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# RELATIONAL GOVERNANCE AND CONTRACT DAMAGES: EVIDENCE FROM FRANCHISING

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The interaction between the use of formal law and more informal means to regulate behavior has been the subject of extensive inquiry.[1] A central question, if not the central question, in this line of research is whether the ability to enforce promises or obligations legally enhances or diminishes the ability to use informal rewards and sanctions to accomplish the same ends. This focus is appropriate because the decision to extend legally enforceable protections to an area of human behavior can turn on whether the introduction of law will bolster or undermine the non-legal mechanisms of influence and control that are already in place. The existing theoretical and experimental research in this area has not, however, produced a definitive answer to this question and has yet to fully isolate the factors that contribute to one outcome or the other. This lack of clarity is a product of competing explanations and conflicting evidence. Some have argued that the ability to enforce promises is a necessary baseline to develop trust-based norms and institutions[2] while others have developed models to show that a threat of legal enforcement can cause an increase in the violation of non-contractual elements of a relationship[3]. The experimental evidence shows that, in some situations, enforceable contracts "crowd out" trust by undermining the reciprocity norm[4] while other studies provide evidence that law can enhance trust over the long run[5].

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[1] *See, e.g.* Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643 (1996); Eric A. Posner*, Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697 (1996); David Charny, *Non-Legal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373 (1990).

[2] *See, e.g.* Frank B. Cross, *Law and Trust*, 96 GEO. L. J. 1457 (2005) (arguing that law's assurance of contract performance encourages trustworthy behavior); DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE 46 (1990) (stating that "formal rules can complement and increase the effectiveness of informal constraints").

[3] *See* Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtue*, 107 THE ECON. J. 1043 (1997) (developing a formal model of the "crowd out" hypothesis).

[4] *See* Iris Bohnet, Bruno S. Frey & Steffen Huck, *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POL. SCI. REV. 131, 141 (2001) ("Individuals perform a contract when enforcement is strong or weak but not with medium enforcement probabilities: Trustworthiness is 'crowded in' with weak and 'crowded out' with medium enforcement.").

[5] *See* Sergio G. Lazzarini, Gary J. Miller & Todd R. Zenger, *Order with Some Law: Complementarity Versus*

The qualitative investigations of how commercial actors use and understand formal and informal threats come to similarly mixed conclusions. Stuart Macaulay's now-classic study of how businesspeople use contracts shows that transactors have little understanding of the legal rules that govern their activities and have a strong preference for avoiding legal disputes.[6] Macaulay endorses the view that relational governance and law are substitutes through his finding that a highly legalistic approach to business relationships "indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horsetrade."[7] Lisa Bernstein also finds antagonism to the use of legal threats in her studies, but her evidence supports the complementarity hypothesis. In her study of the grain industry she finds a preference for avoiding the introduction of contextual evidence into contract disputes, which allows for more credible enforcement of the terms of written agreements.[8] She argues that these credible threats promote the informal resolution of conflicts because parties can feel assured that one-time waivers of contractual rights will not be binding in the future.[9]

But when it comes to quantitative studies of real-world transactors, little evidence has been developed.[10] This paper helps to fill this gap in the literature through an analysis of franchise agreements that shows—at least in this area of contracting—credible threats to impose legal sanctions and informal governance act as substitutes. The quantitative nature of the study helps to identify the factors that influence the choice of one mechanism over the other and assesses the magnitude of their influence.

Franchising provides several advantages for this type of project because this

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*Substitution of Formal and Informal Arrangements*, 20 J.L. ECON. & ORG. 261, 261 (2004) (arguing that when there is some chance that buyers and sellers will transact again, formal enforcement of the verifiable portions of an agreement increases informal enforcement of the nonverifiable aspects of the contract).

[6] *See* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

[7] *Id.* at 64.

[8] *See* Lisa Bernstein*, Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996).

[9] *Id.* at 1789.

[10] For some exceptions that use general measures of legality rather than the specific credible threat of enforcement analyzed in this study *see* Glenn Hoetker & Thomas Mellewigt, *Choice and Performance of Governance Mechanisms: Matching Alliance Governance to Asset Type*, 30 STRAT. MANG. JOUR. 1025 (2009) (finding that firms use formal mechanisms for property-based assets and relational governance for knowledge-based assets); Laura Poppo & Todd R. Zenger, *Do Formal Contracts and Relational Governance Function as Substitutes or Complements?*, 23 STRAT. MANG. JOUR. 707 (2002) (finding a positive relationship between increasing contractual complexity and the use of relational governance).

organizational form implicates a well-known governance problem and a significant amount of data is available about the techniques franchisors use to minimize the losses from this predicament. The franchise relationship typically involves a written contract between the principal (the franchisor) and the agent (the franchisee). This contract allows franchisees to use the trademarks and trade secrets of the franchisor at a single outlet of the business, such as a fast-food restaurant, a hair salon, or a hotel. The governance problem arises from the payment structure that the contract specifies. This structure typically allows franchisees to keep the residual profits from a franchised outlet instead of receiving the salary that a manager would earn if the outlet were vertically integrated into the firm. The residual is what is left over after the franchisee has paid royalties to the franchisor and has paid the costs of operating the outlet. This approach creates incentive problems because, unlike a manager, the franchisee can increase profits by reducing costs, which include the expense of complying with the franchise's quality and uniformity standards.[11]

Franchisors can choose from a wide variety of formal and relational governance mechanisms to prevent franchisees from indulging this incentive to reduce investments in quality and uniformity.[12] The formal mechanisms rely on enforcement of the written franchise agreements and, in their stronger forms, threaten contractually-specified damages against franchisees for failure to comply with franchise standards. The informal approaches to governance, in contrast, rely on the allocation of rewards and punishments that do not require any resort to written contract terms. A franchisor could, for example, condition the award of an additional outlet to a franchisee on the basis of whether the franchisee has invested an appropriate amount of effort into the initial outlet. Of course, neither of these options will be ideal. The contract-centered approaches implicate the expense and uncertainty associated with court enforcement and the ability to use relational governance depends on the availability of

[11] *See* James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 24 J. OF FIN. ECON. 101 (1987) (using agency theory to discuss the incentive conflicts in franchise contracts); *see also* Francine LaFontaine & Emmanuel Raynaud, *Residual Claims and Self-Enforcement as Incentive Mechanisms in Franchise Contracts: Substitutes or Complements?* 315-336, in THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS, Eric Brousseau & Jean-Michel Glachant, eds. (Cambridge 2002).

[12] George Baker, Robert Gibbons, and Kevin Murphy have defined the difference between formal and relational contract as follows: "a formal contract must be specified ex ante in terms that can be verified ex post by the third party, whereas a relational contract can be based on outcomes that are observed by only the contracting parties ex post, and also on outcomes that are prohibitively costly to specify ex ante." *See* George Baker, Robert Gibbons, & Kevin J. Murphy, *Relational Contracts and the Theory of the Firm*, 117 QUAR. J. ECON. 39, 40 (2002).

rewards and punishments that the firm can offer, which can be expensive to generate.

Several features of franchising allow for an empirical inquiry into the connection between these two governance mechanisms. Thirteen states obligate franchisors to make public the disclosure documents they provide to prospective franchisees by filing these documents with the appropriate state agency.[13] These documents provide an array of data about individual franchises and also include the contracts that the franchisors currently offer to potential franchisees. These contracts are uniform across the franchise system, which means that the contract terms should reflect the franchisor's judgment about the wisdom of using formal enforcement given the aggregate characteristics of the franchise and potential franchisees.[14]

Court treatment of these contracts allows for even more precision in identifying the favored approaches of franchisors because, while courts have been hostile to the default rule of expectation damages in the context of franchising, they have been receptive to claims for liquidated damages.[15] This feature of the case law permits the inference that a liquidated damages clause in the uniform contract is a credible commitment to pursue the stipulated payment for breach by the franchisee. Using franchise data about the availability of relational governance mechanisms, combined with the presence of liquidated damages, provides evidence of the factors that influence whether franchisors will use this credible threat of damages to police franchisee behavior.

This paper develops a theory to explain how franchisors are likely to use relational governance and credible damage threats to incentivize franchisees and evaluates that theory using

[13] The states that require public filing of the disclosure documents are: California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. *See* http://www.ftc.gov/bcp/franchise/netdiscl.shtm.

[14] Researchers have suggested that this uniformity is a product of legal registration requirements and a desire to avoid the transaction costs that would be necessary to negotiate contracts individually. *See* ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 269 (2005).54-56 (reviewing the evidence of uniformity in contracts and citing survey evidence on the beliefs of franchisors as to the reasons for uniformity).

[15] Franchise agreements that use the default rule of expectation damages, either by stating the rule expressly or leaving the contract silent on damages, face several obstacles to enforcement. First, it is costly to prove what the profits would have been had the franchisee not breached the agreement. This determination often requires dueling experts whose expense can quickly exceed the likely gain from a damage award. Second, courts have been hostile to lost profits claims on the grounds of certainty and on fairness grounds. They do not have these reservations when it comes to liquidated damages provisions. *See infra* Sec. II.B.2 for further discussion. *See also* Robert L. Ebe, David L. Steinberg & Brett R. Waxdeck, *Radisson and the Potential Demise of the Sealy-Barnes-Hinton Rule*, 27 FRAN. L. J. 3, 11 (2007) (stating, after a review of recent cases, the "admittedly unremarkable proposition" that liquidated damages provisions "increase the likelihood of recovering lost future profits.").

newly collected data from some of the leading franchisors in the United States. The theory speculates that damages and relational governance should act as substitutes because, while both mechanisms can achieve the same goal, the costs of supplying them can vary widely. If one of these mechanisms can effectively deter shirking in a cost-effective way, the use of the other mechanism will tend to increase expenses without a related governance benefit. This theory modifies the prevailing model of how franchisors can induce franchisee compliance. This model, developed by Benjamin Klein, argues that franchisors will get franchisees to invest effort by providing them with a level of compensation that exceeds their next-best opportunities backed by the threat of taking away this compensation if the franchisee is caught shirking.[16] As long as the net present value of this extra compensation—often called rents—eclipses the potential gain from withholding effort, franchisees should refrain from shirking. But using these rents as a governance mechanism requires franchisors to forego revenues, which is not the case for contract damages.[17] This feature makes contract damages attractive and, in a world without enforcement costs or limited liquidity, this approach should be favored by franchisors.

Franchisors do, however, face a reality of expensive litigation and potentially judgment-proof franchisees. Rents can avoid some of these problems because they do not depend on franchisee budget constraints and they do not necessarily require the potential enforcement costs that come with termination of the contract. The ability to avoid enforcement costs can allow franchisors to police franchisee behavior on the basis of observation alone, which provides a substantial advantage when observation is inexpensive and verification is costly.[18] The relative cost of providing these rents should be an important determinant of whether franchisors use them to police franchisees. Some rents are quite inexpensive—if a franchise is growing rapidly, awarding additional outlets to franchisees that do not shirk functions both as a rent and as a

[16] *See* Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. OF CORP. FIN. 9-37 (1995) (developing a model that explains the self-enforcement of contracts through a combination of rent creation and the threat of termination).

[17] As others have noted, Klein's approach is an application of the efficiency wage theory to franchising. *See* LaFontaine and Reynaud, *supra* __, at 267.

[18] Examining the problems that arise when parties can observe breach of a contract, but cannot verify that breach, has been a central focus of incomplete contract theory. For a recent treatment that addresses the principal-agent problems that arise when both parties face moral hazard and considers the role of contract damages and rents *see* Oliver Gürtler & Matthias Kräkel, *Double-Sided Moral Hazard, Efficiency Wages, and Litigation*, J. LAW, ECON. & ORG. (forthcoming) (examining how litigation costs affect the choices of efficiency wages and bonus payments).

cheap screening mechanism. But if a mature franchise has saturated most markets it may be prohibitively expensive to open new outlets, which limits the use of these types of rents to govern franchisee behavior.

