Indiana Law Journal

Volume 90 | Issue 3 Article 7

Summer 2015

Good-Cause Statutes Revisited: An Empirical Assessment

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Good-Cause Statutes Revisited: An Empirical Assessment

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One of the most vital debates in franchise law focuses on whether state or federal law should adopt "good-cause statutes" (GCSs), which require franchisors to show good cause before terminating contractual relations with a franchisee. The traditional law-and-economics analysis suggests that GCSs are inefficient. This inefficiency argument is based upon one central hypothesis: GCSs increase franchisee free riding since they limit the franchisor's ability to terminate the franchise contract easily. The free-riding hypothesis has been significantly influential in the development of franchise law, as is evident in state and federal statutory regimes. To date, the majority of states and the federal government have refused to adopt GCSs.

This Article investigates the free-riding hypothesis empirically and finds it wanting. Direct examination of consumer satisfaction in one of the industries most notoriously susceptible to free riding—hotels serving nonrepeat travelers—shows no significant differences between franchises subject to "at-will" laws and those subject to a GCS. We gathered a sample of 3442 franchised hotels, measured each one along several dimensions of quality, and assessed potential differences using multiple econometric methods. In none did the at-will states outperform the good-cause ones.

Implications of our empirical results on the debate over GCSs are discussed in this Article.

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We thank Adam Badawi, Oren Bar-Gil, Dennis Carlton, Christopher Drahozal, Tamar Frankel, Gideon Parchomovsky, Renana Peres, Arie Reichel, and James White for detailed comments and discussion. This Article won the Best Paper Award at the 2014 International Society of Franchising (ISoF) Conference.

INTRODUCTION

One of the most vital debates in franchise law focuses on whether state or federal law should adopt good-cause statutes (GCSs) requiring franchisors to show good cause before terminating their contracts with franchisees.[1] The traditional law-and-economics analysis suggests that GCSs are inefficient. This analysis derives from one central hypothesis: GCSs increase franchisee free riding by rendering it significantly more difficult for a franchisor to terminate the franchise contract, thereby impeding a central monitoring device used by franchisors.[2] The logic of the traditional free-riding hypothesis is at first glance simple and commonsensical:[3] franchisees operate by selling products and services to consumers who rely on the franchise trademark as a telling brand. Customers purchase from the franchisee believing that the local venue is as good as any other franchised branch, essentially presuming they are interacting with the chain rather than the individual provider. Franchisees realize that much of their allure comes from national or regional campaigns rather than their own efforts, and thus they conserve their own funds and efforts by skimping where possible, that is, where the franchisor cannot catch them. A free-riding franchisee will thus cut corners in services and products, relying on the franchisor and other franchisees to uphold the brand reputation that brings customers through the door. According to the traditional free-riding hypothesis, industries that serve mostly nonrepeat customers, such as hotels and motels, are most prone to free

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1. For articles expressing varying degrees of support for GCSs, see, e.g., Donald P. Horwitz & Walter M. Volpi, *Regulating the Franchise Relationship*, 54 ST. JOHN'S L. REV. 217 (1980); Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29 FRANCHISE L.J. 139 (2010); Tracey A. Nicastro, *How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement*, 28 VAL. U. L. REV. 785 (1994); Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 PENN. ST. L. REV. 105 (2004); Boyd Allan Byers, Note, *Making a Case for Federal Regulation of Franchise Terminations—A Return-of-Equity Approach*, 19 J. CORP. L. 607 (1994); David Hess, Note, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333 (1995). For seminal articles expressing varying degrees of disagreement with GCSs, see James A. Brickley, Frederick H. Dark & Michael S. Weisbach, *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101 (1991); William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 23 (2008); Jonathan Klick, Bruce Kobayashi & Larry Ribstein, *Federalism, Variation, and State Regulation of Franchise Termination*, 3 ENTREPRENEURIAL BUS. L.J. 355 (2009); Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 325 (F. H. Buckley ed., 1999); Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289 (1989); *see also* Byron E. Fox & Henry C. Su, *Franchise Regulation—Solutions in Search of Problems?*, 20 OKLA. CITY U. L. REV. 241 (1995); Mark Pruitt, *Disclosure and Good Cause Legislation: "Where's the Beef" in Franchise Regulation?*, 90 COM. L.J. 563 (1985); David A. Eisenberg, Note, *Balancing a Relationship—"Good Cause" Termination of Franchise Agreements in Michigan*, 72 U. DET. MERCY L. REV. 369 (1995).

2. *See infra* Part II.B.

3. *See infra* Part II.C.

riding. In such industries, free riding saves costs while reducing future sales only slightly and indirectly. At-will contracts then must be used by franchisors to keep franchisees in line. A "shape up or ship out" strategy works best when contracts can be terminated quickly and without recourse; thus, GCSs can get in the way. GCSs are therefore argued to increase franchisee free riding.

This Article investigates the free-riding hypothesis empirically, by direct examination of consumer satisfaction in one of the industries most notoriously susceptible to free riding: hotels serving nonrepeat travelers. We gathered a sample of 3442 franchised hotels and measured each one along several dimensions of quality. We then used these measurements to compare the level of free riding by franchisees in states where GCSs apply with that of franchisees in at-will states. Perceived quality and customer satisfaction serve to proxy for franchisees' investment of effort, as free riding typically results in customer complaints and lower-than-average ratings. Those franchisees who free ride on franchise reputation invest less in keeping their venues clean, their service prompt, and their customers happy. They rely on brand awareness and an ongoing stream of new customers lured by national advertising and chain-wide marketing. The results outlined below show no significant differences in free riding between franchise operations subject to the disparate legal regimes, thus casting considerable doubt on the validity of the traditional economic analysis of GCSs.

This Article will proceed as follows: Parts I and II will provide context by reviewing the statutory framework and the theoretical context underlying the debate over the desirability of GCSs. Part III will present data and discuss the methodology for empirically testing the conventional economic hypothesis—namely, that GCSs reduce the ability of franchisor self-policing, thus increasing franchisee free riding. Part IV discusses normative implications and potential interpretations of the empirical results.

I. GOOD-CAUSE STATUTES: THE LEGAL FRAMEWORK

To date, only seventeen of the fifty states have adopted statutes requiring good cause as a condition for the termination of a franchise contract by a franchisor.[4] Under these statutes, good cause is commonly defined as a franchisee's failure to adequately comply with the franchise agreement.[5] A franchisor terminating the

4. The seventeen good-cause states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, Tennessee, Virginia, Washington, and Wisconsin. ARK. CODE ANN. § 4-72-204(a)(1) (2011); CAL. BUS. & PROF. CODE § 20020 (West 2008); CONN. GEN. STAT. ANN. § 42-133f(a) (West 2012); DEL. CODE ANN. tit. 6, § 2552(a) (2013); HAW. REV. STAT. § 482E-6 (West 2008); 815 ILL. COMP. STAT. ANN. 705/19 (West 2008); IND. CODE § 23-2-2.7-1(7) (2007); IOWA CODE ANN. § 537A.10(7) (West Supp. 2014); MICH. COMP. LAWS ANN. § 445.1527(c) (West 2011); MINN. STAT. ANN. § 80C.14, subdiv. 3(b) (West 2009); NEB. REV. STAT. ANN. § 87-404 (LexisNexis 2012); N.J. STAT. ANN. § 56:10-5 (West 2012); R.I. GEN. LAWS § 6-50-4 (2014); TENN. CODE ANN. 47-25-1503 (2013); VA. CODE ANN. § 13.1-564 (2011); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 2013); WIS. STAT. ANN. § 135.03 (West 2009).

5. *See* ARK. CODE ANN. § 4-72-202(7)(A) (2011); CAL. BUS. & PROF. CODE § 20020; CONN. GEN. STAT. ANN. § 42-133f(a); HAW. REV. STAT. § 482E-6(2)(H); 815 ILL. COMP. STAT.

contract without good cause is obligated, under the GCSs, to pay damages to the franchisee.[6] Recoverable damages may include (1) a fraction of the franchisee's tangible assets (both real and personal) used with respect to the terminated franchise, including sales outlets and facilities, offices, warehouses, trucks, furnishings, equipment, and accessories;[7] (2) loss of goodwill;[8] and (3) loss of profits.[9]

GCSs are often explicitly mandatory, stating that any waiver of the statutory rights by a franchisee in any franchise contract shall be void.[10] GCSs allegedly have two central purposes: first, to correct the perceived inequality in bargaining power between franchisors and franchisees;[11] and, second, to protect franchisees against perceived franchisor opportunism.[12] Without GCSs in place, franchisor opportunism

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ANN. 705/19(b); IND. CODE § 23-2-2.7-1(7); IOWA CODE ANN. § 537A.10(7); MICH. COMP. LAWS. ANN. § 445.1527(c); MINN. STAT. ANN. § 80C.14, subdiv. 3(b); NEB. REV. STAT. ANN. § 87-402(8) (LexisNexis 2012); N.J. STAT. ANN. § 56:10-5; TENN. CODE ANN. 47-25-1502(4) (2013); WASH. REV. CODE ANN. § 19.100.180(2)(j); WIS. STAT. ANN. § 135.02(4) (West 2009). For cases in which courts found statutory good cause lacking, see, e.g., Volvo Constr. Equip. N. Am., Inc. v. CLM Equip. Co., 386 F.3d 581 (4th Cir. 2004); Kealey Pharmacy & Home Care Servs., Inc. v. Walgreen Co., 761 F.2d 345 (7th Cir. 1985); Atl. City Coin & Slot Serv. Co. v. IGT, 14 F. Supp. 2d 644 (D.N.J. 1998).

6. ARK. CODE ANN. § 4-72-208(b) (2011); CONN. GEN. STAT. ANN. § 42-133g(a) (West 2012); DEL. CODE ANN. tit. 6, § 2553(c) (2013); HAW. REV. STAT. § 482E-9(b) (West 2008); 815 ILL. COMP. STAT. ANN. 705/26 (West 2008); IND. CODE § 23-2-2.7-4 (2007); IOWA CODE ANN. § 537A.10(13); MINN. STAT. ANN. § 80C.17, subdivs. 1, 3 (West 2009); NEB. REV. STAT. ANN. § 87-409 (LexisNexis 2012); N.J. STAT. ANN. § 56:10-10 (West 2012); TENN. CODE ANN. 47-25-1509 (2013); VA. CODE ANN. § 13.1-571(a) (2011); WIS. STAT. ANN. § 135.06(12) (West 2009).

7. DEL. CODE ANN. tit. 6, § 2553(c)(1) ("[T]he numerator of the fraction shall consist of the franchised distributor's gross sales (in the most recently completed fiscal year) within this State attributable to the terminated . . . franchise, and the denominator of the fraction shall consist of the franchised distributor's total gross sales (in the most recently completed fiscal year) in this State . . . .").

