (D. Minn. 2002) (ILCS applied over Minnesota Franchise Statute for IL franchisee with MN choice of law).

<sup>E</sup> *JRT v. TCBY Yogurt*, 52 F.3d 734 (C.A.8. (Ark.) 1995) (Enforced choice of AR law over MFIL; AR Franchise law does not apply to MI franchisee).

<sup>F</sup> *Wright-Moore v. Ricoh*, 908 F.2d 128 (7<sup>th</sup> Cir. 1990) (Applying IN franchise statute over choice of NY law). *Morley-Murphy Co. v. Zenith Elec. Corp.*, 142 F.3d 373, 381 (7<sup>th</sup> Cir. 1998) (Wisconsin law).

<sup>G</sup> *Electrical & Magneto Service Co. v. AMBAC*, 941 F.2d 660 (8<sup>th</sup> Cir. 1991) (applying MO franchise law over choice of SC law).

<sup>H</sup> *Banek v. Yogurt Ventures*, 6 F.3d 357 (6<sup>th</sup> Cir. 1993) (Enforcing choice of GA law, dismissing claims under MFIL).

<sup>I</sup> *Tele-Save Merch. V. Consumers Dist. Co.*, 814 F.2d 1120 (6<sup>th</sup> Cir. 1987).

<sup>J</sup> *TCBY v. RSP*, 33 F.3d 925 (8<sup>th</sup> Cir. 1994) (Enforced choice of AK law, dismissing claims under MFA because anti-choice of law clause did not apply retroactively).

<sup>K</sup> *Rutter v. BX of Tri-Cities, Inc.*, 806 P.2d 1266 (C.A. Wash. 1991) (Apply WA Franchise Law over choice of CA law).

<sup>L</sup> *Carlock et al., v. Pillsbury*, 719 F. Supp. 791 (D. Minn. 1989) (uphold choice of NY law over MFA).

<sup>M</sup> *Tri-County Retreading v. Bandag, Inc.*, 851 S.W. 2d 780 (C.A. Mo. 1993) (upholding choice of IA law).

<sup>N</sup> *Flynn Beverage Inc., v. Joseph E. Segram & Sons*, 815 F. Supp. 1174 (C.D. Ill., 1993) (applying IL law over choice of law).

<sup>O</sup> *Great Frame-Up Syst., Inc. v. Jazayeri Ent.*, 789 F. Supp. 253 (N.D. Ill. 1992) (Apply CA statute over choice of IL law).

*Volvo Const. Equipment North America, Inc. v. CLM Equipment Company, Inc.*, 386 F.3d 581 (C.A.4 (N.C.) 2004) (Finding that AR waiver provision was fundamental policy (based on legislative statement), but LA was not (no antiwaiver provision)).

*Cromeens, Holloman, Sibert, Inc v. AB Volvo*, 349 F.3d 376 (C.A.7 (Ill.) 2003) (finding anti-waiver fundamental public policy of Maine based on legislative statement).

## V. THE EFFECT OF TERMINATION RESTRICTIONS

In empirical work we sought to address the shortcomings of the earlier work on franchise termination regulation.<sup>67</sup> This analysis exploits two new sources of panel data to analyze the effects of laws restricting franchisor termination rights, allowing us to avoid the limitations present in prior studies that relied on cross-sectional data. We also explicitly examine the effect of variation in states' statutory treatment of contractual choice-of-law and choice-of-forum clauses.

Our first set of empirical tests used newly collected firm-level UFOC data on franchising in the fast-food industry to examine the effect of the most recently enacted franchise legislation in Iowa. Because of data limitations, this data covers the period only from 1989-2001,<sup>68</sup> when only one new statute, in Iowa, was passed. Enacted in 1992, the Iowa statute is uniformly regarded as the most unfavorable to franchisors.<sup>69</sup> In addition to preventing termination at will, it requires that franchisors allow franchisees a right to cure defects, it restricts encroachment, and it explicitly restricts waiver and enforcement of contractual choice-of-law and choice-of-forum clauses. Our results show that the passage of this statute led to a reduction in both the number of franchised units and the total number of chain outlets.<sup>70</sup> In other words, the increase in the number of franchisor-operated establishments did not offset the decrease in the number of franchised outlets.

While data limitations do not allow us to examine the issue of contractual avoidance of the statute, these results illustrate how a measure of overall activity level (i.e., the number of total outlets in a given state) can be used to measure the effects of a franchise regulation. In order to measure the effects of other state law changes, including parties' ability to bargain over whether the franchise regulations apply, we analyze a second dataset that uses state employment in industries characterized by a high degree of franchising as a proxy for the overall franchisor activity level.<sup>71</sup> This dataset, from the Bureau of Economic Analysis, contains data from

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<sup>67</sup> Klick et al., *supra* note 7.

<sup>68</sup> *Id.*

<sup>69</sup> See Kobayashi & Ribstein, *supra* note 8, at 339.

<sup>70</sup> Klick et al., *supra* note 7 at Tables 2 & 3.

