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

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. Moreover, most states did not enact statutes, choosing instead to use state contract law and state common law to resolve such disputes. The federal government acted only in the specific areas of gas stations and automobile dealers. 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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4 See infra Section III.


economists to use this variation to measure the empirical effect of state regulations.\(^7\) Second, state variation has allowed the forces of competitive federalism to operate in this area.\(^8\) 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.\(^9\) 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.\(^{10}\)

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.


\(^{9}\)*Id.*; see also infra Section IV.

\(^{10}\)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,\textsuperscript{11} which better explained the franchise form of contract and business decisions whether to franchise or own outlets.\textsuperscript{12} Drawing on the agency cost insights of the economic literature,\textsuperscript{13} 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.\textsuperscript{14}

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.\textsuperscript{15}

\begin{thebibliography}{9}
\bibitem{Rubin} Rubin, \textit{supra} note 1.
\bibitem{Brickley} James A. Brickley & Frederick H. Dark, \textit{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).
\bibitem{Bhattacharyya} For a formal model of this “double sided moral hazard” problem, see Sugato Bhattacharyya & Francine Lafontaine, \textit{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, \textit{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, \textit{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).
\end{thebibliography}
The franchise contract, like any long-term contract, still gives the parties room to act opportunistically. 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.

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. 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. 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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17 See Rubin, supra note 1; Klein, supra note 2; Benjamin Klein, Transaction Costs Determinants of ‘Unfair’ Contractual Arrangements, 70 AM. ECON. REV. 356 (1980).


profitable franchises, even where the franchisee is not shirking. 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.

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. 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. 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.

III. STATE FRANCHISE REGULATION

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

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21 See Klein, supra note 17, at 360.
22 See Blair & Lafontaine, supra, note 2, at 271-75.
24 Id. at 273; Lafontaine & Shaw, supra note 15.
franchisors’ ability to terminate franchise contracts. 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. 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. Fifth, some statutes restrict enforcement of contractual provisions waiving franchise protection and contracting for the applicable law and forum.

26 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 that 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)).

27 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.

28 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 manufactures from solving the successive monopoly problem, and result in higher prices to consumers. See Smith, supra note 3; Eckard, supra note 3.

29 These variations are discussed in detail below, and are listed infra in Table 2.
Table 1 - State Regulation of the Franchisor/Franchisee Relationship

<table>
<thead>
<tr>
<th>STATE</th>
<th>STATUTE</th>
<th>CAUSE REQUIRED FOR TERMINATION</th>
<th>RIGHT TO CURE</th>
<th>CAUSE REQUIRED FOR NON-RENEWAL</th>
<th>NOTICE</th>
<th>OTHER STATUTORY RESTRICTIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. AR</td>
<td>AR STAT. ANN 4-72-204</td>
<td>YES</td>
<td>30 days, 10 Days if a, b, None if c, d, e, f, g, h.</td>
<td>YES*</td>
<td>90 days - R/T</td>
<td></td>
</tr>
<tr>
<td>2. CA</td>
<td>CA BUS. &amp; PROF. CODE @ 20020</td>
<td>YES</td>
<td>30 days None if a, c, d, e, f, g, h.</td>
<td>NONE**, ***</td>
<td>180 days</td>
<td></td>
</tr>
<tr>
<td>3. CT</td>
<td>CT GEN. STAT. @ 42-133f</td>
<td>YES</td>
<td>NONE</td>
<td>YES</td>
<td>60 days</td>
<td></td>
</tr>
<tr>
<td>4. DC</td>
<td>D.C. CODE @ 29-1201</td>
<td>YES</td>
<td>60 days</td>
<td>YES</td>
<td>60 days</td>
<td></td>
</tr>
<tr>
<td>5. DE*/* (1970)</td>
<td>6 DEL C. @ 2552 HRS @ 482E-6</td>
<td>YES</td>
<td>NONE</td>
<td>YES</td>
<td>Reasonable Period</td>
<td></td>
</tr>
<tr>
<td>6. HI*/* (1974)</td>
<td>ICA s 523H.7</td>
<td>YES</td>
<td>Reasonable Period None if a, c, d, f.</td>
<td>YES</td>
<td>Reasonable Period</td>
<td>Independant Sourcing, Liability for Encroachment</td>
</tr>
<tr>
<td>7. IA*/* (1992)</td>
<td>815 ILCS 705/19</td>
<td>YES</td>
<td>30 days, None if a, c, d, f.</td>
<td>NONE</td>
<td>30 days T</td>
<td></td>
</tr>
<tr>
<td>8. IN (eff. 1/1/76)<em>/</em></td>
<td>IN ST. 23-2-2.7</td>
<td>YES</td>
<td>NONE</td>
<td>YES*</td>
<td>90 days R/T</td>
<td>Independant Sourcing, Liability for Encroachment</td>
</tr>
<tr>
<td>9. MI</td>
<td>MCLA 445.1527</td>
<td>YES</td>
<td>30 days</td>
<td>NONE</td>
<td>30 days T</td>
<td></td>
</tr>
<tr>
<td>10. MN</td>
<td>MSA s80C.14</td>
<td>YES</td>
<td>60 days None if a, c, d.</td>
<td>NONE**</td>
<td>90 days T</td>
<td></td>
</tr>
<tr>
<td>12. MO (1974)</td>
<td>MO ST 407.405</td>
<td>NONE</td>
<td>NONE</td>
<td>NONE</td>
<td>90 days - R/T</td>
<td></td>
</tr>
</tbody>
</table>
### Table: State Regulation of Franchise Termination

