GOOD CAUSE STATUES REVISITED: AN EMPIRICAL ASSESSMENT

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ABSTRACT

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

This paper investigates the free-riding hypothesis empirically, and finds it wanting. Direct examination of consumer satisfaction in one of the industries most notoriously susceptible to free-riding, hotels serving non-repeat travelers, shows no significant differences between franchises subject to 'at will' laws and those subject to a GCS. We gathered a sample of 3,442 franchised hotels, measured each one along several dimensions of quality, and assessed potential differences using multiple econometric methods. In none did the 'at will' states outperform the 'good cause' ones.

Implications of our empirical results on the debate over GCSs are discussed. We suggest a more nuanced approach to the enactment of GCSs and the debates surrounding it. In any case, one argument can no longer be made: that GCSs increase franchisee free-riding. The customers of hotels in our sample say otherwise.

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I. INTRODUCTION

One of the most vital debates in franchise law focuses on whether state or federal law should adopt good cause statutes (GCSs) requiring franchisors to show "good cause" before terminating their contract with a franchisee.[1] The traditional law and economics analysis suggests that GCSs are inefficient, based upon one central hypothesis: GCSs increase franchisee free riding by rendering it significantly more difficult for a franchisor to terminate the franchise contract, thereby impeding a central monitoring device used by franchisors.[2] The logic of the traditional free-riding hypothesis is at first glance simple and commonsensical:[3] franchisees operate by selling products and services to consumers who rely on the franchise trademark as a telling brand. Customers purchase from the franchisee believing that the local venue is as good as any

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

2 *See infra* Part III.

3 *See infra* Part III.

other franchised branch, essentially believing they are interacting with the chain rather than the individual provider. Franchisees realize much of their allure comes from national or regional campaigns rather than their own efforts, and thus conserve their own funds and effort by skimping where possible, i.e. where the franchisor cannot catch them. A free-riding franchisee will thus cut corners in service and products, and rely on the franchisor and other franchisees to uphold the brand reputation which brings customers through the door. According to the traditional free riding hypothesis, industries that serve mostly non-repeat customers, such as hotels and motels, are mostly prone to free riding. In such industries, free-riding saves costs while reducing future sales only slightly and indirectly. ‘At will’ contracts then must be used by franchisors to keep franchisees in line. A “shape up or ship out” strategy works best when contracts can be terminated quickly and without recourse, thus GCSs can get in the way. GCSs are therefore argued to increase franchisee free-riding.

This paper investigates the free-riding hypothesis empirically, by direct examination of consumer satisfaction in one of the industries most notoriously susceptible to free-riding, hotels serving non-repeat travelers. We gathered a sample of 3,442 franchised hotels, measured each one along several dimensions of quality, and used these to conduct an empirical comparison of the level of free riding by franchisees in states where GCSs apply, with that of franchisees in ‘at will’ states. Perceived quality and customer satisfaction serve to proxy for franchisees’ investment of effort, as free-riding typically results in customer complaints and lower-than-average ratings. Those franchisees, free-riding on franchise reputation, invest less in keeping their venues clean, their service prompt, and their customers happy. They rely on brand awareness and an ongoing stream of new customers lured by national advertising and chain-wide marketing. The results outlined below show no significant differences in free riding between franchise operations subject to the disparate legal regimes, thus casting considerable doubt on the validity of the traditional economic analysis of GCSs.

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

II. GOOD CAUSE STATUTES – THE LEGAL FRAMEWORK

To date, only seventeen of the fifty states have adopted statutes requiring "good cause" as a condition for the termination of a franchise contract by a franchisor.[4] Under these statutes, good cause is commonly defined as a franchisee's failure to adequately comply with the franchise agreement.[5] A franchisor terminating the contract without good cause is obligated, under the GCSs, to pay damages to the franchisee.[6] Recoverable damages may include : (1) a fraction of

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[4] The seventeen "good cause" states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, Tennessee, Virginia, Washington, Wisconsin. ARK. CODE ANN. § 4-72-204(a)(1) (2010); CAL. BUS. & PROF. CODE § 20020 (Deering 2010); CONN. GEN. STAT. ANN. § 42-133f(a) (2010); DEL. CODE ANN. tit. 6, § 2552(a) (2010); HAW. REV. STAT. ANN. § 482E-6 (LexisNexis 2010); 815 ILL. COMP. STAT. ANN. 705/19 (LexisNexis 2010); IND. CODE ANN. § 23-2-2.7-1(7) (LexisNexis 2010); IOWA CODE ANN. §537A.10(7); MICH. COMP. LAWS. ANN. § 445.1527(27)(c) (West 2010); MINN. STAT. ANN. § 80C.14(3)(b) (West 2010); NEB. REV. STAT. ANN. § 87-404 (Lexis-Nexis 2010); N.J. STAT. ANN. § 56:10-5 (West 2010); R.I. GEN. LAWS § 6-50-1 et seq. (2010); TENN. CODE ANN. 47-25-1503; VA. CODE ANN. § 13.1-564 (West 2010); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 2010); WIS. STAT. ANN. § 135.03 (West 2010).

[5] See ARK. CODE ANN. § 4-72-202(7)(a) (LexisNexis 2007); CAL. BUS. & PROF. CODE § 20020 (Deering 2007); CONN. GEN. STAT. ANN. § 42-133f(a) (LexisNexis 2007); HAW. REV. STAT. ANN. § 482E-6(2)(H) (LexisNexis 2007); 815 ILL. COMP. STAT. ANN. 705/19(b) (LexisNexis 2007); IND. CODE ANN. § 23-2-2.7-1(7) (LexisNexis 2007); IOWA CODE ANN. § 537A.10(7); MICH. COMP. LAWS. ANN. § 445.1527(27)(c) (LexisNexis 2007); MINN. STAT. ANN. § 80C.14(3)(b) (LexisNexis 2007); NEB. REV. STAT. ANN. § 87-402(8) (LexisNexis 2007); N.J. STAT. ANN. § 56:10-5 (West 2007); TENN. CODE ANN. 47-25-1502(4); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 2007); WIS. STAT. ANN. § 135.02 (West 2010). For cases in which termination was not based on a statutory good cause *see e.g.*, Kealey Pharmacy & Home Care Servs., Inc. v. Walgreen Co., 761 F.2d 345 (7th Cir. 1985); Atlantic City Coin & Slot Serv. Co. v. IGT, 14 F. Supp. 2d 644 (D.N.J. 1998); Volvo Constr. Equip. N. Am., Inc. v. CLM Equip. Co., 386 F.3d 581 (4th Cir. 2004).