The empirical evidence supports the theory that where one type of governance approach is likely to be effective, franchisors tend to forego use of the other mechanism. That franchisors do not all rely on credible damage threats is evident the simple descriptive statistic that, of the 89 contracts in the sample, only 20 contain liquidated damages provision. Further analysis suggests that when it is less expensive use relational mechanisms of governance, franchisors will favor these approaches over the use of credible damage threats. There is, for example, a negative association between the growth in franchise outlets, which is a plausible measure of the cost of using new outlets to reward franchisees, and the use of liquidated damages. Likewise, there is a negative relationship between of the amount of time a franchisor has been franchising and liquidated damage provisions. This finding is consistent with the theory because one should expect increased experience to allow franchisors to fine tune their ability to monitor franchisees and to reward or punish them without resort to contract. The results also suggest that judgment-proof franchisees pose an impediment to the use of credible damage threats because the startup costs of the franchise—which may be an indication of the ability of a franchisee to satisfy a judgment—have a positive relationship with the use of liquidated damages.

The evidence further suggests that liquidated damages tend only to be attractive when relational mechanisms are difficult to implement. These damage terms are most prevalent in motel and real estate brokerage franchises—industries where the fungible nature of the franchisee's assets make it easier to switch to another franchise.[19] This ability to move to another brand undermines the ability to influence franchisee behavior through relational means because the exit option places a limit on the size of potential punishments. When exit is a much more expensive proposition for a franchisee—one cannot easily convert a Burger King into a Taco Bell—relational punishments should be a more effective means of governance.

These findings have implications for both the contract theory literature and the literature on the economics of franchising. The main contribution to contract theory is a quantitative, real-

[19] In the sample of 89 contracts, all four motel franchises and three of the four real estate brokerages have

world showing that where parties can govern a relationship through informal means they will sometimes forego the option of contract damages even when the marginal cost of adding this term is low—in other words, formal and relational governance can act as substitutes rather than complements. The evidence also suggests that, at least in this sample, the preference for using relational means over formal means can be very strong even when there is extensive use of written agreements and the transactions are, at least at the outset, at arm's length. The primary contribution to the study of franchising is an empirical investigation of Klein's self-enforcement model.[20] While the evidence confirms that some franchisors will use rents to prevent shirking, it also shows that contract damages act as an alternative to this model. In addition, the evidence provides reason to doubt the prominent place given to termination of the entire relationship in Klein's model because franchisors appear to use a wide array of potential rewards for franchisors, many of which do not require formal termination of the contract to be effective.

The analysis proceeds as follows. Section I describes the sample of 2007 franchise disclosure documents and uses descriptive statistics from the data to discuss the observed structure of franchise contracts. Section II draws on the contract theory and franchising literatures to develop a theory about why liquidated damages are likely to substitute for relational means of governing the franchise relationship. Section III finds support for the theory and through a series of regressions that assess whether the presence of a liquidated damage provision has a positive or negative relationship with variables such as startup costs, growth rates, and experience. Section IV discusses some implications for these findings and concludes.

## I. The Structure of Franchise Contracts

This section provides an introduction to the general structure of franchise contracts by reviewing the data source and by describing the content of the agreements. The first subsection details the selection of the sample and the collection of the disclosure documents. The second subsection describes the common elements across the contracts share and provides descriptive statistics on the elements of the agreements that differ.

contracts that contain a liquidated damages provision.

[20] *See* Klein, *supra* note _ (developing a model of franchise self-enforcement that does not consider the role of damages).

*A. The Target Sample and the Data Source*

The franchise contracts collected for this study come from the Uniform Franchise Offering Circulars (UFOCs) that franchisors must file with regulatory authorities in the states that require franchise registration.[21] These UFOCs contain twenty plain-language disclosures required by the FTC's franchise rule and a series of mandatory exhibits includes the franchise agreement, supplementary agreements, financial disclosures, and related information. The twenty items in the UFOC explain key terms in the contract and related startup costs, such as the initial franchise fee, the estimated costs for establishing the business, royalty rates, whether the franchise provides exclusive territories, and the like. For each firm the UFOC also reports the number of franchised outlets, the number of company-owned outlets, and the number of cancellations and terminations for the previous three years.

The target sample for this study is top 100 franchises as ranked by Entrepreneur Magazine in 2008, a list that scholars often use to draw samples in franchise research.[22] Of the 100 franchises on the list, 98 of the UFOCs filed in 2007 were available from FRANdata, a firm that collects data on franchises. Nine of the observations were dropped because either the business model differed materially from the standard franchise arrangement[23] or data from a key variable was not available[24]. Table 1 lists the names of the franchises in the sample by industry.

**[Insert Table 1]**

For each franchisor I coded a number of contract variables, business model variables, and external variables. The contract variables include terms such as length of the contract term,

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[21] I use the term UFOC because the sample documents were, for the most part, filed with state franchise agencies when these documents still had that title. In 2007, the FTC promulgated a rule that changed the title of this document to a Uniform Franchise Disclosure Document. 16 C.F.R. §§.436-37. The rule also changed a number of rules for what must be disclosed to prospective franchisees such as a more complete description of the corporate structure of the franchisor and the chain of ownership of an outlet.

[22] Drahozal and Hylton 2003; Kobayashi and Ribstein 1999. The magazine bases these rankings on "objective quantifiable measures of a franchise operation." The magazine states that "[t]he most important factors include financial strength and stability, growth rate and size of the system." Other considerations include "the number of years a company has been in business and the length of time it's been franchising, startup costs, litigation, percentage of terminations, and whether the company provides financing." *See* http://www.entrepreneur.com/franchises/franchise500/about.html.

[23] In some cases, such as Ace Hardware, the business model is a retailer-owned cooperative rather than a franchise. In other cases, the only UFOC available was for master franchisors who recruit franchisees rather than own or operate outlets.

[24] For example, the length of the Supercuts contract varies based on the length of the lease that the franchisor can acquire. Supercuts is one of the relatively few franchises that obligates franchisees to lease or sublease directly from the franchisor. McDonald's and Seven-Eleven are also in this category.

renewal rights, royalty rates, damage provisions and the like. The business model variables include operational features of the franchise that are memorialized in the contract such as the use of exclusive territories and the requirement that franchisee engage in day-to-day operation of the outlet. The external variables include data that are not contained in the contract such as such as the number of franchised and company-owned outlets in the system, the growth rate, and the average of the minimum and maximum startup cost estimates provided by the franchisor.

For the contract variables I coded the content of the master agreement included in the disclosure document. This master agreement applies in all the states that do not regulate the content of franchise agreements. To accommodate states that do have these regulations, the contracts include state-specific addenda that alter the provisions in the master agreement that do not comply with the relevant statute. With several exceptions noted below, the variables of interest in this project are not the target of franchise regulation laws.

*B. Contract Structure and Some Descriptive Statistics*

The contracts in the sample share several common elements. All of the agreements give the franchisee a limited right to use the intellectual property of the franchisor—principally trademarks and trade secrets—for a stated period of time. The agreements all specify payment obligations of some type, which typically include an upfront franchise fee, an ongoing obligation to pay royalties, and required contributions to advertising and marketing funds. Table 2, which provides summary statistics for a number of internal and external variables, shows that the average contract term in the sample is 12.3 years. While contracts typically do not specify the amount of the startup investment, they do state the obligations that this investment entails such as rental or purchase of suitable property, a commitment to purchase the approved fixtures needed to operate an outlet, training requirements, and the like.

Table 3 breaks down some of these statistics and shows that there is substantial variation in the length of contract terms by industry and reports that the average startup cost across all industries is about $571K. This table shows that fast food, convenience store, and lodging franchise agreements generally require longer terms and higher initial startup costs relative to realtor, gyms, and cleaning service franchises. Table 4 provides a cross-tabulation based on the presence of a liquidated damage provision and demonstrates that there are large differences in the startup costs and two-year growth rates of the firms that do, and do not, have liquidated damages provisions in their contracts.

**[Insert Tables 2, 3, and 4]**

Of primary importance for this project, the contracts state the obligations of the franchisee and spell out the consequences of failing to adhere to these standards. These terms vary from the precise, such as provisions stating the day and time when royalty payments are due or terms specifying the suppliers from which the franchisee must purchase, to the vague and open-ended, such as clauses that require the franchisee to exert "best efforts" in carrying out the requirements of the contract. While about 18 percent of the agreements give the franchisee the right to terminate the agreement for any reason, only one agreement out of the 89 gives the franchisor the right to terminate without cause.[25] This finding is noteworthy because state franchise termination laws often require a showing of cause in order for the franchisor to terminate—a right that nearly all of the franchisors in the sample are providing in the states that do not regulate franchise contracts. Franchisors could specify a right to at-will termination in these states, but they are not doing so.

The contracts that require cause for termination specify a limited number of reasons that allow the franchisor to terminate the agreement immediately—such as the franchisee filing a bankruptcy petition or being convicted of a felony—and those deficiencies that the franchisee has an opportunity to cure. Failure to adhere to the quality and uniformity standards of the franchise is almost always a default that the franchisee has an opportunity to cure.[26] But after multiple violations of this sort, the contract allows the franchisor to terminate the relationship, which usually triggers a specified set of obligations. These obligations almost always provide for prompt payment of outstanding amounts, return of franchise manuals, and immediate take down of signs and fixtures that associate the outlet with the franchise.

The contracts vary substantially in whether they require payment of contract damages when the franchisor properly terminates the agreement for cause. About 65 percent of contracts contain no provision for damages and, presumably, incorporate the default rule of expectation

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[25] The sole contract that allowed termination for cause is Results! Travel, which has a term of only one year and a franchise fee of just $600.

[26] The contracts do not lay out these quality or uniformity standards. Instead, they use mechanisms such as incorporating the franchise manual by reference and reserving the right for the franchisor to conduct unannounced inspections.

damages. Twelve percent of the contracts expressly state the default rule.[27] The remaining contracts, about 23 percent of them, contain liquidated damages clauses that require a payment to the franchisor if the franchisor properly terminates the contract.[28] The liquidated damages terms usually base damages on the average annual amount of royalty payments in the past two or three years and require the franchisee to pay an amount that multiplies the annual average by a number of years. The number of years ranges from a small number of specified years—perhaps one or two years—to the time remaining under the contract, which, given the long length of some franchise contracts, can be a very high number. Of the 20 contracts that contain liquidated damages provisions, nine of them specify that estimated royalty payments are due for the remaining term of the contract. The remaining eleven contracts specify a temporal range of one to four years with a mean of 2.4 years. The motel and real-estate brokerage franchises make particularly heavy use of liquidated terms; all four of the motels and three of the four real-estate brokerages in the sample have contracts that contain liquidated damage provisions.

The agreements specify the rights and procedures that apply if a franchisee wishes to transfer the outlet and the related process triggered by expiration of the agreement. Almost all of the contracts permit the franchisee to transfer the franchise with the permission of the franchisor, although 76 of the agreements give the franchisor a right of first refusal if the franchisee receives a bona-fide offer for the franchise from a third party. A majority of the contracts—52 out of 89—grant the franchisor an option to purchase the assets of the franchisee upon expiration of the contract (and usually termination). Expiration or termination usually triggers a post-term non-competition clause that prohibits the franchisee from working in related businesses for a specified period of time and within a specified range of the outlet (or in some cases of any outlet in the system). Indeed, almost 89 percent of the contracts in the sample have a post-term non-competition term of some sort. The average length of the restriction is 1.8 years with a standard

[27] The hostility that courts have shown to the lost profits measure of damages does not appear to be dampened by an express incorporation of that rule. For example, in *Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc.*, the Franchise Agreement specified that, in the event of termination, "the Franchisor shall have the right to recover lost future Royalties during any period in which the Franchisee fails to pay such Royalties through and including the remainder of the then current term of this Agreement." 2009 WL 579516 (D. Colo.) (March 4, 2009). The court refused to enforce this provision because the franchisor was unable to demonstrate the costs it would have had to expend in order to earn the lost profits. *Id.* at *7-8.