<table>
<thead>
<tr>
<th>State</th>
<th>Code/Act Reference</th>
<th>Requirements</th>
<th>Franchisee Notice</th>
<th>Franchisor Notice</th>
<th>Time Period</th>
</tr>
</thead>
</table>
| MS     | MS ST s75-24       | NONE         | NONE              | NONE              | 90 days -  
|        |                    |              |                   |                   | R/T        |
| NE     | RRS Neb @ 87-404   | YES          | NONE              | YES               | 60 days -  
|        |                    |              |                   |                   | R/T        |
|        |                    |              |                   |                   | 15 days    |
| NJ     | NJSA 56:10-5       | YES          | NONE              | YES               | 60 days -  
|        |                    |              |                   |                   | R/T        |
|        |                    |              |                   |                   | 15 days    |
| TN     | TCA 47-25-150B     | YES          | 30 days, non if c,  
|        |                    |              |                   |                   | d, f.      |
|        |                    |              |                   |                   | 60 days    |
| VA     | VA ST s 13.1-564   | YES          | NONE              | NONE              | NONE       |
| WA     | RCWA 19.100.180    | YES          | 30 days or substantial  
|        |                    |              |                   |                   | continuing action to cure. |
|        |                    |              |                   |                   | None if a, c,  
|        |                    |              |                   |                   | d, f.       |
| WI     | WSA 135.03         | YES          | 60 days, 10 days if h  
|        |                    |              |                   |                   | YES        |
|        |                    |              |                   |                   | 90 days -  
|        |                    |              |                   |                   | R/T        |
|        |                    |              |                   |                   | None if f  

### 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 & franchisor has right of first refusal.
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.\(^{30}\) 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.\(^{31}\)

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

\(^{30}\) Brickley, \textit{supra} note 3, at 117-126.

\(^{31}\) \textit{Id.} at 111.
other industries.\footnote{Id. at 123-26.} 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 and included.\footnote{Id. at 125.} 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.\footnote{Id. at 125-26.}

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.\footnote{Id. at 126.} 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,\footnote{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).} 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

data from this source is now over 20 years old because the federal
government’s publication of the data ended in 1988.\textsuperscript{37}

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.\textsuperscript{38} The
relevant statute may allow contracts between the parties to waive the
regulation,\textsuperscript{39} apply a more permissive law to the interpretation or
enforcement of the contract,\textsuperscript{40} 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.\textsuperscript{41} 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,\textsuperscript{42}
thereby achieving beneficial flexibility.\textsuperscript{43} Thus, the actual effect of states’
regulations on contracting parties can be trivial.\textsuperscript{44}

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

\textsuperscript{37} See, e.g., Brickley et al., supra note 3.
\textsuperscript{38} Existing studies have explicitly analyzed how bargaining between the parties affects
the terms of the franchise contract. See, e.g., Seth W. Norton, \textit{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, \textit{The Economics of Litigation and Arbitration: An
Application to Franchise Contracts}, 32 J. LEG. STUD. 549 (2003) (discussing use of
arbitration clauses).
\textsuperscript{39} See infra Table 2.
\textsuperscript{40} See infra Section IV.
\textsuperscript{41} Id.
\textsuperscript{42} See Kobayashi & Ribstein, supra note 8. See generally, Larry E. Ribstein, \textit{From
\textsuperscript{43} See generally, Alan Schwartz & Robert E. Scott, \textit{Contract Theory and the Limits of
\textsuperscript{44} Kobayashi & Ribstein, supra note 8.
wealth transfers from out of state to in state parties. Whether such regulatory competition is effective depends significantly on the parties’ cost-of-exit from a given state, 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.

