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In Defense of Franchisors: The Law and Economics of Franchise Quality Assurance Mechanisms

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IN DEFENSE OF FRANCHISORS: THE LAW AND ECONOMICS OF FRANCHISE QUALITY ASSURANCE MECHANISMS

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I. INTRODUCTION

IN RECENT YEARS, the franchise form of business has become an increasingly important and efficient means of producing and distributing products and services of uniform quality.1 Although franchising is a contractual alternative to vertical integration,2 the franchisor-franchisee relationship presents inherent difficulties which do not exist in vertically integrated firms.3 Specifically, the franchisor's interest in assuring a consistent level of standardized quality across franchise outlets is at odds with the franchisees' interests in maximizing their own profits by "shirking" their responsibilities to provide a minimal level of acceptable product

1. See U.S. DEPT. OF COMMERCE, FRANCHISING IN THE ECONOMY 1984-86 (Jan. 1986). Franchising sales of goods and services in 1986 are expected to be $576 billion or approximately 15.7% of gross national product (GNP). Id. at 1. Product and trade-name franchises (such as auto and truck dealers, gasoline retailers and soft drink bottlers) account for $424.5 billion while business format franchises (such as restaurants, nonfood retailing and personal and business services) account for $151.3 billion. Id. at 2-3. The 10-year growth rate of sales is 9.5% for product and trade-name franchises and 12.5% for business format franchises. The projected two-year growth rates for the period 1984-86 are 7.1% and 11.2% respectively. Consequently, the growth rate of sales by business format franchises historically and currently outpaces that of product and trade-name franchises.

2. See R. BLAIR & D. KASERMAN, LAW AND ECONOMICS OF VERTICAL INTEGRATION AND CONTROL (1983). Vertical integration is the result of a firm's decision to replace a market exchange of a good or service with an intra-firm transfer. Id. at 11. For example, a firm replacing its open market sales of its final product to distributors with ownership of its own distributors becomes vertically integrated. There are many reasons firms decide to vertically integrate or exercise vertical controls. The authors describe franchise agreements as complex market adaptations designed to alleviate the simultaneous opportunistic inclinations of franchisors and franchisees. Id. at 26. One of the main reasons for franchising agreements is the degree of control franchisors can exert over the production and distribution of its products. In the franchise context, the relationship and resultant business identity the participants create lies between one firm and open market transactions. Rather than vertically integrate, the parties bilaterally bargain and divide the benefits of their relationship. See Klein, Crawford & Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & ECON. 297 (1978).

3. See generally R. BLAIR & D. KASERMAN, supra note 2 (identifying difficulties in contractual alternatives to vertical integration).
quality. As a result, franchisors have implemented various quality assurance mechanisms designed to minimize the problems associated with recalcitrant franchisees. Despite the procompetitive potential of these mechanisms, their legality is questionable.

This paper examines the law and economics of franchise quality assurance mechanisms. The first section describes the nature of the franchisor-franchisee relationship, focusing on the parties’ sometimes dissimilar economic motivations. Because these motivations depend to a great extent upon the method a franchisor uses to collect revenues from franchisees, the economic and behavioral impacts of the most common methods of revenue collection are discussed. Next, because franchisors and franchisees share the intangible asset of franchise goodwill, this first section will address the free riding problems which result. These problems arise when a franchisee attempts to advance its own economic interests through surreptitious reductions in its costs of providing the standardized product. The franchisee does benefit from the product demand which the franchise system generates; however, the franchisee’s failure to maintain minimal quality levels concurrently erodes the system’s overall goodwill. The section concludes with an analysis of relational contract law in the franchise context. The interactive, ongoing nature of franchise agreements distinguishes them from other forms of business operations and has practical considerations for product quality control agreements.

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4. See infra notes 18-46 and accompanying text.
5. See infra notes 47-84 and accompanying text.
6. The term “mechanism” is used rather than the term “agreement” because franchisees would probably consider most product quality mechanisms to be “disagreeable.” The franchisee would characterize the product quality clause in the franchise contract as objectionable, but necessary to acquire a franchise. However, such mechanisms are “agreements” in the traditional sense because franchisees voluntarily enter such contracts. In fact, in the absence of a franchisor, franchisees would have to create some agent or protective association to police product quality. Consequently, franchisees ultimately have to come to some agreement with the franchisor to deter product quality erosion. See Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 AMER. ECON. REV. 519, 529-30 (Sept. 1983). So, at the outset it should be clear that perceptive franchisors who recognize the need for product quality assurance in advance and provide for it in franchise contracts, are not “imposing objectionable ex ante terms on unwilling franchisees. They are merely taking steps to realize the full value of the franchise.” Id. at 530.
7. See infra notes 18-26 and accompanying text.
8. See infra notes 18-46 and accompanying text.
9. See infra notes 27-36 and accompanying text.
10. See infra notes 37-46 and accompanying text.
The second section presents the most common quality assurance mechanisms. These include direct product provision, contractual specification, bonding agreements and tying arrangements. The third section discusses and evaluates each mechanism according to contemporary legal standards. The fourth section analyzes the economic effects of these mechanisms focusing primarily on their potential for reducing policing, agency and transactions costs. Many of these mechanisms are legally suspect despite economic justifications for their use in assuring product quality. Finally, this paper recommends that when courts and policymakers evaluate the legality of these mechanisms, they consider the overall franchise agreement, including the economic benefits of these quality assurance mechanisms.

II. Franchisee-Franchisor Relationships

A. Franchise Contracts and Divergent Goals

Franchisors typically generate revenue from a combination of fixed lump-sum fees and percentage royalties on franchisees' sales. A brief description of policing, agency and transactions costs is necessary at this stage. For purposes of this paper, policing costs consist of the time, money and effort that the franchisor expends to monitor franchisee product quality. These costs are the result of joint sharing of the intangible goodwill asset. Transactions costs are costs of negotiating, drafting and enforcing contracts between parties. These costs occur in all contractual relations and are borne by both parties. Agency costs are expenditures resulting from the principal-agent relationship, including monitoring expenditures by the principal, bonding expenditures by the agent and residual loss. Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 308 (1976). These monitoring expenditures differ from policing costs because they result from the divergent goals of the principal and agent. The principal can limit this divergence by establishing incentives for the agent and monitoring the agent's potentially aberrant activity. Id.

Bonding expenditures are costs the agent incurs to guarantee that it will not take action harmful to the principal or to ensure that the principal is compensated upon such action. Id. Examples are penalty clauses, firm-specific capital investments and franchise fees. For a further economic discussion of bonding agreements, see infra notes 143-73 and accompanying text.

Because it is generally impossible for any contractual arrangement to costlessly ensure that an agent will always act in the principal's best interest, there necessarily will be some divergence between the agent's action and the action that would maximize the welfare of the principal. The dollar equivalent of this loss in welfare is the residual loss. Jensen & Meckling, supra at 308.
In addition, most franchise contracts require franchisees to contribute a particular percentage of sales for advertising expenses. Under such agreements, a franchisor’s primary objective is maximizing the level of sales generated by franchisees. A franchisee’s objective, however, is to maximize its own profits. This objective does not necessarily correlate with sales revenue maximization. In fact, economic theory suggests otherwise.

The economic explanation of franchisee behavior is based on the unique nature of the franchisor-franchisee relationship. Most franchise contracts exist as substitutes for vertical integration. Franchisors generally cannot bear the financial burden of creating their own distribution systems but wish to maintain the greatest degree of control possible over their product’s preparation and distribution. Consequently, a franchisor typically will engage franchisees to perform services on the franchisor’s behalf. This strategy, however, involves delegating at least some decision-making authority to the franchisees. Because the franchisees have their own incentives and goals divergent from those of

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18. See R. BLAIR & D. KASERMAN, supra note 2, at 170-71; Blair & Kaserman, Optimal Franchising, 49 S. Econ. J. 494 (1982); see also Mathewson & Winter, The Economics of Franchise Contracts, 28 J.L. & Econ. 503, 503 (1985). The authors of the latter article state:

"In contrast to conventional market exchange, franchise contracts typically impose on franchisees retail quality standards, common hours of business, price controls, and nonlinear payment schedules (for example, fixed initial royalty fees plus a percentage of gross retail revenues), while franchisors typically provide national advertising and training programs, monitor and inspect the franchisees’ performance (with varying intensity across industries), and hold the residual power to terminate the franchise agreement."

Id.

19. The franchisor-franchisee relationship resembles the principal-agent relationship in many ways. Though the legal conception of the principal-agent relationship is more limited than the economic conception, there is a considerable amount of analytical overlap. Both legal and economic conceptions of agency involve the agent choosing alternative actions with the principal specifying the parameters of the agent’s discretion and the payoffs for the agent’s performance. See Arrow, The Economics of Agency, Tech. Report No. 451, INSTITUTE FOR MATHEMATICAL STUDIES IN THE SOCIAL SCIENCES, STANFORD UNIV. (Oct. 1984). Although the franchisee may not technically be the principal’s legal agent, the franchisor legally controls much of the franchisee’s discretionary authority. Consequently, the economic principal-agent model provides a valuable descriptive model for analyzing the franchisee’s behavior. See Rubin, The Theory of the Firm and the Structure of the Franchise Contract, 21 J.L. & Econ. 223, 225 (1978) (“definition of franchisee as a separate firm, rather than as part of franchisor, is a legal and not an economic distinction”).

20. Jensen & Meckling, supra note 17, at 308. Many franchisors use psychological tests in their selection of new franchisees to identify applicants with strong entrepreneurial qualities such as creativity and independence. These applicants ironically are less likely to receive franchises because they generally tend
the franchisor, there is reason to expect that the franchisees will not always act in the franchisor's best interests. For example, because of sales revenue royalties, a franchisee receives only a portion of the sales revenue it generates while fully bearing the costs of producing that revenue. At some point, the franchisee's incremental production costs exceed its incremental net revenues, and it becomes economically more efficient for the franchisee to stop producing. The franchisor, however, would prefer the franchisee to continue expanding output because the franchisor receives a percentage of the revenues without incurring costs.

This pursuit of sales revenue maximization results in an output level greater than that of the profit maximizing firm. The reasoning underlying this statement is straightforward: sales revenue maximization myopically neglects the production and operating costs of expanding output. Increases in output without regard to these additional costs results in a movement away towards changing the franchise system and doing things their own way. Testing Psyches of Future Franchisees, Wall St. J., May 20, 1988 at 27, col. 1.

21. Testing Psyches of Future Franchisees, supra note 20. This problem manifests itself in many other contexts and is the central dilemma encountered in any delegation of authority. See, e.g., K. Davis, Discretionary Justice 15-21 (1969). One of that author's major theses is that the degree of discretion given to governmental agencies is too great. He posits that rules should govern and guide the exercise of unbridled discretion but "[t]he problem is not merely to choose between rule and discretion but is to find the optimum point on the rule-to-discretion scale." Id. at 15. In the context of the private sector, a similar problem exists. This tradeoff between steadfast rules and discretion is evident in the formation of franchise agreements particularly in penalty and termination clauses. See infra notes 85-98, 112-23 and accompanying text.


23. Id.
Where $\text{TC} = \text{Total cost of production}$

$\text{TR} = \text{Total revenue function}$

$\text{P} = \text{Profit Function}$

$\text{Q} = \text{Quantity of good X}$

Under typical assumptions, this graph is representative of most firms' production and cost functions. The total revenue function is increasing but at some point reaches a maximum. It is at this point, output $Q_0$, where sales revenues are maximized. Profits, however, are maximized at the output level $Q_1$ where the difference between total revenue and total cost is the greatest.
from the firm's profit maximizing output. The additional output above the point of profit maximization reduces total profits because the marginal costs of production exceed marginal revenue. A franchisor encouraging sales-revenue maximization implicitly requires franchisees to forego at least some of their profits by increasing their sales above the point of cost-efficient production. It is, therefore, not surprising that franchisors and franchisees favor different managerial goals. The next section explains how these motivational differences are exacerbated by the joint sharing of the intangible asset of franchise goodwill.

\[ MR = \text{Marginal revenue} \]
\[ MR_1 = \text{Marginal revenue to franchisee} = MR \times (1 - r) \]
\[ MC = \text{Marginal production costs} \]

The graph above depicts the marginal revenue and marginal cost functions derived from the revenue and cost functions. In the situation where a franchisor collects a royalty on sales revenues, the franchisee's total revenue function will be \( TR_I = TR \times (1 - r) \) where \( r \) = royalty rate. As a consequence, the franchisee's profit maximizing output is even further reduced. Instead of producing at output \( Q_I \), the franchisee will produce at the point where marginal revenue \( (MR_2) \) equals marginal cost at output equal to \( Q_2 \).