8. Tit. 6, § 2553(c)(2).

9. Tit. 6, § 2553(c)(3); *see also* ROGER D. BLAIR & FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 280 (2005); Roger D. Blair, *Measuring Damages for Lost Profits in Franchise Termination Cases*, 8 FRANCHISE L.J. 3 (1988); Joseph Schumacher & Kimberly Toomey, *Recovering Lost Future Royalties in a Franchise Termination Case*, 20 FRANCHISE L.J. 116 (2001).

10. *See, e.g.*, CAL. BUS. & PROF. CODE § 20010 (West 2008); CONN. GEN. STAT. ANN. § 42-133f(f); DEL. CODE ANN. tit. 6, § 2552(e) (2013); HAW. REV. STAT. ANN. § 482E-6(2)(F); IOWA CODE ANN. § 537A.10(4); 815 ILL. COMP. STAT. ANN. 705/41 (West 2008); MINN. STAT. ANN. § 80C.21 (West 2009); WASH. REV. CODE ANN. § 19.100.220(2) (West 2013); WIS. STAT. ANN. § 135.025(3) (West 2009).

11. *See, e.g.*, WIS. STAT. ANN. § 135.025(2)(b); *see also* Lagarias & Boulter, *supra* note 1, at 141; Dennis D. Palmer, *Franchises: Statutory and Common Law Causes of Action in Missouri Revisited*, 62 UMKC L. REV. 471, 491 (1994); Pitegoff, *supra* note 1, at 289; Christopher J. Curran, Note, *Claims Against a Franchisor upon an Unreasonable Withholding of Consent to Franchise Transfer*, 23 J. CORP. L. 135, 152 (1997).

12. *See, e.g.*, WIS. STAT. ANN. § 135.025(2)(b); *see also* Geib v. Amoco Oil Co., 29 F.3d 1050, 1056 (6th Cir. 1994); Bitronics Sales Co. v. Microsemiconductor Corp., 610 F. Supp. 550, 556 (D. Minn. 1985); Hartford Elec. Supply Co. v. Allen-Bradley Co., No. CV 96562061S, 1997 WL 297256, at *3 (Conn. Super. Ct. May 28, 1997), *aff'd*, 736 A.2d 824

may take one of three central forms: (1) franchisors can force one-sided modifications of agreements on franchisees by threatening to terminate the franchise relationship at will;[13] (2) franchisors may terminate the contract of an efficient franchisee who fully complies with the contract in order to sell the latter's profitable unit to a new franchisee for higher franchise fees;[14] and (3) the franchisor could terminate the contract of an efficient franchisee simply in order to manage the successful unit himself.[15]

States that adopted GCSs vary significantly in population and location.[16]

Figure 1. Relative geographical heterogeneity of good-cause states

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(Conn. 1999); Holiday Inns Franchising, Inc. v. Branstad, 537 N.W.2d 724, 728–29 (Iowa 1995); McDonald's Corp. v. Markim, Inc., 306 N.W.2d 158, 162 (Neb. 1981); Kubis & Perszyk Assocs. v. Sun Microsystems, Inc., 680 A.2d 618, 626 (N.J. 1996); David L. Cahn & Jeffrey S. Fabian, *Mobility, the Home, and the Scope and Application of State Franchise Relationship and Termination Laws*, 30 FRANCHISE L.J. 107, 107 (2010); Robert W. Emerson & Uri Benoliel, *Are Franchisees Well-Informed? Revisiting the Debate over Franchise Relationship Laws*, 76 ALB. L. REV. 193, 196–97 (2012–2013); Palmer, *supra* note 11, at 491; Pitegoff, *supra* note 1, at 289; Curran, *supra* note 11, at 152.

13. *See* Munno v. Amoco Oil Co., 488 F. Supp. 1114, 1118 (D. Conn. 1980); Michael J. Lockerby, *Franchise Termination Restrictions: A Guide for Practitioners and Policy Makers*, 30 ANTITRUST BULL. 791, 833 (1985); Byers, *supra* note 1, at 621.

14. *See* Neptune T.V. & Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., 462 A.2d 595, 601 (N.J. Super. Ct. App. Div. 1983); BLAIR & LAFONTAINE, *supra* note 9, at 271.

15. *See* BLAIR & LAFONTAINE, *supra* note 9, at 271; *see also* Lockerby, *supra* note 13, at 834; Nicastro, *supra* note 1, at 801; Pruitt, *supra* note 1, at 565; Byers, *supra* note 1, at 621; Hess, *supra* note 1, at 334.

16. *See* James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511, 518 (2002). See *supra* note 4 for a list of the seventeen good-cause states.

The vast majority of GCSs were adopted in the 1970s.[17] However, to this day most states do not have GCSs on their books. Since 1992, thirty states have considered enacting franchisee-protection laws, including GCSs, but the proposed laws have not passed.[18] At the federal level, several GCSs have also been rejected.[19] For example, in 1998 and 1999, the federal government declined to enact several bills that would have made it unlawful for a franchisor to terminate a franchise agreement prior to its expiration without good cause.[20] To date, no general federal law on franchise termination has been enacted.

II. THE TRADITIONAL ECONOMIC ANALYSIS OF GOOD-CAUSE STATUTES

GCSs have been a source of intense debate and controversy among legal theoreticians.[21] Given the centrality of law and economics in legal scholarship, it is not surprising that legal economists play a dominant role in this debate. The traditional analysis along these lines contends that GCSs are inefficient, relying on a three-step argument: First, franchisees are assumed to have an intrinsic incentive to free ride on the franchise chain's reputation, squandering the goodwill enjoyed by franchisors as well as non-free-riding franchisees, thus reducing consumer welfare.[22] Second, the franchisee's incentive to free ride is argued to be minimized via an essential control mechanism: the ability of the franchisor to terminate any franchise contract at will.[23] Third, GCSs, which prevent franchisors from utilizing the indispensable at-will control mechanism, are understood to increase the level of franchisee free riding compared to an at-will regime.[24] These three arguments will be presented in more detail below, in order to contextualize our critical and empirical analysis.

A. Franchisees' Inherent Incentive To Free Ride

Individual franchisees at any franchise chain have a basic incentive to free ride on the efforts of franchisors as well as those of the other franchisees.[25] In other words,

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17. Thomas M. Pitegoff & W. Michael Garner, *Franchise Relationship Laws*, *in* FUNDAMENTALS OF FRANCHISING 183, 185 (Rupert M. Barkoff & Andrew C. Selden eds., 3d ed. 2008).

18. Brickley, *supra* note 16, at 519.

19. *See, e.g.*, Ernest A. Braun, *Policy Issues of Franchising*, 14 SW. U. L. REV. 155, 203–04 (1984); Robert W. Emerson, *Franchise Terminations: Legal Rights and Practical Effects When Franchisees Claim the Franchisor Discriminates*, 35 AM. BUS. L.J. 559, 562–63 (1998); Horwitz & Volpi, *supra* note 1, at 218.

20. Small Business Franchise Act of 1999, H.R. 3308, 106th Cong. (1999); Small Business Franchise Act of 1998, H.R. 4841, 105th Cong. (1998).

21. *See supra* note 1.

22. *See infra* Part II.A.

23. *See infra* Part II.B.

24. *See infra* Part II.C.

25. Brickley et al., *supra* note 1, at 104 ("Individual franchisees have the incentive to free ride on the trademark . . . ."); Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9, 12 (1995) ("One type of behavior that has been analyzed at great length is the free riding incentive created when franchisees jointly use a common brand name."); Alan J. Meese, *Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying*

franchisees are enticed to produce a product or service of substandard quality relative to that which would maximize joint profits for the entire franchise chain.[26] Common claims are that franchisees seek to conserve funds by neglecting the appearance of their employees, skimping on workplace cleanliness, and overcharging customers.[27] The individual franchisee incentive, according to this view, is to "cheat" customers by providing them with low-quality products or services at the same price charged by other franchisees in the chain who maintain higher standards.[28]

According to traditional economic analysis, the franchisee's incentive to free ride derives from two central cumulative factors: On one hand, the individual franchisee *fully* internalizes the benefits of her free riding.[29] On the other hand, the individual franchisee incurs only *part* of the reputational costs suffered by the franchise brand name due to her free-riding behavior.[30]

Contracts, 95 MICH. L. REV. 111, 118 (1996) ("Each franchisee will thus find it rational to engage in opportunistic behavior at the expense of the franchise system—behavior that involves . . . 'free riding' . . . .").

26. Brickley et al., *supra* note 1, at 104 ("Individual franchisees have the incentive to . . . produce a below-standard-quality product . . . ."); Victor P. Goldberg, *The Free Rider Problem, Imperfect Pricing, and the Economics of Retailing Services*, 79 NW. U. L. REV. 736, 746 (1984) ("All of the franchisees have a short-run incentive to produce a below-average product . . . ."); Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356, 358 (1980) ("[T]here is an incentive for an individual opportunistic franchisee to cheat the franchisor by supplying a lower quality of product than contracted for."); Byers, *supra* note 1, at 620–21 ("Free riding occurs when the franchisee reduces its costs by offering products and services below franchise quality standards . . . .").

27. Roland E. Kidwell, Arne Nygaard & Ragnhild Silkoset, *Antecedents and Effects of Free Riding in the Franchisor-Franchisee Relationship*, 22 J. BUS. VENTURING 522, 525 (2007) ("Examples [of franchisee free riding] include failure to follow company procedures in terms of quality or service, overcharging customers, or lack of effort regarding appearance of employees or the workplace.").

28. Meese, *supra* note 25, at 118 ("This free riding will consist of attempts to 'cheat' customers, by providing them with products inferior to those ordinarily associated with the trademark, presumably at the same price charged by those fellow franchisees who maintain a higher level of quality.").

29. J. Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157, 159 (1995) ("The lower-quality franchisee will benefit by the full amount of the savings from reducing quality . . . ."); Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL. STUD. 549, 556 (2003) ("[T]he franchisee has an incentive to free ride on the brand's capital, since he captures the full savings from reducing his effort level . . . ."); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 228 (1978) ("[I]f one franchisee allows the quality of his establishment to deteriorate, he benefits by the full amount of the savings from reduced quality maintenance . . . .").

30. Beales & Muris, *supra* note 29, at 159 ("The lower-quality franchisee . . . will only lose part of the cost."); Janet E. L. Bercovitz, *The Organizational Choice Decision in Business Format Franchising: An Empirical Test*, *in* ECONOMICS AND MANAGEMENT OF FRANCHISING NETWORKS 38, 44 (Josef Windsperger et al. eds., 2004) ("The outlet manager bears only a portion of the costs of such chiseling . . . ."); Goldberg, *supra* note 26, at 746 ("If a franchisee reduces the quality of the product sold, it bears only some of the costs . . . ."); Rubin, *supra*

In more detail, providing a lower-quality product or service allows the franchisee to cut her individual costs.[31] Consequently, the free-riding franchisee can increase her individual profits.[32] Since franchisees use a common brand as a trademark, a reduction in quality by one free-riding franchisee has the effect of reducing future demand facing all franchisees, not just that of the individual franchisee providing reduced quality.[33] The free-riding franchisee is thus able to externalize a large portion of the reputational costs imposed on the franchise brand by her behavior.[34] Furthermore, the benefits of free-riding behavior are immediate

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note 29, at 228 (The free-riding franchisee "loses only part of the costs, for part is borne by other franchisees."); Note, *A Clarification and Reformulation of Prevailing Approaches to Product Separability in Franchise Tie-In Sales*, 67 MINN. L. REV. 1165, 1174–75 (1983) ("The individual franchisee bears only a percentage of the cost of any consumer dissatisfaction . . . .").