[28] Some states, such as Minnesota and North Dakota, prohibit the use of liquidated damages in franchise agreements. *See* MINN. ADMIN. RULES § 2860.4400(j).

deviation of 1.1 years.[29] Expiration of the contract often triggers a renewal option for the franchisee. About 80 percent of the contracts require the franchisor to renew the contract if the franchisee meets specified conditions such as being in good standing, updating the franchise outlet as required, and paying the renewal fee.[30]

The contracts also specify certain characteristics of the franchise business model. Some franchises require the franchisee to devote full-time effort to the franchise, a requirement that restricts the ability to act as a passive investor. Thirty-three of the contracts contain this requirement, with some specifying a precise number of hours that the franchisee must spend on-site, while others use an open-ended standard to articulate the obligation to operate the franchise. Over half of the contracts—49 of them—provide the franchisee with an exclusive territory, which the agreements define through a variety of means such as a defined radius or by zip code. These terms specify that the franchisor will not open a competing outlet within that defined territory, although there are occasional exceptions for company-operated outlets.

The franchise agreements typically end by specifying the rules for resolving disputes. Just over half of the franchise contracts in the sample provide for arbitration over litigation in general courts, although almost all of the agreements that opt for arbitration contain an exception that allows the franchisor the right to obtain an injunction if the franchisee violates any trademark rights. The contracts also specify the location of where any litigation or arbitration is to take place, which can sometimes vary based on who files the claim, *e.g.* the forum will be at the election of the party filing the suit. In addition to these choice-of-forum clauses, the contracts also have choice-of-law provisions. These provisions overwhelmingly opt for the law of the franchisor's home state, with about 85 percent of the agreements containing such a clause.

Table 5 presents a simple correlation matrix of some of the variables. The table shows a strong positive association between the presence of liquidated damages clause and the average startup costs of an outlet as well as moderate negative associations between these damage clauses

[29] It is difficult to summarize the scope of the post-term non-competition agreements because the scales vary. Some prohibit competition within a specified range of miles from the outlet that the franchisee operated, some prohibit operating a similar business within the exclusive territory given to the franchisee, and some prohibit competition within the same county as the outlet.

[30] Some states, such as Minnesota, prohibit franchisors from failing to renew an agreement unless there is good cause to terminate or unless the franchisee has been given an opportunity to continue to operate the outlet until the going concern value of the outlet has been recouped, as measured from the date of the decision not to renew the agreement. *See* MINN. ADMIN. RULES § 2860.4400(m).

and the mandatory renewal of agreements and the use of arbitration. As one might expect, there is a negative association between the length of the contract term and the use of mandatory renewal, which are plausible substitutes for the optimal length of the relationship. As the franchisor gains more experience with the franchise model there is a negative association with exclusive territories, an outcome that one might expect of a maturing franchise that may be running out of attractive options for opening outlets.

**[Insert Table 5]**

## II. A MODEL OF CONTRACT DAMAGES IN FRANCHISE AGREEMENTS

### *A. Governance and the Economics of Franchising*

An enduring puzzle in the structure of franchise relationships is the existence of franchisee rents and the queues they create. The right to operate a McDonald's, after accounting for all the franchise fees, royalty rates, the costs of establishing and operating the business, and the next-best opportunity of the franchisee, has been estimated to be worth about $300K to $455K in 1982 dollars.[31] As one might expect, there are long lines to receive what is, in essence, free money: acceptance rates to be a McDonald's franchisee are between 2 and 7.5%.[32] Economists wonder why a franchisor would give away that amount of money instead of making a franchisee pay for the right to receive these supra-competitive rents. Most of the explanations for this phenomenon draw on the incentive benefits that the rents may be able to provide, many of which overlap with the reasons why a firm may choose to franchise a given outlet rather than vertically integrate it into the firm.[33] The literature has identified two mechanisms used in franchise contracts to create these incentive benefits: the right to residual claims on the profits of an individual outlet and the use of self-enforcing contracts that generate rents for franchisees,

[31] *See* Patrick J. Kaufman & Francine LaFontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J. OF LAW & ECON. 417, 420 (1994). In 2008 dollars, the range is from $661K to $1.00M. Kaufman and LaFontaine estimate the rents by using a net present value approach and verify the results by looking at the prices at which existing franchise outlets have been transferred.

[32] *See id.* at 418 (citing Barbra Marsh, *Going for the Golden Arches*, Wall St. J., May 1, 1989, at B1; D.L. Noren, *The Economics of the Golden Arches*, 34 AMER. ECONOMIST 60 (1990)).

[33] Two other explanations for franchising that have been critiqued by the literature. First, some have argued that franchising can be an effective mechanism for funding growth of a business. Cite. Others are skeptical of this view because they believe that the return on investment demanded by franchisees would be greater than obtaining the resources to fund growth from capital markets. Cite. Second, others have claimed that franchising has a signaling function by indentifying those who are strong operational managers and have knowledge of local business conditions. Cite.

which they will lose if the franchisor terminates the contract.[34] By giving franchisees a right to the residual profits in an outlet, franchisors provide motivation for franchisees to expend a level of effort in operating the outlet that might be difficult to do via a salary, particularly if the amount of this effort is difficult to observe. But these residual claim rights are not an entirely satisfactory explanation because franchisors could still charge large upfront fees to capture the rents, while maintaining the residual claim structure to incentivize franchisees to exert effort. Moreover, these rights are relatively uninteresting from the legal side of contract theory because the contract terms that create and address these rights, such as the amount of the upfront franchise fee, the structure of the ongoing royalty fee, and the creation of audit rights, are straightforward to interpret and enforce.[35]

The self-enforcing theory of the franchise contract, on the other hand, has more analytical traction and it implicates several issues that have been analyzed intensely by contract theorists. The very need to create a contract that enforces itself through a combination of rent creation and the threat of termination is, in part, a consequence of the inability to draft a complete contract. If a contract could specify the obligations of both parties with precision and could be enforced costlessly, there would be no need to worry about shirking by the franchisee because the contract could accommodate this concern. But specifying this level of detail is neither practical nor cost-justified and, as a consequence, these contracts contain large gaps. Unless parties can devise mechanisms that effectively address this contractual risk, the ability to act opportunistically provided by these gaps could eclipse the gains from entering into the contract.[36] In the franchise context, the gaps in the contracts arise from the difficulty of specifying the types and levels of effort that the franchisee needs to expend. These interstices can allow the franchisee to act opportunistically by shirking on the effort required to maintain the quality and uniformity standards that the franchisor desires—behavior that benefits the franchisee because it increases profitability by lowering costs and allows the franchisee to externalize the diminution in the

[34] *See* Paul Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J. OF L. & ECON. 223-33 (1978) (identifying the importance of residual claims in franchising). The development of the self-enforcement framework in the franchise context is most closely associated with Benjamin Klein. *See* Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. OF CORP. FIN. 9-37 (1995) (developing a model that explains the self-enforcement of contracts through a combination of rent creation and the threat of termination).

[35] There are, of course, interesting economic issues related to the residual claim rights. Cite LaFontaine literature review.

[36] In the conventional story of incomplete contracting, the contractual risk created by the threat of

value of the brand, which is largely borne by the franchisor and other franchisees.

Klein argues that franchisors use rents as a self-enforcement mechanism to counteract the incentive to free ride on brand capital that contractual gaps create.[37] The threat of termination, and the associated loss of the rents, give the franchisor motivation to avoid shirking. Klein observes that franchise agreements can create these self-enforcing mechanisms both by including terms that create or increase rents and through terms require that minimize the ability of the franchisor to shirk. He provides the example of a grant of an exclusive territory with clearly defined borders as a contract term that creates rents for a franchisee. This right gives franchisees an incentive to exert effort to develop business in their territories with an assurance that the franchisor is not going to appropriate those rents in the future by opening additional outlets. As an example of the terms that minimize the opportunities to shirk he includes minimum levels of required expenditures on marketing budgets.

Klein uses a simple model to describe this self-enforcement mechanism. He defines the expected gain that a franchisor can receive from shirking on compliance as $W^1$ and the present value of the rent that franchisee earns as $W^2$. A contract is self-enforcing when $W_t^2 > W_t^1$ for every period *t*. $W^2$ should include the rents expected not just over the term of the contract, but also over the term of the relationship between the franchisee and the franchisor. Klein categorizes contract terms into those that affect the value of $W^1$ and those that affect the value of $W^2$. In addition to terms like mandatory spending on local advertising, Klein places requirements such as minimum staffing levels and the purchase of inputs from specified suppliers in the former category. In the latter category, he includes terms and mechanisms such as the use of exclusive territories, the potential for expansion of the number of units owned by the franchisee, and mandatory contract renewal. Klein argues that contractual incompleteness assures that $W^1$ will not equal zero, so franchise contracts must create some degree amount of rent to be self-enforcing. But franchisors are limited in the amount of rent they can credibly commit to because the possibility of vertical integration suggests that, at some point, the rents will be large enough to overcome the relative governance benefits associated with franchising.[38]

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opportunism can lead to vertical integration. *See* Williamson.

[37] Klein 1995.

[38] As Klein discusses, the use of franchising implies that the profitability of that model is larger than the integrated model or $\Pi^F - \Pi^I > 0$. Accordingly, the prospect of using rents as a means to enforce the contract is

This model of self-enforcing contracts struggles, however, to explain some of the observed content of franchise agreements. As Klein notes, one should expect to see at-will termination provisions because the ability to terminate the contract at little expense enhances the credibility of this threat and should, consequently, minimize the amount of supra-competitive rents that the franchisee must pay.[39] But as the review of the contracts in the previous section shows, almost all of the contracts studied in this sample require a showing of cause to terminate the agreement. For deficiencies related to shirking, such as cleanliness problems or deviations from franchise uniformity standards, the contracts typically give the franchisee time to cure the deficiency and the franchisor can only terminate after multiple defaults. Using this approach has the potential to increase the cost of terminating the contract dramatically because it can be difficult to show the violation of the quality and uniformity standards of a franchise. This additional cost is readily apparent to franchisors—as an in-house counsel for Hardee's has explained: "It is easy to prove in court whether a franchisee has paid or not. It is really hard, though, to make an operational default stick. They might be making $700,000 per year so a judge will often not buy the argument that the operation is failing."[40] The Chief Operating Officer of Jack in the Box put the matter more starkly: "You need a dead rat in the kitchen, and preferably three or four, if you want a chance at winning."[41]

This prevailing structure of franchise contracts poses two related questions. First, why do franchisors commit themselves to an expensive and uncertain termination procedure when the theory suggests that at-will termination is vitally important to their ability to minimize shirking?[42] Second, given that franchisors seem to have given up a useful tool for ensuring compliance franchise standards, what mechanisms do they use to minimize shirking? The

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only credible if $W^2 < \sum_t^{\infty} \frac{\Pi_t^F - \Pi_t^I}{(1+r)^t}$.

[39] *See* Klein, *supra* note ___, at __. Blair and LaFontaine explain the primacy of termination in the self-enforcement model when, in the course of discussing franchisee opportunism, they state that "termination and non-renewal rights are central to the concept of self-enforcement. While other punishments are surely available and used by franchisors, ultimately it is the threat of termination that prevents franchisees from engaging in behavior that the franchisor does not approve of." ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 269 (2005).

[40] JEFFREY L. BRADACH, FRANCHISE ORGANIZATIONS 35 (1988).

[41] *Id.*

[42] Even in states that permit franchisors to use at-will termination provisions, it may be difficult for franchisors to terminate a contract without substantial litigation because the requirement that parties to a contract deal in good faith may allow a terminated franchisee to initiate a credible lawsuit.

remainder of this paper focuses on the second question because there is variation that permits empirical evaluation of the relevant variables, but some brief thoughts on the first question are appropriate because they implicate a continuing debate in the economics of franchise contracts and the issue provides some guidance for how to think about other mechanisms governance.