<sup>71</sup> *Id.* Specifically, we collected data on the proportion of employees in a state employed in four SIC codes that historically have a relatively high rate of franchising. These include automotive dealers and service stations (624), eating and drinking places (627), hotels and other lodging places (805), and automotive repair, services, and parking (825). In addition, to allow us to control for variables that are coincidentally correlated with the enactment of franchise termination that affect employment in franchising industries, we also collected data on the proportion of employees in a state employed in four SIC codes where there was a low rate of franchising. These include contractors (310), lumber products (413), textiles (462), and depository institutions (710).

1969 to 2000. Because the dataset covers the period when all nineteen statutes listed in Table 1 were enacted, it is rich enough to analyze the contractual avoidance issue.<sup>72</sup>

Using this data, we find that employment in franchise industries, as a proportion of total employment, drops significantly when states enact restrictions on franchisor termination rights.<sup>73</sup> The negative effect is larger in industries that typically do not have repeat business, bolstering the inference that the statutes limit franchisors' ability to police franchisee opportunism.<sup>74</sup> These results complement the direct test based on the UFOC data, which supports the view that these termination statutes serve to reduce overall activity in franchise industries.

We find that statutory variations as to whether the parties can directly waive their application or effectively contract over the applicable law or forum are important. Controlling for these variables, termination restrictions, by themselves, do little to affect behavior. But termination restrictions coupled with restrictions on the franchisee's ability to waive its rights have a significant and negative effect on franchising. Specifically, we find that the effect on employment is larger when states restrict the parties' ability to contract around these restrictions through waiver, choice-of-law, and choice-of-forum clauses.<sup>75</sup>

The prior empirical literature franchising has generally ignored state-by-state substantive variation in the statutes. One exception is Muris & Beales, who examined the additional effect of statutory provisions that give franchisees a right to cure violations on the franchisee/own decision.<sup>76</sup> As noted above,<sup>77</sup> eleven states with franchise-termination restrictions also require that a franchisor permit the franchisee to cure any problem offered as cause for terminating their relationship. Because giving the franchisee a right to cure further limits the franchisor's ability to discipline franchisee opportunism, such statutory restrictions should have a marginal effect on the franchise-versus-own decision. Like the Brickley et al. study, the Muris & Beales study was based on cross-sectional data collected by the Department of Commerce.<sup>78</sup> In contrast to the findings in Brickley et al.,<sup>79</sup> Muris & Beales found that the right to cure had negative and significant effects in both repeat and non-repeat industries, though the largest negative effects on franchising were in non-repeat industries, concentrated in states where the statute mandated a franchisee right to cure.

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<sup>72</sup>*Id.*

<sup>73</sup>*Id.* at Table 6.

<sup>74</sup>*Id.* at Table 7; *see also* Brickley et al., *supra* note 3.

<sup>75</sup>Klick et al., *supra* note 7 at Tables 8-9.

<sup>76</sup>Timothy J. Muris & J. Howard Beales III, *State Regulation of Franchise Contracts*, unpublished manuscript, (1994).

<sup>77</sup>*See* Table 1.

<sup>78</sup>*See* discussion in *supra* note 36.

<sup>79</sup>Brickley et al., *supra* note 3.

These results suggest that the right to cure is an important statutory variation, and it may be an important factor in determining the effect of franchise regulations. Table 5 reports the results of regressions that investigate the effect of a right to cure using the employment panel data set from Klick et al.<sup>80</sup> To estimate the effects of franchise regulations on employment in franchise industries, we performed a difference-in-difference-in-difference (“DDD”) analysis in which we independently control for state-specific year dummies ( $\upsilon$ ) to net out any unobservable variables that affect this segment of the workforce. Additionally, we control for industry-specific state fixed effects ( $\lambda$ ) and industry-specific year dummies ( $\tau$ ) generating the following regression:

$$\frac{employment_{ist}}{employment_{st}} = \sum_j \alpha_j law_{jist} + \lambda_{is} + \tau_{it} + \upsilon_{st}$$

where  $i$  represents the industry,  $s$  stands for the state, and  $t$  is the year.<sup>81</sup>

We identify the effects of franchise termination laws by examining changes in the portion of the state’s workforce in franchising industries when termination laws are adopted. This change is reflected in the coefficient of the law variables, and is measured relative to non-franchising industries in the same state and year. This change is also net of any existing baseline within the state and any contemporaneous changes in franchising industries in states without termination laws. In regressions that do not take into account substantive variation in termination laws, there is a single law variable that equals one if the state  $s$  in year  $t$  has a franchise termination statute in effect. Our approach allows for multiple law variables to take into account state variation.

**Table 4**  
**Effect of Cure Requirement in Franchising Relationship**

(robust standard errors in parentheses)  
[standard errors clustered by state in brackets]

	Results without Effect of Cure Requirement	Average Incremental Effect of Cure Requirement	Effect of Cure Requirement Interacted with Other Contract Restrictions	Termination Restriction and Cure Requirement Only
Termination	-0.00012	0.00039	0.00141	-0.00051

<sup>80</sup> Klick et al., *supra* note 7.