31. Bercovitz, *supra* note 30, at 44 ("[T]he outlet manager may free-ride on the system's brand name and substitute cheaper, lower quality inputs in order to lower their store's operating costs."); James A. Brickley, Frederick H. Dark & Michael S. Weisbach, *An Agency Perspective on Franchising*, 20 FIN. MGMT. 27, 29 (1991) ("[T]he cost savings from providing a lower quality product go directly to the given [free-riding] franchisee."); Kidwell et al., *supra* note 27, at 525 ("A franchisee engaged in a contractual relationship with a franchisor might seek to lower his or her own costs by failing to participate in activities that would be collectively profitable for the overall franchise network."); Klein, *supra* note 25, at 12 ("[E]ach franchisee can reduce its costs by reducing the quality of the product it supplies . . . ."); Note, *supra* note 30, at 1174 ("Individual franchisees, on the other hand, have an incentive to lower quality, which decreases the franchisee's costs . . . .").

32. Jean Wegman Burns, *Vertical Restraints, Efficiency, and the Real World*, 62 FORDHAM L. REV. 597, 641 n.197 (1993) ("[A]ny one franchisee has a financial incentive to 'ride' on the reputation being upheld by her fellow franchisees and to cut her own costs (and hence increase her profits) by offering a lower quality product or service to the consumer."); Richard E. Caves & William F. Murphy II, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 577 (1976) ("A franchisee who reduces the quality of the good or service he offers for a given price might increase his own profits . . . ."); Byers, *supra* note 1, at 620–21 ("Free riding occurs when the franchisee reduces its costs by offering products and services below franchise quality standards, thereby increasing its own profits . . . ."); Eisenberg, *supra* note 1, at 372 ("The franchisee increases profits by cutting costs and offering lower quality products."); Hess, *supra* note 1, at 343 n.74 ("Franchisees free-ride by providing a lower quality product to cut costs and receive higher profits . . . ."); Note, *supra* note 30, at 1174 ("Individual franchisees . . . have an incentive to lower quality, which decreases the franchisee's costs and increases the franchisee's profit margin.").

33. Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 349–50 (1985) ("The individual franchisee directly benefits from the sales of the lower-quality product, and the other franchisees share in the losses caused by decreased future demand."); Rubin, *supra* note 29, at 228 ("All franchisees would lose something as a result of this deterioration in one franchise: consumers would have less faith in the quality promised by the trademark.").

34. *See* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 950 n.88 ("[F]ree-riding is an example of an economic externality."); Rubin, *supra* note 29, at 228 ("What is involved is a classic externality problem."); *see also* Goldberg, *supra* note 26, at 746.

and obvious, while costs are both dispersed along the network and delayed to an uncertain future.

Ultimately, the free-riding franchisee harms not only the franchisor and non-free-riding franchisees but also consumers and aggregate efficiency.[35] Consumers are normally unaware ex ante of free riding by individual franchisees or of quality distinctions between stores belonging to the same chain and bearing a common trademark.[36] This problem is exacerbated when marketing is conducted centrally by the franchisor, through national or regional advertising, online reservation systems, and the like. Consumers therefore bear the cost of free riding, "overpaying for a product of less than anticipated quality."[37] In the long run, free riding reduces demand and deteriorates brand reputation—costs dispersed among all those participating in franchise profits.

The traditional economic literature on franchisee free riding distinguishes between two basic scenarios: high probability of repeat purchase by particular customers versus low probability of the same.[38] According to this distinction, the franchisee's incentive to free ride is lower where the probability of repeat customers is high, as customers experiencing subpar performance will refrain from future business at the same location.[39] Repeat business to an individual franchisee unit thus serves as a constraining factor on free riding, since the franchisee will bear the costs

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35. *See* Beales & Muris, *supra* note 29, at 159 ("These lower quality franchisees benefit at the expense of the franchisor, higher-quality franchisees, and consumers.").

36. Klein & Saft, *supra* note 33, at 351.

37. *Id.*; *see also* Burns, *supra* note 32, at 641 n.197 ("Such free riding . . . harms the consumer who receives a lower quality good although paying full price . . . .").

38. *See* Rajiv P. Dant & Nada I. Nasr, *Control Techniques and Upward Flow of Information in Franchising in Distant Markets: Conceptualization and Preliminary Evidence*, 13 J. BUS. VENTURING 3, 11 (1998) ("[Franchising r]esearchers classify businesses into repeat versus nonrepeat industries. Although this repeat/nonrepeat dichotomy oversimplifies consumer purchasing behavior, it is still useful in studying agency relationships in the context of franchising as it highlights the differences in the consequences of shirking for the franchisee." (citation omitted)).

39. *See* Robert Dahlstrom & Arne Nygaard, *A Preliminary Investigation of Franchised Oil Distribution in Norway*, 70 J. RETAILING 179, 184 (1994) ("In repeat selling situations the owner of a specific outlet is interested in maintaining quality."); Dant & Nasr, *supra* note 38, at 12 ("[I]n repeat purchase industries, there are fewer opportunities for reputational abuse and a lesser incidence of the free-rider problem by the franchisees . . . ."); Lorelle Frazer & Donald J. Stokes, *Franchising Operational Units in Australia*, 2 FRANCHISING RES. 32, 34 (1997) ("The propensity for free-riding to occur is lower where repeat customers form a large part of an outlet's sales."); Kidwell et al., *supra* note 27, at 531 ("[R]epeated business establishes a relationship between customer and operator that potentially lowers the likelihood of free riding; it would be rational to decrease free riding on a brand name when there is a greater chance that customers would offer repeat business."); Klein & Saft, *supra* note 33, at 348 n.15 ("The creation of 'neighborhood stores' increased the repeat purchase probability and hence reduced the incentive of individual franchisees to free ride on the group."); Kobayashi & Ribstein, *supra* note 1, at 340 ("Operators who rely on local repeat business are less able to free-ride off the franchisor's brand name . . . ."); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 275 ("Operators who rely on local repeat business are less able to free ride off the franchiser's brand-name . . . .").

of her own shirking.[40] Industries that are particularly likely to attract repeat customers, and are therefore less prone to free riding, include those that serve local populations, such as lawn care, laundry and dry cleaning, automotive services, health and fitness centers, and homecare.[41]

Conversely, a franchisee's incentive to free ride is particularly great where the probability of repeat purchase by a particular customer is very low.[42] In such cases, the probability that a franchise will suffer the costs of losing customers already unlikely to return renders free riding rational: decreasing effort levels and reducing both monetary and personal investment in quality then becomes profitable.[43] The risk of losing customers in these situations is borne by the entirety of the franchise chain, affecting the free-riding franchise only marginally.[44] This is because the dissatisfied customer is likely to refrain from future business with *any* branch within the franchise chain where subpar performance was experienced. The local franchisee who caused the initial dismay loses little, as in any case repeat business by the same customer was unlikely. Overall, though, this scenario has each local venue externalizing the costs of dissatisfied customers onto other branches within the same chain, potentially creating a sizable overall effect.

According to the traditional law-and-economics perspective, industries that serve mostly nonrepeat customers are therefore much more prone to free riding.[45] This is

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40. Drahozal & Hylton, *supra* note 29, at 557; *see also* ELIZABETH CRAWFORD SPENCER, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY 69 (2010) ("In the case of a particular franchise unit, when repeat customers accrue to the benefit of that particular franchisee . . . there are positive incentives for that franchisee to cultivate his customers."); Frazer & Stokes, *supra* note 39, at 34.

41. *See* James A. Brickley, *Incentive Conflicts and Contractual Restraints: Evidence from Franchising*, 42 J.L. & ECON. 745, 755 (1999); James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401, 416 (1987); *see also* Dant & Nasr, *supra* note 38, at 11 ("Franchise outlets in repeat customer industries are likely to cater to largely local populations; such industries may include sports equipment, department, and clothing stores." (citation omitted)).

42. Brickley et al., *supra* note 31, at 29 ("The incentives to free-ride are particularly high at units where the level of repeat customers is low."); Brickley et al., *supra* note 1, at 104 ("[T]he incentives to shirk on quality are highest in units where the level of repeat customers is low . . . ."); *see also* ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 16 (2006) ("Free-riding is a particular problem when a franchisee serves mainly nonrepeat customers . . . ."); Mick Carney & Eric Gedajlovic, *Vertical Integration in Franchise Systems: Agency Theory and Resource Explanations*, 12 STRATEGIC MGMT. J. 607, 610 (1991) ("The danger of free riding is greatest where repeat customers constitute a small proportion of unit sales . . . ."); Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees*, 72 N.C. L. REV. 905, 951 n.224 (1994) ("Free-riding is potentially most severe at locations . . . where the probability of repeat sales to that same customer is quite low."); Klein, *supra* note 26, at 359 n.2; Hess, *supra* note 1, at 343 n.74 ("A franchisee at a location with low probability of repeat sales to the same customer has the greatest incentive to free-ride.").

43. *See* Kidwell et al., *supra* note 27, at 531.

44. Frazer & Stokes, *supra* note 39, at 34.

45. *See* Brickley et al., *supra* note 1, at 104 ("[T]he incentives to shirk on quality are highest in units where the level of repeat customers is low . . . ."); Brickley et al., *supra* note

especially relevant in industries serving travelers, such as hotels, motels, and car-rental agencies.[46] Although there is potential for some repeat sales within the same location in these industries, the likelihood of such sales is relatively low.[47] For example, although some travelers visit the same cities frequently and stay repeatedly at favorite hotels, many others pass through a city only once and must stay at an unfamiliar hotel.[48] In many cases, therefore, "the hotel owner has little incentive to please a one-time visitor."[49] The one-time visitor does not present the potential of future business.[50] Once the traveler has decided to stay at the hotel, there is little recourse if, for example, the room is unclean or the service slow.[51] The guest will leave unsatisfied, but since there was little chance of the guest returning anyway, no significant harm has occurred from the perspective of the hotel.[52]

B. At-Will Termination as an Essential Control Mechanism Against Free Riding

According to the conventional law-and-economics analysis, an essential mechanism for reducing franchisee free riding is the ability of the franchisor to terminate the franchise contract at will, namely without having to prove before a disinterested third party that good cause for termination exists.[53] As the late Larry Ribstein proffered:

31, at 29 ("The incentives to free-ride are particularly high at units where the level of repeat customers is low.").