Still, the parties can skirt such anti-waiver provisions through alternative contract clauses. 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. 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.

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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45 Id.
47 See infra Table 2.
48 Kobayashi & Ribstein, supra note 8.
50 Kobayashi & Ribstein, supra note 8.
favoring enforcement or that is otherwise inclined to enforce the parties’ choice-of-law clause. The vast majority of jurisdictions have a general policy favoring enforcement of choice-of-forum clauses. Enforceability also has been supported by the U.S. Supreme Court, 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. 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. 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.

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. 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. 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

51 Id.
54 Ribstein, supra note 42.
55 Id.
57 Ribstein, supra note 42.
58 Burger King, supra note 53.
the franchisee thirty days to cure any defects, did not govern the relationship.\textsuperscript{59}

Following this decision were two cases in the late 1980's that enforced choice-of-law clauses. \textit{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.\textsuperscript{60} \textit{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.\textsuperscript{61}

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 \textit{Electrical & Magneto} in the Eighth Circuit\textsuperscript{62} and \textit{Wright-Moore} in the Seventh Circuit,\textsuperscript{63} which directly cover franchise statutes in Illinois, Wisconsin and Indiana. \textit{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 \textit{Modern} that the franchisee's domicile (Minnesota) had expressed a strong preference for upholding contractual choice of law, the court in \textit{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 \textit{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.\textsuperscript{64} However, there is

\textsuperscript{59} Id. For a description of the Michigan Franchise Investment Law, see Table 1, supra.

\textsuperscript{60} Tele-Save Merchandising Co. v. Consumers Distributing Company, Ltd., 814 F.2d 1120 (6th Cir. 1987).

\textsuperscript{61} Modern Computer Systems, Inc. v. Modern Banking Systems, Inc., 871 F.2d 734 (8th Cir. 1989).


\textsuperscript{63} Wright-Moore v. Ricoh, 908 F.2d 128 (7th Cir. 1991).

\textsuperscript{64} MINN. STAT. § 80C.21 (2008).

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

<table>
<thead>
<tr>
<th>JURISDICTION</th>
<th>RESTRICTION ON WAIVER</th>
<th>RESTRICTION ON CHOICE OF FORUM</th>
<th>RESTRICTION ON CHOICE OF LAW</th>
<th>RESTRICTION ON APPLICABILITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>CT (2nd Circuit)</td>
<td>GEN. STAT. @ 42.133f (f) 1975</td>
<td>NONE</td>
<td>NONE</td>
<td>GEN. ST @ 42.133h FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>NJ (3rd Circuit)</td>
<td>NJSA @ 56:10-7(A) 1971</td>
<td>NONE</td>
<td>NONE</td>
<td>NJSA @ 56:10-4 FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>DE (3rd Circuit)</td>
<td>NONE</td>
<td>NONE</td>
<td>NONE</td>
<td>6 DEL. C. @ 2551 FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>VA (4th Circuit)</td>
<td>VA ST @ 13.1-571 1972</td>
<td>NONE</td>
<td>NONE</td>
<td>VA ST. s 13.1-559 FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>MI (6th Circuit)</td>
<td>MCLA @ 445.1527 (27b) 1974</td>
<td>MCLA @ 445.1527 (27f) 1988</td>
<td>NONE</td>
<td>MCLA @ 445.1504 OFFER ORIGINATES OR RECEIVED IN STATE OR FRANCHISE IN STATE</td>
</tr>
<tr>
<td>IN (7th Circuit)</td>
<td>IN. ST. @ 23-2-2.7-1(5) 1976</td>
<td>NONE</td>
<td>NONE</td>
<td>IN. ST. 23-2-2.7-1 FRANCHISE IN-STATE OR RESIDENT OF IN</td>
</tr>
<tr>
<td>WI (7th Circuit)</td>
<td>WSA @ 135.025 Effective 11/24/77</td>
<td>NONE</td>
<td>NONE</td>
<td>WSA @ 135.02 FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>IL (7th Circuit)</td>
<td>815 ILCS @ 705/4 1988</td>
<td>815 ILCS @ 705/4 1988</td>
<td>NONE</td>
<td>815 ILCS @ 7-5/19-20 FRANCHISE IN-STATE</td>
</tr>
<tr>
<td>AR (8th Circuit)</td>
<td>ASA @ 4-72-206(1) 1977</td>
<td>NONE</td>
<td>NONE</td>
<td>ASA @ 4-72-203 FRANCHISEE IN-STATE</td>
</tr>
<tr>
<td>MN (8th Circuit)</td>
<td>MSA @ 80C.21 1973</td>
<td>NONE</td>
<td>MSA @ 80C.21 1989</td>
<td>MSA @ 80C.19 OFFER ORIGINATES OR RECEIVED IN STATE OR FRANCHISE IN STATE</td>
</tr>
<tr>
<td>MO (8th Circuit)</td>
<td>NONE</td>
<td>NONE</td>
<td>NONE</td>
<td>MO. ST. 407.400 FRANCHISE IN-STATE</td>
</tr>
</tbody>
</table>
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.65 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).66 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.