25. The profit maximizing output is \( Q_I \), which is less than the revenue maximizing output \( Q_0 \).

26. The franchisee foregoes profits equal to \( (\Pi_{10} - \Pi_{22}) \). In return the franchisor receives \( (R_0 - R_1)\times r \) where \( r \) = percentage royalty on sales.
B. Intangible Assets and the Free Rider Problem

The success of both business-format and product franchises depends upon the development and maintenance of consumer demand and goodwill for the franchised product or service. To a great degree, the franchisor-franchisee relationship is based on the benefits flowing from the mutual sharing of this joint resource. Maintenance of this shared asset is accomplished by generating demand for the product through marketing and product quality systems. In either type of franchise, the franchisor generally provides national or regional marketing and advertising assistance to the franchisees in return for a royalty of franchisee sales. Though the local franchisees may be willing and authorized to provide local advertising and marketing, a franchisor primarily develops the franchise's reputation through this national or regional advertising. This reputational asset is jointly shared by the franchisor and all franchisees and is oftentimes based upon a standardized franchise format or formula that consumers recognize as representing a particular type and quality of product or service.

Because franchisors cannot precisely control which franchisees receive the benefits flowing from the creation of national or regional goodwill, franchisees have an incentive to accept the benefits of goodwill without contributing to the costs of maintaining product quality. In essence, the franchisees receive a "public good." A national or regional marketing program creates an intangible asset, goodwill, from which each franchisee cannot be

27. Mathewson & Winter, supra note 18, at 504-05.
29. See R. Blair & L. Kenny, supra note 22, at 361-62. In general, business format franchising occurs when the minimum-cost output in advertising exceeds the minimum-cost output in production. Thus, the organizational structure of a franchise includes one firm (the franchisor) exploiting advertising economies of scale while several others (the franchisees) produce the product locally. Id. at 362.
30. A public good, often termed a demand externality, is one which has two properties: (1) nonexcludability and (2) nonrivalry in consumption. A nonexcludable good is one which it is impossible (or extremely costly) to prevent consumers or producers from consuming or using in the production of a given unit of the commodity. National advertising and marketing programs are examples of nonexcludable goods. It is impossible or exceedingly costly to prevent a local franchisee from the benefits of such a program. A nonrival good is one whose consumption by one consumer or producer does not diminish the amount of the good others may consume. For example, two or more franchisees can simultaneously benefit from "consuming" a single "unit" of national advertising. See R. Russell & M. Wilkinson, Microeconomics 373-75 (1979).
excluded. For example, a franchise advertisement on a nationally broadcasted television network provides benefits which all franchisees share; only a local blackout of the advertisement would significantly reduce the benefits a particular franchisee receives.\textsuperscript{31}

The creation of this shared asset creates a “free-rider” problem. Each franchisee has an incentive to “free ride” on the demand the franchisor and other nonshirking franchisees create for the franchised product.\textsuperscript{32} Free riding involves franchisees who decrease operating costs by reducing the level of product or service quality below franchise standards.\textsuperscript{33} These cheating franchisees “free ride” on the goodwill that the franchisor and conforming franchisees create among consumers.\textsuperscript{34} By free riding, the franchisee increases its own profits but potentially erodes the shared goodwill asset.\textsuperscript{35} However, the franchisee’s actions are somewhat shortsighted because it is the franchise system that ultimately is harmed: as part of the system, the franchisee is injured

\begin{itemize}
\item \textsuperscript{31} The benefits a franchisee enjoys from national or regional advertising are reduced to the extent the franchisee relies upon repeat business. For example, a fast-food franchise located along a busy interstate relies upon such advertising more than a franchise located near a moderately populated university location. The interstate location dictates fewer repeat sales than the university location.
\item \textsuperscript{32} See Klein & Saft, The Law and Economics of Franchise Tying Contracts, 28 J.L. & Econ. 345, 349 (1985). To a certain degree, this incentive exists independent of the free-rider problem. In basic principal-agent situations, the agent has a general incentive to “shirk” on obligations because the agent’s motivations do not precisely correspond to the principal’s. The potential to free-ride on the goodwill generated by nonshirking franchisees greatly increases this incentive.
\item \textsuperscript{33} Id. at 350-51; see also Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 J.Q. Econ. 488 (1970). If the quality of the product is observable before purchase, the incentive to reduce quality is diminished. Consequently, search goods and experience goods are dissimilar with respect to the free-riding problem. For a discussion of search, experience and credence goods, see infra notes 140-42 and accompanying text.
\item \textsuperscript{34} See Mathewson & Winter, supra note 18, at 506. Two externalities result when a franchisor creates a brand name through national advertising. The first, termed a vertical externality, occurs when franchisees free ride on the national brand name. The second, termed a horizontal externality, results when a franchisee free rides on the local quality of other franchisees. Id.; see, e.g., Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977). In an antitrust action based upon an illegal supplier system, a court has stated “[i]ndividual franchisees, after all, may increase profits by utilizing inferior supplies while continuing to attract customers because of the reputation established and maintained by other franchisees who conform to the quality standards.” Id. at 381 n.12.
\item \textsuperscript{35} See Williamson, supra note 6, at 529. “[S]ince the costs savings that result from local quality debasement accrue to the local operator while the adverse demand effects are diffused throughout the system, suppliers now have an incentive to free ride off of the reputation of the system.” Id.
\end{itemize}
As a result of the franchisee's incentive to diminish and conceal product quality, the franchisor will necessarily institute some mechanisms to ensure franchisees maintain minimal levels of product quality. These mechanisms are oftentimes legally suspect because they restrain the economic freedom of the franchisee. By their very nature, mechanisms assuring product quality eliminate various decision-making options the franchisee may otherwise desire. However, these contractually imposed mechanisms are integral parts of the overall franchise agreement. The maintenance of consumer goodwill is the raison d'être for quality control mechanisms. Franchises without strictly enforced quality standards will suffer in the competitive marketplace. As the next section explains, an understanding of the distinctive nature of franchise contracts is critical before one can properly assess the usefulness of product quality assurance mechanisms.

C. relational contract theory and franchising

Because franchise relationships are contractually based, it is instructive to examine the idiosyncracies of franchise quality control arrangements relative to contract law theory. For example, because many quality control mechanisms are based upon ongoing, interactive franchise relationships, they are dissimilar from quality agreements in discrete sales contracts where parties merely engage in autonomous exchange. This difference affects the manner in which franchisors implement, and courts construe, product quality agreements. Recognition of the distinctions between the various contractual arrangements has resulted in two major descriptive theories of contractual relationships: classical contracting and relational contracting.

Under classical contract theory, parties are presumed to completely specify all risks arising from their dealings. This presupposes that the parties have complete information regarding the material aspects of the subject matter of their contract. Upon the
occurrence of a breach or other contingency, the parties turn to their agreement to determine who bears the risk of the breach. If their agreement is silent on the contingency, common law or statutory principles fill the gaps.38

The conception of completely specified contracts does not accord with the types of contracts used in highly interactive contractual arrangements.39 Completely specified contracts are frequently not feasible due to the continuous and lengthy nature of the contractual relationship which makes future contingencies uncertain or particularly difficult to specify. Consequently, parties will seek other contractual arrangements, termed relational contracts, to satisfy their mutual goals.

Relational contracts are characterized by the parties' inabilities to reduce important terms of their agreement into well-defined obligations.40 In the franchise context it is difficult for parties to precisely specify certain obligations, such as the level of effort a franchisee must exert in promoting sales.41 Many franchise quality assurance agreements fall into this relational contract category. Rather than concrete standards, franchise contracts often have language such as "best efforts," "reasonable efforts," or "good faith" to describe the standard of performance.

38. The role of legal regulation of contractual terms has an economic foundation.

[O]n contract rules serve as standard or common risk allocations that can be varied by the individual agreement of particular parties. These rules serve the important purpose of saving most bargainers the cost of negotiating a tailor-made arrangement. If the basic risk allocation provided by a legal rule fails to suit the purposes of particular parties, then bargainers are free to negotiate an alternative allocation of risks.


39. See generally Macaulay, Non-Contractual Relations in Business, 28 AM. Soc. Rev. 55 (1963) (study indicating businessmen rely less on making agreements understandable than upon forming complete contingent contracts); see also Goetz & Scott, supra note 38, at 1090-91.

40. Goetz & Scott, supra note 38, at 1091. "Such definitive obligations may be impractical because of [an] inability to identify uncertain future conditions or because of [an] inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance." Id.

41. See Mathewson & Winter, supra note 18, at 503. The authors note "[a]n organizational arrangement, the franchise contract lies between anonymous price-mediated exchange and centralized intrafirm employment." Id.; accord Goetz & Scott, supra note 38, at 1100. The latter authors find that there is a subset of relational contracts, termed sequential contingent contracts, that deal with methods of handling the uncertainty and complexity of negotiations. Parties agree to a sequence of increasingly specific short-term contracts rather than one long-term contract. Id. A series of short-term contracts, in some contexts, better allocates risks by allowing parties to recontract in future periods based upon increased experience and information. Id.
expected. This lack of precision in the franchise agreement creates a potential for litigation when the parties differ over contractual obligations.

Relational agreements necessarily inject the element of materiality into any dispute over parties’ respective obligations under the agreement. Under complete contingent contracting, a franchisor specifies definitive formulae and standards for the production of the franchised good or service. Termination and damage clauses specify the precise procedures and sanctions franchisees could incur based upon the particular deviations from the standards the franchisors might detect. The fundamental assumption underlying this type of contractual relationship is that the parties are perfectly informed of contractual obligations and penalties for the breach of such duties. Consequently, the materiality of the breach does not matter; if a breach occurs, there is a specified remedy the parties must follow. However, relational contract standards are more indefinite. They require parties to interact to a greater degree in those situations where the standard of conduct is vague by nature and the materiality of the breach questionable. Thus, product quality clauses may be difficult to draft with enough specificity for a court to fully understand and enforce. Consequently, the distinctions between the classical contract and relational contract theories have practical implications as applied to franchise quality agreements.

42. For an economic definition of “good faith,” see Goetz & Scott, supra note 38, at 1139. “Good faith is best conceived as a rule for policing cheating on the terms of the contract or other opportunistic behavior designed to redistribute risks already allocated by the agreement.” Id.

43. See, e.g., Bloor v. Falstaff Brewing Corp., 454 F. Supp. 258 (S.D.N.Y. 1978), aff’d, 601 F.2d 609 (2d Cir. 1979). Bloor, a trustee in bankruptcy for Ballantine Beer, sued Falstaff alleging breach of contract. Falstaff had purchased the Ballantine brand for four million dollars plus a 50-cent royalty per barrel. 454 F. Supp. at 260. Falstaff also agreed to “use its best efforts to promote and maintain a high volume of sales.” Id. The court found that Falstaff had failed to act as an “average, prudent, comparable brewer” would have acted given Falstaff’s capabilities. Id. at 272. One motivating factor for Falstaff’s failure to adequately promote the Ballantine brand was the fact that, although the two brands were identical, Falstaff produced more profit because it was a “premium” beer. However, the court held that Falstaff’s marketing policies, though treating both brands equally, were improper because Falstaff’s duties regarding its own beer were to its shareholders while its duties in promoting Ballantine were contractually to the plaintiff. Id. at 276-77.