[6] ARK. CODE ANN. § 4-72-208(b) (2007); CONN. GEN. STAT. ANN. § 42-133g(a) (2007); DEL. CODE ANN. tit. 6, § 2553(c) (2007); HAW. REV. STAT. ANN. § 482E-9(b) (LexisNexis 2007); 815 ILL. COMP. STAT. ANN. § 705/26

the franchisee's tangible assets (both real and personal) used with respect to the terminated franchise, including sales outlets and facilities, offices, warehouses, trucks, furnishings, equipment, and accessories;[7] (2) loss of goodwill;[8] and, (3) loss of profits.[9]

GCSs are often explicitly mandatory, stating that any waiver of the statutory rights by a franchisee in any franchise contract shall be void.[10] GCSs allegedly have two central purposes: first, to correct the perceived inequality in bargaining power between franchisors and franchisees;[11] and, second, to protect franchisees against perceived franchisor opportunism.[12]

(2007); IND. CODE ANN. § 23-2-2.7-4 (LexisNexis 2007); IOWA CODE ANN. §537A.10(13); MINN. STAT. ANN. § 80C.17(1) & (3) (2007); NEB. REV. STAT. ANN. § 87-409 (LexisNexis 2007); N.J. STAT. ANN. § 56:10-10 (West 2007); TENN. CODE ANN. 47-25-1509; VA. CODE ANN. § 13.1-571(a) (2007); WIS. STAT. ANN. § 135.06 (West 2010).

7 DEL. CODE ANN. tit. 6, § 2553(c) (2007) ("The numerator of the fraction shall consist of the franchised distributor's gross sales (in the most recently completed fiscal year) within this State attributable to the terminated […] franchise, and the denominator of the fraction shall consist of the franchised distributor's total gross sales (in the most recently completed fiscal year) in this State").

8 *Id*. § 2553(c)(2)

9 *Id*. § 2553(c)(3). See *e.g.*, Roger D. Blair, *Measuring Damages for Lost Profits in Franchise Termination Cases*, 8 FRANCHISE L.J. 3 (1988-1999); Roger D. Blair & Francine Lafontaine, THE ECONOMICS OF FRANCHISING 280 (2005); Joseph Schumacher & Kimberly Toomey, *Recovering Lost Future Royalties in a Franchise Termination Case*, 20 FRANCHISE L.J. 116 (2000-2001).

10 See *e.g.*, CAL. BUS. & PROF. CODE § 20010 (Deering 2010); CONN. GEN. STAT. ANN. § 42-133f(f) (2010); DEL. CODE ANN. tit. 6, § 2552(e) (2010); HAW. REV. STAT. ANN. § 482E-6 (LexisNexis 2010); IOWA CODE § 537A.10(4) (2012); 815 ILL. COMP. STAT. ANN. 705/41 (LexisNexis 2010); MINN. STAT. ANN. § 80C.21 (West 2010); WASH. REV. CODE ANN. § 19.100.220(2) (West 2010); WIS. STAT. ANN. § 135.03(3) (West 2010).

11 *See, e.g.*, WIS. STAT. § 135.025(2)(b) (2011); *see also* Christopher J. Curran, *Claims Against a Franchisor upon an Unreasonable Withholding of Consent to Franchise Transfer*, 23 J. CORP. L. 135, 152 (1997); Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29 FRANCHISE L.J. 139, 141 (2010); Dennis D. Palmer, *Franchises: Statutory and Common Law Causes of Action in Missouri Revisited*, 62 UMKC L. REV. 471, 491 (1994); Pitegoff, *supra* note 1, at 289.

12 *See, e.g.*, WIS. STAT. § 135.025(2)(b) (2011); *see also* Geib v. Amoco Oil Co., 29 F.3d 1050, 1056 (6th Cir. 1994); Bitronics Sales Co. v. Microsemiconductor Corp., 610 F. Supp. 550, 556 (D. Minn. 1985); Hartford

Without GCSs in place, franchisor opportunism may take three central forms: 1) franchisors can force one-sided modifications of agreements on franchisees by threatening to terminate the franchise relationship at will;[13] 2) franchisors may terminate the contract of an efficient franchisee who fully complies with the franchise contract, in order to sell the latter's profitable unit to a new franchisee for higher franchise fees;[14] and, 3) the franchisor could terminate the contract of an efficient franchisee simply in order to manage the successful unit himself.[15]

States that adopted GCSs vary significantly in population and location, ranging from states such as Hawaii and Delaware, to states such as California and Illinois.[16]
Figure 1 illustrates the relative geographical heterogeneity 'good cause' states:

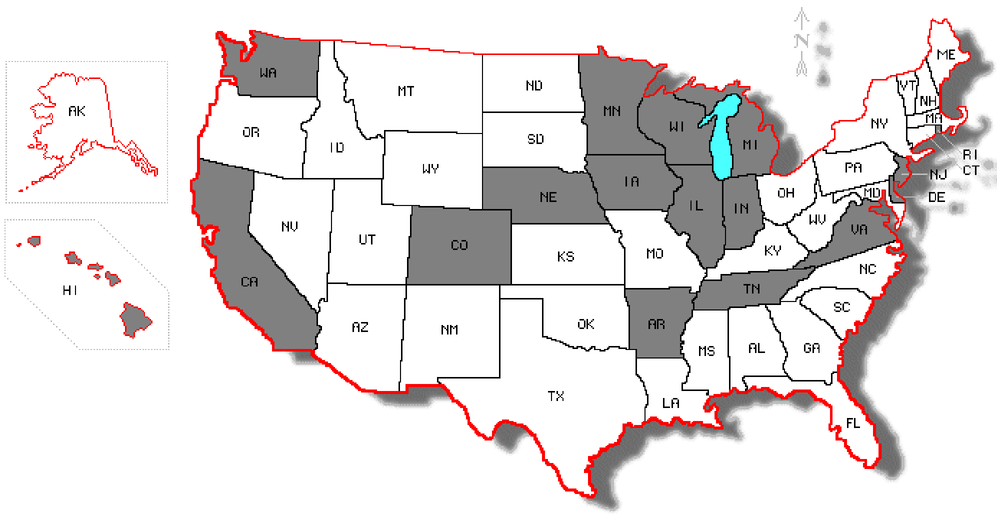
Elec. Supply Co. v. Allen-Bradley Co., No. CV 96562061S, 1997 WL 297256, at *3 (Conn. Super. Ct. May 28, 1997), *aff'd*, 736 A.2d 824 (Conn. 1999); Holiday Inns Franchising, Inc. v. Branstad, 537 N.W.2d 724, 728–29 (Iowa 1995); McDonald's Corp. v. Markim, Inc., 306 N.W.2d 158, 162 (Neb. 1981); Kubis & Perszyk Assocs. v. Sun Microsystems, Inc., 680 A.2d 618, 626 (N.J. 1996); David L. Cahn & Jeffrey S. Fabian, *Mobility, the Home, and the Scope and Application of State Franchise Relationship and Termination Laws*, 30 FRANCHISE L.J. 107, 107 (2010); Curran, *supra* note 11, at 152; Palmer, *supra* note 11, at 491; Pitegoff, *supra* note 1, at 289.

[13] Michael J. Lockerby, *Franchise Termination Restrictions: A Guide for Practitioners and Policy Makers*, 30 ANTITRUST BULL. 791, 833 (1986); Munno v. Amoco Oil Co., 488 F. Supp. 1114, 1118 (D. Conn. 1980); Byers, supra note 1, at 621.

[14] Blair & Lafontaine, *supra* note 9, at 271; Neptune T.V. & App. v. Litton Microwave, Etc., 190 NJ. Super. 153, 163-64,462 A.2d 595, 601 (NJ. Super. A.D. 1983).

[15] Blair & Lafontaine, supra note 9, at 271. See also Nicastro, supra note 1, at 801; Pruitt, supra note 1, at 565; Lockerby, supra note 13, at 834; Byers, supra note 1, at 621; Hess, supra note 1, at 334.

[16] James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511, 518 (2002).



■ Good Cause States

□ At will States

The vast majority of good statutes were adopted in the 1970s.[17] However, to this day most states do not have GCSs on the books. Since 1992, 30 states have considered enacting franchisee protection laws, including GCSs.[18] In each case, the proposed laws did not pass.[19] At the federal level, several GCSs have also been rejected.[20] For example, in 1998 and 1999, the federal

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

[18] James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511, 519 (2002).

[19] *Id*.

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

government declined to enact several bills that would have made it unlawful for a franchisor to terminate a franchise agreement prior to its expiration without good cause.[21] To date, no general federal law on franchise termination has been enacted.

III. The Traditional Economic Analysis of Good Cause Statutes

GCSs have been a source of intense debate and controversy among legal theoreticians.[22] Given the centrality of law and economics in legal scholarship, it is not surprising that legal economists play a dominant role in this debate. The traditional analysis along these lines contends that GCSs are inefficient, relying on a three-step argument: First, franchisees are assumed to have an intrinsic incentive to free ride on the franchise chain's reputation, squandering the goodwill enjoyed by franchisors as well as non-free-riding franchisees, thus reducing consumer welfare.[23] Second, the franchisee's incentive to free ride is argued to be minimized via an essential control mechanism: the ability of the franchisor to terminate any franchise contract at will.[24] Third, GCSs, which prevent franchisors from utilizing the indispensable at-will control mechanism, are understood to increase the level of franchisee free riding, compared to an at-will regime.[25] These three arguments will be presented in more detail below.

A. Franchisees' Inherent Incentive to Free Ride

Individual franchisees at any franchise chain have a basic incentive to free ride on the efforts of franchisors as well as those of the other franchisees'.[26] In other words, franchisees are enticed to

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

22 See supra note 1.

23 *See infra* Part III.A.

24 *See infra* Part III.B.

25 *See infra* Part III.C.

26 Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. Corp. Fin. 9, 12 ("One type of behavior that has been analyzed at great length is the free riding incentive created when franchisees jointly use a common brand

produce a product or service of substandard quality relative to that which would maximize joint profits for the entire franchise chain.[27] Common claims are that franchisees seek to conserve funds by neglecting the appearance of their employees, skimping on workplace cleanliness, and overcharging customers.[28] The individual franchisee incentive according to this view, is to "cheat" customers by providing them with low-quality products or services, at the same price charged by other franchisees in the chain who maintain higher standards.[29]

According to traditional economic analysis, the franchisee's incentive to free ride derives from two central cumulative factors: On one hand, the individual franchisee **fully** internalizes the benefits of her free riding.[30] Providing a lower quality product or service allows the franchisee to

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name"); Brickley et al., supra note 1, at 104 ("Individual franchisees have an incentive to free ride on the trademark"); Alan J. Meese, *Franchise Tying Contracts*, 95 MICH. L. REV. 111, 118 (1996) ("Each franchisee will thus find it rational to engage in opportunistic behavior at the expense of the franchise system -- behavior that involves the sort of "free riding"…").