An appealing explanation for the almost universal absence of at-will termination is as a guard against potential opportunism by the franchisor rather than the franchisee. After an agreement has been signed, the franchisee must make substantial specific investments before the outlet is ready for operation. If the agreement were terminable at-will, franchisees may fear that franchisors would use this threat to extract concessions or as a response to any complaints by the franchisee. Or franchisees may worry that, if their outlet turns out to be particularly successful, the franchisor will terminate the contract and vertically integrate it.[43] Some theorists have not been convinced that these fears play a role in the franchise relationship. Mathewson and Winter argue that this sort of opportunism may be a problem for new franchises that cannot rely on their reputations, but should not be an issue for established franchises who would not want to risk reputational harm by terminating opportunistically.[44] While reputation surely plays some role in preventing franchisors from acting opportunistically the reputation constraint relies on the availability of reliable information. Nearly all franchisors of substantial size have groups of dissatisfied franchisees who are vocal about their displeasure. The claims by these groups rely on gossip and innuendo and a potential franchisee could reasonably conclude that the quality of the negative information is not very good. Given this noisy signal, it may be the case that the marginal franchisee prefers the contractual assurance that the franchisor will not be able to act opportunistically. Klein and Saft contend that the costs of vertical integration may also protect against franchisor opportunism.[45] While these costs may inhibit widespread termination to take over successful locations, they may not stop franchisors from acting opportunistically to terminate the agreements of particularly profitable outlets. To the degree that the chance of

[43] The theory here is that the extra revenue from the desirable location is larger than the increased sales that come from the franchise model. This rationale has frequently been cited as a reason for state-level franchise statutes that require cause for termination. For evidence that these laws have done more harm than good *see* Klick, Kobayashi & Ribstein (unpublished).

[44] *See* G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J. OF LAW & ECON. 506 (1985).

[45] Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28, J. OF LAW & ECON. 345 (1985).

opening a very lucrative outlet drives the decision to become a franchisee, the marginal franchisee may care quite a lot about the protection that a written promise to only terminate for cause provides.[46]

An important point to take away from the widespread use of for-cause provisions is what they imply about how potential franchisees react to contract terms. While franchise agreements are sometimes portrayed as one-sided contracts that accommodate the franchisors concerns, a more accurate model incorporates the effect of the contract terms on the ability to recruit franchisees. This dynamic is particularly strong in light of the uniform nature of these contracts; the content of each provision implicates a tradeoff between the governance benefit that the term provides and the effect that the term will have on the ability to attract franchisees to the system. As Richard Epstein has put it, in standard form contracts that are used to govern recurrent transactions "[f]ine-tuning in drafting is the order of the day."[47] This outlook is helpful to understanding the enforcement mechanisms that the franchise agreements use to guard against shirking because it emphasizes that a franchise agreement, at least to some degree, must address the moral hazard concerns of both the franchisor and the franchisee.

### *B. Legal and Relational Governance: Damages versus Rents*

Meeting the cause standard in order to terminate a contract is a difficult and expensive proposition, which the self-enforcement model suggests will give franchisors substantial latitude to shirk. Put in terms of the model, the cause requirement can be expected to increase the value of $W^1$ because franchisors will know that that any threat to terminate entails uncertainty and expense and hence may not be credible. If $W^1$ is large, the self-enforcement mechanism would require even larger rents to operate effectively. But to the degree that providing these rents is costly to franchisors, one would expect them to try and find ways to minimize the amount of rents they have to generate in order to prevent franchisee shirking. One alternative would be to include contract damages that a franchisee must pay the franchisor upon termination for cause.

[46] Though not necessary for this effect to be influential, over-optimism may play a role here. Though all franchisors are careful to emphasize that no results can be guaranteed, some franchisors and franchise agents stress emphasize the earnings of the most successful franchisees in their disclosure and marketing materials. This earning potential may lead more franchisees to believe that they will wind up in the highest group of earners than is warranted much like most newlyweds believe they will not get divorced and most new employees believe they will not get fired or laid off. *See* Sean Williams piece on optimism bias.

[47] Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEG. ST. 105, 109 (1989).

These damages should decrease the amount of rent that is necessary to prevent shirking because the threat of paying these damages should diminish the latitude that the expense associated with terminating a franchise for cause may provide. Put in terms of the simple self-enforcement model, the expected level of damages, $D$, should decrease the right hand side of the equation: $W^2 > W^1 - D$. Hence, these two mechanisms should be, to some extent, substitutes. The remainder of this section discusses the costs and benefits that are specific to damages and rents and then discusses some issues implicated in the choosing among these options.

1. Damages

If franchisors want to use damages to deter shirking, they have a choice between the default standard of expectation damages or they can stipulate a precise amount through a liquidated damages clause. There are very strong reasons to believe that—if franchisors are serious about using damages as a credible threat to govern franchisee behavior—they will opt for liquidated damages rather than expectation damages.[48] The expectation measure can be relatively simple to administer and enforce in situations where it only requires observation of the contract price and the market price, such as a buyer's breach in the sale of fungible goods.[49] But in the context of franchising, the expectation measure poses a much more onerous evidentiary burden because it is difficult to discern the profits that the franchisor would have made had the contract been performed. Most franchise agreements have a fixed term, so the damage calculus would attempt to estimate the royalty payments that the franchisor would have received through the duration of the contract minus the costs that would be necessary to generate those profits and less any appropriate mitigation, such as finding a replacement franchisee.[50] Establishing these figures in court can be expensive because it will often require dueling experts and, even after all

[48] Practitioners writing on the subject appear to take a dim view of franchisors that wish to recover lost profits, yet rely on imprecise specifications of their desired remedy. *See* Ebe, et al., *supra* note __ at 11 ("Franchisors that seek [lost profits] yet nonetheless persist, for whatever reason, in relying upon ambiguous language as to the remedy they want reduce the likelihood of achieving their goals.").

[49] Richard Epstein pointed out the ramifications of this mismatch between the appropriateness of the expectation measure when a buyer breaches and when a seller breaches. In the case of buyer's breach, he argues that the expectation measure—the difference between the contract price and the market price—is necessary to promote efficiency, but in the case of seller's breach, the expectation measure—insofar as it includes foreseeable consequential damages—can inflate the costs of contractual failure. Epstein shows that parties can and do opt out of the expectation rule for breach by the seller with alarming frequency. *See* Epstein, *supra* note __ at 113-21.

[50] The damages might also compensate the franchisor for the deficient performance of the franchisee by calculating the difference between the actual royalty payments prior to termination and the royalty payments that the franchisor would have received had the franchisee devoted appropriate effort.

this effort, franchisors face hostility from courts when making lost profits claims. One obstacle is the certainty rule, which denies recovery when damage claims are unreasonably speculative.[51] Indeed, courts often reject claims by franchisors for expectation damages because the franchisors have not been able to show the amount of lost profits with sufficient precision.[52] Other cases have rejected franchisor claims for lost profits as exploitative and unconscionable.[53]

Threats to impose liquidated damages, in contrast, are more credible for two principal reasons. First, this measure poses little marginal cost. Once a franchisor has shown a permissible reason to terminate for cause, the imposition of liquidated damages is a straightforward application of the amount listed in the contract.[54] The expense of enforcing this type of provision pales in comparison to the evidentiary showing that would be necessary to establish damages under the expectation measure.[55] Second, courts have shown much more willingness to enforce liquidated damage terms in franchise contracts relative to expectation damages provisions and have identified the ease of application and the clarity of these terms as

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[51] *See* RESTATEMENT (SECOND) OF CONTRACTS § 352 ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."); *cf.* Saul Levmore, *Stipulated Damages, Super-Strict Liability, and Mitigation*, 107 MICH. L. REV. 1365, 1371-76 (2009) (arguing that the certainty rule promotes the stipulation of damages and that stipulation can encourage parties to bundle their private knowledge of potential damages and the savings from avoiding litigation over mitigation strategies into a specified amount of damages in the contract).

[52] *See Rocky Mountain supra* note __; *Meineke Car Centers, Inc. v. RLB Holdings, LLC*, 2009 WL 2461953 at *4-7(W.D.N.C. August 10, 2009) (rejecting a lost profits claim on lack of certainty grounds and noting that the court had twice rejected similar claims by Meineke in the previous two years); *Environmental Biotech, Inc. v. Sibbitt Enterprises, Inc.*, 2008 WL 5070251 (M.D. Fla. 2008) (rejecting a lost profits claim for failure to present sufficiently certain evidence). Awarding lost profits to a franchisor in the absence of a liquidated damages provision does happen on rare occasions. *See Burger King v. Barnes*, 1 F. Supp. 2d 1367 (S.D. Fla. 1998). The judge who decided *Barnes*, however, subsequently denied a franchisor's lost profits claim on the basis of a failure to plead the defense of anticipatory repudiation. *See Burger King v. Hinton, Inc.* 203 F. Supp. 2d 1357 (S.D. Fla. 2002). *See also* Robert M. Einhorn, *Case Note: Burger King v. Hinton: Are Lost Future Profits Disappearing?*, 22 FRAN. L. J. 159 (2003) (noting that "*Hinton*'s legal ramifications are likely to be far reaching, because it so sharply limits *Barnes*").

[53] The leading case in this vein is *Postal Instant Press, Inc. v. Sealy*, 43 Cal.App.4th 1704 (1996). The case involved breach of a franchise contract by the franchisee and claim for lost profits by the franchisor on the basis of a term in the agreement that entitled the franchisor to the "benefit of the bargain" in the event of a material breach. The court rejected the claim, *inter alia*, because such an award would render the agreement an "unconscionable and oppressive contract." *Id.* at 1718.

[54] Most of the liquidated damages provisions in franchise contracts state that a figure that is based on the average annual royalties paid in the over the previous years. Enforcing this type of term in court would require evidence of the prior royalties paid, but this showing would presumably be relatively straightforward.

[55] Epstein makes this point in disputing the wisdom of the default rule for consequential damages in the context of breach by the seller. Where enormous liabilities can turn on the interpretation of standard, such as the consequential damages default, the associated litigation costs can scale with the liabilities. Consequently, one should expect to observe liquidated damage terms in this situation because they can dramatically decrease the

reasons that favor their enforcement.[56] And, even when courts find that a liquidated damages term requires a franchisee to pay an unacceptable amount of money, they appear to reduce the level of damages to an acceptable level rather than bar any amount of damages, as happens with the application of the certainty rule to claims for expectation damages.[57] The combination of these effects strongly suggests that if franchisors want to use contract damages to counteract the potential gains from shirking—and as a means of minimizing the rents that help to prevent that shirking—they will use liquidated damages rather than rely on the default rule.

There are, however, reasons why franchisors may decline to include liquidated damages terms despite the governance advantages they provide. Just as there may be potential franchisees who dislike at-will termination clauses, liquidated damages terms may make it more difficult to recruit franchisees. For example, those potential franchisees who are particularly risk averse may shy away from franchisors that include liquidated damages clauses because they fear that a failed venture plus a damages judgment would be too large a loss to sustain. There may be another complication because liquidated damages may not be all that effective as deterrent to shirking if the franchisees are judgment proof. When franchisees are deficient in their payments to franchisors and do not have the resources to even pay the amounts owing, the further threat of liquidated damages is of little consequence as a deterrent. The bevy of default judgments that against franchisees who fail to show up to court attests to these difficulties.[58]

2. Rents

Given the potential downsides of using liquidated damages, franchises may find it more cost-effective to govern franchisees by providing rents and threatening to take them away. This

expected litigation costs. *See* Epstein, *supra* note __ at 117-18.

[56] Courts enforce these liquidated damage provisions. *See, e.g., Days Inn Worldwide, Inc. v. BFC Management, Inc. v. BFC Management, Inc.*, 544 F.Supp.2d 401, 406-07 (D.N.J. 2008) (enforcing a liquidated damages provision and noting that the clause is appropriate because actual damages would be difficult to assess); *see also Radisson Hotels Intern., Inc. v. Majestic Towers, Inc.*, 488 F.Supp.2d 953, 962-63 (C.D.Cal. 2007) (enforcing a liquidated damages term in a hotel franchise agreement and expressly distinguishing *Sealy* based on the distinction between the uncertain term at issue in that case and the precise liquidated damages term in the hotel contract).