44. See Goetz & Scott, supra note 38, at 1139.

45. See Muris, Opportunistic Behavior and the Law of Contracts, 65 MINN. L. REV. 521, 575 (1981). The author suggests that terminable-at-will clauses provide an attractive alternative to extensive quality assurance agreements. Id. at 575-80.

46. As these agreements become less well-defined, a court or arbiter will emphasize the materiality factor more heavily. For a discussion of judicially im-
This brief description of the franchisor-franchisee relationship sets forth the analytical underpinnings necessary to evaluate the usefulness of various quality assurance mechanisms. Because of the incongruity between franchisee and franchisor goals, the chosen method for maintaining product quality is critical to the long term health of a franchise system. A mechanism that compels minimum quality standards increases the competitive strength of an entire franchise network. Independent of other contractual requirements, particular quality control mechanisms may appear harsh and occasionally inequitable. However, given the discordant objectives that drive franchisees to spurn their duties to maintain product quality, franchisors need an adaptable and effective collection of quality control devices. The next section examines and describes the primary methods of assuring product quality.

III. QUALITY ASSURANCE MECHANISMS

A. Direct Sale of Product

The most obvious method of assuring product quality is the direct sale by the franchisor of final products to the franchisee. This method assures the franchisor that the franchisee sells a product conforming to the given quality level. This arrangement also allows the franchisor to directly monitor the franchisee's sales. For example, a shoe franchisor directly selling its products to its franchisees ensures that the franchisees are not substituting an inferior product; in addition, the franchisor can account for any discrepancies between reported and actual franchisee sales.

Often, a franchise cannot economically provide franchisees with finished products for distribution. In some industries, the

posed remedies in termination cases, see infra note 114. See, e.g., Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir. 1985) (franchisee's misbranding of gasoline within class of offenses under franchise contract's 10 day cure provision), aff'd, 802 F.2d 975 (7th Cir. 1986), cert. denied, 107 S. Ct. 1374 (1987).

47. See, e.g., Susser v. Carvel Corp., 332 F.2d 505 (2d Cir. 1964), cert. dismissed, 381 U.S. 125 (1965). The court in Susser accepted the franchisor's product quality defense to a charge of tying of ice cream purchases to the trademark license. The decision was based on the difficulty of contractually specifying "the desired texture and taste of an ice cream cone or sundae." 332 F.2d at 520.

48. Franchisors who collect royalties on gross sales benefit from this type of monitoring because the actual sales information is useful in verifying reported sales. Variations of actual from reported sales would possibly signal franchisee noncompliance with the franchise agreement. In addition, the information is useful in other areas such as inventory and sales projections as well as others.
economies of scale in producing the franchised product are much greater in marketing than in production. 49 Many times the economies of scale in production are such that local production of the franchise product is more cost-efficient than national production. 50 As a consequence, franchises may turn to other contractual methods of assuring product quality.

B. Contractual Specification

One widely used method of product quality assurance is contractual specification. Franchisees, or intermediate producers, construct the final product in accordance with the franchisor's specifications. These specifications may take several forms and may provide for varying levels of franchisee effort and discretion. In addition, the franchisor may require that certain inputs be purchased from the franchisor 51 or from other designated sources. 52

This manner of product quality assurance affords the franchisee a degree of discretion unavailable under direct provision. Because the franchisee exercises some control over the production of the final commodity, there exists the possibility that a franchisee will violate the franchisor's contractual formulation. The typical example would be a franchisee's substitution of a cheaper input in the production process in order to decrease production costs. 53 Although a franchisee is able under this arrangement to abuse its discretion, such abuse may result in a franchisor's suing the franchisee for breach of contract. 54

A contractually specified franchise formula will necessarily

49. See R. Blair & L. Kenny, supra note 22, at 360-62.
50. Id. The authors state "[t]he profitability of a franchise will depend on the scale economies in advertising and in production. Products where the minimum-cost levels of production are low (e.g., locally produced products) are likely candidates for franchises." Id. at 362.
51. For a discussion of tying arrangements, see infra notes 68-82 and accompanying text.
52. For a discussion of supplier systems, see infra text accompanying notes 57-58.
53. The franchisee may reduce costs in other ways as well. For example, it can cut maintenance costs by providing substandard sanitation and health related services. See, e.g., Bonanza Int'l, Inc. v. Restaurant Management Consultants, Inc., 625 F. Supp. 1431 (E.D. La. 1986) (failure to comply with sanitation and cleanliness standard, inter alia, justified automatic termination). Additional examples include avoiding expenditures on new products and reducing product promotion expenses. Even the failure to maintain adequate lighting in and around a franchise facility reduces the franchisee's production costs.
54. For a discussion of termination clauses, see infra notes 112-22 and accompanying text.
require occasional franchisor monitoring of franchisees' operations and production processes. Consumers of the franchise product implicitly rely upon the franchisor to police and control product quality. Inattentive franchisors will face marketplace sanctions if they inadequately perform their quality control responsibilities. The demand for their products will fall as consumers consistently encounter shirking franchisees.

The franchisor's primary monitoring method is direct inspection of franchisees' production procedures and final product quality. The franchisor develops and institutes a methodology for monitoring and detecting violations of the contractually imposed quality standards. The sanctions for violations may be monetary, reputational, or terminative. This system of policing product quality imposes costs upon the franchisor. However, the franchisor expects to benefit directly from the investment in policing costs. First, the system preserves the value of the franchise's goodwill by meeting consumer product quality expectations. Thus, the franchisor benefits by avoiding a decline in product demand due to consumer dissatisfaction. Second, the threat of sanctions directly affects franchisee behavior. Franchisees must consider the possibility of sanctions, and resulting reduction in profits, for detected breaches of the franchise agreement. Consequently, franchisees will devote greater effort to avoid sanctions either by avoiding detection or by complying with quality standards.

Another device franchisors use to assure product quality through contractual specification is the creation of a system of approved suppliers. Franchisors may require that certain inputs be of particular grades or qualities or supplied by particular suppliers. Instead of directly monitoring every franchisee to ensure compliance with product input quality standards, the franchise agreement may require franchisees to provide documentation of its purchases to the franchisor. In this manner, franchisee compliance with product standards is efficiently achieved.

This method of quality assurance is not without pitfalls, how-

55. Policing costs include: (1) direct inspection costs (including salaries and travel); (2) product testing costs; and (3) administrative costs.

56. Franchisees may simply invest in methods of avoiding detection. For example, if a franchisee can determine when an inspection will occur, it can avoid detection of substandard quality by complying with standards for the inspection period. Also, it may be cost-efficient for a franchisee to continue violating the quality standards absent sanctions sufficient to ensure compliance. For an economic analysis of bonding and tying arrangements as means to prevent these practices, see infra notes 143-85 and accompanying text.
ever. While the free rider problem is reduced to a great extent at the franchisee level, a sub-free rider problem develops among the specified suppliers. Because suppliers know their approved product has a captive market of franchisees, each will find it profitable to free ride on the goodwill of other complying suppliers. Of course, the franchisor's monitoring problem may not be as great because there may be fewer suppliers than franchisees to monitor. Nevertheless, because franchisors generally find it necessary to monitor final product provision, a supplier system may simply provide an additional monitoring problem. Despite these drawbacks, for franchisors requiring a particular input to be of special quality, supplier systems provide a means of at least partially reducing monitoring costs and ultimately ensuring product quality.

C. Bonding Agreements

Indirect incentive systems are a way of assuring product quality when monitoring costs are substantial. For instance, franchisors may require franchisees to enter into bonding agreements. These agreements are designed to discourage franchisees from taking action which would harm the franchisor or, in the alternative, to ensure that the franchisor will be compensated if the franchisee does take such action. Bonding agreements essentially require the franchisees to expend or pledge resources as a guarantee that they will perform in conformity with the franchisor's desires. These types of agreements are generally

57. See, e.g., Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977). The court recognized that "[m]anufacturers and franchisees alike may profit by ignoring [the franchisor's] product specifications." Id. at 381 n.12. The franchisor may then find it necessary not only to announce product specifications but also to police observance of those standards. Id.

58. Id. The court noted that "controlling quality at the franchisee level may be impractical for [Kentucky Fried] with 3800 outlets. . . . It may thus be reasonable . . . for Kentucky Fried to control quality at the manufacturer level." Id.

59. Goetz & Scott, supra note 38, at 1093.

60. Id. at 1130-34.

61. Jensen & Meckling, supra note 17, at 308.

62. A bonding agreement is also a form of warranty. When the franchisor has difficulty monitoring and detecting the quality of franchisee products, the franchisor may require a franchisee to guarantee that product quality will meet certain standards. Conceptually, the franchisee is providing a warranty of product quality by pledging assets in case of a breach. See generally Grossman, The Informational Role of Warranties and Private Disclosure About Product Quality, 24 J.L. & Econ. 461 (1981) (warranties facilitate allocation of resources by signalling higher product quality).
self-enforcing because the franchisee continues in the relationship until it believes that it would profit by terminating the relationship.63

There are a number of ways a franchisor can bind the franchisee into compliance with the franchise agreement. First, penalty clauses providing for fines in excess of direct damages deter franchisee violations.64 Second, the reduction in value of firm-specific capital assets upon termination imposes a loss on shirking franchisees.65 Third, franchisee forfeiture of high initial capital contributions for breaches of franchise quality control agreements encourage at least initial compliance with franchise standards.66 In each of these situations, the franchisor is contractually requiring his franchisees to credibly commit some current or future asset as a “hostage” in case a breach should occur.67

D. Tying

Tying is an intermediate method of ensuring product quality. Tying involves a contractually imposed duty on franchisees to purchase particular items exclusively from the franchisor and to use them in the local production of the final product. A franchisor may desire this arrangement for a number of reasons.


No one would enter an agreement expecting the other parties to violate it. In a self-enforcing agreement the only penalty that can be imposed on the violator is stopping the agreement. Therefore, aware of this, a potential violator compares the current gain from a violation with the sacrifice of future gains that will result in response to his current violation. These future gains would accure to him were he to remain faithful to the agreement. He chooses the more profitable alternative. It follows that the parties to a self-enforcing agreement do not expect any violations of it. The terms of the agreement are such that adherence is more advantageous than violation.

Id. at 43-44.

64. For a legal analysis of penalty clauses, see infra notes 85-98 and accompanying text. For an economic analysis of penalty clauses, see infra notes 145-68 and accompanying text.

65. See infra notes 169-73.

66. See infra note 173 and accompanying text. Another similar form of bonding is a covenant not to compete. Upon termination, such a covenant prevents the franchisee from operating a similar business in competition with the franchisor, the economic effect of which is to impose a potentially costly constraint on the franchisee post-termination. Viewed ex ante, however, the covenant acts as the franchisee’s pledge or guarantee of performance in conformity with the franchise agreement.

67. See Williamson, supra note 6, at 519; see also Telser, supra note 63, at 43.
First, franchisors may use tying as a protection against disclosure of trade secrets. Franchisee production of an input protected as a trade secret necessarily increases the chances of both disclosure and loss of legal protection. Consequently, tying provides a legitimate means of protecting a formula or process from inadvertent disclosure. Second, a particular secret formula or ingredient may be subject to intolerable irregularities in local franchisee production. In such a case, direct provision of the input reduces uncertainty in product quality by ensuring that critical inputs meet minimum standards. Thus, tying is prominent in those franchises where a franchisee's local production of either particular inputs or the final product is subject to unacceptable variations.

Third, because tying arrangements afford franchisors a degree of certainty over the quality of inputs used in the franchisee's production process, the level of policing costs may decline. With a tying arrangement, the production process no longer requires the same level of franchisor monitoring to ensure consistency. However, the magnitude of the reduction of policing costs depends upon the extent to which franchisor monitoring is still required after the tie. For example, a franchisee might still cheat despite the purchase of particular tied inputs, because a tying arrangement, a priori, will not affect a franchisee's incentive to cheat. The franchisee can resell the tied goods and purchase cheaper inputs. Incidentally, this method of cheating is limited by the transactions costs of such a scheme.