27 Victor P. Goldberg, *The Free Rider Problem, Imperfect Pricing, and the Economics of Retailing Services*, 79 NW. U. L. REV. 736, 746 (1984) ("All of the franchisees have a short-run incentive to produce a below-average product"); Brickley et al., supra note 1, at 104 ("Individual franchisees have an incentive to…produce a below-standard-quality product"); Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356, 358 (1980) ("there is an incentive for an individual opportunistic franchisee to cheat the franchisor by supplying a lower quality of product than contracted for"); Byers, supra note 1, at 620-621 ("Free riding occurs when the franchisee reduces its costs by offering products and services below franchise quality standards").

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

29 Meese, supra note 26, at 118 ("This free riding will consist of attempts to "cheat" customers, by providing them with products inferior to those ordinarily associated with the trademark, presumably at the same price charged by those fellow franchisees who maintain a higher level of quality").

30 Christopher R. Drahozal and Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL. STUD. 549, 556 ("the franchisee has an incentive to free ride on the brand's capital, since he captures the full savings from reducing his effort level"); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 228 ("if one franchisee allows the

cut her individual costs.[31] Consequently, the free-riding franchisee can increase her individual profits.[32] On the other hand, the individual franchisee incurs only **part** of the reputational costs suffered by the franchise brand name due to her free riding behavior.[33] Since franchisees use a

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quality of his establishment to deteriorate, he benefits by the full amount of savings from reduced quality maintenance"); J. Howard Beals III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157, 159 (1995) ("The lower-quality franchisee will benefit by the full amount of the savings from reducing quality").

31 Klein, supra note 26, at 12 ("Each franchisee can reduce its costs by reducing the quality of the product it supplies"); Kidwell, supra note 28, at 525 ("A franchisee engaged in a contractual relationship with a franchisor might seek to lower his or her own costs by failing to participate in activities that would be collectively profitable for the overall franchise network"); Janet E. L. Bercovitz, *The Organizational Choice Decision in Business Format Franchising: An Empirical Test*, in ECONOMICS AND MANAGEMENT OF FRANCHISING NETWORKS 38, 44 (J. Windsperger and G. Hendrikse eds., 2004) ("the outlet manager may free ride on the system's brand name and substitute cheaper, lower quality inputs in order to lower their store's operating costs"); Note, *A Clarification and Reformulation of Prevailing Approaches to Product Separability in Franchise Tie-In Sales*, 67 MINN. L. REV. 1165, 1174 (1983) ("Individual franchisees, on the other hand, have an incentive to lower quality, which decreases the franchisee's costs"); James A. Brickley et al., *An Agency Perspective on Franchising*, 20 FIN. MGMT. 27, 29 (1991) ("The cost savings from providing a lower quality product go directly to the given [free-riding] franchisee").

32 Richard E. Caves & William F. Murphy, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 577 (1976) ("A franchisee who reduces the quality of the good or service he offers for a given price might increase his own profits"); Byers, supra note 1, at 620-621 ("Free riding occurs when the franchisee reduces its costs by offering products and services below franchise quality standards, thereby increasing its own profits"); Hess, supra note 1, at 343 n. 74 ("Franchisees free ride by providing a lower quality product to cut costs and receive higher profits"); Note, supra note 31, at 1174 ("Individual franchisees, on the other hand, have an incentive to lower quality, which decreases the franchisee's costs and increases the franchisee's profit margin"); Jean Wegman Burns, *Vertical Restraints, Efficiency, and the Real World*, 62 FORDHAM L. REV. 597, 641 n. 197 (1993) ("any one franchisee has a financial incentive to "ride" on the reputation being upheld by her fellow franchisees and to cut her own costs (and hence increase her profits) by offering a lower quality product or service to the consumer"); Eisenberg, supra note 1, at 372 ("The franchisee increases profits by cutting costs and offering lower quality products").

33 Rubin, supra note 30, at 228 (the free riding franchise "loses only part of the costs, for part is borne by other franchisees"); Goldberg, supra note 27, at 746 ("If a franchisee reduces the quality of the product sold, it bears only some of the costs"); Beals & Muris, supra note 30, at 159 ("The lower-quality franchisee […] will only

common brand as a trademark, a reduction in quality by one free-riding franchisee has the effect of reducing future demand facing all franchisees, not just that of the individual franchisee providing reduced quality.[34] The free-riding franchisee is thus able to externalize a large portion of the reputational costs caused to the franchise brand by her behavior.[35] Furthermore, the benefits of free-riding behavior are immediate and obvious, while costs are both dispersed along the network and delayed to an uncertain future.

Ultimately, the free-riding franchisee harms not only the franchisor and non-free riding franchisees, but also consumers and aggregate efficiency.[36] Consumers are normally unaware ex ante of free-riding by individual franchisees or of quality distinctions between stores belonging to the same chain and bearing a common trademark. This problem is exacerbated when marketing is conducted centrally by the franchisor, such as relying on national or regional

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lose part of the cost"); Bercovitz, supra note 31, at 44 ("The outlet manager bears only a portion of the costs of such chiseling"); Note, supra note 31, at 1174-1175 ("The individual franchisee bears only a percentage of the cost of any consumer dissatisfaction").

34 Brickley et al., supra note 1, at 104 ("A given customer is less likely to frequent the franchise chain after receiving a low-quality product. However, this cost is shared with other units, which lose the customer's patronage"); Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 349-350 (1985) ("The individual franchisee directly benefits from the sales of the lower-quality product, and the other franchisees share in the losses caused by decreased future demand"); Rubin, supra note 30, at 228 ("All franchisees would lose something as a result of this deterioration in one franchise: consumers would have less faith in the quality promised by the trademark"); Klein, supra note 26, at 12-13 ("Because a reduction in quality has the effect of reducing the future demand facing all franchisees using the common name, not just the future demand facing the individual franchisee who has reduced quality, the incentive for individual franchisees to supply the desired level of quality is reduced")

35 Rubin, supra note 30, at 228 (”what is involved is a classic externality problem"); Gillian Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927, 950 n. 88 ("free-riding is an example of an economic externality"); Goldberg, supra note 27, at 746 (the free-riding franchisee "saves money by degrading quality and externalizes the costs to the franchisor").