[57] *See Guesthouse Intern. Franchise Systems, Inc. v. British American Properties MacArthur Inn, LLC*, 2009 WL 278214 (M.D. Tenn. February 5, 2009) at *9-10 (finding a liquidated damages provision that required the franchisee to pay the fixed fees for the remaining term of the contract valid, but severing the portion that that allowed the franchisor to round up the liquidated damages to a full calendar year for the year of termination, *i.e.*, though there were only about six and one-third years remaining on the contract, the liquidated damages provision allowed the franchisor to collect seven years of payments—the court found this rounding up to be impermissible and only allowed damages for the approximately six and one-third years remaining on the contract).

is an approach suggested by the modern contract scholarship that examines the problems that arise when parties can easily observe contract performance, but the verification of that behavior is costly.[59] This is a plausible depiction of the principal-agent problem in franchising—franchisors may be able to observe shirking with relative ease, but it may be difficult for them to do the verification that would be necessary to terminate the contract for cause. If franchisors are able to punish those franchisees who they observe shirking through extra-legal means that do not require verification,[60] they may prefer these mechanisms if they turn out to be more cost-effective than the expense that comes with using liquidated damages as a governance mechanism.

Using rents to govern franchisees can take the form of either offering future rewards or threatening future punishments. One prominent reward is permission to open an additional outlet, which can substantially increase the earnings of a franchisee. Qualitative studies of franchisors suggest that this mechanism may be among the most important tools available to police franchisee behavior. A history of McDonald's discusses Ray Kroc's early recognition of the this mechanism and explains: "By retaining the right to determine whether a franchisee is to be granted a license to operate a second store and then another, McDonald's also retained the only carrot it could use to motivate a franchisee to follow the system's rules on quality, service, cleanliness, and value."[61] A franchise consultant to Hardee's echoes this sentiment: "Growth is the real lever of control we have. Two of the franchisees I have [of eight] are not qualified to grow until they resolve some outstanding issues."[62] The promise of this reward functions as a rent—as long as the net present value of the income from additional potential outlets is larger than the gain from shirking, franchisees should invest the desired effort. [63] Franchisors can also

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[58] Cite cases.

[59] Cite Hart and Moore.

[60] By extra-legal I mean governance mechanisms that do not require the enforcement, or the threat of enforcement, of the written contract between the two parties.

[61] JOHN F. LOVE, MCDONALD'S: BEHIND THE ARCHES 61 (1986).

[62] JEFFREY L. BRADACH, FRANCHISE ORGANIZATIONS 79 (1988).

[63] Academics have viewed the model of multi-unit ownership with some suspicion because it is difficult to understand how it provides an advantage over single outlet ownership. If franchising is appealing because it improves the incentives to exert effort, why would the separation of ownership and control for the franchisor who owns multiple units be more desirable than achieving this separation through vertical integration, particularly when this format dilutes the earnings stream because it must be divided among the franchisor, the multi-unit owning franchisee, and the manager that operates an outlet. *See* Arturs Kalnins & Francine La Fontaine, *Multi-Unit Ownership in Franchising: Evidence from the Fast-Food Industry in Texas*, 35 RAND J. OF ECON. 747, 748-49 (2004) (surveying the academic suspicions of multi-unit franchising). But if multiple-unit ownership economizes on governance costs, these benefits may outweigh the costs that come with incentive and earnings dilution.

take away existing rents as a punishment for shirking. For example, when franchises do not provide exclusive territories, the threat of opening a nearby outlet can provide powerful motivation for a franchisee. In these situations the expected future rent that comes from the lack of proximate competition serves as the enticement for refraining from shirking.

Using rents to govern behavior can be a more credible threat than damages because some rents do not require the franchisor to pay verification costs to take rewards away or to deliver punishments. Both the reward of additional outlets and the punishment of nearby competition fit this model—neither requires resort to contractual rights to be implemented. But franchisors may also rely on rents that require termination of the contract to take them away. These types of rents have usually been fixed at the time of contracting and are difficult to alter until the contract comes up for renewal. Exclusive territories are an example of this type of rent—giving this right to a franchisee provides a guarantee that the franchisor will not be able to add outlets or impose additional fees if the amount of business in the territory grows. But taking away this rent would be an expensive proposition for the franchisor because it would require formal termination of the contract. Given that these contracts require cause to terminate, the necessary verification costs could be substantial. This approach seems to involve the expensive costs associated with damages and none of the economizing benefits of relational governance. One should, accordingly, tend only to observe this strategy where there is a high cost of providing rents that do not require verification and damages are unlikely to be effective, *i.e.* franchisees tend to be judgment proof.

3. Damages versus Rents

Whether franchisors use damages or rents should depend on the relative effectiveness of these two strategies and the costs of supplying each mechanism. If rents can be supplied at low cost, franchisors should prefer them because they can economize on verification costs and do not face the problem of ineffectiveness due to judgment-proof franchisees. But rents will not always be cheap and, because they require franchisors to give up revenue, damages may sometimes be the least-expensive governance mechanism. Section III.A uses an analytical model to examine these tradeoffs, but it is worth addressing two theoretical issues that pertain to this choice before proceeding to the model. The first addresses the role of specific assets and the second involves a contrast of high and low externality industries.

Franchises that do not require franchisees to invest in a high amount of specific assets face a unique problem in choosing between contract damages and relational governance.[64] This is a common difficulty when the relationship limits the franchisor's obligations to providing marketing services. In the hotel and motel industry, for example, the franchisees typically own the real estate and are responsible for the management of the property.[65] The franchisor's tasks in these situations are generally limited to promoting the brand and providing a reservation system that sends customers to the franchisee. This structure makes it relatively simple for the franchisee to switch to another franchisor—a practice known in the industry as reflagging—because most of the assets owned by the franchisee can be easily redeployed to another franchise system.[66] Real estate franchises are similar; the franchisor mostly provides marketing and branding services, which allows the agent to switch franchises quite easily. Contrast this situation to the fast food context where franchisees must make substantial specific investments in fixtures and equipment that cannot be easily redeployed in another system.

For those franchises that do not require substantial specific investments, the appeal of using rents to govern behavior will be diminished because the threat of withdrawing the rent will be limited by the ability of the franchisee to defect to another system.[67] Take, for example, the possibility of punishing franchisees that shirk by opening nearby outlets. If a franchisee can jump to another franchise at little cost, the threat of a nearby outlet may not be effective because it will not cause that large a loss in future revenue. The possibility of cheap exit should limit the overall effectiveness of rent as a governance mechanism and may leave liquidated damages as the only effective alternative. Indeed, one study of real estate brokerages shows that franchised outlets are no more profitable than individual outlets, which suggests that the franchisors are not supplying rents. This evidence is consistent with the data here, which prevalent use of liquidated

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[64] Asset specificity is the concept that an asset may have more value within a particular relationship than outside of that relationship. Use of highly specific assets is pervasive in franchising. Take, for example, a statute of Colonel Sanders. Within a KFC franchise relationship this item maybe an effective marketing tool, but once the relationship has ended, it is a worthless piece of kitsch. Some franchise assets, however, may be more fungible; the beds for a hotel room are roughly as valuable outside a franchise relationship as they are within one.

[65] Cite hotel trade press.

[66] Cite trade press articles on the advantages and disadvantages of reflagging.

[67] Indeed, one study of residential real estate brokerages argues that franchisors are able to extract the rents from their franchisees based on evidence that there is no difference in net profitability between franchised and freestanding brokerages. *See* John D. Benjamin, Peter Chinloy, G. Donald Jud, and Daniel T. Winkler, *Franchising in Residential Brokerage*, 28 J. OF REAL ESTATE RES. 61 (2006).

damages provisions in real estate franchise contracts.[68]

An additional theoretical point relates to the literature that has tied the amount of repeat business that an outlet receives to the incentive that franchisees have to externalize the costs of shirking. Cleaning and hair-cutting franchises, for example, may not be able to externalize the cost of shirking because these businesses rely on repeat clientele—if these businesses skimp on maintaining quality they will be at substantial risk of decreased profitability. Other businesses, like fast food outlets and roadside motels, tend to rely more transient customers who are unlikely to return to an individual outlet. This feature may allow franchisees in these sectors to do more relative shirking because they will not lose much future business as a consequence. Brickley has collected data on this facet of franchising and groups sectors into low-externality franchises and high-externality franchises on the basis of these results.[69] This ability to externalize costs has straightforward implications for the self-enforcement model—franchisees who can more easily externalize the costs of shirking have a stronger incentive to withhold effort than those franchisees who rely on repeat business. [70]

The potential for increased gains in high-externality industries suggests that the rents provided by franchisors need to be higher for the self-enforcement mechanism to work. But this increased incentive to shirk should not have not necessarily have a strong effect on the relative propensity to use liquidated damages because the choice to use this mechanism depends on how it compares to other potential means of governance. If a franchisor has concerns about externality issues and there are cheap rents available to address this problem, there is little reason to observe the use of liquidated damages. At most, externality problems should affect the use of liquidated damages by creating governance problems that otherwise would not exist. Imagine a hypothetical firm that rapidly transitions from low-externality conditions to high-externality conditions, with all other variables remaining the same. If, prior to this shift, the franchisees had little to gain from shirking, the firm would have to assess the relative merits of the mechanisms

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[68] *See supra*, Sec. I.B.

[69] *See* James A. Brickley, *Incentive Conflicts and Contractual Restraints: Evidence from Franchising*, 42 J. OF L. & ECON. 745, 748-50 (1999) (explaining the hypothesis that the ability to externalize costs will generate more shirking and should result in the use of prohibitions on passive ownership, the use of area development plans, and mandatory advertising expenditures).

[70] There can, of course, be substantial variation in the ability to externalize within any given franchise system. Brickley uses the example of a fast-food restaurant that that is near a large factory and whose clientele is made up largely factory employees. *See id.* at 755.

that could address this new governance challenge. In this situation one might observe a decision to use liquidated damages, but that is only because the externality issue created a new problem that had to be addressed—this problem would not, however, convert liquidated damages into a more effective means of governance relative to other alternatives that address rents and the incentives to shirk.

## III. EMPIRICAL EVIDENCE OF THE RELATIONSHIP BETWEEN RENTS AND DAMAGES

This section uses the theory developed in Section II to construct a model of the choice whether to include liquidated damages in a franchise agreement that can be estimated through a linear probability model. The model, combined with assumptions about how certain variables interact with rents, generates hypotheses about the likely signs of the independent variables in the regressions. The section ends with the regression results and a discussion of those results.

### *A. A Model of the Choice to Control Shirking*

The Klein model, even with the incorporation of damages into it, looks only at the decision faced by the franchisee. This section expands that model to take into account the factors that affect the franchisee's incentive to shirk vis-à-vis the franchisor's costs of altering the franchisee's decision calculus. The model takes the form of a simple game between a franchisor and a franchisee where the payoffs depend on whether the franchisee invests effort and the costs of inducing that effort. Let $\pi$ be the franchisor's profit and $R$ be the franchisee's profit.[71] The model assumes that a franchisee has a choice between investing effort or not investing effort and that $c$ is the cost of that effort. Let $v$ be the harm to the franchisor that results from the franchisee's failure to invest effort. The franchisor has two potential governance mechanisms: extra-compensatory rents and contract damages. The rent allows the franchisor to grant a benefit, $B_e$, to the franchisee at a cost of $B_r$.[72] These costs and benefits are determined by exogenous factors such as demand for the franchise's product. The contract damages mechanism provides a damage term, $D$, that will be transferred from the franchisee to the franchisor if the franchisee breaches by failing to invest effort.

In a first-best world without monitoring or enforcement costs, it is straightforward to

[71] The model assumes that the franchisor drafts the contract and has all the bargaining power.