Finally, tying arrangements provide franchisors with a means of metering franchisee sales and revenue collection. This method of measuring franchisee sales not only provides a secondary assurance that franchisees are properly reporting sales, but also acts as a means of extracting rents either in proportion to a franchisee's sales or from specific profitable products. This ex-

68. See Klein & Saft, supra note 32, at 351-54. For a discussion of the reduction of policing costs through the use of penalty clauses, see infra notes 132-42 and accompanying text.

69. For example, the negotiating and enforcement costs of secondary trading agreements may outweigh the benefits of substituting an inferior input.

70. See, e.g., International Business Machines Corp. v. United States, 298 U.S. 131 (1936); see also Bowman, Tying Arrangements and the Leverage Problem, 67 Yale L.J. 19 (1957). Bowman, in analyzing the Button-Fastener case, Heaton Peninsula Button-Fastener Co. v. Eureka Specialty Co., 65 F. 619 (C.C.W.D. Mich. 1895), rev'd, 77 F. 288 (6th Cir. 1896), found that Button-Fastener's requirement that users of its patented button-stapling machine buy staples from Button-Fastener at a price slightly above the market price for use with the machine, allowed Button-Fastener to collect the equivalent of a small royalty on the rental of the
traction, while subject to challenges of unfairness,\textsuperscript{72} can be justified by the benefits a franchisee receives from the franchise goodwill. Because most franchise agreements require franchisees to pay a particular percentage of total sales for advertising and marketing, tying arrangements act as alternative methods of revenue collection.\textsuperscript{73} In competitively structured markets, these types of tying arrangements are particularly benign given their potential for assuring product quality at minimal cost.\textsuperscript{74}

Franchisees may also desire and benefit from tying arrangements. Under a tying arrangement, the franchisor bears the risks of market price fluctuations and input availability, thereby lessening a franchisee's uncertainty over the price and quantity of particular inputs.\textsuperscript{75} Eliminating these risks allows the franchisee to make production and marketing decisions without concern for adverse changes in market conditions.\textsuperscript{76} Consequently, franchisees tend to produce a greater level of output, which ultimately benefits both the overall franchise and the consumers.\textsuperscript{77}

machine. As a result of the pricing arrangement, more machines were rented because of their lower rental rates. Button-Fastener then collected a return from the machines in proportion to the amount of use. So, Button-Fastener collected more from those who used the machines more heavily. Bowman, supra at 23-24. Some commentators have characterized this method of extracting revenues as price discrimination; however, it is more analogous to a metering method which enables the collection of revenue in proportion to usage. \textit{Id.} at 24. For a further discussion, see \textit{infra} notes 176-77 and accompanying text.

71. \textit{See, e.g.,} Siegel v. Chicken Delight, Inc., 311 F. Supp. 847 (N.D. Cal. 1970), \textit{aff'd in part}, 448 F.2d 43 (9th Cir. 1971), \textit{cert. denied}, 405 U.S. 955 (1972). \textit{See also} Klein & Saft, supra note 32, at 345. The authors suggest that the Chicken Delight franchisors monitored purchase of paper products "not because of quality control considerations but because it collected the franchise fee as a profit on these items (in lieu of a percentage of gross sales charge)." \textit{Id.} at 348.

72. For a discussion of the fairness argument, which is based upon the transfer of wealth from one party to another, see \textit{infra} notes 186-89 and accompanying text.

73. \textit{See generally} R. BLAIR & D. KASERMAN, supra note 2, at 48-82. However, at least one court has held that this is a legally insufficient justification for a tying arrangement. \textit{See, e.g.,} Siegel, 311 F. Supp. 847.

74. For a further analysis of the economic justifications for tying, see \textit{infra} notes 174-85 and accompanying text.

75. \textit{See} R. BLAIR & D. KASERMAN, supra note 2, at 83-109. The benefits attributable to tying are greatest when the franchisee is more risk adverse than the franchisor. \textit{Id.} at 106.

76. With the tie-in, the franchisee is relatively certain about the cost of the input bundle. Therefore, its demand for the bundle increases. Essentially, the reduced risk of input price fluctuations results in franchisees demanding more of the tied bundle. \textit{Id.} at 106-07.

77. \textit{Id.} at 103-09. The tying arrangement is a contractual alternative to vertical integration. The franchisor could vertically integrate forward to dispel the effects of random input prices; a tie-in sale, however, would result in the same fall in the market price and the expansion of output of the final good. \textit{Id.} at 107-
Tying arrangements are not without criticisms. Historically, legislative and judicial responses to them have been hostile. Conventional antitrust jurisprudence condemns tying due to fears that monopolists will extend their monopoly power into other markets, that consumers will purchase products they do not want, and that tying will foreclose competition in the tied good. Despite tying’s alleged potential for anticompetitive effects, the current trend is to consider more closely the economic justifications for tying in particular situations.

The next sections provide the legal and economic analyses of the various quality control mechanisms described above. The legal analysis states the current standards courts apply when determining the legality of these mechanisms. That section also describes the possible abusive uses of each mechanism. The economic analysis presents the procompetitive justifications for the use of alternative mechanisms. That section focuses on the efficiency-enhancing benefits of these mechanisms and their potential for minimizing policing, agency and transactions costs.

IV. LEGAL ANALYSIS OF QUALITY CONTROL MECHANISMS

Currently, many of the mechanisms franchises might choose for assuring product quality are illegal. Penalty clauses, tying arrangements and termination provisions all have been subject to judicial or legislative antipathy in many jurisdictions. A brief overview of these methods, and the legal and policy rationales for their disfavor, follows.

08. Additionally, the franchisor’s profits would increase, causing a net increase in social welfare. See infra notes 188-89 and accompanying text.

78. See infra notes 188-89 and accompanying text.


82. See infra notes 108-11 and accompanying text.

83. Other various legal methods of assuring product quality, such as contractual specifications or termination with due process, are not considered in this analysis.

84. For a discussion of policing, agency and transactions costs, see supra notes 132-42.
A. Penalty Clauses

Contractual provisions fixing a definite sum to be paid in the event of a breach are enforceable if such provisions are construed as valid liquidated damages clauses and not as efforts to penalize the breaching party.85 If a court determines that a clause operates as a penalty, the clause is unenforceable and only actual damages are recoverable.86 Consequently, it is important to identify factors courts use to distinguish liquidated damages from penalties.

Courts follow certain guidelines in determining whether provisions are reasonable estimates of compensatory damages or punitive in nature. Courts first determine if the parties, in good faith, intended the damage clause to be an estimate of the actual damages which would result from a particular breach.87 Factors courts consider include the language of the contract,88 the difficulty or uncertainty of estimating damages at the time the parties entered the contract89 and the reasonableness of the estimate.90 If a court finds, based on these factors, that the clause was intended to estimate actual damage, the contractual provision is enforceable as a valid liquidated damages clause. A contrary holding results in the provision being void as a penalty clause. In addition to this mutually exclusive approach to classifying such provisions, courts have fashioned tests for punitive damages.91 A damage clause is punitive in nature if it is intended as a threat to

85. See 5 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 783 (3d ed. 1961 & Supp. 1987). Courts consider the parties’ intent at the time of contracting in determining whether a clause is punitive in nature. See Stenor, Inc. v. Lester, 58 So. 2d 673, 675 (Fla. 1951). This determination is generally based on objective principles such as whether the stated damages are proportionate to actual damages. See, e.g., Hyman v. Cohen, 73 So. 2d 398-99 (Fla. 1954) (en banc).

86. See, e.g., Williams v. Crouch, 186 So. 2d 491, 492-93 (Fla. 1966). The measure of actual damages recoverable may exceed the amount of the liquidated damages. See Hutchinson v. Tompkins, 240 So. 2d 180, 182 (Fla. Dist. Ct. App. 1970), cert. granted and district court ruling quashed, 259 So. 2d 129 (Fla. 1972).

87. 5 S. WILLISTON, supra note 85, § 778.

88. Id. §§ 776, 778. For example, the fact that parties call a stipulated sum “liquidated damages” or a “penalty” is not conclusive. See, e.g., Hyman, 73 So. 2d at 398. However, courts will give such terms effect when they appear to be reasonable. See, e.g., Stenor, 58 So. 2d at 675-76.

89. 5 S. WILLISTON, supra note 85, § 783; see, e.g., Bill Heard Leasing, Inc. v. Rocco Enters., Inc., 334 So. 2d 296, 297 (Fla. 1976).

90. 5 S. WILLISTON, supra note 85, § 779; see, e.g., Hungerford Constr. Co. v. Florida Citrus Exposition, Inc., 410 F.2d 1229, 1231-32 (5th Cir.), cert. denied, 396 U.S. 928 (1969).

91. Analytically, a clause may not satisfy the liquidated damages test but still not be a penalty clause. A finding that a particular clause fails to satisfy the
prevent a breach,\textsuperscript{92} or as a kind of security or guarantee insuring the other party’s performance.\textsuperscript{93}

Another factor courts consider is the “unjust enrichment” that may result from penalty clauses. The inequitable nature of penalties can arise in two ways: (1) such clauses may encourage franchisors to make fraudulent claims against franchisees simply to collect penalty payments;\textsuperscript{94} and (2) penalties sometimes provide a “windfall” to franchisors even where franchisees do breach. The first situation is a clear case of unjust and unlawful enrichment, and remedies exist to prevent such opportunistic behavior. The second situation myopically focuses on the benefit to the franchisor rather than the reproachfulness of the franchisee’s conduct or the deterrent effect of a penalty. The concept of unjust enrichment implies a relative balancing of the circumstances and moral context surrounding a breach.\textsuperscript{95} Judicial disfavor with “unjust enrichment” must be consistent with the other underlying policies of the law.\textsuperscript{96} In sum, a court will invalidate a penalty clause if it finds that the primary purpose of the clause is to en-

\textsuperscript{92} The common-law rationale of such provisions is their tendency to frighten or terrorize a beneficiary or lessee into performing or not performing certain acts, such as not contesting a will or lease. Courts have held these \textit{in terrorem} clauses to be against public policy and have viewed them as mere attempts to improperly influence the behavior of affected parties. See 5 S. \textsc{Williston}, \textit{supra} note 85, § 776.

\textsuperscript{93} Id.

\textsuperscript{94} See infra notes 165-67 and accompanying text.

\textsuperscript{95} See, e.g., \textit{Dunkin’ Donuts of America, Inc. v. Middletown Donut Corp.}, 100 N.J. 166, 184-85, 495 A.2d 66, 75 (1985). A doughnut franchisor sought to terminate its contract with a doughnut franchisee who had been grossly underreporting gross revenues. In upholding the forfeiture of the franchisee’s two locations, valued collectively at $250,000, the court stated:

[I]n applying the concept of ‘unjust enrichment’ we are mindful of the ‘moral aura’ surrounding the phrase and must take care not to elevate the principle to a higher level than it deserves. ‘[T]he task is to make the unjust enrichment principle work with, not instead of, the other policies of the law. . . .’

Even where a person has received a benefit from another, he is liable to pay therefor only if the circumstances of its receipt or retention are such that, as between the two persons, it is unjust for him to retain it.

Here the franchisee deserves to have the full weight of the legal remedies fall upon him.

\textit{Id.} (citations and emphasis omitted). The court recognized that the franchisee’s misconduct not only damaged the franchisor but all other franchisees as well. \textit{Id.} at 185, 495 A.2d at 75.

\textsuperscript{96} Id.
sure contractual performance. 97 The economic justifications for using such clauses will be addressed later in this paper. 98

B. Tying

Tying arrangements are illegal under section 3 of the Clayton Act 99 and section 1 of the Sherman Act. 100 Judicial hostility towards tying arrangements is evident by their classification under the per se standard of antitrust scrutiny. 101 Proof of the existence of an illegal tie requires three conditions: (1) the tied and tying products are separate products; 102 (2) there is sufficient market power in the tying good to enforce the tie; 103 and (3) there is a not insubstantial amount of commerce affected in the tied

97. The fundamental reasons courts disfavor the use of penalty clauses are first, the notion that these clauses overcompensate the non-breaching party and second, the fear that a penalty may prevent an economically efficient breach. Goetz & Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 COLUM. L. REV. 554, 556 (1977).