65 JRT v. TCBY Yogurt, 52 F.3d 734 (8th. Cir. 1995).
### Table 3 - Applicable State Franchise Termination Laws
by Franchisor’s Principal Place of Business and Franchisee’s State

<table>
<thead>
<tr>
<th>Franchisor’s State</th>
<th>AR(8)</th>
<th>CA(9)</th>
<th>CT(2)</th>
<th>DE(3)</th>
<th>HI(9)</th>
<th>IA(8)</th>
<th>IL(7)</th>
<th>IN(7)</th>
<th>MI(6)</th>
<th>MN(8)</th>
<th>NE(8)</th>
<th>NJ(3)</th>
<th>TN(6)</th>
<th>VA(4)</th>
<th>WA(9)</th>
<th>WI(7)</th>
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<tr>
<td>Non-Reg. State</td>
<td>N</td>
<td>N</td>
<td>N</td>
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</tbody>
</table>

### 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:

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

### Specific Cases:
A Modern Computer Systems v. Modern Banking, 871 F.2d 734 (8th 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).

B Following Eighth Circuit holdings in Modern Computer and JRT upholding contractual choice absent specific provisions in statute.


E 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).


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

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

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

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


P 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)).

V. THE EFFECT OF TERMINATION RESTRICTIONS

In empirical work we sought to address the shortcomings of the earlier work on franchise termination regulation. 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, when only one new statute, in Iowa, was passed. Enacted in 1992, the Iowa statute is uniformly regarded as the most unfavorable to franchisors. 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. 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. This dataset, from the Bureau of Economic Analysis, contains data from

67 Klick et al., supra note 7.
68 Id.
69 See Kobayashi & Ribstein, supra note 8, at 339.
70 Klick et al., supra note 7 at Tables 2 & 3.
71 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.\footnote{Id.}

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.\footnote{Id. at Table 6.} 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.\footnote{Id. at Table 7; see also Brickley et al., supra note 3.} 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.\footnote{Klick et al., supra note 7 at Tables 8-9.}

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 franchise/own decision.\footnote{Timothy J. Muris & J. Howard Beales III, State Regulation of Franchise Contracts, unpublished manuscript, (1994).} As noted above,\footnote{See Table 1.} 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.\footnote{See discussion in supra note 36.} In contrast to the findings in Brickley et al.,\footnote{Brickley et al., supra note 3.} 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.
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. 80 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 (υ) to net out any unobservable variables that affect this segment of the workforce. Additionally, we control for industry-specific state fixed effects (λ) and industry-specific year dummies (τ) generating the following regression:

\[
\frac{employment_{ist}}{employment_{st}} = \sum_j \alpha_j law_{jst} + \lambda_s + \tau_t + \nu_{ist}
\]

where \(i\) represents the industry, \(s\) stands for the state, and \(t\) is the year. 81

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

<table>
<thead>
<tr>
<th></th>
<th>Results without Effect of Cure Requirement</th>
<th>Average Effect of Cure Requirement Interacted with Other Contract Restrictions</th>
<th>Termination Restriction and Cure Requirement Only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination</td>
<td>-0.00012</td>
<td>0.00039</td>
<td>-0.00051</td>
</tr>
</tbody>
</table>

80 Klick et al., supra note 7.

81 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.
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.\textsuperscript{82} As discussed \textit{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

\textsuperscript{82} See Klick et al. \textit{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.83 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

83 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.