46. Dant & Nasr, *supra* note 38, at 11–12 ("Nonrepeat purchase industries are those where customers are generally mobile and less prone to repeat purchasing from the same outlet (at least in the short-run) even though they may patronize the same franchise system; restaurants, hotels, motels, and auto rental service franchises, in general, are considered examples of such industries."); *see also* Brickley, *supra* note 41, at 755 n.20; Brickley & Dark, *supra* note 41, at 416; Brickley et al., *supra* note 1, at 121; Chris Manolis, Robert Dahlstrom & Arne Nygaard, *A Preliminary Investigation of Ownership Conversions in Franchised Distribution Systems*, 11 J. APPLIED BUS. RES., no. 2, 1995, at 4.

47. Manolis et al., *supra* note 46, at 4.

48. Paul Ingram, *Organizational Form as a Solution to the Problem of Credible Commitment: The Evolution of Naming Strategies Among U.S. Hotel Chains, 1896–1980*, 17 STRATEGIC MGMT. J. 85, 86 (1996).

49. *Id.* at 86–87.

50. *Id.* at 87.

51. *Id.*

52. *Id.*; *see also* You-Ta Chuang & Joel C. Baum, *It's All in the Name: Failure-Induced Learning by Multiunit Chains*, 48 ADMIN. SCI. Q. 33, 36 (2003) ("[B]ecause travelers are unlikely to return to the same hotel repeatedly and are unable to gauge its service quality without prior experience, hotels have no incentive to provide good service in order to attract future business.").

53. Erin Ann O'Hara, *Economics, Public Choice, and the Potential Conflict of Laws*, 90 GEO. L.J. 941, 945 (2002) (The ability of the franchisor to terminate the contract at will is "necessary to prevent individual franchisees from free-riding off the value of the trademark. . . . The only way to ensure that [the franchisee] complies with her obligations is to enable the franchisor to threaten immediate termination."); *see also* Rubin, *supra* note 29, at 228 ("The franchisor wants to eliminate any operations not maintaining the quality of the franchise. Contracts calling for easy termination of franchises make it possible to avoid the period of quality deterioration."); Martin Edward Loeber, Comment, *A DTPA Cause of Action for the Terminated or Nonrenewed Franchisee: A Jack in the Box for the Unfair Franchisor*, 43

"Termination at will can be an important right for franchisers, since it may be *the only way* they can effectively monitor their franchisees to prevent franchisees from free-riding on and decreasing the value of the franchiser's brand name."[54]

The conventional assumption that at-will termination is an essential control mechanism against franchisee free riding is based on the following analysis: when a franchisor has the ability to terminate a contract at will, the franchisee will know that detection of free riding results in swift termination and loss of lucrative business opportunities within the chain.[55] Furthermore, termination induces direct costs, such as the loss of relationship-specific investments.[56]

Relationship-specific investments, also known as idiosyncratic investments, are investments specific to a concrete franchise relationship.[57] They are highly specialized and tailored to that franchise relationship[58] and, as such, are difficult or impossible to redeploy elsewhere.[59] Such costs are therefore sunk, having little or no salvage value to the franchisee after contract termination.[60] Relationship-specific

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BAYLOR L. REV. 809, 816 (1991) ("[E]conomists argue that broad termination clauses are necessary for the franchisors to protect the franchise from the inherent tendency of franchisees to undermine the value of the trademark."). Similarly, franchisors, and not only legal economists, argue that the threat of at-will termination is the only means by which they can protect themselves from free-riding franchisees. *See* Eisenberg, *supra* note 1, at 372 ("Franchisors argue that the threat of arbitrary termination is the only means by which they can protect themselves from franchisees engaging in potentially opprobrious behavior."); Hess, *supra* note 1, at 342 ("Franchisors claim a need for an unrestricted termination power to protect the value of their trademark and to insure a uniform standard of quality among all franchises.").

54. Ribstein, *supra* note 39, at 248 (emphasis added).

55. *See* Beales & Muris, *supra* note 29, at 160 ("[T]he existence of the clause that has caused so much trouble and given rise to so much sympathy for franchisees—the franchisor's right to terminate 'at will'—becomes understandable. When such clauses are enforced, the franchisee would know that detection results in swift termination. The clause is thus a lower-cost method than litigation of reducing the franchisee incentive to cheat."); *see also* Brickley et al., *supra* note 1, at 104 (The franchisee's incentive to free ride "will be lower if franchisees who are caught cheating are punished by contract termination and thus lose any remaining quasi rents on firm-specific investments."); Byers, *supra* note 1, at 657 ("The franchisor's termination power is therefore essential—as both a threat to encourage franchisee compliance and a means to actually purge noncomplying franchisees from the system—to ensure that goods and services of requisite quality are supplied to consumers.").

56. The following explanation is based on Uri Benoliel, *Rethinking the U.S. Supreme Court's Abandonment Requirement in* Mac's Shell Service Inc. v. Shell Oil Products, 43 RUTGERS L.J. 77, 83–87 (2011).

57. Erin Anderson & Barton Weitz, *The Use of Pledges To Build and Sustain Commitment in Distribution Channels*, 29 J. MARKETING RES. 18, 20 (1992).

58. Shankar Ganesan, *Determinants of Long-Term Orientation in Buyer-Seller Relationships*, J. MARKETING, Apr. 1994, at 1, 6; Jan B. Heide & George John, *The Role of Dependence Balancing in Safeguarding Transaction-Specific Assets in Conventional Channels*, J. MARKETING, Jan. 1988, at 20, 21 n.1.

59. Anderson & Weitz, *supra* note 57, at 20; Heide & John, *supra* note 58, at 21 n.1.

60. *See* James R. Brown, Jody L. Crosno & Chekitan S. Dev, *The Effects of Transaction-Specific Investments in Marketing Channels: The Moderating Role of Relational Norms*, 17 J. MARKETING THEORY & PRAC. 317, 317 (2009) ("[*T*]*ransaction-specific investments* . . . have little or no value outside of that relationship." (emphasis in original));

investments include "leasehold improvements," fixtures that are attached to the retail or commercial space and installed by the franchisee when setting up a new location, such as walls, doors, cabinets, light fixtures, and floor coverings.[61] Such improvements may be significant and costly: for example, a Subway franchisee may be required to invest up to $134,500 in leasehold improvements.[62] The costs involved are typically sunk, as franchisors often require the franchisee to lease, rather than own, the land upon which the outlet is located.[63] The lease arrangement grants the franchisor the right to require the franchisee to evacuate the leased property upon termination of the franchise contract.[64] As a result, the leasehold improvements, which remain the property of the franchisor, must be surrendered by the franchisee along with the property, causing the free-riding franchisee substantial economic loss.[65]

Equipment expenditures are another form of relationship-specific investments lost by a free-riding franchisee if the franchise agreement is terminated at will by a franchisor.[66] Depending upon the conditions of the space and the particular business model, the required equipment expenditures can be extensive: for example, a McDonald's franchisee may be required to invest more than $1.5 million dollars in equipment, including signs, seating, and décor.[67] Frequently, much of the equipment purchased cannot be used outside the franchise, thus making the expenditure relationship specific.[68] Obviously, the fast-food franchisee's outdoor signs cannot be used by the franchisee with any other franchisor.[69] Similarly, franchise-specific décor

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Ganesan, *supra* note 58, at 6 ("Transaction-specific assets are investments in durable assets that are . . . not easily redeployable and have little salvage value in other relationships."); Jan B. Heide & George John, *Alliances in Industrial Purchasing: The Determinants of Joint Action in Buyer-Supplier Relationships*, 27 J. MARKETING RES. 24, 27 (1990) ("Specific investments are investments made by a firm that are of considerably less value outside the focal relationship.").

61. *See Franchise Tutorial 20: Intro to Leasehold Improvements*, CANADIAN FRANCHISE ASS'N, https://web.archive.org/web/20140327184418/http:/cfa.ca/Publications_Research/Tutorials/tutorial20.aspx.

62. *See Subway Franchise Cost & Fees*, FRANCHISE DIRECT, http://www.franchisedirect.com/directory/subway/ufoc/915/ (last updated 2014).

63. *See* ANNE T. COUGHLAN, ERIN ANDERSON, LOUIS W. STERN & ADEL I. EL-ANSARY, MARKETING CHANNELS 539 (7th ed. 2006); Klein, *supra* note 26, at 359.

64. *See* Klein, *supra* note 26, at 359.

65. Antony W. Dnes, *'Unfair' Contractual Practices and Hostages in Franchise Contracts*, 148 J. INST. & THEORETICAL ECON. 484, 487 (1992) ("Tenants normally make alterations to commercial premises (leasehold improvements) which must be given up with the property. If the franchisor fails to renew the lease the franchisee cannot adapt improvements to other uses."). Of course, the sunk nature of these costs, together with the direct benefit franchisors accumulate from repossessing the improved property, are major causes of concern for franchisees, as they point to potential franchisor opportunism.

66. Benoliel, *supra* note 56, 85–86.

67. *See McDonald's Franchise Cost & Fees*, FRANCHISE DIRECT, http://www.franchisedirect.com/foodfranchises/mcdonalds-franchise-07030/ufoc/ (last updated 2014).

68. Dnes, *supra* note 65, at 502.

69. Brown et al., *supra* note 60, at 317.

is regarded as worthless outside the franchise's chain.[70] But beyond these expenditures, many franchises operate with idiosyncratic procedures, necessitating specialized equipment and investments well beyond those observable by customers; as a result, contract termination typically necessitates resale of franchisee equipment at a substantial loss.[71]

C. Good-Cause Statutes as Increasing Franchisee Free Riding

According to the conventional law-and-economics analysis, good-cause statutes disrupt the essential control mechanism against franchisee free riding: at-will termination.[72] GCSs increase the costs of terminating a franchise contract, as compared to an at-will regime, for four cumulative reasons.

First, GCSs generate documentation costs for a franchisor who wishes to terminate a contract.[73] The GCSs place the burden on the franchisor to prove that there was good cause for terminating the contract.[74] These statutes require increased payments to a franchisee in the case of termination unless good cause can be documented by the franchisor in a court proceeding, which naturally bears high additional costs.[75] Even clear cases of cause-based termination will thus be subject to burdens of proof, leading to an ex-ante policy of procedures and complaints, and early monitoring will be carefully documented.[76] Documentation costs thus plague franchise relationships even where no free riding occurs, as the necessary protocols must be in place and documentation gathered throughout the life of the contract, regardless of eventual use.

Second, GCSs generate significant litigation costs: by granting franchisees protection from arbitrary termination, GCSs invite every terminated franchisee to litigate the issue of whether or not good cause existed.[77] Such litigation is costly,

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70. *Cf.* Dnes, *supra* note 65, at 489–91. The secondhand value of trademarked franchise equipment is normally one quarter of its original cost. *See* COUGHLAN ET AL., *supra* note 63, at 537.