98. See infra notes 145-68 and accompanying text.

99. Section 3 of the Clayton Act states:
It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale . . . or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the . . . commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

100. Section 1 of the Sherman Act states: “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. . . .” 15 U.S.C. § 1 (1982).


102. Jefferson Parish Hosp. v. Hyde, 466 U.S. 2, 18-19 (1984). The test is whether there is sufficient demand for the purchase of the tied good separate from the tying good “to identify a distinct product market in which it is efficient to offer [the tied and tying goods] separately.” Id. at 21-22. The single product rule provides some exceptions to this element. For example, a franchisor tying its trademark to its unique formula or product is simply marketing a distinctive commodity. See New York v. Carvel Corp., Bus. Franchise Guide (CCH) ¶ 8147 (N.Y. Sup. Ct. March 26, 1984) (tie of trademark to ice cream mix); see also Principe v. McDonald’s Corp., 631 F.2d 303 (4th Cir. 1980), cert. denied, 451 U.S. 970 (1981) (tie of trademark, lease and security deposit a method of doing business and one product).

103. Jefferson Parish, 466 U.S. at 13-14. The Court stated “we have condemned tying arrangements when the seller has some special ability—usually
good. The historical concern with tying is based upon "the seller's exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms."  

Some courts, recognizing that franchisors have a legitimate interest in preserving the quality of products or services offered by franchisees, have recognized a "product quality" defense to tying. Upon a showing of an illegal tie, the franchisor may justify its actions by proving that specifications for product substitutes would be so complex and detailed that such specifications would be impracticable.

The current trend, emerging in both the courts and academia, is toward softening the *per se* rule against tying. The United States Supreme Court's most recent tying decision, though continuing with *per se* language, contains a four-member concurrence urging the reclassification of tying under the rule of reason. The concurrence argued that because tying analysis requires extensive economic inquiry before the *per se* label applied.

...
plies, it "incurs the cost of the rule-of-reason approach without achieving its benefits. . . ." The concurrence further noted that restrictions on a franchisee's freedom to purchase inputs is subject to greater scrutiny than restrictions on the franchisee's freedom of resale. It appears probable that courts will soon abandon the per se label on tying.

C. Termination Clauses

Contractually based termination clauses outline, with varying specificity, the allocation of burdens and risks in case of franchisee misfeasance or nonfeasance. These clauses have been subject to judicial interpretations and legislative restrictions. The legality of privately contracted termination provisions turns on courts' interpretations of the sufficiency and reasonableness of such terms. For example, courts have upheld terminations for

110. Id. at 34. The Court noted: "[T]he [tying] doctrine calls for the extensive and time-consuming economic analysis characteristic of the rule of reason, but then may be interpreted to prohibit arrangements that economic analysis would show to be beneficial." Id.

111. Id. at 35 n.2. The concurrence contrasted this case with both Siegel v. Chicken Delight Inc., 311 F. Supp. 847 (N.D. Cal. 1970), aff'd in part, 448 F.2d 43 (9th Cir. 1971), cert. denied, 405 U.S. 955 (1972) and Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977). Siegel used a per se analysis in finding a tying arrangement illegal despite the franchisor's defense of product quality and goodwill maintenance, while Continental used a rule-of-reason analysis in the context of vertical nonprice restraints. The concurrence found it anomalous that some courts analyze tying under the per se doctrine while other courts analyze largely indistinguishable arrangements under the rule-of-reason. 466 U.S. at 35 n.2.

112. This paper does not consider the situation where the franchise agreement is silent on termination. In such a case, courts determine whether the termination is reasonable based upon "the sufficiency of the notice of termination, the reason for the termination, the ability of the franchisee to absorb the loss associated with an unrecouped investment, the franchisee's ability to start the business anew at another location, and the income derived by the franchisee during the entire relationship in comparison to the resources invested." Laufer, Wrongful Termination of a Franchise, 3 CAL. L. 21 (April 1983).

113. The termination of franchisees occurs for a number of reasons. For example, of the 2,649 franchisor-initiated terminations in 1984, 1419 were for nonpayment of royalties or other financial obligations, 270 were for franchisee failure to comply with quality control standards and 960 were for other unspecified reasons. See U.S. DEP'T OF COMMERCE, FRANCHISING IN THE ECONOMY, 1984-86 13 (Jan. 1986).

114. See, e.g., Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir. 1985), aff'd, 802 F.2d 975 (1986), cert. denied, 107 S. Ct. 1374 (1987). In Lippo, a franchise oil company discovered one of its service station operators had been purchasing gasoline from another supplier (at lower cost) and selling it under the franchise mark and through its pumps and facilities. 776 F.2d at 708. The franchise agreement provided for a ten-day cure period during which the station operator ceased selling the misbranded gasoline. Id. at 709. The oil company filed suit to terminate the station operator; however, the district court entered judgment in
failure to maintain minimum sales requirements,\textsuperscript{115} cleanliness standards\textsuperscript{116} and product quality.\textsuperscript{117} On the other hand, courts have implied covenants of good faith or voided termination agreements on grounds of public policy\textsuperscript{118} or uncon- 

\textit{favor of the franchisee.} \textit{Id.} On appeal the United States Court of Appeals for the Seventh Circuit affirmed, holding that the franchisor could not terminate under the agreement since the station operator cured within 10 days. \textit{Id.} at 716. In dissent, Judge Posner found the court's rationale flawed. He stated:

"Since liability for breach of contract is strict and since the franchise contract imposes many duties on the franchisee that he might violate accidentally (for example, his worker might fail to clean the station's restrooms one day), the provision allowing cure serves to prevent Mobil from using the pretext of an inadvertent, unimportant, and perhaps even involuntary breach by Lippo to yank his franchise. Misbranding, however, is never that kind of breach."

\textit{Id.} at 722. Judge Posner continued his diatribe by chastising his brethren for failing to view the contract terms from the parties' perspective. He said:

"What we ought to ask, and use common sense and a sense of commercial reality in answering, is whether the parties would have agreed to make the ten-day cure provision applicable to misbranding if the issue had come up during the contract negotiation. It seems to me pretty obvious that Mobil would never have agreed to such an application and that for Lippo to have pressed for it would just have convinced Mobil of Lippo's unreliability and have made the negotiations collapse. Imagine Lippo saying to Mobil: 'I would like to be able to sell another supplier's gas under your name for up to ten days after you catch me at it, as that will enable me among other things to enjoy the use of your premises at a much lower rent during that period.'"

\textit{Id.} at 725. In this case, Posner's "common sense" approach to materiality and termination agreements highlights the inequity to franchisors, and indirectly to compliant franchisees, who work diligently to maintain the franchise system's reputation.


\textsuperscript{117} See, e.g., Dayan v. McDonald's Corp., 126 Ill. App. 3d 11, 466 N.E.2d 945 (failure to adhere to franchise quality, service and cleanliness standards) aff'd, 125 Ill. App. 3d 972, 466 N.E.2d 958 (1984), aff'd, 138 Ill. App. 3d 367, 485 N.E.2d 1188 (1985); McDonald's Corp. v. Markin, Inc., 209 Neb. 49, 306 N.W.2d 158 (1981) (failure to adhere to company policies and vacillating ratings regarding quality, service and cleanliness); cf. Lippo, 776 F.2d at 706 (oil company could not terminate franchisee for misbranding gasoline because of ten-day cure provision).

\textsuperscript{118} See, e.g., Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973), cert. denied, 415 U.S. 920 (1974). The court voided a termination agreement based upon "grossly disproportionate bargaining power" and the "grossly unfair contractual provisions which clearly tend to the injury of the public in some way." 63 N.J. at 408, 307 A.2d at 601. The court further stated that public policy required that there be read into lease and dealer agreements the restriction that franchisors shall not have the right of unilateral termination unless there is a showing that a franchisee has failed to substantially perform his obligations under the agreement. \textit{Id.} at 409, 307 A.2d at 603.
Statutory schemes generally allow termination upon a franchisor's showing of "good cause." However, the definition of what constitutes "good cause" varies from state to state. Also, some states impose additional economic burdens upon franchisors who terminate franchisees. For example, some states require a franchisor to repurchase a terminated franchisee's inventory even though termination is for "good cause." These differing combinations of judicial decisions and legislative enactments limit a franchisor's ability to use termination clauses to ensure franchisee compliance with the franchise agreement. Economic analysis suggests that the elimination of or further reductions in the use of termination agreements are ill-advised because of the agreements' potential for procompetitive uses.

V. Economic Analysis of Quality Control Mechanisms

The primary reason for engaging in an economic analysis of quality control mechanisms is that economic theory provides an analytical framework for determining the most cost-efficient means of achieving a social goal. Positive economic theory presupposes autonomous individuals pursuing their own interests subject only to limited budgets. Consequently, economic models, and economic methodology in general, are extraordinarily helpful when setting social policy because they focus upon the

119. See, e.g., Ashland Oil, Inc. v. Donahue, 159 W. Va. 463, 223 S.E.2d 433 (1976) (provision giving gasoline supplier right to cancel on ten-days notice if, in supplier's judgment, dealer had impaired the quality, good name, goodwill or reputation of products was unconscionable on its face).


121. Id. at 1044-50.


123. See infra notes 169-72 and accompanying text.

124. Positive economic theory focuses on determining the most efficient method of achieving a particular social goal. The goal of positive economics is not to determine a particular social goal, but to determine the cost-efficient means of attaining one society has chosen. C. Ferguson & J. Gould, Microeconomic Theory 3 (4th ed. 1975).

125. See id. at 29. In the commercial setting, this assumption translates into profit maximization as a firm's goal. Id. at 2.
fundamental social goal of maximizing the benefits to society from scarce resources.

A. Consumer Welfare

A fundamental goal of positive economic theory is the maximization of consumer welfare.\textsuperscript{126} In a competitive economy, the independent utility-maximizing behavior of consumers and firms eventually results in a social organization that maximizes social welfare. This result is limited, of course, to those markets fitting the structural prerequisites of a competitive market. Due to the pervasiveness of the franchising form of business in the United States, this paper will employ the classic microeconomic models in its economic analysis.\textsuperscript{127}

This section will examine which of the alternative regulatory systems, including no governmental intervention, minimizes the costs of providing goods and services through a franchise system. It will additionally explore which regulations, if any, will increase social welfare beyond that attained in the absence of regulation.\textsuperscript{128} At the outset it should be noted that economic theory provides certain benchmarks to measure changes in welfare. The basic measures of increased social welfare are the reduction of input costs to producers and prices to consumers,\textsuperscript{129} and the re-


\textsuperscript{127}A few assumptions are necessary before further developing an economic thesis. Unless otherwise noted, this paper is founded upon the assumptions of perfect competition, which are "(1) firm produce a homogeneous commodity . . . ; (2) both firms and consumers are numerous . . . ; (3) both firms and consumers possess perfect information" and pursue individual profit or utility maximizing behavior; and "(4) entry into and exit from the market is free for firms and consumers in the long run." J. Henderson & R. Quandt, Microeconomic Theory: A Mathematical Approach 136 (3d ed. 1980). These conditions assure that there are no market imperfections created by monopoly power in either input or output markets. However, these assumptions merely provide the default structure of the paper. For example, because most franchises involve the use of trademarks, the first assumption may be invalid because product differentiation is a hallmark of many franchise markets. Consequently, violations of these structural assumptions are noted where necessary. However, this paper's economic analysis is limited to traditional theory, suggesting that values such as productive and allocative efficiency are those most worthy in the paper's limited context.

\textsuperscript{128}The determination of which of various alternative states maximizes social welfare involves the concept of pareto efficiency. A pareto efficient allocation is a utility maximizing distribution of resources resulting from perfect competition. M. Waterson, supra note 126, at 5.