36 Beals and Muris, supra note 30, at 159 ("These lower quality franchisees benefit at the expense of the franchisor, higher-quality franchisees, and consumers").

advertising, online reservation systems, and the like.[37] Consumers, therefore, bear the cost of free riding, overpaying for a product of less-than-anticipated quality.[38] In the long-run this reduces demand and deteriorates brand reputation – costs dispersed among all those participating in franchise profits.

The traditional economic literature on franchisee free riding distinguishes between two basic scenarios: high probability of repeat purchase by particular customers, versus low probability of the same.[39] According to this distinction, the franchisee's incentive to free ride is lower where the probability of repeat customers is high, as customers experiencing sub-par performance will refrain from future business at the same location.[40] Repeat business to an individual franchisee

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37 Klein & Saft, supra note 34, at 351.

38 Klein & Saft, supra note 34, at 351; Burns, supra note 32, at 641 n. 197 (""Such free riding [..] harms the consumer who receives a lower quality good although paying full price").

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

40 Klein & Saft, supra note 34, at 348 ("the creation of "neighborhood stores" increased the repeat purchase probability and hence reduced the incentive of individual franchisees to free ride on the group"); Kidwell et al., supra note 28, at 531("repeated business established a relationship between customer and operator that potentially lowers the likelihood of free riding; it would be rational to decrease free riding on a brand name when there is a greater chance that customers would offer repeat business"); Lorelle Frazer & Donald J. Stokes, *Franchising Operational Units in Australia*, 2 FRANCHISING RESEARCH: AN INTERNATIONAL JOURNAL 32, 34 (1997) ("The propensity for free-riding to occur is lower where repeat customers form a large part of an outlet's sales"); Robert Dahlstrom & Arne Nygaard, *A Preliminary Investigation of Franchised Oil Distribution in Norway*, 70 J. RETAILING 179, 184 (1994) ("In repeat selling situations the owner of a specific outlet is interested in maintaining high quality"); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 275 ("Operators who rely on local repeat business are less able to free ride off the franchiser's brand name"); Dant & Nasr, supra note 39, at 12 ("In repeat purchase industries, there are fewer opportunities for reputational abuse and a lesser incidence of the free rider problem by the franchisees"); Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom, in* THE FALL AND RISE OF FREEDOM OF CONTRACT 325, 340 (F. H.

unit thus serves as a constraining factor on free-riding, since the franchisee will bear the costs of her own shirking.[41] Industries that are particularly likely to attract repeat customers, and are therefore less prone to free riding, include those that serve local populations, such as lawn care, laundry and dry cleaning, automotive services, health and fitness centers, and homecare.[42]

Conversely, a franchisee's incentive to free ride is particularly great where the probability of repeat purchase by a particular customer is very low.[43] In such cases, the probability that a franchise will suffer the costs of losing customers already unlikely to return, renders free-riding rational. Decreasing effort levels and reducing both monetary and personal investment in quality

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Buckley ed., 1999) ("Operators who rely on local repeat business are less able to free ride off the franchisor's brand name").

41 Drahozal & Hylton, supra note 30, at 557; Frazer & Stokes, supra note 40, at 34; Elizabeth Crawford Spencer, THE REGULATION OF FRANCHISING IN THE NEW GLOBAL ECONOMY 69 (2011) ("In the case of a particular franchise unit, when repeat customers accrue to the benefit of that particular franchisee, […] there are positive incentives for that franchisee to cultivate his customers").

42 James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401, 416 (1987); James A. Brickley, *Incentive Conflicts and Contractual Restraints: Evidence from Franchising*, 42 J.L. ECON. 745, 755 (1999); See also Dant & Nasr, supra note 39, at 11 ("Franchise outlets in repeat customer industries are likely to cater to largely local populations; such industries may include sports equipment, department, and clothing stores").

43 Klein, supra note 27, at 359, n. 2; Brickley et al., supra note 1, at 104 ("[T]he incentives to shirk on quality are highest in units where the level of repeat customer is low"); See also Robert W. Emerson, *Franchise Contract Clauses and the Franchisor's Duty of Care Toward its Franchisees*, 72 N.C.L. REV. 905, 951, n.224 ("Free-riding is potentially most severe at locations [..] where the probability of repeat sales to that same customer is quite low"); Hess, supra note 1, at 343 n. 74 ("A franchisee at a location with low probability of repeat sales to the same customer has the greatest incentive to free ride"); Brickley et al., supra note 31, at 29 (1991) ("The incentives to free ride are particularly high at units where the level of repeat customers is low"); Mick Carney & Eric Gedajlovic, *Vertical Integration in Franchise Systems: Agency Theory and Resource Explanations*, 12 STRATEGIC MGMT. J. 607, 610 (1991) ("The danger of free riding is greatest where repeat customers constitute a small proportion of the unit sales"); Section Members from the ABA Section of Antitrust, ANTITRUST LAW AND ECONOMICS OF PRODUCT DISTRIBUTION 16 (2006) ("Free-riding is a particular problem when a franchisee serves mainly nonrepeat customers").

then becomes profitable.[44] The risk of losing customers in these situations is borne by the entirety of the franchise chain, affecting the free-riding franchise only marginally.[45] This is because the dissatisfied customer is likely to refrain from future business *with any* branch within the franchise chain where sub-par performance was experienced. The local franchisee who caused the initial dismay loses little, as in any case repeat business by the same customer was unlikely. Overall, though, this scenario has each local venue externalizing the costs of dissatisfied customers onto other branches within the same chain, potentially creating a sizable overall effect.