71. *Cf.* COUGHLAN ET AL., *supra* note 63, at 537; Dnes, *supra* note 65, at 495; Warren S. Grimes, *Making Sense of* State Oil Co. v. Khan*: Vertical Maximum Price Fixing Under a Rule of Reason*, 66 ANTITRUST L.J. 567, 586 (1998); Warren S. Grimes, *Market Definition in Franchise Antitrust Claims: Relational Market Power and the Franchisor's Conflict of Interest*, 67 ANTITRUST L.J. 243, 250–51 (1999).

72. *Cf.* Klein, *supra* note 25, at 30 (GCSs "entail the associated cost of making the self-enforcement mechanism more difficult to use."); Pruitt, *supra* note 1, at 569 ("By disrupting the essential control component of franchise contracts, relationship statutes [namely, GCSs] undermine the very benefits to be achieved through the franchising method of distribution."); Ribstein, *supra* note 39, at 275 ("Consider the example of a statute that limits termination-at-will of franchisees . . . . Limitations on termination reduce the franchiser's ability to discipline shirking or free-riding franchisees."); Byers, *supra* note 1, at 657 ("Good cause limitations on termination are the primary manner in which lawmakers have attempted to protect the franchisee's nonrecoverable investment. However, such laws can hinder the franchisor's ability to effectively police its franchise system.").

73. *See* Pitegoff, *supra* note 1, at 310 n.88.

74. *Id.* at 309–10.

75. Brickley et al., *supra* note 1, at 104.

76. *See* Pitegoff, *supra* note 1, at 310 n.88.

77. Pruitt, *supra* note 1, at 569.

both directly (court/attorney fees and the like) and indirectly (diverting attention from business concerns to legal ones, tarnishing franchise reputation, and more).[78] Litigation costs obviously limit the franchisor's incentive to instigate proceedings, making a threat to sue less credible and its use in preventing free riding ex ante less effective. Of course, litigation costs might also lead to pretrial negotiations and suboptimal settlements, making even those franchisees whose contracts are terminated less worried about such a result.

Third, GCSs expose franchisors who terminate a free-riding franchisee for good cause to costs stemming from errors. Namely, franchisors are required to bear the risk of erroneous court decisions.[79] A franchisor must not only convince itself that termination was based on good cause;[80] in order to prevail in litigation, it must also convince external observers of the existence of good cause. Since legal results are typically uncertain, courts may wrongfully decide that termination was arbitrary and unlawful even when good cause existed. Given that GCSs shift the burden of proof and make the franchisor's case harder to win, error costs are borne mostly by the plaintiff, further reducing the incentive to exercise the contractual threat of termination.

Last, GCSs expose the franchisor to the risk of a biased jury. More specifically, when a franchisee can request a jury trial, the franchisor faces the additional obstacle of juror bias, as jurors may favor the "little" franchisee over the "bigger" franchisor and the local owner over the national chain.[81] These costs and risks are reduced, if not eliminated, if termination can be conducted at will.[82]

Law-and-economics scholars argue that, by disrupting the essential at-will control mechanism, GCSs increase free riding in franchise relationships.[83] As Professors Bruce Kobayashi and Larry Ribstein straightforwardly claimed, "franchisee protection laws increase shirking and free-riding."[84] Similarly, Professor Jonathan Klick joined Kobayashi and Ribstein when he argued that the benefits of GCSs "may be outweighed by their costs in *preventing* franchisors from disciplining shirking franchisees."[85] Likewise, Professor Erin Ann O'Hara assumed that GCSs "transfer wealth from franchisor to franchisee because they enable individual franchisees some latitude to free ride off the company trademark and thereby earn greater profits."[86] Similarly, Professor Matthew Ellman implies that under the governance of GCSs, "the free-riding problem is very hard to solve."[87]

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78. *See* Beales & Muris, *supra* note 29, at 159.

79. Pitegoff, *supra* note 1, at 310 n.88.

80. Beales & Muris, *supra* note 29, at 159.

81. *Id.* at 159–60.

82. Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 314 (1975).

83. *See* Matthew Ellman, *Specificity Revisited: The Role of Cross-Investments*, 22 J.L. ECON. & ORG. 234, 250 n.36 (2005); Klick et al., *supra* note 1, at 364; Kobayashi & Ribstein, *supra* note 1, at 340; O'Hara, *supra* note 53, at 946.

84. Kobayashi & Ribstein, *supra* note 1, at 340.

85. Klick et al., *supra* note 1, at 364 (emphasis added).

86. O'Hara, *supra* note 53, at 946.

87. Ellman, *supra* note 83, at 250 n.36; *see also* Byers, *supra* note 1, at 657 (GCSs "can hinder the franchisor's ability to effectively police its franchise system.").

Given that prevailing wisdom is aligned with economic principles and paints a black picture of GCSs, we decided to empirically assess whether common sense is indeed based on fact and whether at-will termination is as important as many would have us believe.

III. TESTING PREVAILING WISDOM: DO GCSS INCREASE FREE RIDING?

The scant existing empirical literature assessing the influence of GCSs on franchisee free riding focuses on indirect indicators, such as the number of local businesses within a given industry owned by franchisors versus franchisees or the level of employment in franchise-intensive industries.[88] These indicators are used as proxies for the quality of franchise operations, with commentators attempting to disentangle franchisee free riding from franchisor opportunism.[89] In order to avoid the pitfalls of indirect inference, we sought a database that would provide for more direct evidence of free riding, ideally one that rates franchise operations on an individual basis (rather than cumulative results for the entire state or industry). Such data could then be examined for direct evidence of quality differences between otherwise-similar franchise operations in states where GCSs were enacted versus states where at-will termination is possible at the franchisors' discretion. If the standardly accepted free-riding hypothesis is valid, we should observe—in *each* typical franchise chain—the following phenomenon: the average level of free riding of all the franchisee units located in good-cause states should be higher than the average level of free riding among all of the franchisee units located in at-will states.

With this in mind, we decided to examine, as a case study, the level of free riding among franchisees in the hotel industry. Free riding is obviously impossible to assess directly, as it takes many forms. We thus focused on its output: effects on customer satisfaction and assessments of service and cleanliness. These are the results of effort and care on the part of the service provider, with lower investment in quality assumed to result in lower service and satisfaction. We chose the hotel industry as our case study because, according to the traditional law-and-economics approach, it is particularly prone to a high risk of franchisee free riding.[90] Since the hotel industry generally serves travelers who are nonrepeat customers, hotel franchisees do not internalize the full costs of their free riding.[91] We would thus expect free riding to be prevalent, and where it is left unchecked, the investment in quality (and thus customer satisfaction) should be low.

A. Methodology

In order to locate suitable candidates for comparison, we selected franchise chains according to several criteria. We sought national chains with multiple locations in each state and a sizable presence in both good-cause and at-will states.

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88. *See* Brickley et al., *supra* note 1; Klick et al., *supra* note 1.
89. *See* Brickley et al., *supra* note 1, at 130; Klick et al., *supra* note 1, at 375.
90. *See supra* notes 45–46.
91. *See supra* Part II.A.

This approach allowed for a sample size that reduced the effects of random variation across sites and states. We focused on chains that serve many travelers unlikely to return to the same location and that rely to a great degree on investment in quality that is difficult to quantify (e.g., effort, employee supervision, investment in service and quality). Thus, we focused on customer assessment of service and cleanliness (which serve as proxies for investment of effort) and total satisfaction (which captures multiple dimensions of quality). Free-riding franchisees would be expected to achieve lower satisfaction ratings by customers expecting certain standards that were not met. Last, we screened for franchises that operate exclusively as franchisee-owned-and-operated businesses, in order to avoid complications arising from including company-owned sites less prone to the type of free riding we set out to examine. It should be noted that all conditions were set to make free riding easier to discern using publicly available data. Thus, if the prevailing wisdom regarding GCSs is correct, our test should pick up any differences between states with and without such statutes.

In order to find suitable candidates, we used the well-known website Entrepreneur.com to generate a list of ten chains meeting our initial criteria.[92] From this list, we decided to focus on the larger chains for sample-size purposes, and we set our lower threshold to admit only those chains having more than four hundred U.S. hotels. Where hotel chains featured different quality tiers (such as discount hotels, suites, and luxury hotels), we assessed each tier as a separate chain to avoid quality-specific attributes being lost and to screen for free riding in disparate circumstances.

Screening for franchisee-owned hotel chains, operating nationally and consisting of more than four hundred franchised hotels, led to a sample totaling some 3700 hotels across three relevant chains: Days Inn,[93] Ramada,[94] and Super 8.[95] If the free-riding hypothesis is valid, we should observe—in *each* of these three sample chains—the following phenomena: The average level of free riding of all the franchisee units located in good-cause states should be higher than the average level of free riding of all the franchisee units located in at-will states. This should lead to higher customer ratings for hotels located in at-will states compared to good-cause hotels from within the same chain and quality tier.

In order to ascertain the average level of free riding among the franchises subject to different laws, we took the following three steps for each of the three selected chains across all states: First, we located—via an online hotel search engine called freehotelsearch.com—all the hotels situated in good-cause states

92. These chains were Baymont Inn & Suites; Centerstone Inns, Hotels & Plaza Hotels; Days Inn; Hospitality Int'l Inc.; Knights Inn; Microtel Inn & Suites by Wyndham; Ramada; Super 8; Travelodge; and Wingate by Wyndham.

93. Days Inn has 1552 units in the United States. *Days Inn*, ENTREPRENEUR.COM, http://www.entrepreneur.com/franchises/daysinn/282270-0.html.

94. Ramada has 416 units in the United States. *Ramada*, ENTREPRENEUR.COM, http://www.entrepreneur.com/franchises/ramada/282743-0.html.

95. Super 8 has 1696 units in the United States. *Super 8*, ENTREPRENEUR.COM, http://www.entrepreneur.com/franchises/super8/282845-0.html.

belonging to the chains in question.[96] Second, for each hotel, we searched Expedia.com for customer ratings left by actual guests regarding service, cleanliness, and total satisfaction. These criteria were rated by hotel guests on a scale from 1 to 5, with 1 being the least favorable and 5 being the most favorable. The guest ratings for these criteria serve, in our study, as a proxy for the franchisee's level of free riding. Free-riding hotels typically receive low ratings by guests under the service, cleanliness, and total satisfaction criteria, as these qualities are difficult to specify in contractual terms, making cost-reducing shirking by franchisees more prevalent. Conversely, non-free-riding hotels will normally receive higher ratings. Third, we calculated average ratings in each criterion and compared across states, contrasting good-cause with at-will states.