\textsuperscript{129}For example, a hypothetical franchise system providing X units of its product per year at a cost of Y dollars has a clear improvement in social welfare...
lated concepts of producer and consumer surplus. The sum of
if its costs fall to (Y-1). Similarly, if a consumer purchases X units of a good at Y
dollars and the price falls to (Y-1) dollars, the consumer experiences increased
satisfaction. In a competitively structured economy, the reduction in production
costs would be passed on to consumers in the form of lower prices. Conse-
quently, the reduction of production costs or consumer prices both increase so-
cial welfare. It is sufficient to note that social welfare is increased when a firm
experiences reduced production costs. Someone, whether stockholders, em-
ployees or management, will receive the benefit depending upon the particular
theory of allocation.

130. Consumer surplus is the excess benefits consumers receive from con-
suming a particular good above the amount they pay. Producer surplus is the
excess benefits producers receive from selling their product at a particular price.

![Graph](image)

Where $S =$ supply of good X
$MC =$ marginal production costs
$D =$ Demand function for good X

Graphically, consumer surplus is the area $AEP_0$ given price equals $P_0$. This
area represents the additional benefits consumers of good X receive for which
they do not have to pay. Producer surplus is the area $BEP_0$. This area repre-
sents the benefits producers receive from the sale of good X above marginal
production costs. This measure is also termed quasi-rents. The sum of pro-
ducer and consumer surplus, area $AEB$, is the standard economic measure of
welfare. In a competitively structured industry, the supply function becomes
producer and consumer surplus is the standard measure of economic welfare. The following sections analyze the economic benefits, in terms of consumer and producer surplus, for various significant control mechanisms. The analysis begins by discussing how the reduction of policing, agency and transactions costs increases social welfare. The analysis then considers the economic benefits of particular quality control mechanisms. A summary follows urging policy makers to consider the economic effects of precluding efficiency-enhancing mechanisms.

B. Reduction of Policing, Agency and Transactions Costs

One rationale underlying the use of various quality assurance mechanisms is that they will increase social welfare by reducing policing, agency and transactions costs. The franchisor's goal is to maximize its own profits by decreasing expenditures and increasing revenues. Because a franchisor generally extracts its revenues from its franchisees in the form of royalties on sales, its goal is to maximize sales by franchisees subject to a particular level of franchisor costs. Additionally, the franchisor desires to reduce the expenditures necessary to police product quality and eliminate costs of recontracting, while ensuring franchisee compliance with contractual provisions.

Absent legal constraints on the use of quality control mechanisms, it is reasonable to expect franchisors to pursue their own pecuniary interests by selecting the most cost-efficient method of ensuring product uniformity. Precluding certain methods of quality control or making others more costly increases the ultimate cost of providing franchised products and services, while re-
ductions in these costs directly increase the profits to the franchisor. Avoiding the evident normative question, these franchisor profits increase overall social welfare because they are resources the franchisor would otherwise have used for the unproductive purpose of cost-inefficient monitoring.

Stringent quality control mechanisms which reduce the level of franchisor policing costs may also increase franchisee expenditures on quality maintenance. At first glance, these expenditures seem to counterbalance franchisor savings. However, the franchisees merely are fulfilling their duty to provide a particular level of contractually specified quality. Absent some incentive to over-invest in quality, the franchisees' expenses are not socially wasteful because they produce a quality standard representative of the franchise system. Without such expenditures on product and service quality, the franchise itself would suffer.

An additional rationale for relaxing legal constraints on product quality control mechanisms is the minimization of contract enforcement costs. Undoubtedly, the costs of enforcing contractual terms through a third party are prohibitive. Both litigation and alternative methods of dispute resolution are costly and time-consuming means of enforcing agreements and assessing damages. Oftentimes contracting parties employ self-enforcing mechanisms in order to avoid such delays and expenses. This is particularly true with long-term relationships where neither party expects the other to be liable. If a breach occurs, the terminating party forfeits some asset pledged in case of termination. There is no need to utilize either a third party or ambiguous standards such as "willful" or "good cause." As with

133. The normative question is whether franchisor wealth should be socially beneficial. Absent a concurrent reduction in any other group's wealth, there is an increase in social welfare.

134. Risk averse franchisees may overinvest in quality to reduce the risk of breaching contractual standards. In essence, the franchisee pays a premium to insure against the risks of breach and potential termination. See R. Blair & L. Kenny, supra note 22, at 161-66. This premium may not be socially wasteful because the franchisee's consumers receive supercompetitive quality.

135. The expenditures are necessary to maintain a particular standard of quality consumers expect. These expenditures may raise franchisees' costs. The costs, however, are used to maintain goodwill and to differentiate the franchise from other competitors. As such, the expenditures contribute to competition in the marketplace. See, e.g., Stigler, Price and Non-price Competition, 76 J. Pol. Econ. 149 (1968).

136. See Telser, supra note 63, at 28.

137. Id. at 29-30.

138. Id. at 27-28.
bonding agreements, self-enforcing agreements assume that the parties will not terminate unless it is in their economic interest to do so.\(^{139}\)

Finally, the product quality assurance mechanisms selected should take into account the characteristics of the franchised good or service. For example, a franchisor of shoes faces a different quality control problem than a fast food franchisor. Consumers can directly inspect shoes before purchase to determine product quality. Fast food, however, must be consumed before a consumer can judge its quality. Consequently, a taxonomy of goods and services results. Goods whose qualities can be determined prepurchase, such as shoes, are termed "search goods," while goods whose qualities are determined postpurchase, such as fast-food, are termed "experience goods."\(^{140}\) A third category, "credence goods," are those goods whose qualities cannot be evaluated through normal use; rather, their qualities are discernable only after a long period of time has elapsed.\(^{141}\) An example of a credence good is medical services.

The importance of distinguishing among experience, search and credence goods is twofold. First, a franchisor may use various quality assurance mechanisms according to the inherent characteristics of the franchised good or service. Maintaining a consistent level of product quality may be of greater concern to high-price search good franchises than to low-price experience good franchises. For example, consumers are generally willing to sample a meal from McDonald’s more frequently than an automobile from Ford.\(^{142}\) Second, the economic justifications for different quality control mechanisms vary among search, experience and credence goods. A search good such as shoes may require less franchisor monitoring than an experience good such as fast

\(^{139}\) For example, "[a] party to a self-enforcing agreement calculates whether his gain from violating the agreement is greater or less than the loss of future net benefits that he would incur as a result of detection of his violation and the consequent termination of the agreement by the other party." Id. at 28.


\(^{141}\) Darby & Karni, Free Competition and the Optimal Amount of Fraud, 16 J. L. & Econ. 67, 68-69 (1973).

\(^{142}\) The lower the price of an experience good, the greater the likelihood consumers are willing to test such goods multiple times before formulating a conclusion as to product quality. However, consumers will invest a greater level of time and inspection before purchasing high-priced search goods. The amount of information consumers demand prior to making a purchase of either a search or experience good relates directly to the price of the good. Nelson, Advertising as Information, 82 J. Pol. Econ. 729, 737-38 (1974).
food. As a result, the type of goods influences the amount and cost of product quality policing.

C. Economic Analysis of Bonding Agreements

In the law, penalty and unilateral termination clauses have opprobrious and repugnant connotations; in economics, however, their existence finds justification.143 In fact, the economic vindication of bonding agreements transcends the franchise relationship, finding applications in noncommercial areas.144 Because a rational economic agent is presumed to avoid costs, the primary way of deterring conduct is to impose penalties of appropriate magnitude. This imposition of penalties or forfeitures is the foundation of economic behavior modification.

1. Penalty Clauses

Franchisees who provide substandard products breach the franchise agreement and damage the entire franchise system by diminishing the franchise's goodwill.145 If the franchisor merely collects damages, as measured by the amount of costs the franchisee avoided, the franchisee has very little incentive to be honest. For a given probability of detection and the absence of a penalty clause, a franchisee will almost always cheat and reimburse the franchisor for lost sales and avoided costs.146 In this situation, the franchisor must continually monitor franchisees to prevent their diminishing the level of product quality. The costs of monitoring could be substantial and enforcement would necessarily be imperfect.147

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143. But see Clarkson, Miller & Muris, Liquidated Damages v. Penalties: Sense or Nonsense?, 1978 Wis. L. Rev. 351 (arguing policy of not enforcing penalty clauses may be efficient).


145. For a discussion of the free-rider problem, see supra notes 32-36 and accompanying text.

146. See Klein & Saft, supra note 32, at 352. Suppose the probability of detection is 10% each year. If the franchisee continually cheats, it will find it profitable to do so in nine out of every ten years. In one year, the franchisee will have to disgorge profits; but overall, the franchisee has not been deterred and will continue to cheat. Of course, this analysis assumes a probability of detection less than one and may, therefore, be unrealistic.

147. Imperfect enforcement exists when the costs of detection and enforcement result in breachers being penalized with a probability of less than one. See
One way of reducing these policing costs is for the franchisor to institute supercompensatory damages or penalty clauses. If the shirking franchisee must compensate the entire franchise system for damages due to a reduced level of sales and goodwill, there is a greater likelihood of deterrence. In this case, the level of damages, though seemingly punitive, is actually compensatory. It appears punitive because it exceeds the level of self-enrichment the franchisee receives. Because the franchisee takes account of only its own costs and benefits, its expected benefits or cheating may be less than the damage to the franchise system overall. In contrast, true penalty clauses would require

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148. Plaintiffs are often undercompensated in contract actions because of the uncompensated costs of transactions costs and imperfect information. Consequently, some types of contracts are underenforced, resulting in excessive levels of breach and resort to self-help remedies. See id. at 1444-45. Supercompensatory damages, which are damages in excess of directly compensatory damages, can improve economic efficiency in these situations.

149. See id. at 1462-64. Increasing damages removes two sources of inefficiency: (1) cheating by franchisees; and (2) detection costs by franchisors. Id. at 1462.

150. Analytically, the measure of damages attributable to a franchisee's breach of product quality standards includes total lost sales (present and future) due to reduced levels of consumer demand and goodwill. See Klein & Saft, supra note 32, at 352 n.23. The authors state that a franchisee will continue cheating on the franchise unless a penalty clause is included in the contract. They describe such a clause as

[a] penalty term in the sense that, when detected, the franchisee would pay more to the franchisor than the cost saving resulting from the supply of lower quality in the individual transaction. It need not be a penalty in the sense of a payment greater than the estimated cost of lower quality on all transactions likely to have been made prior to detection plus the capital depreciation of the franchisor's brand name.

Id.

151. An analogy to the franchise context is the contractual relationship between cooperative marketing associations and their members. 5 S. Williston, supra note 85, § 783. Williston quotes at length an opinion of the United States Court of Appeals for the Third Circuit:

"These contracts made between the association and its members, provide that the member shall market a given crop exclusively with the association and stipulate an amount as liquidated damages in case the member sells elsewhere. . . . 'If any member breaks his contract by not bringing his produce into the pool controlled by the selling agent . . . he may cause damage to the association and its members which, while very substantial, will be difficult to value precisely'."


152. See C. Goetz, LAW & ECONOMICS 314-15 (1984). Generally, individuals take into account only those costs and benefits they must bear directly. However, individual actions often impose costs on others. If the individual does not
payments in excess of the damages to the franchise system attributable to the franchisee's action. Theoretically, such penalty clauses would provide a level of deterrence not available through ordinary liquidated damages provisions.\textsuperscript{153} Because the franchisor's goal is to prevent franchisee cheating, penalty clauses would provide a low-cost means of deterrence.

For example, if the costs of avoiding detection outweigh compliance with quality standards,\textsuperscript{154} the franchisee will be forced to make a cost/benefit decision. A particular franchisee must decide what minimal level of product quality is sufficient to satisfy its consumers' expectations and the franchisor's standards in case of inspection. The franchisee has an independent self-interest in maintaining product quality especially when the franchisee's location results in a high level of repeat business.\textsuperscript{155} Additionally, the franchisee has an interest in avoiding franchisor sanctions for product quality breaches. In some instances, the former interest may result in a product quality level sufficient to satisfy the latter. However, absent this situation, the franchisee's strategy is dependent upon these factors: (1) the probability of inspection; (2) the probability of detection; and (3) the severity of sanctions for detected violations. In short, the expected benefits of breach must exceed the expected costs of a violation to the franchisee for a substandard level of product quality.