According to the traditional law and economics perspective, industries that serve mostly non-repeat customers are therefore much more prone to more free riding. This is especially relevant in industries serving travelers, such as hotels, motels, and car-rental agencies.[46] Although there is potential for some repeat sales within the same location in these industries, their likelihood is relatively low.[47] For example, although some travelers visit the same cities frequently and stay repeatedly at favorite hotels, many others pass through a city only once and must stay at an unfamiliar hotel.[48] In many cases, therefore, the hotel owner has little incentive to please the one-time visitor.[49] The one-time visitor does not bear the potential of future business.[50] Once the traveler has decided to stay at the hotel there is little recourse if, for example, the room is unclean

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44 Kidwell et al., supra note 28, at 531.

45 Frazer & Stokes, supra note 40, at 34.

46 Brickley & Dark, *supra* note 42, at 416; Brickley et al., supra note 1, at 121; Brickley, supra note 42, at 755 n. 20; Chris Manolis et. al., *A Preliminary Investigation of Ownership in Franchised Distribution Systems*, 11 J. APPL. BUS. RES. 1, 4 (1995); Dant & Nasr, supra note 39, at 12 ("Nonrepeat purchase industries are those where customers are generally mobile and less prone to repeat purchasing from the same outlet (at least in the short-run) even though they may patronize the same franchise system; restaurants, hotels, motels, and auto rental service franchises, in general, are considered examples of such industries").

47 Manolis, supra note 46, at 4.

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

49 *Id*. at 86-87.

50 *Id*. at 87.

or service slow.[51] The guest will leave unsatisfied, but since there was little chance of the guest returning anyway, no significant harm has occurred from the perspective of the hotel.[52]

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

According to the conventional law and economics analysis, an essential mechanism for reducing franchisee free riding is the ability of the franchisor to terminate the franchise contract at will, namely without having to prove before a disinterested third-party that good cause for termination exists. As the late Larry Ribstein proffered: "Termination at will can be an important right for franchisers, since it may be ***the only way*** they can effectively monitor their franchisees to prevent franchisees from free-riding on and decreasing the value of the franchiser's brand name." (emphasis added).[53]

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51 *Id*.

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

53 Ribstein, supra note 40, at 248; Erin Ann O'Hara, *Economics, Public Choice, and the Potential Conflict of Laws*, 90 GEO. L.J. 941, 945 (2002) (the ability of the franchisor to terminate the contract at will is "necessary to prevent individual franchisees from free-riding off the value of the trademark…The only way to ensure that [the franchisee] complies with her obligations is to enable the franchisor to threaten immediate termination"); Rubin, supra note 30, at 228 ("The franchisor wants to eliminate any operations not maintaining the quality of the franchise. Contracts calling for easy termination of franchises make it possible to avoid the period of quality deterioration"); Martin E. Loeber, *A DTPA Cause of Action for the Terminated or Nonrenewed Franchisee: A Jack in the Box for the Unfair Franchisor*, 43 BAYLOR L. REV. 809 (1991) ("…[E]conomists argue that broad termination clauses are necessary for the franchisors to protect the franchise from the inherent tendency of franchisees to undermine the value of the trademark"). Similarly, franchisors, and not only legal economists, argue that the threat of at will termination is the only means by which they can protect themselves from free-riding franchisees. Hess, supra note 1, at 343 ("Franchisors claim a need for an unrestricted termination power to protect the value of their trademark and to insure a uniform standard of quality among all franchises");

The conventional assumption that at-will termination is an essential control mechanism against franchisee free riding is based on the following analysis: when a franchisor has the ability to terminate a contract at will, the franchisee will know that detection of free riding results in swift termination and loss of lucrative business opportunities within the chain.[54] Furthermore, termination induces direct costs, such as the loss of relationship-specific investments.[55]

Relationship-specific investments, also known as idiosyncratic investments, are investments specific to a concrete franchise relationship.[56] They are highly specialized and tailored to that franchise relationship[57] and, as such, are difficult or impossible to redeploy elsewhere.[58] Such costs are therefore sunk, having little or no salvage value to the franchisee after contract termination.[59] Relationship-specific investments include *leasehold improvements*, namely

Eisenberg, supra note 1, at 372 ("Franchisors argue that the threat of arbitrary termination is the only means by which they can protect themselves from franchisees engaging in potentially opprobrious behavior").

54 Beals and Muris, supra note 30, at 160 ("The existence of the clause that has caused so much trouble and given rise to so much sympathy for franchisees - the franchisor's right to terminate 'at will' – becomes understandable. When such clauses are enforced, the franchisee would know that detection results in swift termination. The clause is thus a lower-cost method than litigation of reducing the franchisee incentive to cheat"); Brickley et al., supra note 1, at 104 (The franchisees's incentive to free ride "will be lower if franchisees who are caught cheating are punished by contract termination and thus lose any remaining quasi rents on firm-specific investments"); Byers, supra note 1, at 657 ("The franchisor's termination power is therefore essential--as both a threat to encourage franchisee compliance and a means to actually purge noncomplying franchisees from the system--to ensure that goods and services of requisite quality are supplied to consumers.").

55 The following explanation is based on the article, Uri Benoliel, *Rethinking the U.S. Supreme Court's Abandonment Requirement in Mac's Shell Service Inc. v. Shell Oil Products*, 43 RUTGERS L.J. 77, 83–86 (2011).

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

57 *See* Shankar Ganesan, *Determinants of Long-Term Orientation in Buyer-Seller Relationships*, 58 J. MARKETING 1, 6 (1994); Jan B. Heide & George John, *The Role of Dependence Balancing in Safeguarding Transaction-Specific Assets in Conventional Channels*, 52 J. MARKETING 20, 21 n.1 (1988).

58 *See* Anderson & Weitz, *supra* note 56, at 20; Heide & John, *supra* note 57, at 21 n.1.