[72] The potential for $B_e$ and $B_r$ to differ captures the dynamic that some rents can be inexpensive to supply, yet can provide large benefits to franchisees. An example here would be the award of an additional outlet, which will be cheap to supply for a growing franchisor, but will provide large rewards to franchisees. This approach differs from the simple rent model, where there is a one-to-one correspondence between the rent provided and the revenue lost.

show that the franchisor will use the damages mechanism rather than rents. Under the rent mechanism the franchisee's payoff from not investing effort is $R$ and the franchisor's payoff is $\pi - v$. If the franchisee does invest in effort under the rent approach the payoff is $R - c + B_e$ and the payoff for the franchisor is $\pi - B_r$. The franchisee will invest effort as long as $B_e \geq c$ and the franchisor will want to provide this incentive as long as $B_r > v$. Under the damages mechanism, the payoff for the franchisee who does not invest effort is $R - D$ and the payoff to the franchisor in this situation is $\pi - v + D$. The franchisee's payoff if it does invest effort is $R - c$ and the franchisor's payoff is $\pi$. The franchisor will always choose damages under first-best conditions because as long as $D$ is set at a level that is greater than c, the franchisee will invest effort, leaving the franchisor with profit of $\pi$. Under the rent mechanism the franchisor's profit will either be $\pi - v$ if the franchisee does not invest effort or $\pi - B_r$ if the franchisee does invest effort; as long as $v$ and $B_r$ are both greater than zero, the franchisor will prefer the damages mechanism.

But the assumption of costless enforcement is not realistic, so a model that accounts for the impediments to the use of damages would include the cost of verifying the franchisee's lack of effort to a court and the potential upper bound on damage awards due to franchisees being judgment proof or due to the unwillingness of courts to enforce damage awards that they consider to be penalties. The verification cost can be accounted for with a constant $\varphi$, which the franchisor must pay in order to receive damages from the franchisee. The potential upper bound on damages will mean that $D \leq \overline{D}$. Under the rent mechanism, which does not require verification, the decision calculus remains the same as the first-best world—the franchisee will invest in effort as long as $B_e \geq c$, which leaves the franchisor with a payoff of $\pi - B_r$. But verification alters the structure of the damages mechanism by changing the payoffs and adding an additional decision node. If the franchisee fails to invest effort, the franchisee must decide whether to pursue damages at cost $\varphi$. The payoff if the franchisor does pursue damages is $\pi - v - \varphi + D$ and is $\pi - v$ if the franchisor foregoes damages. As long as the franchisor can set damages at a level that exceeds both $\varphi$ and $c$, the franchisor will use damages and enjoy profits of $\pi$ because there is a credible threat of damages that will cause the franchisee to invest effort. The damage level must be higher than $\varphi$ for the franchisor to be able to credibly threaten termination and the damage level must be higher than c in order to induce franchisee effort.

If, however, the constraint on damages means that $D$ is less than either $\varphi$ or $c$, the franchisor will not be able to use damages to motivate franchisee effort. Using rents may be the only option to prevent shirking in this situation and the franchisor should be expected to use this approach when $B_e \geq c$ and $B_r > v$.[73] This model that incorporates the constraint on damages and the cost of verification can be used to make several predictions about the relative appeal of the rent mechanism and the damages mechanism:

1. Where franchisees are likely to be judgment-proof, one should observe less frequent use of damages.
2. Where the cost of verification is high or entails significant uncertainty, one should observe less frequent use of damages.
3. Where the cost of supplying benefits or imposing a punishment without verification is inexpensive for the franchisor one should observe less frequent use of damages.

To isolate these effects I estimate a linear probability model.[74] The most inclusive regression models take the following form:

$$Y_f = X_f\beta_1 + W_f\beta_2 + Z_f\beta_3 + \varepsilon_f$$

where $Y_f$ indicates whether the contract for franchisor *f* contains a liquidated damages term, the $X_f$ term contains external variables for franchisor *f*, $W_f$ term contains business model variables for franchisor *f*, $Z_f$ term contains contract variables for franchisor *f*, and $\varepsilon_f$ is an error term for franchisor *f*.

The external variables include those factors that are not specified in the contract such as the natural log of the average startup costs, the growth in franchised outlets from 2004 to 2006, and the number of years the franchisor has been franchising. The business model variables code the structural features of the franchise that are specified in the contract such as the "must operate"

[73] It would, of course, be possible to use both the option mechanism and damage mechanism at the same time. If, however, the damage mechanism imposes some cost to the franchisor, such as making it difficult to recruit franchisees, and if the option mechanism alone can induce franchisee effort, one should not expect to observe both the damage mechanism and the option mechanism.

[74] A linear probability model provides coefficient estimates that are easier to interpret than probit and logit models, but have the drawback of predicting the likelihood of an event with a negative probability or with a probability greater than one. *See* Angus Deaton, *The Analysis of Household Surveys* 85-92 (1998) (stating that limited dependent variable models such as probit and logit are often "artificial and unnecessarily elaborate"). Unreported probit models provide estimates of marginal effects that are similar, and in some cases larger than, the coefficients in the linear probability models and the estimates of the probit marginal effects are nearly identical in their statistical significance to the corresponding estimates in the linear probability models.

requirement and whether the franchise uses exclusive territories. The contract variables include rights and remedies provided under the contract such as the length of the term, mandatory renewal and whether the contract gives the franchisor the option to purchase franchise-related assets from the franchisee upon termination or expiration of the contract.

### *B. Expected Signs of the Coefficients*

1. External Variables

*Log of Startup Costs*. The startup costs should be positively associated with the presence of liquidated damage terms insofar as they are a measure of whether a franchisee is likely to be judgment proof.[75] This prediction assumes that the ability to pay larger startup costs is an indication of relative financial strength and, hence, shows a higher likelihood of being able to satisfy a judgment. Moreover, franchises that involve relatively high startup costs—such as motels, automotive repair shops, and some restaurants—involve significant investment in fixtures and other hard assets that can be attached to satisfy judgments. As franchisees are better able to pay damage awards, the use of damages should be more attractive to franchisors because it allows them to avoid paying rents to induce effort. Conversely, the inability to pay damage awards dilutes the power of this threat to deter and should, consequently, make the use of rents attractive.

The ability to finance startup costs may mute the association between startup costs and the financial strength of the franchisee because the use of debt may mask the relatively weak financial position of the franchisee. But the decision whether to finance is likely to be based on the concerns that mirror the ability to satisfy judgments such as the franchisee's assets and creditworthiness.[76] Financing may also weaken the connection between startup costs and financial strength of the franchisor because lending institutions factor in the strength of a franchise's brand in the decision whether to provide a loan. But if one assumes that brand strength grows with time, the inclusion of years franchising in the equation should control for

[75] The disclosure documents sometimes omit the expected real estate costs associated with a franchise so I back out the real estate costs for all of the franchises for consistency. Taking out these costs presumably biases the coefficients towards zero insofar as ownership of the land or the ability to get financing for the land indicates an ability to satisfy a judgment.

[76] The International Franchising Association claims that lenders typically require franchisees to provide about a third of the total startup capital needed to start a franchise in order to approve a loan. *See* http://www.franchise.org/franchiseesecondary.aspx?id= 10004.

this effect.

*Franchise Outlet Growth Rate for 2004-06*. The growth rate for the number of franchise outlets should be negatively related to the use of liquidated damages. For the lure of an additional outlet to be effective as a means of generating the promise of future rents for franchisees, there must additional outlets available. If a franchise has matured using awards of additional outlets to incentivize franchisees is more difficult because, presumably, the market for outlets is close to saturation. The inability to use this sort of governance mechanism at low cost, all other things being equal, drive franchisors to use alternatives such as liquidated damages. But where franchisees are experiencing growth, the use of this mechanism is particularly attractive because not only does it provide the governance benefit of inducing franchise effort, it economizes on the costs of screening franchisees.[77]

*Years Franchising*. This variable should have a negative relationship with the use of liquidated damages for several reasons. First, as the franchisor gains more experience with franchising one would expect that its ability to monitor franchisee behavior will improve. This enhanced ability to monitor should allow improved use of rents that do not require verification because the ability to detect when franchisees may be shirking, and punishing them for it, should be less expensive. Second, the franchisor may be able to find other ways to punish and reward franchisees as the collection and analysis of information improves. For example, fast food franchises may roll out popular new products to favored franchisees first as an enticement to invest effort. Third, more time in business may increase the franchisor’s ability to use rents as a reward for exerting effort because the value of the brand has increased. A franchise that has just begun operations may not have significant brand capital, which will inhibit the ability of outlets to attract customers on the basis of name alone. With this limited traffic it may be difficult to generate the rents that are necessary to use self-enforcing contracts, but, as the franchise develops this brand capital, it will be easier to develop and use rents as a governance mechanism that can substitute for liquidated damages.

2. Business Model Variables

*Must-Operate Clauses*. It is unclear what effect “must operate” clauses will have on the use of liquidated damages. These clauses will tend to lower the opportunity costs

[77] *See* Bradach, *supra* note __, at ___.

associated with failing to invest effort or, put in terms of the self-enforcement model, these clauses decrease the gain from shirking.[78] The effect is difficult to predict because this decreased incentive to shirk does not say much about the relative benefits of using damages and of using rents. The smaller amount of damages that are necessary to deter shirking in the presence of a "must operate" clause may make this approach appealing, but if a franchisor can already supply rents at low cost, there is little reason to think that a "must operate" clause would promote a shift to damages.

*Exclusive Territories*. Providing franchisees with exclusive territories is likely to have ambiguous effects on the use of liquidated damages because both the presence and absence of exclusive territories allow a franchisor to rely on mechanisms that do not require enforcement of the contract. The use of exclusive territories can function as a carrot because it provides franchisees rents through the guarantee that future business growth in the area will not be appropriated by the franchisor.[79] But absence of exclusive territories also enables relational governance because it allows franchisors to use the threat of opening nearby outlets if a franchisee has been observed shirking. The increased use of rents should be correlated with diminished use of liquidated damages, but the threat of opening additional outlets close to a shirking franchisee—which the use of exclusive territories inhibits—should also be associated with a diminished use of liquidated damages.

To attempt to identify these two effects I use an interaction term in a second set of regressions. The interaction term is the product of a binary variable that equals one if a franchise does not use exclusive territories and zero otherwise and the number of years franchising. This variable should be an indication of a franchisor's ability to use its monitoring experience and expertise to use nearby competition to punish franchisors if the contract permits them to use this mechanism. With this control, both the exclusive territory variable and the interaction effect should be negative because they are both indications of an ability to use relational means to control franchisee behavior.

3. Contract Variables

*Duration of the Contract*. Long contract terms and mandatory renewal of contract terms should have a negative association with the use of liquidated damages. If franchisors

[78] Cite Brickley on passive investment.

provide rents to franchisees to prevent shirking, franchisees should compare the net present value of shirking to the net present value of the future rents when deciding whether to invest effort.[80] Extending the term of an agreement increases the net present value of rents because the franchisee has an assurance that the relationship will endure for a longer amount of time. Likewise, mandatory renewal increases the time frame associated with the relationship and should increase the net present value of expected rents. Including both of these variables in the regressions would be problematic because a longer contract term is a substitute for a shorter-term contract with a mandatory renewal clause, so the variables may not be an accurate measure of the expected length of the relationship. A proper measure would also account for the discounting of rents that are in the future. To capture these two effects I construct a variable that takes the natural log of the sum of the contract term and the interaction of the contract term and the mandatory renewal dummy variable.

*Arbitration Clause*. The effect of an arbitration clause on the use of liquidated damages provisions is not clear. In a study of the use of arbitration in franchise contracts Drahozal and Hylton find that franchisors prefer arbitration not because of the dispute resolution cost savings it may provide, but because it is an effective means of avoiding the overdeterrence that can come with the use of regular courts in high-litigation jurisdictions.[81] The relevant metric in their study is a comparison of the amount and severity of the likely lawsuits that will arise if the parties use regular courts versus those that will arise if the parties use arbitration. Similarly, one should expect arbitration clauses to matter for the use of liquidated damage clauses if courts and arbitrators tend to treat these clauses differently. But there is little reason to believe that this will be the case. As a general matter, courts are receptive to the liquidated damage clauses in franchise agreements and tend to enforce them. Insofar as arbitration is more likely to result in enforcement of the express terms of the contract, this forum should not provide a relative advantage if courts are inclined to enforce these provisions accurately.