A franchisor could ensure a particular level of product quality by taking account of these external costs, inefficiency results. So, shirking franchisees not having to consider the external costs of reduced goodwill on the franchise system, are undeterred in their underproduction of quality. In such a case, the franchisor and other franchisees suffer harm. Requiring shirking franchisees to compensate for these losses forces the franchisee to consider the external effects of its actions.

\textsuperscript{153} See Farber, supra note 147, at 1476. Absent a termination clause, a franchisee's incentive to totally comply with the terms of a product quality agreement is minimal. Suppose the likelihood of a franchisor detecting a breach in a given year is 10% and damages are equal to the level of franchisee profits (or costs avoided) of, say, $1000. The expected value of continually cheating is $900 because for every time the franchisee is detected cheating and forced to disgorge profits, on average the franchisee will avoid detection nine times out of ten. Without a punitive element to the damages, franchisees will always find it in their best interest to cheat.

\textsuperscript{154} This assumption will not hold for certain types of franchise agreements. If the cost of complying with quality standards is exceedingly high, franchisees will continue to provide substandard products but attempt to avoid detection.

\textsuperscript{155} For example, a fast food franchise located near an interstate highway exit is less likely to rely on repeat business compared to a location adjoining a business center. The location with a high level of repeat sales has a greater interest in maintaining product quality standards.
ity without an elaborate monitoring system by instituting a system of fines set at appropriate levels. The greater the magnitude of the sanctions, the greater the franchisees' incentive to comply with the standards. Franchisors would not need to expend as much on policing costs because the greater the fine to the franchisee for noncompliance, the greater the expected cost of noncompliance, assuming a particular probability of detection. Consequently, franchisors could allow the probability of detection to fall and still expect, on average, a particular quality level among franchisees' products. As the franchisor decreases the level of monitoring, there is a decline in the probability of detection; in this manner, the franchisor reduces monitoring expenditures while maintaining the same disincentive against franchisee cheating.

A number of other rationales have developed for the use of penalty clauses. First, penalty clauses have an informational aspect. A party who voluntarily accepts a penalty clause provision may be signalling his willingness to establish a reputation for performance. Second, penalty clauses may be methods of allocat-

156. This result is evident in the franchisee's expected cost function. The cost of noncompliance is:

\[ E(\text{cost}) = E(\text{probability of detection and punishment}) \cdot (\text{fine}) \]

So, for example, a risk-neutral franchisee will have expected costs of $1000 if the probability of detection is one percent and the fine is $100,000. If the expected benefits of cheating are greater than $1000, the franchisee will find it profitable to cheat.

157. The mathematical relationship is:

\[
\text{Net expected benefits} = E(\text{marginal revenue } Q_p) - E(\text{costs}) = (\text{marginal revenue } Q_d) - E(P \cdot \text{fine})
\]

Where \( Q_d \) = quality level set by franchisee
\( P \) = probability of detection and punishment
\( \text{fine} \) = cheating fine set by franchisor

Consequently, as the amount of the fine increases, the expected costs increase, causing a decline in the net expected benefits from cheating. However, holding net expected benefits constant, the probability of detection must fall. So, the franchisor need only increase the level of fine to reduce the level of detection costs necessary to maintain the current level of "cheating."

158. The relationship between monitoring expenditures and probability of detection is positively correlated and probably nonlinear. As franchisor expenditures on monitoring increase, the probability of detection should increase. Conversely, a decrease in expenditures should result in a decreased probability of detection. However, there are decreasing returns to monitoring expenditures; as expenditures increase, the probability of detection increases but at a decreasing rate.


Although no one ever knows for sure that he will honor a contract, those who know that they are more likely to honor than others will find it less costly to agree to penalty clauses. If buyers cannot differentiate
ing risks in case of a breach. If expected damages are uncertain or difficult to establish, or if one party is more risk-averse than the other, the parties may desire to specify such damages.\textsuperscript{160} These contractually stipulated damages may exceed the actual pecuniary measure of damages upon a subsequent breach.\textsuperscript{161} Third, punitive damages provide a means of minimizing the impact of imperfect enforcement. When the probability of detection and enforcement is less than one, parties not operating under penalty clause will always find it in their interest to breach. Penalty clauses allow a franchisor to minimize monitoring costs in these instances.\textsuperscript{162} Arguably the optimal measure of punitive damages should be infinite to cause the probability of breach to approach zero.\textsuperscript{163} However, because most individuals are risk-averse, the level of damages need not be “draconian” to force the probability of breach close to zero.\textsuperscript{164}

Penalty clauses may be inappropriate when either party has the power to affect the probability of a breach. If a party to a contract can benefit by influencing the probability of breach, a low risk from high risk sellers, a seller’s acceptance of a penalty clause is a signal of a low probability of breach.

\textit{Id.} at 156. The author provides the example of a company placing a security deposit in a bank offering purchasers of an influenza medicine a cash payment if the medicine failed to work. \textit{Id.} at 156 n.37 (citing Carill v. Carbolic Smoke Ball Co., [1893] 1 Q.B. 256 (C.A.)).

\textsuperscript{160} See Goetz & Scott, supra note 97, at 557-58.

\textsuperscript{161} \textit{Id.} The authors contend that because of courts’ unwillingness to compensate nonpecuniary losses such as risk allocation, courts have undercompensated victims of breach. Consequently, contracting parties have sought other means of risk allocation. \textit{Id.} at 555. \textit{But cf.} Rea, Nonpecuniary Loss and Breach of Contract, 11 J.L. STUD. 35 (1982) (nonpecuniary losses not fully compensable in an efficient contract).

\textsuperscript{162} See Farber, supra note 147. The author demonstrates that increasing the level of damages reduces detection and agency costs. \textit{Id.} at 1462.

\textsuperscript{163} \textit{Id.} The author states:

Efficiency thus can always be increased by increasing damages; complete efficiency would apparently require infinitely high punitive damages.

This result may seem puzzling. One might expect that with sufficiently high damages, [franchisees] would be completely deterred from breach. While the deterrent effect of damages obviously does increase with higher damages, the incentive for [franchisors] to engage in detection decreases as the level of breach decreases. The decreased level of detection undermines the deterrent effect of increased damages by decreasing the probability of being caught. As a result, the level of breach declines as damages increase, but never reaches zero.

\textit{Id.} at 1463.

\textsuperscript{164} \textit{Id.} at 1463 n.67. At some level the amount of damages will be sufficiently high, given the franchisee’s wealth, forcing the franchisee into strict compliance with the franchise contract.
FRANCHISE QUALITY ASSURANCE

moral hazard problem exists. For example, a franchisor who ensures quality through a penalty clause has a reduced incentive to invest energies in assisting franchisees with quality control. Conversely, high punitive damages increase the franchisor's incentive to discover a franchisee's breach and profit from the penalty provision. This incentive is tempered by the franchisor's interest in maintaining long-term relations with existing and potential franchisees.

In the legal literature, there is no general consensus regarding the proper distinction between liquidated damages and penalty clauses. There is actually a continuum of damage measures that includes compensatory, liquidated, supercompensatory and punitive damages. The economic analysis suggests that each of these measures may be beneficial in different situations. In particular, both supercompensatory and punitive damages tend to increase efficiency by reducing policing, agency and transactions costs. Consequently, policymakers should consider the efficiency-enhancing attributes of these clauses despite their legally maleficent status.

2. Firm-specific Capital Assets and Initial Franchise Payments

A second way franchisors can use bonding agreements to influence franchisee behavior is to include termination clauses in franchise contracts. Upon a franchisee's material breach of the agreement, the franchisor is authorized to terminate the rel-

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165. See Rea, supra note 159, at 155.
166. See Clarkson, Miller & Muris, supra note 143, at 369-70. The authors assert that if a promisee has more to gain from the promisor's breach, the promisee will expend resources on inducing a breach; in like manner, the promisor will counter the promisee's efforts with socially wasteful investments of resources. Id. But see A. Kronman & R. Posner, supra note 159, at 225. The authors state:

If the penalty clause survives the negotiating process, that is presumably because the benefits to the promisee exceed the costs to the promisor. However costly a contract containing a penalty clause may be, all of the relevant costs are fully borne by the contracting parties and therefore all will be taken into account in the negotiation. Only if it is believed that the parties will fail to assess these costs correctly is there a basis for intervention; the basis, however, is paternalism rather than efficiency.

Id.
168. For a discussion of the economic benefits of these clauses, see supra notes 148-64 and accompanying text.
169. Concern for the materiality of the breach has caused some legislators to institute "good cause" requirements in some states. This type of legislation is
Termination often leaves the franchisee with specialized inventories and franchise-specific capital assets. These assets may have little or no value outside of their use in the particular franchise. Consequently, termination could impose a substantial financial burden on the franchisee. This burden is reduced to the extent the assets have resale value. However, to the extent the assets have reduced value outside the franchise relationship, they can serve as sources of franchisor control over franchisee performance in a bonding agreement.

Most franchise agreements require franchisees to pay large initial lump-sum fees in order to acquire a franchise. These payments are generally not recoverable unless the franchisor procures them in a fraudulent or illegal manner. The franchisee expects to recoup its franchise investment from profits earned from its operations. Therefore, the franchisee has the incentive to maintain an adequate level of product quality to ensure an investment is not lost.

170. A terminable-at-will clause allows a franchisor to "more effectively eliminate cheating because the costs of proving cheating to an external observer, such as a court, would be avoided and the franchisee would know that detection results in swift termination." Muris, supra note 45, at 575.

171. See Williamson, supra note 6, at 521-23. "Costs that are highly specific to a transaction have two attributes: they are incurred in advance of the contemplated exchange; and their value in alternative uses, or by alternative users, is greatly reduced." Id. at 522. Common examples of such costs are physical plant or fixed accounting costs; however, investments in labor can produce transaction specific human capital. Id.

172. See, e.g., In re Tastee-Freeze Int'l, Inc., 82 F.T.C. 1195 (1973). This case involved a franchisor requiring franchisees to purchase soft ice cream equipment; however, the equipment required a patented feeder mechanism the franchisor rented for one dollar per month. Without the mechanism, the franchisees' equipment had little market value and the value of the franchisees' investment would be lost upon termination. Thus, the investment in the equipment served the franchisor's goal of assuring product quality (or franchisee compliance in general) by acting as security against a franchisee breach. However, if the franchisor had rented the equipment and mechanism together, it would lose financial leverage because it could not impose a capital loss on the franchisee upon termination. A similar result follows if the mechanism were sold to franchisees; in this case, the franchisee could sell the equipment and mechanism upon termination without a capital loss. See Klein, Crawford & Alchian, supra note 2, at 306 n.22.

173. These future expected profits are termed "quasi-rents." Quasi-rents are returns to short-run fixed inputs measured as the difference between short-run total revenue and short-run total variable costs. See C. Ferguson & J. Gould, supra note 124, at 381-83.
adequate financial return. In addition, the possibility of termination and imposition of a capital loss for breaching the franchise agreement weighs heavily upon the franchisee's choice of product quality levels. The combination of these effects influences the franchisee to comply with the franchise's product quality standards.

D. Economic Analysis of Tying

The economic analysis of tying has been extensive. In most instances, economic commentators fail to discover any of the evil anticompetitive effects attributed to tying arrangements. The primary concern with tying is the alleged potential for a monopolist to expand its power into the tied product market. However, this leverage theory has been largely discredited. Economic theory demonstrates that monopoly power in one market generally can not be extended into another. Tying has also been criticized as a method of price discrimination. Again, economic theory has rebutted the reputed anticompetitive effects such a theory alleges. In fact, tying has a number of procompetitive justifications. For example, when the tied and tying goods are technologically interdependent, the tying good may not perform satisfactorily without the specific tied good. Thus, the franchisor may wish to protect its goodwill by instituting a tie. Another justification is the exploitation of economies of joint sales. If the concurrent sale or production of two goods is more cost-efficient than the separate sale or provision of the same goods, a seller can lower its costs through a tie. Tie-ins can also mitigate the in-

174. See R. BORK, THE ANTITRUST PARADOX 365-81 (1978). "The law's theory of tying arrangements is merely another example of the discredited transfer-of-power theory, and perhaps no other variety of that theory has been so thoroughly and repeatedly demolished in the legal and economic literature." Id. at 372.