It should be noted that we selected Expedia.com as our database for guest ratings because of its inherent protection from manipulation by self-interested parties. The common fear with all rating systems is that participants will attempt to "game the system" in order to bolster their reputation and attract potential clients. With online ratings, there is always a risk of business owners inserting positive ratings and false recommendations for their own facilities and negative ratings for their competitors. On Expedia.com, only those who actually booked a hotel through the site, paid for it, and had their stay verified can enter a review.[97] The sheer financial cost of a franchisee posting a falsified review on Expedia.com is prohibitive, thus bestowing credibility on those reviews found online.[98] Furthermore, booking a hotel night through Expedia requires the reviewer to undertake a credit card transaction on Expedia.com. The reviewer, therefore, does not remain anonymous to Expedia, raising the probability that the company will detect phony reviews. Ultimately, detection can prove costly for a forging franchisee, as it may lead to government fines, private lawsuits, penalties imposed by the review-hosting platform, and associated reputational costs.[99] Given that such significant costs may spill over, at least in part, to franchisors, many of them contractually constrain the social-media practices of franchisees, thereby increasing the franchisees' forging costs.[100]

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96. This website allows searching for Days Inn, Ramada, and Super 8 hotels within the boundaries of each U.S. state. *See, e.g.*, *Days Inn Hotels in U.S.A.*, FREEHOTELSEARCH.COM, http://www.freehotelsearch.com/U_S_A-Days_Inn-chain.html.

97. Press Release, Expedia, Inc., Expedia Overhauls Hotel Reviews: Consumers Can Now Sort Verified Reviews by Shared Interest (Mar. 8, 2012), *available at* http://mediaroom.expedia.com/travel-news/expedia-overhauls-hotel-reviews-consumers-can-now-sort-verified-reviews-shared-interest-; Danny King, *Expedia Touts 'Verified' Reviews*, TRAVEL WEEKLY (Dec. 29, 2011), http://www.travelweekly.com/travel-news/online-travel/expedia-touts--verified--hotel-reviews.

98. The same is not true for other common review sites, such as TripAdvisor, where the same (nonpaying) individual can post multiple reviews. *See* Dina Mayzlin, Yaniv Dover & Judith A. Chevalier, *Promotional Reviews: An Empirical Investigation of Online Review Manipulation* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 18340, 2012), *available at* http://www.nber.org/papers/w18340.pdf.

99. *Id.* at 14.

100. *See id.* at 15.

After separately measuring—via Expedia.com—customer perceptions of cleanliness, service quality, and overall satisfaction for each of the three selected chains in both the good-cause states and the at-will states, we tested the free-riding hypothesis for each chain and quality tier: namely, whether ratings for franchisee units located in good-cause states are indeed inferior to ratings in at-will states.

B. Data

The Days Inn chain has 490 hotels situated in good-cause states that were rated by guests via Expedia.com. These hotels were rated by a total of 79,060 guests, averaging 161 ratings per hotel. Similarly, we located 989 Days Inn hotels in at-will states under the same conditions, rated by 139,563 guests via Expedia.com. This resulted in an average of 141 ratings per hotel.

As for the Ramada chain, data gathering was more complex. This chain has three different hotel tiers, which differ in price and services offered: Ramada Hotel, Ramada Limited Hotel, and Ramada Plaza. The Ramada Hotel tier includes hotels for the midmarket traveler. The hotels at this tier are full-service properties with swimming pools, exercise rooms, room service, and free breakfast items. Ramada Limited Hotels, on the other hand, are budget-oriented properties, typically with no on-site restaurant. Finally, Ramada Plazas are full-service hotels, which are conveniently located near city centers and/or airports.[101] Since each tier at the Ramada franchise chain—Ramada Hotel, Ramada Limited Hotel, and Ramada Plaza—has different characteristics than the other tiers in the chain, our empirical test on the level of franchisee free riding was conducted separately for each of the three tiers.

For the Ramada Hotel tier, we identified 112 hotels located in good-cause states that had been rated by guests via Expedia.com. These hotels were rated by a total of 39,276 guests, leading to an average of 351 ratings per hotel. In at-will states, 190 hotels in this tier were rated by 54,115 guests, leading to an average of 285 ratings per hotel. At the Ramada Limited Hotel tier, we located 31 hotels in good-cause states, rated by 8598 guests and averaging 277 ratings per hotel. At-will states had 51 such hotels, rated by 8521 guests, for an average of 167 ratings per hotel. Ramada Plaza had merely 9 hotels in good-cause states and 11 hotels in at-will states. These hotels were rated by 4353 guests and 4381 guests, respectively, averaging 484 and 398 ratings per hotel.

Last, for the Super 8 chain, we located 631 hotels in good-cause states, rated by 69,022 guests, for an average of 109 ratings per hotel. At-will states have 928 such hotels, rated by 100,755 guests, for an average of 109 ratings per hotel. Table 1 summarizes the available data.

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101. *See About Ramada*, RAMADA WORLDWIDE, http://www.ramada.com/about-us/about-ramada (last updated 2014).

Table 1. Hotel chains in good-cause and at-will states

	Good-cause states[102]	At-will states[103]
Days Inn		
Number of hotels	490	989
Number of reviews	79,060	139,563
Average number of reviews per hotel	161	141
Ramada Hotel		
Number of hotels	112	190
Number of reviews	39,276	54,115
Average number of reviews per hotel	351	285
Ramada Limited Hotel		
Number of hotels	31	51
Number of reviews	8598	8521
Average number of reviews per hotel	277	167
Ramada Plaza		
Number of hotels	9	11
Number of reviews	4353	4381
Average number of reviews per hotel	484	398
Super 8		
Number of hotels	631	928
Number of reviews	69,022	100,755
Average number of reviews per hotel	109	109
Total hotels	1273	2169
Total reviews	200,309	307,335

C. Results

The folk theorem of GCS literature is that free riding in good-cause states exceeds free riding in at-will states due to the disciplinary effect of franchisor termination.[104] We should thus expect customer ratings of difficult-to-quantify variables to be higher in at-will states relative to states in which GCSs were enacted.

102. These states include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, Tennessee, Virginia, Washington, and Wisconsin. *See supra* note 4.

103. These states include Alabama, Alaska, Arizona, Colorado, Florida, Georgia, Idaho, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Vermont, West Virginia, and Wyoming.

104. *See supra* Part II.

In order to test for free riding, we compared customer ratings along several dimensions, beginning with average results for each hotel chain and quality tier within good-cause versus at-will states. The results show that, on average, ratings for all measures are similar across hotels subject to different contractual regulation, thereby negating the folk theorem. Initial results are summarized in Table 2, with further details and more nuanced investigation thereafter.

Table 2. Average rating per hotel

	Good-cause states	At-will states
Days Inn		
Service	3.596	3.615
Cleanliness	3.543	3.538
Total satisfaction	3.379	3.399
Ramada Hotel		
Service	3.796	3.744
Cleanliness	3.749	3.687
Total satisfaction	3.581	3.514
Ramada Limited Hotel		
Service	3.635	3.621
Cleanliness	3.597	3.596
Total satisfaction	3.452	3.455
Ramada Plaza		
Service	3.844	3.864
Cleanliness	3.867	3.864
Total satisfaction	3.667	3.709
Super 8		
Service	3.734	3.685
Cleanliness	3.705	3.638
Total satisfaction	3.540	3.482

Casual observation shows the distribution of ratings in states with a GCS to be similar to states without one. Since a good picture is worth a thousand words, below we show a graphical boxplot representation of the three categories for Days Inn hotels (similar results were obtained for the other chains):

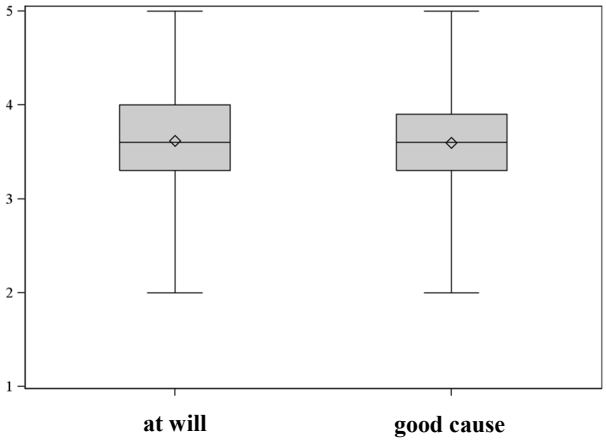

Figure 2. Boxplot representation for Days Inn hotels: service

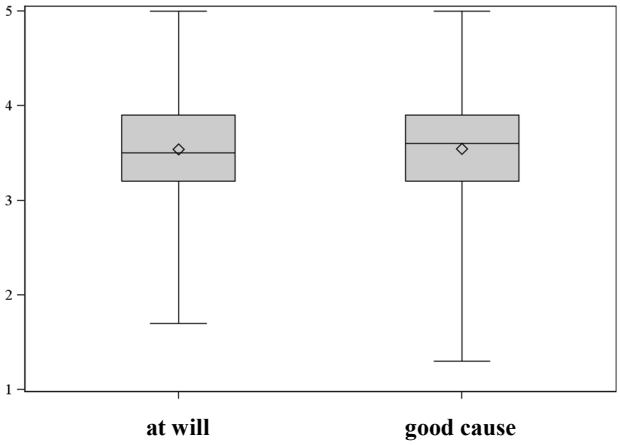

Figure 3. Boxplot representation for Days Inn hotels: cleanliness

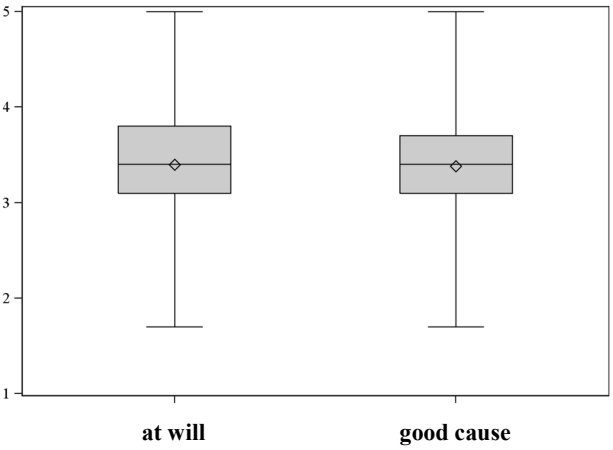

Figure 4. Boxplot representation for Days Inn hotels: total satisfaction

While the picture seems clear, appearances might be misleading. In order to verify that our results indeed show GCSs have little effect on perceived quality, we employed a variety of econometric methods designed to tease out any differences that might escape initial detection. Since our purpose was to determine whether the at-will sample outperforms good-cause hotels, we tested the data using a Wilcoxon rank-sum test (also known as the Mann-Whitney U test), which examines two given samples to determine whether one is drawn from a population with higher variables.[105] If the folk theorem is correct, as the law-and-economics literature suggests, we would be able to reject the null hypothesis that the populations are identical.