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[79] Cite Klein 1995.

[80] *Id.*

[81] *See* Christopher R. Drahozal and Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEG. ST. 549, 580-81 (2003).

## *C. Regression Results*

The regression results provide evidence that franchisors do trade-off the use of rents and contract damages in the manner that the theory suggests. Table 6 reports the OLS estimates of the coefficients under six different specifications that use the presence of a liquidated damages term as the dependent variable. The first three specifications include all of the observations and the last three specifications omit motel and real estate brokerage franchises because the observations in the sample from these industries almost all use liquidated damages provisions. The first and fourth specifications use only the external variables, the second and fifth specifications add in the business model variables, and the third and sixth specifications include several contract terms.[82] For the continuous variables the coefficients can be interpreted as the estimated percentage change in the likelihood of observing a liquidated damages clause for every unit change in the independent variable with all other independent variables held constant. The coefficients on the binary variables can be understood as the estimated percentage change in the likelihood of observing a liquidated damages term with a discrete change in the variable from zero to one with all the other independent variables held constant.

**[Insert Table 6]**

The startup cost variable is statistically significant at the one-percent level in every specification in Table 6. With all the observations the coefficient ranges from .1509 to .1774 and without the motel and real estate franchises, which use liquidated damage clauses at high rates, the range drops to .1278 to .1485. Because the variable is in log form, the coefficient can be interpreted in percentage terms—the model suggests that doubling the average startup cost can be expected to result in about a 13-percent to 18-percent increase in the chance of observing a liquidated damages provision. The consistent significance of this result provides support for the hypothesis that as franchisees become less judgment proof or as the stakes of the relationship

[82] There is a potential endogeneity concern with including the contract variables on the right-hand side of the equation because these variables could be jointly determined with the use of liquidated damages. As a check for endogeneity some researchers have used pairwise bivariate probits with the contract variable of interest and the other binary contract terms as dependent variables and the external variables as independent variables. *See* Drahozal and Hylton, *supra* note __, at __. This approach provides a test of whether the disturbance terms for the two equations are correlated. I performed this check for the must-operate, exclusive territory, and arbitration clause variables and in all cases the value of rho was not statistically significantly different than zero, so the results fail to reject the null hypothesis that the disturbance terms are uncorrelated. The chi-squared statistics and p-values for the bivariate equations are as follows: for the must-operate equation, $\chi^2$= 1.95, p= .162, for the exclusive territory equation, $\chi^2$= .85, p= .357, and for the arbitration equation, $\chi^2$= 1.76, p= .185.

eclipse verification costs, franchisors are more likely to use liquidated damages to police franchisees.

The results also provide evidence for the theory that rents are substitutes for the use of liquidated damages clauses. The variables most closely associated with the ability to use rents that do not require verification, the rate of growth in franchise outlets and the number of years franchising, both have consistently negative coefficients and are statistically significant under all specifications of the model in Table 6. The coefficient on the growth rate variable ranges from -.0318 to -.0387, which means that if all the other variables are held constant, doubling the the two-year rate of growth is associated with a drop of three percentage points in the likelihood of observing a liquidated damages provision.[83] This result suggests that the availability of new outlets to use as rewards for franchisees that do not shirk decreases the need to use liquidated damages to enhance the penalty associated with termination. The coefficient for years franchising varies between -.0077 and -.0094 with all the observations and -.0072 and -.0080 with motels and real estate franchises omitted. This result implies that, with other variables at held constant, an additional year of franchising experience is associated with about a .9 to .7 percentage-point drop in the likelihood of observing a liquidated damages provision. This outcome supports the contention that increased expertise in monitoring and rewarding that comes with experience allows franchisors to better detect, and punish, franchisees who shirk and accordingly reduces the need for a credible threat of contract damages.

The exclusive territory variable is not significant under any of the specifications in Table 6. This result is consistent with the hypothesis that exclusive territories have an ambiguous effect on the use of liquidated damages. If franchisors only used exclusive territories as a mechanism to provide rents for franchisees, one would expect this variable to be negative and significant. But if the lack of exclusive territories allows franchisees to use the threat of opening a nearby outlet, this effect should diminish the degree to which the use of exclusive territories serves as a substitute for contract damages. As explained above, I interact a dummy variable that equals one if a franchisor does not use exclusive territories and equals zero otherwise with the variable for the number of years franchising. This interaction effect should provide a measure of the ability to monitor and punish franchisees by opening nearby outlets or directing business to

[83] This effect may seem small, but recall that many of the firms are growing explosive rates that reach can

nearby outlets. The results of controlling for this effect are reported in Table 7. With this control included, the exclusive territory variable is statistically significant with all the variables included and the variable remains significant after omission of the motel and real estate franchises. The coefficient is large under all specifications and varies from -.4109 to -.4317. The interaction effect is also negative, as expected, and is statistically significant in all specifications with a range of -.0128 to -.0146. This result suggests that an additional year of franchising experience for firms that do not use exclusive territories reduces the chance of observing a liquidated damages provision by more than a percentage point. The significance and magnitude of both these variables suggests both that the use of exclusive territories to supply rents is a substitute for liquidated damages and that, in the absence of exclusive territories, franchisors will use the ability to open nearby outlets and send customers to neighboring franchise outlets as a governance mechanism. This latter mechanism has the advantage of not requiring any resort to written contracts.

**[Insert Table 7]**

The results from the omission of motels and real estate franchises from the regressions in Tables 6 and 7 suggest that these industries have specific characteristics that contribute to the frequency with which these sectors use liquidated damage clauses. But omitting these variable makes it difficult assess the magnitude of the industry effects. To isolate these effects in the real estate sector, I use a matching estimator that focuses on a subset of franchises where there is overlap in the three external covariates, log average startup costs, the 2004-06 growth rates, and the number of years franchising, and the two business model covariates, exclusive territories and must-operate requirements. I do not include motels in this analysis because the average startup costs for this sector are substantially larger than any other group and, consequently, there are no other observations that can be matched closely to this group.[84] Table 8 reports the Population Average Treatment Effect for the Treated (PATT) for four franchise sectors, including real estate, where being a member of the relevant sector is the treatment and all other firms are the controls. The PATT estimand is the effect of being a member of the relevant sector as opposed to a

exceed 1500 percent.

[84] *See* Richard Crump, V. Joseph Hotz, Guido Imbens, and Oscar Mitnik, *Nonparametric Tests for Treatment Effect Heterogeneity*, 90 REV. OF ECON. & STAT. 389 (2008) (discussing the problem of estimating treatment effects when there is little overlap in the covariate distribution).

member of the other franchises that exist in the population. Each entry four control (outside-of-sector firms) matches for every treatment (within-sector firms) observation. The matches are approximate for the three external variables and are exact for the business model variables.

**[Insert Table 8]**

The results confirm the intuition that real estate franchises act differently relative to other franchises that share similar startup costs, growth rates, and experience. The matching estimator for the real estate model is quite large, .625, and is statistically significant at the one-percent level. Insofar as the real estate sector varies in the amount of mobility its franchisees have, this result provides some support for the view that this increased fungibility may make it more difficult to use relational means to punish franchisees because franchisees who have been observed shirking know that they will be able to seek out another franchise without experiencing large losses from devalued specific assets. Given this inability to punish undesirable behavior through relational governance, the presence of a liquidated damages clause can substitute as an alternative method to sanction undesirable behavior.

Table 8 also shows the estimates of the PATT for fast food, salon and cosmetics, and cleaning franchises. The PATT for the convenience store, fast food, and the salon and cosmetics sectors are statistically significant, which suggests that—relative to similarly situated firms—these industries are not unique in their approach to liquidated damages. The result for cleaning franchises is, however, statistically significant at the one-percent level and is negative with a value of -.182. A potential reason for this result is the relative lack of incentive conflict in the cleaning sector. This industry typically involves a very high degree of repeat business and, for many franchisees, all of their business will come from repeat customers.[85] Moreover, cleaning franchisors often act as the intermediaries between customers and the franchisees, which allows the franchisor to replace an ineffective franchisee with a more capable one. This structure means that franchisees are likely to bear a large amount of the cost of shirking because poor service means that clients will choose not to do business with them or the franchisor will not direct clients to them. Unlike fast food franchises, motels, or other consumer-oriented firms that make up the sample, cleaning franchisees cannot rely as much on walk-in business based on the brand. This diminished ability to externalize the cost of shirking minimizes the governance

[85] *See* Brickley, *supra* note __, at 756 (discussing why cleaning franchises may be less likely to be subject to

problem posed by the franchise model and, consequently, cleaning franchises may not need to use the threat of threat of substantial punishments—be they legal or relational—for franchisees to refrain from providing quality service.

## IV. CONCLUSION

This paper contributes to both contract theory and the economics of franchising. The study adds to contract theory with empirical evidence that when it comes to credible threats to impose damages, formal and relational governance can act as substitutes. This evidence is consistent with the theory I develop to contrast the relative advantages of providing rents and threatening damages. If a threat of damages is credible and can sufficiently deter franchisee shirking, providing rents will decrease revenues without supplying any governance benefit. Franchisors should avoid rents in these situations and, indeed, they appear to do so. But the evidence leaves open another question; namely, why don't franchisors that rely on rents to police franchisees include a credible threat of damages as well? Even where the cost of providing rents is relatively low and most franchisees are judgment proof there might be a handful of situations where a credible threat to impose damages would be useful.[86] Prior work on the relationship between formal and relational governance suggests one possible answer. Some evidence suggests that formal and informal governance are substitutes because reliance on formal punishments undermines the reciprocity norm that is necessary to support informal arrangements.[87] If a franchisor's threatened use of damages against some franchisees tends to undermine the effectiveness of informal relationships with other franchisees—a plausible assumption given the vibrant gossip networks in franchisee communities—this effect may explain why franchisors refrain from including liquidated damage terms when they are only likely to be useful in a subset of cases.

The primary contributions of this paper to the franchising literature are an expansion of the self-enforcement model that accounts for the use of contract damages and an empirical challenge to the primacy of termination in that model. Contract damages can be incorporated

incentive conflicts relative to other commonly franchised businesses).

[86] Perhaps franchisors do not want to turn away potential franchisees who dislike the risk of a judgment against them, but supplying supra-competitive rents should more than compensate for this risk.

[87] *See, e.g.*, Simon Gächter & Ernest Fehr, *Fairness and Retaliation: The Economics of Reciprocity*, 14 J. OF ECON. PERSPECTIVES 159 (2000) (arguing that threatening formal sanctions frames relationships in strictly economic, as opposed to social, terms).

into the self-enforcement model as a means to reduce the rents that franchisors have to pay to ensure self-enforcement of the contract. But making these threats credible requires expensive court proceedings that leave franchisors searching for alternatives mechanisms of governance. The regressions that estimate this model provide evidence both that damages can play this role and that franchisors use rent as a substitute for the deterrence function that damages can play. At a broader level, this approach suggests that studies of contracting and industrial organization can benefit from attention to the legal doctrines that affect the feasibility of different governance mechanisms.

This paper also poses an empirical challenge for franchise research. The widespread use of for-cause requirements in this sample is not consistent with existing models of the franchise relationship and requires further explanation. Either the parties are getting something in return, such as franchisee assurance against franchisor moral hazard, or, as the model developed in this paper suggests, franchisors may be able to police franchisees effectively using extra-contractual means that avoid the costs of showing proper cause.