175. See generally R. BLAIR & D. KASERMAN, supra note 81, at 403-04 (economic analysis of judicial concerns with market foreclosure and denial of consumers' freedom of choice); see also Blair & Finci, supra note 80, at 545.

176. See, e.g., Bowman, supra note 70. However, tying is more properly defined as a metering method rather than a form of price discrimination. See Hansen & Roberts, Metered Tying Arrangements, Allocative Efficiency, and Price Discrimination, 47 S. ECON. J. 73 (1980).

177. See R. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 173-84 (1976) (condemns tying only if used as systematic form of price discrimination).


179. See Blair & Finci, supra note 80, at 549-50.
fluence of risk and uncertainty,\textsuperscript{180} or be means of promotional selling.\textsuperscript{181}

Most commentators believe that tying offers an efficient and effective solution to the free rider problem.\textsuperscript{182} They argue that contractual minimum product quality standards are ineffective for two reasons. First, most franchisees often find it to be in their financial interest to breach the contract by cheating.\textsuperscript{183} Second, because penalty clauses are generally illegal, franchisors must rely on termination clauses to penalize such breaches. But in order for termination to be effective, franchisors must devise methods of ensuring that franchisees invest in specific nonsalvageable assets.\textsuperscript{184} Consequently, so long as tying remains illegal, franchisors are forced to substitute more cumbersome and inefficient quality assurance mechanisms. The franchisor has the choice of incurring greater policing costs or allowing product quality to erode—in either case, social welfare declines.

Balanced against the procompetitive arguments for tying are those urging that tying is a coercive and exclusionary practice. However, in light of the protracted and exceedingly vigorous debate over the past two decades, it seems apparent that tying has a generally neutral and oftentimes positive effect on social welfare. As such, legal standards should give way to economic realities.\textsuperscript{185}

E. Wealth Redistribution and Relational Contracts

Tying, penalty clauses and termination provisions also create the potential for redistribution of wealth between franchisor and franchisee. Tying arrangements, for example, allow franchisors to collect revenues from franchisees by requiring the purchase of a particular bundle of items. The franchisor may set the price of the tied bundle at a level that approximates a percentage royalty. While revenue generating methods such as royalties on sales and franchise fees pose no outcry, the tying extractions evoke feelings of "unfairness." The economic result of all these methods is the franchisee's compensation to the franchisor for the benefits of be-

\textsuperscript{180} See supra notes 75-77 and accompanying text.
\textsuperscript{181} See Blair & Finci, supra note 80, at 551-52.
\textsuperscript{182} See, e.g., Klein & Saft, supra note 32, at 351.
\textsuperscript{183} Id.
\textsuperscript{184} Id. at 352.
\textsuperscript{185} "That the law's course remained utterly undeflected for so long casts an illuminating and, if you are of a sardonic turn of mind, amusing sidelight upon the relation of scholarship to judicial lawmaking." R. Bork, supra note 174, at 372.
ing a part of the system. If the tie-in, or other quality control mechanism, is contained in the original franchise agreement, there seemingly can be no objection, absent fraud or duress, to the resulting exchange between franchisor and franchisee. This transfer of wealth between contractually bound parties is simply a bargain fulfilled.

Alternatively, franchisors may invoke postcontractual tie-ins under broadly phrased franchise clauses to alter or tighten product quality standards. Franchisors may utilize such clauses to engage in opportunistic behavior that results from the nature of the relational contract between the parties.\textsuperscript{186} This opportunistic behavior, though outwardly reproachful, is consistent with the franchisor's primary economic interest: maximizing the profits that result from the competitive success of the franchise system. Consequently, and because franchisors are not in the business of bankrupting franchisees, these types of revenue extractions have limitations. The franchisor's main interests are maintaining profitable franchises and an eager queue of potential franchisees. A franchisor's shortsighted and avaricious extractions of additional wealth may frustrate both these goals.\textsuperscript{187}

From an economic perspective, the transfer of wealth from franchisee to franchisor has an indeterminate effect on social welfare absent some standard of comparing interpersonal satisfaction.\textsuperscript{188} In fact, erroneous conclusions can result from examining

\textsuperscript{186} See Klein, Crawford & Alchian, \textit{supra} note 2. The authors explore the incentive for vertical integration based upon the possibility of postcontractual opportunistic behavior which occurs when specialized quasi-rents are appropriable from one party's specific capital investment. \textit{Id.} at 297-98.

\textsuperscript{187} The court in Ungar v. Dunkin' Donuts of America, Inc., 531 F.2d 1211 (3d Cir.), \textit{cert. denied}, 429 U.S. 823 (1970), provided a particularly insightful analysis of the franchisor-franchisee relationship:

\textit{We do not imagine that many persons are, in any meaningful sense forced to enter into franchise agreements. . . . \[W\]e would expect to find that an arrangement apparently reasonable at its inception begins to seem burdensome to the franchisee as the business is successfully established. Only from the successful business can the franchisor effectively seek a continuing return on investment; yet as the venture prospers, the franchisee, in time, may come to regard the arrangement as onerous, restricting his profitability. \textit{Id.} at 1223.}

\textsuperscript{188} See, e.g., A. Atkinson & J. Stiglitz, \textit{Lectures on Public Economics} 351-52 (1980). One method of public policy analysis establishes a procedure for determining the benefits and costs to different groups and then assigning a "weight" to each group. Under this type of analysis, if the franchisor's and franchisees' welfare are given equal weight, the transfer of one dollar between them renders social utility unchanged. This Bergson-Samuelson social utility function requires some determination of the ethical beliefs underlying the proper
the transfer in isolation from the parties' previous interactions. This type of revenue extraction may have been an expectation the parties had at the time they entered the franchise agreement. Perhaps a highly successful franchisee could expect the franchisor to impose, within the legal limits of the agreement, additional revenue-generating provisions. Because franchise contracts are frequently incomplete regarding future recontracting terms, franchisor discrimination between successful and less successful franchisees can be expected as a means of extracting additional profits from profitable franchisees.

F. Summary

An economic analysis of tying, termination agreements and penalty clauses reveals the discrepancies in the legal justifications for allowing certain quality control arrangements and not others. For example, some courts uphold termination agreements based upon violations of contract terms despite the franchisee's financial loss resulting from forfeiture of assets and future expected profits. Given the same factual basis for termination, no court would uphold a penalty clause sanctioning the violation in question. Even though the magnitude of the penalty may be less than the economic consequences of termination, courts are reluctant to enforce such penalties. Consequently, the form of the contractual provision weighs heavily when a franchisor seeks termination of a franchisee. This legal anomaly weakens the franchise form of business because it forces the franchisor to utilize the harshest form of control (i.e., termination) instead of an intermediate method (i.e., supercompensatory damages or penalty clauses). Because the economic impacts of both termination clauses and penalty clauses are very similar, a more unified and

weights; unfortunately, there is little assistance in the economic literature. See D. MUELLER, PUBLIC CHOICE 181 (1979).

189. For a brief discussion of sequential contingent contracts, see supra note 41.

190. For example, suppose a franchisee upon termination forfeits $100,000 in future expected profits. If the franchise agreement had specified a $100,000 penalty for the same breach, it is highly unlikely any court would uphold such a "draconian" provision. In either instance the franchisee loses $100,000. However, under the penalty provision the franchisee may continue operating (absent some contrary contractual provision) while the terminated franchisee must forfeit his investment and find another business opportunity.

191. "The common law, at the same time that it was forbidding penalty clauses, allowed sellers to keep deposits and installment payments even if the result was to give the seller more money than any reasonable estimate of his damages." R. POSNER, ECONOMIC ANALYSIS OF LAW 116 (3d ed. 1986).
consistent approach would permit the use of such intermediate methods.\textsuperscript{192}

The economic effects of foreclosing particular methods of product quality assurance are conceptually straightforward. The judicial or legislative elimination of one method causes the franchisor to search for the next best alternative. Presumably, the franchisor must substitute a more costly system of product quality maintenance. Someone bears these additional costs. In the short term, it may be the franchisor, locked into a particular contractual arrangement with its franchisees and under a legal duty to maintain quality standards,\textsuperscript{193} who experiences reduced profits. However, following the substitution of a system of control, a new equilibrium would occur. It is a matter of conjecture, but it seems probable that the gross profits which the franchise system can now conceivably generate are reduced by the additional amount the franchise system must expend on product quality assurance.\textsuperscript{194} The division of this lost profits would be a matter of bargaining between franchisor and franchisee. In the aggregate, however, there is a net social welfare loss equal to the additional resources expended on a relatively more inefficient product quality assurance system. With the goal of increasing competition,

\textsuperscript{192} One argument for allowing such intermediate methods is to avoid the use of one uniformly severe penalty (i.e., termination). If the only sanction a franchisor can impose on a breaching franchisee is termination, the franchisee has an incentive to breach not just the marginally important contract terms, but any and all others. See, e.g., id. at 208. This "all-or-nothing" approach to deterrence eliminates the relative distinctions between various types of breaches. In fact, the lack of an intermediate sanction probably contributes to the incidence of franchisee breach of quality and cleanliness standards without fear of termination. Oftentimes, these types of "nonmaterial" breaches fall outside the "good cause" category, resulting in judicial reluctance to enforce termination clauses.

\textsuperscript{193} One source of this legal duty is the trademark laws. Franchisors who license their products are under an affirmative duty to assure that franchisees (licensees) continue to maintain product quality. A franchisor who permits a substandard product to be represented under its trademark may be using its mark in a deceptive manner. 15 U.S.C. §§ 1055, 1125 (1982); see also Note, Quality Control and the Antitrust Laws in Trademark Licensing, 72 YALE L.J. 1171 (1963).

\textsuperscript{194} This additional expenditure on product quality assurance may cause an increase in the marginal or fixed costs of production. If the marginal production costs increase, both the franchisor and franchisee experience reduced profits, assuming a model of monopolistic competition. This results from the upward shift of the supply curve causing price to increase and total revenues to fall. See, e.g., C. FERGUSON & J. GOULD, supra note 124, at 293-95. If the increased costs take the form of a lump-sum expenditure, the franchisor's short-run profits fall; the franchisor may attempt to allocate these costs to franchisees through increased royalty rates or tied input costs. The long-run analysis in this case would be similar to an increase in marginal costs: price increases and industry output decreases. Id. at 300-01.
limitations on quality control mechanisms appear to protect nobody. In summary, this economic argument suggests that consumer welfare may actually be reduced through limitations on the use of penalty clauses, tying arrangements and termination agreements for quality control purposes.

VI. RECOMMENDATION AND CONCLUSION

The franchisor's goal of assuring product quality is furthered by penalty clauses, tying arrangements and termination agreements. Each of these mechanisms can provide efficient means of ensuring that franchisees maintain a particular level of product quality. However, economic theory is at odds with current legal standards governing the use of these methods. This paper has analyzed various quality control mechanisms which courts and legislators should more closely scrutinize before rejecting them as harmful to consumer welfare. In particular, penalty clauses serve legitimate purposes in many areas of commercial law by reducing policing and agency costs. Yet courts find their use repugnant to public policy. Tying arrangements serve analogous purposes. Judicial hostility, though historically severe, has currently waned, indicating courts' willingness to reanalyze the per se treatment of tying. Finally, judicial and legislative animosity towards franchise termination clauses appears to be misdirected. Termination clauses serve useful purposes and are based on principles of private ordering and freedom of contract. Absent franchisors' fraudulent or blatantly anticompetitive uses of such clauses, courts and legislatures should carefully consider whether maintaining or expanding the use of franchisee protectionism favors consumers or franchisees.