59 *Cf.* James R. Brown et al., *The Effects of Transaction-Specific Investments in Marketing Channels: The Moderating Role of Relational Norms*, 17 J. MARKETING THEORY & PRAC. 317, 317 (2009) ("Transaction-

fixtures that are attached to the retail or commercial space and installed by the franchisee when setting up a new location, such as walls, doors, cabinets, light fixtures, floor coverings, and the like.[60] Such improvements may be significant and costly. For example, a Subway franchisee may be required to invest up to $130,000 in leasehold improvements.[61] The costs involved are typically sunk, as franchisors often require the franchisee to lease, rather than own, the land upon which the outlet is located.[62] The lease arrangement grants the franchisor the right to require the franchisee to evacuate the leased property upon termination of the franchise contract.[63] As a result, the leasehold improvements, which remain the property of the franchisor, must be surrendered by the franchisee along with the property, causing the free-riding franchisee substantial economic loss.[64]

Equipment expenditures are another form of relationship-specific investments lost by a free-riding franchisee if the franchise agreement is terminated at will by a franchisor. Depending upon the conditions of the space and the particular business model, the required equipment

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specific investments…have little or no value outside of that relationship."); Ganesan, *supra* note 57, at 6 ("Transaction-specific assets are investments in durable assets that are . . . not easily redeployable and have little salvage value in other relationships."); Jan B. Heide & George John, *Alliances in Industrial Purchasing: The Determinants of Joint Action in Buyer-Supplier Relationships*, 27 J. MARKETING RES. 24, 27 (1990) ("Specific investments are investments made by a firm that are of considerably less value outside the focal relationship.").

60 *See Franchise Tutorial 20: Intro to Leasehold Improvements*, CAN. FRANCHISE ASS'N (Jan. 2011), http://www.cfa.ca/Publications_Research/Tutorials/tutorial20.aspx (last visited Feb. 19, 2014).

61 *See Subway*, FRANCHISE DIRECT, http://www.franchisedirect.com/directory/subway/ufoc/915 (last visited Feb. 19, 2014).

62 *See* ANNE T. COUGHLAN ET AL., MARKETING CHANNELS 539 (7th ed. 2006); Klein, supra note 27, at 359.

63 *See* Klein, *supra* note 27, at 359.

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

expenditures can be extensive. For example, a McDonald's franchisee may be required to invest more than one million dollars in equipment, including signs, seating, and décor.[65] Frequently, much of the equipment purchased cannot be used outside the franchise, thus making the expenditure relationship-specific.[66] Obviously, the fast-food franchisee's outdoor signs cannot be used by the franchisee with any other franchisor.[67] Similarly, franchise-specific décor is regarded as worthless outside the franchise's chain.[68] But beyond these, many franchises operate with idiosyncratic procedures, necessitating specialized equipment and investments well beyond those observable by customers. As a result, contract termination typically necessitates resale of franchisee equipment at a substantial loss.[69]

C. Good Cause Statues as Increasing Franchisee Free Riding

According to the conventional law and economics analysis, good cause statues disrupt the essential control mechanism against franchisee free riding: at-will termination.[70] GCSs increase

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65 *See McDonald's*, FRANCHISE DIRECT, http://www.franchisedirect.com/foodfranchises/mcdonalds-franchise-07030/ufoc/ (last visited Feb. 19, 2014).

66 Dnes, supra note 64, at 379–80.

67 *See* Brown et al., *supra* note 59, at 317.

68 *See* Dnes, *supra* note 64, at 378. The secondhand value of trademarked franchise equipment is normally one quarter of its original cost. *See* COUGHLAN ET AL., *supra* note 62, at 537; Dnes, *supra* note 64, at 378.

69 *Cf.* COUGHLAN ET AL., *supra* note 62, at 537; Dnes, *supra* note 64, at 377–78; Warren S. Grimes, *Making Sense of State Oil Co. v. Khan: Vertical Maximum Price Fixing Under a Rule of Reason*, 66 ANTITRUST L.J. 567, 586 (1997); Warren S. Grimes, *Market Definition in Franchise Antitrust Claims: Relational Market Power and the Franchisor's Conflict of Interest*, 67 ANTITRUST L.J. 243, 250–51 (1999).

70 *Cf.* Klein, supra note 26, at 30 (GCSs "entail the associated cost of making the self-enforcement mechanism more difficult to use"); Klick et al., *supra* note 1, at 364 (GCSs "may be costly for franchisors because state regulation of termination […] of franchisee limit a franchisor's primary means of deterring shirking or free-riding on the franchisor's trademark by franchisees"); Ribstein, supra note 40, at 275 ("Consider the example of a statute that limits termination-at-will of franchisees…Limitations on termination reduce the franchiser's ability to discipline shirking or free-riding franchisees"); Byers, supra note 1, at 657 ("Good cause limitations on termination are the primary manner in which lawmakers have attempted to protect the franchisee's nonrecoverable investment. However, such laws can hinder the franchisor's ability to effectively

the costs of terminating a franchise contract, as compared to an at-will regime. This is for four cumulative reasons: **First**, GCSs generate documentation costs for a franchisor who wishes to terminate a contract. The GCSs place the burden on the franchisor to prove that there was good cause for terminating the contract.[71] These statutes require increased payments to a franchisee in the case of termination unless good cause can be documented by the franchisor in a court proceeding, which naturally bears high additional costs.[72] Even clear cases of good-cause-based termination will thus be subject to burdens of proof, leading to an ex ante policy of procedures and complaints, and early monitoring will be carefully documented.[73] Documentation costs thus plague franchise relationships even where no free-riding occurs, as the necessary protocols must be in place and documentation gathered throughout the life of the contract, regardless of eventual use.

Second, GCSs generate significant litigation costs. By granting franchisees protection from arbitrary termination, GCSs invite every terminated franchisee to litigate the issue of whether or not good cause existed.[74] Such litigation is costly, both directly (court/attorney fees and the like) and indirectly (diverting attention from business concerns to legal ones, tarnishing franchise reputation, and more).[75] Litigation costs obviously limit the franchisor's incentive to instigate proceedings, making a threat to sue less credible and its use in preventing free-riding ex ante less effective. Of course, litigation costs might also lead to pre-trial negotiations and sub-optimal settlements, making even those franchisees whose contract is terminated less worried about such a result.

police its franchise system"); Pruitt, supra note 1, at 569 ("By disrupting the essential control component of franchise contracts, relationship statutes [namely, GCSs] undermine the very benefits to be achieved through the franchising method of distribution").