TABLE 1

Franchisors in the Sample
(Franchisors whose contracts have liquidated damages provisions are in bold)

| **Industry** | **Franchisor** | **Industry** | **Franchisor** |
|---|---|---|---|
| Automotive | AAMCO | Home Care | Comfort Keepers |
| | Jiffy Lube | | Home Helpers |
| | Midas | | Home Instead |
| Cleaning Services | Chem-Dry | Lodging | **Days Inn** |
| | CleanNet | | **Hampton Inn** |
| | Heaven's Best | | **La Quinta Inn** |
| | Jani-King | | **Super 8 Motels** |
| | Maid Brigade | Miscellaneous | Aaron's Rental Center |
| | Maids Home Service | | **Action Coach** |
| | Merry Maids | | Aussie Pet Mobile |
| | Molly Maid | | Budget Blinds |
| | ServiceMaster | | Candy Bouquet |
| | ServPro | | Cartridge World |
| | Vanguard Cleaning | | Certa ProPainters |
| Convenience Store | **am/pm** | | Coffee News |
| | **Circle K** | | Edible Arrangements |
| | Seven-11 | | Express Employment Professionals |
| Fast Food | Arby's | | **GNC** |
| | **Auntie Anne's** | | Jazzercise |
| | Baskin-Robbins | | Kumon Learning Centers |
| | Blimpie | | LA Weight Loss Centers |
| | Carl's Jr. | | Massage Envy |
| | **CiCi's Pizza** | | Matco Tools |
| | Cold Stone Creamery | | Miracle Ear |
| | Denny's | | Results! Travel |
| | Domino's | | Snap-On Tools |
| | Dunkin' Donuts | | Sylvan Learning Center |
| | Hardee's | Realtors | **Century 21** |
| | Hot Stuff | | **Coldwell Banker Commercial** |
| | **Jimmy John's** | | **Electronic Realty Associates** |
| | KFC | | ReMax |
| | **Long John Silver's** | Salons and Cosmetics | Cost Cutters |
| | McDonald's | | **Fantastic Sams** |
| | Papa John's Pizza | | Great Clips |
| | Papa Murphy's | | Merle Norman Cosmetics |
| | **Pizza Hut** | | Sport Clips |
| | Popeye's Chicken & Biscuits | Tax and Business Services | Instant Tax Service |
| | Qdoba | | Jackson-Hewitt Inc. |
| | **Rita's Water Ice** | | Liberty Tax Service |
| | Sonic Drive-in | | Minuteman Press |
| | Subway | | Postal Annex |
| | **Taco Bell** | | Sign-A-Rama |
| Gyms | Anytime Fitness | | **UPS Store** |
| | Fitness Together | | WSI |
| | Snap Fitness | | |

TABLE 2

Summary Statistics for Selected Variables

| Contract Term | Percentage of Contracts with that Term (n=89) |
|---|---|
| | |
| Liquidated Damages | 22.5% |
| Exclusive Territory | 55.0% |
| Must Operate | 37.1% |
| Mandatory Renewal | 79.8% |
| Arbitration | 51.7% |

| Continuous Variables (n=89) | | | | |
|---|---|---|---|---|
| Variable | Mean | St. Dev. | Minimum | Maximum |
| Contract Term (in years) | 12.3 | 6.6 | 1 | 35 |
| Average Startup Costs | $571.1 K | $125.5K | $5K | $9.1M |
| Average Franchise Fee | $30.7 K | $17.9K | 0 | $135.6 K |
| Years Franchising | 24.6 | 13.9 | 3 | 55 |
| Outlets in 2006 | 1879 | 2871 | 14 | 20721 |
| Percentage of Company-Owned Outlets | 9.8% | 18.5% | 0 | 95.9% |
| Franchise Outlet Growth Rate for 2004-06 | 71.8% | 221.7% | -24.3% | 1583.3% |

TABLE 3

Summary Statistics for Selected Variables by Industry

| Industry | N | Average Contract Term (in years) | Average Startup Cost | Average Years Franchising | Average Number of Outlets in 2006 |
|---|---|---|---|---|---|
| Automotive | 3 | 18.3 | $257,009 | 41.0 | 1,378 |
| Cleaning Services | 11 | 9.5 | $78,857 | 29.1 | 2,322 |
| Convenience Store | 3 | 15.0 | $1,187,893 | 21.7 | 1,478 |
| Fast Food | 25 | 15.6 | $717,341 | 32.8 | 2,955 |
| Gyms | 3 | 6.7 | $162,131 | 6.3 | 265 |
| Home Care | 3 | 10.0 | $55,150 | 10.0 | 457 |
| Lodging | 4 | 20.5 | $5,459,643 | 24.3 | 1,316 |
| Miscellaneous | 20 | 7.8 | $146,573 | 16.1 | 1,024 |
| Realtors | 4 | 8.8 | $149,417 | 28.3 | 2,536 |
| Salons and Cosmetics | 5 | 10.0 | $148,312 | 22.0 | 1,326 |
| Tax and Business Services | 8 | 16.3 | $117,172 | 21.1 | 1,898 |
| **Total** | **89** | **12.3** | **$571,170** | **24.6** | **1,886** |

TABLE 4

Means for Selected Variables Based Presence of a Liquidated Damages Provision

| Variable | Contract has LD provision | Contract has no LD provision | Δ |
|---|---|---|---|
| Startup Cost | $1,567,966<br>(522,772) | $282,244<br>(44,299) | $1,285,722<br>(289,499) |
| Outlet Growth Rate 2004-06 | 19.95%<br>(6.58) | 86.85%<br>(30.06) | -66.90%<br>(56.14) |
| Years Franchising | 24.25<br>(2.69) | 24.70<br>(1.74) | -0.45<br>(3.55) |
| Term (in years) | 13.95<br>(1.93) | 11.86<br>(0.83) | 2.09<br>(1.67) |
| Exclusive Territory | 0.50<br>(0.11) | 0.57<br>(0.06) | -0.07<br>(0.13) |
| Must Operate | 0.30<br>(0.11) | 0.39<br>(0.06) | -0.09<br>(0.12) |
| Arbitration Clause | 0.30<br>(0.11) | 0.58<br>(0.06) | -0.28<br>(0.12) |
| Mandatory Renewal | 0.65<br>(0.11) | 0.84<br>(0.04) | -0.19<br>(0.10) |

Note: Standard errors in parentheses.

TABLE 5

Correlation Matrix for a Subset of Variables (n=89)

| | Liquidated Damages Clause | Log of Average Startup Costs | Franchise Growth Rate 2004-06 | Years Franchising | Must Operate | Exclusive Territory | Mandatory Renewal of Agreement | Contract Term (in years) | Option to Purchase Assets | Arbitration Clause |
|---|---|---|---|---|---|---|---|---|---|---|
| Liquidated Damages Clause | 1 | | | | | | | | | |
| Log of Average Startup Costs | 0.43 | 1 | | | | | | | | |
| Franchise Growth Rate 2004-06 | -0.13 | -0.08 | 1 | | | | | | | |
| Years Franchising | -0.01 | 0.33 | -0.40 | 1 | | | | | | |
| Must Operate | -0.08 | 0.04 | -0.19 | 0.15 | 1 | | | | | |
| Exclusive Territory | -0.05 | 0.01 | 0.16 | -0.30 | -0.24 | 1 | | | | |
| Mandatory Renewal of Agreement | -0.20 | -0.16 | 0.14 | -0.34 | -0.02 | 0.33 | 1 | | | |
| Contract Term | 0.13 | 0.58 | -0.20 | 0.40 | 0.06 | -0.13 | -0.22 | 1 | | |
| Option to Purchase Assets | -0.09 | 0.23 | 0.13 | 0.07 | -0.11 | -0.12 | 0.09 | 0.19 | 1 | |
| Arbitration Clause | -0.23 | -0.27 | 0.25 | -0.26 | 0.00 | -0.06 | 0.13 | -0.05 | 0.05 | 1 |

TABLE 6.
Linear Probability Analysis of Liquidated Damage Terms in Franchise Contracts

| | All Observations | | | Motels and Real Estate Omitted | | |
|---|---|---|---|---|---|---|
| RHS Variables | (1) | (2) | (3) | (4) | (5) | (6) |
| Log of Average Startup Costs | .1509*** | .1565*** | .1774*** | .1278*** | .1280*** | .1485*** |
| | (.0247) | (.0259) | (.0293) | (.0335) | (.0333) | (.0401) |
| Outlet Growth Rate 2004-06 | -.0358*** | -.0387*** | -.0374*** | -.0313** | -.0318** | -.0337** |
| | (.0119) | (.0135) | (.0134) | (.0118) | (.0125) | (.0135) |
| Years Franchising | -.0077** | -.0088** | -.0094*** | -.0072** | -.0078** | -.0080** |
| | (.0029) | (.0034) | (.0033) | (.0030) | (.0035) | (.0035) |
| Must Operate | | -.1143 | -.1066 | | -.0416 | -.0449 |
| | | (.0803) | (.0796) | | (.0773) | (.0783) |
| Exclusive Territory | | -.1247 | -.1211 | | -.0794 | -.0736 |
| | | (.0946) | (.0949) | | (.0889) | (.0902) |
| Length of Contract term | | | -.1183* | | | -.0760 |
| | | | (.0608) | | | (.0536) |
| Arbitration Clause | | | -.0916 | | | -.0127 |
| | | | (.0874) | | | (.0842) |
| Observations | 89 | 89 | 89 | 81 | 81 | 81 |
| $R^2$ | .240 | .269 | .307 | .172 | .182 | .194 |

Notes: The dependent variable is a binary variable for the presence of a liquidated damages provision in the franchise contract. Robust standard errors are in parentheses. ***, **, and * denote statistical significance at the one-percent, five-percent, and ten-percent levels respectively.

TABLE 7.
Linear Probability Analysis of Liquidated Damage Terms in Franchise Contracts with Interaction Variable Included

| | All Observations | | Motels and Real Estate Omitted | |
|---|---|---|---|---|
| RHS Variables | (1) | (2) | (3) | (4) |
| Log of Average Startup Costs | .1457*** | .1720*** | .1118*** | .1379*** |
| | (.0256) | (.0285) | (.0300) | (.0363) |
| Outlet Growth Rate 2004-06 | -.0269* | -.0266* | -.0184 | -.0212 |
| | (.0140) | (.0140) | (.0134) | (.0139) |
| Years Franchising | -.0010 | -.0012 | .0010 | .0014 |
| | (.0053) | (.0052) | (.0053) | (.0055) |
| Must Operate | -.0739 | -.0651 | -.0018 | -.0043 |
| | (.0792) | (.0777) | (.0733) | (.0734) |
| Exclusive Territory | -.4309** | -.4317** | -.4179** | -.4200** |
| | (.1824) | (.1829) | (.1739) | (.1778) |
| No Exclusive Territory * Years Franchising | -.0128* | -.0132** | -.0141** | -.0146** |
| | (.0066) | (.0066) | (.0063) | (.0065) |
| Length of Contract Term | | -.1360** | | -.0936 |
| | | (.0681) | | (.0588) |
| Arbitration Clause | | -.0710 | | .0116 |
| | | (.0888) | | (.0860) |
| Observations | 89 | 89 | 81 | 81 |
| $R^2$ | .304 | .343 | .238 | .253 |

Notes: The dependent variable is a binary variable for the presence of a liquidated damages provision in the franchise contract. Robust standard errors are in parentheses. ***, **, and * denote statistical significance at the one-percent, five-percent, and ten-percent levels respectively.

TABLE 8.
Matching Model of Different Franchise Sectors.

| Sector | Coefficient on Sector Indicator Variable |
|---|---|
| Cleaning | -.182***<br>(.070) |
| Convenience Stores | .167<br>(.202) |
| Fast Food | -.040<br>(.120) |
| Salons and Cosmetics | .000<br>(.243) |
| Real Estate | .625***<br>(.255) |

Notes: The dependent variable is a binary variable for the presence of a liquidated damages clause. Each model matches approximately on log of the average startup costs, the 2004-06 growth rate, and the number of years franchising and matches exactly on exclusive territory and must-operate clause. The coefficient for the sector indicator variable measures the population average treatment effect on the treated using four matches. Standard errors are in parentheses. ***, **, and * denote statistical significance at the one-percent, five-percent, and ten-percent levels respectively.