<sup>81</sup> We estimate this equation using weighted least squares where each observation is weighted by the total labor force in the state. In this regression, the law variables only take the value of one in states with termination laws for those industries assumed to have a high degree of franchising, in order to avoid collinearity with the state year dummies. In addition, we use robust standard errors to allow for heteroskedasticity across states. We also provide standard errors that are clustered by state to mitigate concerns about serial correlation.

Restriction Only	(0.00027) [0.00090]	(0.00031) [0.00086]	(0.00050)*** [0.00062]**	(0.00024)** [0.00073]
Termination Restriction and Cure Requirement Only	--	--	-0.00087 (0.00034)*** [0.00093]	--
Termination and Waiver Restriction Only	-0.00107 (0.00023)*** [0.00071]	-0.00059 (0.00026)** [0.00075]	-0.00141 (0.00039)*** [0.00084]	--
Termination and Waiver Restriction and Cure Requirement Only	--	--	-0.00122 (0.00029)*** [0.00100]	--
Termination, Waiver, and either COL or COF Restriction	-0.00204 (0.00028)*** [0.00101]**	-0.00145 (0.00032)*** [0.00095]	-0.00102 (0.00033)*** [0.00101]	--
Termination, Waiver, and COL or COF Restriction and Cure Requirement	--	--	-0.00229 (0.00032)*** [0.00118]*	--
Termination, Waiver, and COL and COF Restriction	-0.00306 (0.00042)*** [0.00132]**	-0.00222 (0.00047)*** [0.00118]*	--	--
Termination, Waiver, and COL and COF Restriction and Cure Requirement	--	--	-0.00288 (0.00041)*** [0.00134]**	--
Cure Requirement	--	-0.00083 (0.00033)** [0.00107]	--	-0.00123 (0.00031)*** [0.00102]

Note: Weighted least squares regressions are presented; each observation is weighted by total state employment. All regressions include Industry-specific year and state effects, as well as state-specific year effects. These are not reported for expositional clarity.

$R^2 = .980$

\*\*\* $p < 0.01$ ; \*\* $p < 0.05$ ; \* $p < 0.10$  (two-sided test of null hypothesis that coefficient equals 0).

Table 4 reports several regressions that examine state variation in franchise protections statutes. The results in column 1 show the effect of contractual waiver, choice-of-law, and choice-of-forum provisions reported in Klick et al.<sup>82</sup> As discussed *supra*, permitting enforcement of these provisions increases the contracting parties' ability to avoid regulation. This analysis shows the importance of taking these contractual variations into account when measuring the effect of regulation. The results in Column 1 show that termination restrictions alone have very little effect on

<sup>82</sup> See Klick et al. *supra* note 7 at Table 8, column 2.



the employment share of franchise industries. The coefficient on the “termination restriction only” variable is small in magnitude and is not statistically significant. Adding a “waiver restriction” variable increases the negative effect of the termination by a factor of ten. And adding either a “choice of law” or “choice of forum restriction” variable doubles the negative effect generated by the waiver restriction. This effect is statistically significant using robust standard errors and using standard errors clustered by state. Finally, states that restrict both choice-of-law and choice-of-forum have the largest negative effect on employment.

The second column of Table 4 provides estimates from re-running the above regression, adding an additional variable that equals one for franchise industries operating in states that have a cure requirement in a given year. In this specification, we do find a negative average treatment effect for the cure requirement. The effect is statistically significant at the five percent level with robust standard errors, but is not statistically significant when standard errors are clustered by state.

We also present a specification in column 3 that interacts the cure requirement indicator with each of the various groupings of state contractual restrictions (i.e., termination restriction only, termination and waiver restrictions only, termination, waiver, and either COL or COF restrictions only, and all of the restrictions). We again find evidence that the cure requirement independently reduces the employment share of franchising industries and, in general, that this effect is larger in magnitude as states adopt more restrictions on the parties’ ability to contract around state law. The last column of Table 5 examines the effect of cure in the absence of the contractual avoidance variables, and is closest to the Muris & Beales results.<sup>83</sup> The regression results show that a right to cure marginally increases the negative effect of the franchise termination statutes. The effect is statistically significant with robust standard errors, but neither of the variables’ coefficients are significant with standard errors clustered by state.

## V. CONCLUSION

Prior empirical studies of franchise termination regulations show that those regulations reduce the use of franchising. These studies, in effect, assume that franchise regulations have uniform effects on franchising. In this paper, we argue that such an approach ignores significant variation in states’ approaches to franchise regulation. We show that a state’s approach to allowing parties contractually to avoid regulation is a significant factor in determining the actual effect of regulation, and should be taken into account by policy makers and by those analyzing the effects of state regulation. We also provide evidence that the substantive

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<sup>83</sup> Muris & Beales, *supra* note 79.

provisions of franchise regulation statutes, such as the right to cure, can have important effects in determining the impact of the regulation.