Across the five samples (Days Inn, Ramada Hotel, Ramada Limited Hotel, Ramada Plaza, Super 8) and the three parameters examined (service, cleanliness, overall satisfaction), in no case did the statistical test return a value showing any advantage to at-will states over good-cause ones. Thus, in fifteen separate analyses, examining a total of 200,309 reviews in good-cause states versus a total of 307,335 reviews in at-will states, *not one* stratum returned a result lending credence to the prevailing wisdom that GCSs increase free riding.[106] The results therefore cast considerable doubt on the validity of the traditional law-and-economics analysis of GCSs.

After assessing average ratings in the three categories and failing to find differences between at-will and good-cause states, we decided to investigate further. In order to rule out the possibility of skewed results due to some peculiarity of the online ranking method, we reassessed each of the fifteen tests (five hotel chains, three qualities that proxy for free riding) by further stratifying according to rating levels. Thus, we disentangled the online ratings according to low-to-high strata rather than focusing on average results. This allowed us to examine whether some rating levels were more sensitive to differences among populations, differences that might escape detection if averaged out by opposite biases in different rating levels. For example, it might be that more significantly low ratings were given to hotels in good-cause states than at-will states, even if the average ratings were similar due to an opposite bias affecting high ratings.

In order to assess this possibility, we separated each of the fifteen strata into groups, ranking low to high ratings according to the numerical scale used by Expedia. Thus, we compared ratings in each group to similar ratings in the other group rather than aggregating within group averages. We then applied a chi-square test and a

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105. *See* H. B. Mann & D. R. Whitney, *On a Test of Whether One of Two Random Variables Is Stochastically Larger Than the Other*, 18 ANNALS MATHEMATICAL STAT. 50 (1947); Frank Wilcoxon, *Individual Comparisons by Ranking Methods*, 1 BIOMETRICS BULL. 80 (1945). This test was warranted due to the populations of ratings not being distributed normally. On a scale of 1 to 5, 1s are almost unheard of, while 5s are prevalent. The tails are thus heavy and nonsymmetric. We therefore used a nonparametric test so as to avoid unwarranted assumptions that might skew the results.

106. In order to reject the null hypothesis that the distributions are equal, the two-sided Wilcoxon test must return a value below 5% or 1% (0.05 or 0.01), depending on the significance criterion chosen. Actual results ranged between 28% and 97%, thus suggesting (strongly) that the distributions are similar and GCSs have no effect on customer ratings. Indeed, in one case, the result was opposite that predicted by the standard explanation. In the case of Super 8 hotels, we were unable to reject a hypothesis that good-cause states had *higher* ratings than at-will states, though only at the 5%, rather than 1%, level.

Fisher's exact test,[107] but we again failed to find any statistically significant difference among states along any of the dimensions examined. Below is a sample table showing the distribution and analysis of ratings for total satisfaction at Days Inn hotels (all other tables are available upon request and show similar results):

Table 3. Distribution and analysis of ratings for total satisfaction at Days Inn hotels[108]

Frequency, %, Row %, Col %	Low	Middle	High	Total
At-will states	195 13.18 19.72 66.33	643 43.48 65.02 66.02	151 10.21 15.27 71.56	989 66.87
Good-cause states	99 6.69 20.20 33.67	331 22.38 67.55 33.98	60 4.06 12.24 28.44	490 33.13
Total	294 19.88	974 65.86	211 14.27	1479 100.00

Statistic	DF	Value	Probability
Chi-square	2	2.4580	0.2926
Likelihood ratio chi-square	2	2.5123	0.2848
Mantel-Haenszel chi-square	1	0.9410	0.3320
Phi coefficient		0.0408	
Contingency coefficient		0.0407	
Cramer's V		0.0408	

Fisher's exact test	
Table probability (P)	0.0010
Pr <= P	0.2970

Note: sample size = 1479

We can thus safely say that not only are average ratings per hotel similar in good-cause and at-will states, but there is no statistically significant difference among any group of reviewers at any level of satisfaction. Therefore, it is safe to say that good-cause statutes do not diminish customer satisfaction along any dimension

107. Both tests are used to examine whether the results measured differ significantly from the results expected under the null hypothesis—that is, whether reality differs from expectations. *See* WILLIAM H. GREENE, ECONOMETRIC ANALYSIS 104–06 (5th ed. 2003). In this case, they allow for examining whether the differences between states are random fluctuations or whether they stem from the existence of GCSs in some states and not in others. It turned out that GCSs had no statistically significant effect on customer reviews.

108. For each rubric in the table, four quantities are reported: Frequency (the number of occurrences in the data); % (the percentage of the population falling within this rubric); Row % (the percentage of the row population, for example, at-will states, falling within this rubric); and Col % (the percentage of the column population, for example, low satisfaction, falling within this rubric).

measured. Since ratings for cleanliness, service, and overall satisfaction were presumed to proxy for quality differences associated with free riding, there appears to be no support in our data for the folk theorem that good-cause statutes induce free riding and impede franchisor control of on-site quality.

IV. DISCUSSION AND NORMATIVE IMPLICATIONS

The conventional law-and-economics analysis of GCSs contends that they increase franchisee free riding.[109] This analysis rests on one central assumption: an *essential* control mechanism against franchisee free riding is the ability of the franchisor to terminate the franchise contract at will.[110] The results of our empirical tests show that the traditional economic approach is questionable. Specifically, these tests demonstrate that the level of free riding in good-cause states, which prohibit at-will termination, is similar to the level of free riding in at-will states.

Several explanations might be offered for this phenomenon. One might argue that the result applies to hotels but not to other industries. Of course, then one would have to supply corroboration and a convincing explanation of why hotels are different. Even if such a claim was considered, the hotel industry is sufficiently large to warrant consideration in and of itself. Furthermore, most discussions of free riding in the franchise industry focus on travel hotels as the paradigmatic case of nonrepeat customers, relying on free riding to justify contractual mechanisms and regulatory noninterference more generally. Even if our results do not generally extend to other related industries, normative issues arise within the hotel industry itself, and these will be discussed below.

Before we move on to our preferred interpretation of the results, it is important to rule out several factors that, if present, would limit any conclusions drawn. It might be, for instance, that the presence of GCSs does not increase free riding because contractual terms in good-cause states override the effective protection of such statutes. However, this hypothesis is ruled out by the mandatory nature of most GCSs, negating any contractual waiver of the rights. Thus, a franchisee who agreed to a contract stipulating at-will termination in a good-cause state would still be protected and could bring suit based on the GCS regardless of contractual language to the contrary.[111]

It might also be that the opposite is true—that national franchises include good-cause language in all their contracts, obviating at-will termination by contractually conceding the case and essentially implementing GCS-like protection even in at-will states. But such a claim is wrong on two counts: First, the facts are different. Examination of the contracts shows that most include at-will termination clauses or other clauses that do not satisfy the statutory good-cause requirement.[112]

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109. *See supra* Part II.C.

110. *See supra* Part II.B.

111. *See supra* note 10 and accompanying text.

112. For example, according to the Days Inns and Super 8 franchise contracts, the franchisor may terminate the agreement for convenience at any time upon six months' advance notice. *See* DAYS INN WORLDWIDE, INC., FRANCHISE DISCLOSURE DOCUMENT 9 (2013), *available at* https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showPoup&documentId={D01E9B8F-E1F5-4937-B901-7079A48A50BA}&documentTitle=42280&documentType=4; SUPER 8, FRANCHISE DISCLOSURE DOCUMENT 9 (2013), *available at* https://www.cards.commerce

Second, if all franchise contracts included good-cause language, there would be no effective at-will states, making franchisor resistance to good-cause statutes unnecessary. Since such resistance is strong, there must be a reason franchisors view GCSs as problematic.[113] We will return to this issue below, when discussing normative recommendations.

In our opinion, the most appropriate interpretation of the results described above relates to the means used to obtain them, namely the review sites from which we drew our empirical data. Such review sites—namely, websites that allow customers to post reviews about franchisees—are prevalent and widely used, and they serve a primary purpose of allowing customers to give feedback regarding the business they interacted with. Such feedback is directly aimed at the specific venue, but probably more intended for the indirect communication with other customers considering the same provider. For reasons detailed below, online review sites facilitate quality control within franchise chains, as free riding will be directly disciplined by negative customer ratings that reduce future business of potential customers. The Expedia rating system allows all potential customers to incorporate observed results in their decision whether to use the reviewed business's offerings or to pursue a better alternative. In other words, where online ratings are sufficiently trustworthy, franchisors can rely on customer participation in monitoring wayward franchisees. Such a system thus supplants at-will termination as a quality-control mechanism, making the statutory differences between states with and without GCSs less important. Ultimately, a successful online review system forces individual franchisees to conform to expected quality levels, making the once-indispensable at-will mechanism obsolete.

A. The Role of Review Sites

Online review sites force the free-riding franchisee to bear the costs of his or her shirking, as even first-time visitors have the benefit of information regarding venue quality. Since shirking on difficult-to-quantify investment in quality is policed by customers, it need not be policed to the same extent as previously required by franchisors. Thus, traditional explanations regarding GCSs inducing free riding might have been true before, but it seems that online reputation mechanisms have supplanted threats of contractual termination. Of course, our study does nothing to corroborate (and nothing to dispute) the traditional explanations' efficacy prior to the advent of online rankings, and not all industries operate with such reputation

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.state.mn.us/CARDS/security/search.do?method=showPoup&documentId={4DCCC980-68EE-488C-9DA8-12B151322F53}&documentTitle=41631&documentType=4; *see also* Jonathan Klick, Bruce Kobayashi & Larry Ribstein, *The Effect of Contract Regulation: The Case of Franchising* 8 (George Mason Law & Econ. Research Paper Series, Working Paper No. 07–03, 2006), *available at* http://ssrn.com/abstract=951464 ("[M]ost franchise contracts contain at will termination clauses.").

113. *See* Eisenberg, *supra* note 1, at 372 ("Franchisors argue that the threat of arbitrary termination is the only means by which they can protect themselves from franchisees engaging in potentially opprobrious behavior."); Hess, *supra* note 1, at 342 ("Franchisors claim a need for an unrestricted termination power to protect the value of their trademark and to insure a uniform standard of quality among all franchises.").

mechanisms. Still, given that Expedia is but one of many review websites and that social media networks such as Facebook make online reputations the rule rather than the exception, these findings are significant.[114]

In the hotel industry, the focus of our empirical study, online review sites have become a widespread phenomenon. Sites such as Expedia, TripAdvisor, and Orbitz allow travelers to write reviews and rate the hotels in which they have stayed. Empirical studies show that online hotel reviews written by travelers influence travelers' booking decisions. For example, Ulrike Gretzel, Kyung Hyan Yoo, and Melanie Purifoy conducted a survey among 7000 TripAdvisor.com users in order to examine several factors, including the impact of travel reviews on travelers' trip-planning processes.[115] According to the survey, 91.8% of respondents avoided places or services due to the content of online reviews posted by other travelers.[116] Similarly, an experimental study conducted by Aurelio Mauri and Roberta Minazzi tested, among other things, whether travelers consult comments of other travelers before booking a hotel.[117] The experiment shows that respondents' hotel booking intentions indeed increased where there was a prevalence of positive comments and decreased in the face of negative ones.[118] Other studies produced similar results.[119]

Empirical studies reveal more than the mere influence of reviews on booking decisions; they also demonstrate that hotel revenues are significantly impacted.[120] In one study by Chris K. Anderson, a 1% increase in online reputation measures led to a 0.54% increase in occupancy and a 1.42% increase in hotel revenues.[121]

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114. *See* Courtney Christman, *Reputation Management Through Social Media and Online Reviews*, MAINSTREETHOST (Mar. 3, 2014), http://blog.mainstreethost.com/reputation-management-social-media-online-reviews#.VODAnPnF98E.

115. ULRIKE GRETZEL, KYUNG HYAN YOO & MELANIE PURIFOY, ONLINE TRAVEL REVIEW STUDY: ROLE & IMPACT OF ONLINE TRAVEL REVIEWS 4 (2007), *available at* http://www.tripadvisor.com/pdfs/OnlineTravelReviewReport.pdf.

116. *Id.* at 25.

117. Aurelio G. Mauri & Roberta Minazzi, *Web Reviews Influence on Expectations and Purchasing Intentions of Hotel Potential Customers*, INT'L J. HOSPITALITY MGMT., Sept. 2013, at 99.

118. *Id.* at 102–04.

119. *See, e.g.*, Beverley A. Sparks & Victoria Browning, *The Impact of Online Reviews on Hotel Booking Intentions and Perception of Trust*, 32 TOURISM MGMT. 1310 (2011); Qiang Ye, Rob Law, Bin Gu & Wei Chen, *The Influence of User-Generated Content on Traveler Behavior: An Empirical Investigation on the Effects of E-Word-of-Mouth to Hotel Online Bookings*, 27 COMPUTERS HUM. BEHAV. 634 (2011); *Online Consumer-Generated Reviews Have Significant Impact on Offline Purchase Behavior*, COMSCORE (Nov. 29, 2007), http://www.comscore.com/Insights/Press_Releases/2007/11/Online_Consumer_Reviews_Impact_Offline_Purchasing_Behavior.

120. *Cf.* Qiang Ye, Rob Law & Bin Gu, *The Impact of Online User Reviews on Hotel Room Sales*, 28 INT'L J. HOSPITALITY MGMT. 180 (2009) (showing that a 10% improvement in travel review ratings increased online bookings by 4.4%).

121. CHRIS K. ANDERSON, THE IMPACT OF SOCIAL MEDIA ON LODGING PERFORMANCE: CORNELL HOSPITALITY REPORT 5 (2012); *see also* Jonathan Brinksman, *How a Higher TripAdvisor Ranking Can Help Hotels Book More Room Nights*, MICROS.COM (Apr. 25, 2013) http://blog.microsecommerce.com/index.php/uncategorized/how-a-higher-tripadvisor-ranking-can-help-hotels-book-more-room-nights/.

B. Normative Implications

Given that online review sites dramatically impact hotel revenues, franchisors in the hotel industry need no longer rely on the at-will termination mechanism to discipline their franchisees. Customers, assisted by online review sites and the lowered transaction costs of obtaining and disseminating information, are able to directly punish hotels who free ride on chain reputations and provide subpar service.

Online review sites are not alone in supplanting at-will termination in franchise contracts. Adam Badawi has shown that informal mechanisms operate alongside formal ones and that at-will termination is far from the only way to make franchisees conform to quality standards.[122] In the classic carrot-and-stick terminology, where the "stick" of contractual termination is difficult to effectuate, a "carrot" emerges—such as using promises of additional franchises to incentivize investment in quality. In his study, Badawi focuses on liquidated damages, which streamline contractual enforcement and operate similarly to the type of at-will termination we study here—but he finds that the use of liquidated damages is limited and negatively correlated with informal mechanisms.[123] In other words, "carrots" might be preferable to "sticks," especially where customers can punish franchisees directly.[124] Where online review sites operate effectively, the marketplace wields the "stick," making courts and formal proceedings dispensable. Since formal and informal mechanisms are viewed as substitutes, franchisors would do well to avail themselves of positive reinforcements—such as promising future business growth and additional franchise opportunities—while leaving punishment to anonymous customers who post negative reviews online.

The question remains: To what extent do online review sites discipline businesses beyond the hotel industry and beyond franchise operations? To the extent that the data assessed above is representative of other industries, we should expect quality to be maintained due to fear of negative reprisals—not by the franchisor or organized groups but by the free flow of information attributable to modern-day Internet usage. We focused on Expedia.com due to the nature of its control over review procedures, but one could think of expanding the purview to almost any industry in which customers exchange information online. For "old school" professors like us, the way Expedia restricts ratings to paying customers inspires faith in the results. Still, one might imagine that in the era of Facebook and near-constant and universal online discussion, reviews may very well be a dependable source of incentives for provision of quality even in the face of incomplete contracts and unverifiable information.

While we focused on franchise operations and the role of good-cause statutes, the insight gained goes further. Where the online world provides for customer interaction, exploitation of nonrepeat customers may be a losing prospect. When information is freely available and customer dissatisfaction can be conveyed online, businesses of all sorts need to adapt to a world in which the one-shot consumer is a

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122. Adam B. Badawi, *Relational Governance and Contract Damages: Evidence from Franchising*, 7 J. EMPIRICAL L. STUD. 743 (2010).

123. *Id.* at 756.

124. *See id.* at 749. Interestingly, all lodging franchises included in Badawi's study incorporate liquidated-damages clauses in their contracts (including Super 8 and Days Inn, which we studied as well). *See id.* at 752. This observation conforms with the prevailing view of hotels as a nonrepeat industry in which free riding is rampant and strict oversight is necessary.

disappearing species. The fear that good-cause statutes impede franchise operations and induce free riding is thus overstated, especially in the online world.

Still, franchisor groups are notoriously opposed to GCSs, and attempts to enact such statutes are usually stifled.[125] If our conclusions are correct, what would explain this attitude? First, opposition to GCSs might be a path-dependent result, explained more by what was once true than what is relevant today. If at-will termination once operated as an important factor constraining free riding, past resistance to GCSs is understandable. Given that most public debates on the matter predate effective review sites being widely available, we might be seeing the lasting impression of a dying world.

Second, it may be that at-will termination is still important in industries in which review sites are unavailable or ineffective. Hotels, together with the rest of the travel industry, are at the forefront of the online revolution, and it may be that results obtained here are not universally applicable. While this may be the case, it merits investigation into which other industries are characterized by effective online review, whether via official sites devoted to the matter or via alternative means such as Facebook, Twitter, and other widely available social media. It stands to reason that online review is a growing industry, regardless of the form it takes, given that an ever-growing percentage of the population is spending an ever-growing percentage of its time conversing with others and offering opinions on almost everything under the sun.[126]

Third, the simplest explanation might be the truest—that franchisors oppose GCSs since these statutes impede not just contractual monitoring but also franchisors' abilities to exploit the franchisees within their networks. Franchisor opportunism was described above as consisting of three related behaviors: raising fees and requiring additional purchases, revoking licenses in order to resell them to new franchisees at higher prices, and revoking licenses in order to repossess the site and run it as a company-owned franchise.[127] At-will contracting is less necessary today (in specific industries) than it formerly was, from the perspective of constraining franchisee opportunism (i.e., free riding on the brand), but it retains its power as a forcing mechanism. Proponents of GCSs thus have another weapon in their rhetorical arsenal when arguing for enactment: franchises manage to maintain equivalent quality with or without GCSs. If there are distributional reasons to prefer protection of the weaker party, and if franchisees are assumed to have less bargaining power, GCSs might very well be the answer.

Of course, the result we show is too narrow to support an argument for GCSs as a whole. Some industries can rely on review sites; others cannot. One might consider tailoring the law to specific industries based on the effectiveness of online reviews, while others might argue that this approach is too regulation intensive and that simple "yes or no" answers work better. In any case, one argument can no longer be made—that at-will contracting is indispensable and that "franchisee protection laws increase shirking and free-riding."[128] The customers of the hotels in our sample suggest otherwise.

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125. *See supra* notes 18–20.

126. *See* Steve Olenski, *Social Media Usage Up 800% for U.S. Online Adults in Just 8 Years*, FORBES (Sept. 6, 2013, 10:13 AM), http://www.forbes.com/sites/steveolenski/2013/09/06/social-media-usage-up-800-for-us-online-adults-in-just-8-years/.

127. *See supra* notes 13–15.

128. Kobayashi & Ribstein, *supra* note 1, at 340.

CONCLUSION

Franchisee free riding lies at the center of the debate over the appropriateness of GCSs. The traditional law-and-economics analysis distinguishes between industries with repeat customers, in which the risk of franchisee free riding is low, and industries with nonrepeat customers, in which the risk of franchisee free riding is high. In these latter industries, GCSs are argued to be inefficient, as they are likely to increase the level of free riding.[129]

In this Article, we empirically investigated the conventional economic analysis of GCSs. We did so by attempting a direct comparison between the levels of franchisee free riding in good-cause and at-will states. Online hotel reviews written by guests allowed us to measure franchisee free riding with reasonable precision. Examining a sample of three hotel chains—Days Inn, Ramada, and Super 8—we found no significant differences in the level of free riding in good-cause states versus at-will states in any of these chains. These results question the validity of the conventional economic analysis of GCSs.

One potential explanation that we have provided for these results is that although GCSs may curtail the at-will control mechanism against franchisee free riding, there is a substitute, market-based control mechanism in place: online review sites. Franchisee free riding is constrained not by an at-will contract but by the fear of negative consumer reviews, which ultimately may dramatically reduce a franchisee's revenues.

Although our empirical analysis focuses on the hotel industry, our results may apply to other industries with nonrepeat consumers. We predict that normally, in industries with effective online review sites and those in which consumer interaction exists via social media, the at-will control mechanism will not prove an essential control mechanism against franchisee free riding. Negative reviews by consumers may serve as an adequate substitute for at-will contracts. As a result, good-cause statutes, which prevent the at-will termination of the contract, are not likely to increase the level of franchisee free riding in those industries. Since the same GCSs offer the benefit of reducing the converse fear—of franchisor opportunism—their enactment may very well increase aggregate welfare while protecting what are usually small-business owners from large-chain operations.

Our results call for a novel subdistinction, overlooked so far in the debate over GCSs. Industries with nonrepeat customers should be divided into two major groups: those subject to effective consumer interaction via social media (including, but not limited to, effective online review sites), in which the risk of free riding is relatively low; and those without such consumer interaction, in which the risk of free riding may be higher. Within the first group, the necessity of an at-will contract as a control mechanism against free riding is questionable. This conclusion opens the door for reconsideration of the adoption of GCSs, even in industries with nonrepeat customers, as appropriate mechanisms for limiting franchisor opportunism and protecting individual franchisees from unequal bargaining terms.

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129. *See supra* Part II.C.