71 Pitegoff, *supra* note 1, at 309-310.

72 Brickley et al., supra note 1, at 104.

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

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

75 Beals & Muris, *supra* note 30, at 159.

Third, GCSs expose franchisors who terminate a free-riding franchisee for good cause to error costs. Namely, franchisors are required to bear the cost of risking erroneous court decisions.[76] A franchisor must not only convince herself that termination was based on good cause;[77] in order to prevail in litigation she must also convince external observers of the existence of good cause. Since legal results are typically uncertain, courts may wrongfully decide that termination was arbitrary and unlawful even when good cause existed. Given that GCSs shift the burden of proof and make the franchisor's case harder to win, error costs are borne mostly by the plaintiff, further reducing the incentive to exercise the contractual threat of termination.

Lastly, GCSs expose the franchisor to the risk of a biased jury. More specifically, when a franchisee can request a jury trial, the franchisor faces the additional obstacle of juror bias, favoring the 'little' franchisee over the 'bigger' franchisor, and the local owner over the national chain.[78] All these costs and risks are reduced, if not eliminated, if termination can be conducted at will.[79]

Ultimately, by disrupting the essential at-will control mechanism, GCSs are argued to increase free riding in franchise relationships. As Professors Bruce Kobayashi and Larry Ribstein straightforwardly claimed: "franchisee protection laws increase shirking and free-riding."[80] Similarly, Professor Jonathan Klick, joining Kobayashi and Ribstein, argued that the benefits of GCSs "may be outweighed by their costs in **preventing** franchisors from disciplining shirking franchisee." (emphasis added)[81] Likewise, Professor Erin Ann O'Hara assumed that GCSs "transfer wealth from franchisor to franchisee because they enable individual franchisees some latitude to free ride off the company brand and thereby earn greater profits."[82] Similarly,

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

77 Beals & Muris, *supra* note 30, at 159.

78 Beals & Muris, supra note 30, at 159-160.

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

80 Kobayashi & Ribstein, supra note 40, at 340.

81 Klick, supra note 1, at 364.

82 O'Hara, supra note 53, at 946.

Professor Matthew Ellman implies that under the governance of GCSs, "the free-riding problem is very hard to solve."[83]

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

IV. TESTING PREVAILING WISDOM: DO GCSS INCREASE FREE-RIDING?

The scant existing empirical literature assessing the influence of GCSs on franchisee free-riding focuses on indirect indicators such as the number of local businesses within a given industry owned by franchisors vs. franchisees, or the level of employment in franchise-intensive industries.[84] These indicators are used as proxies for the quality of franchise operations, with commentators attempting to disentangle franchisee free-riding from franchisor opportunism. In order to avoid the pitfalls of indirect inference, we sought a database that would provide for more direct evidence of free-riding, ideally one that rates franchise operations on an individual basis (rather than cumulative results for the entire state or industry). Such data could then be examined for direct evidence of quality differences between otherwise-similar franchise operations in states where GCSs were enacted vs. states where at-will termination is possible at the franchisors' discretion. If the standardly accepted free-riding hypothesis is valid, we should observe – in *each* typical franchise chain – the following phenomenon: the average level of free riding of all the franchisee units located in 'good cause' states should be higher than the average level of free riding among all of the franchisee units located in 'at-will' states.

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83 Matthew Ellman, *Specifity Revisited: The Role of Cross-Investments*, 22 J.L. ECON. & ORG. 234, 250 n.36 (2006). See also Byers, supra note 1, at 657 (GCSs "can hinder the franchisor's ability to effectively police its franchise system").

84 See Brickley et al., supra note 1; Klick et al., supra note 1.

With this in mind, we decided to examine, as a case study, the level of franchisees free riding among franchisees in the hotel industry. Free riding is obviously impossible to assess directly, as it takes many forms. We thus focused on its output – effects on customer satisfaction and assessments of service and cleanliness. These are results of effort and care on part of the service provider, with lower investment in quality assumed to result in lower service and satisfaction. The hotel industry was chosen to serve as our case study, since according to the traditional law and economics approach it is particularly prone to a high risk of franchisee free riding.[85] Since the hotel industry generally serves travelers who are non-repeat customers, hotel franchisees do not internalize the full costs of their free riding.[86] We would thus expect free-riding to be prevalent, and where it is left unchecked, the investment in quality (and thus customer satisfaction) should be low.

This Part will proceed as follows: First, we outline the methodology underlying our empirical strategy. Second, we present the relevant data and its sources. Third, we show the results of our study. The next section will present further discussion interpretation of the results as well as the normative conclusions to be drawn.

A. Methodology

In order to locate suitable candidates for comparison, we selected franchise chains according to several criteria. We sought national chains with multiple locations in each state, and a sizable presence in both 'good cause' and 'at will' states. This allows for a sample size that would reduce the effects of random variation across sites and states. As earlier mentioned, we focused on national chains in the hotel industry, which serve many travelers unlikely to return to the same location, as well as relying to a great degree on investment in quality that is difficult to quantify (e.g., effort, employee supervision, investment in service and quality). Thus we focused on customer assessment of service and cleanliness, which proxy for investment of effort, and

[85] *See supra* Part III.A.

[86] *See supra* Part III.A.

total satisfaction, which captures multiple dimensions of quality. Free-riding franchisees would be expected to achieve lower satisfaction ratings by customers expecting certain standards that were not met. Lastly, we screened for franchises that operated exclusively by franchisee-owned-and-operated businesses, in order to avoid complications arising from some of the sites being company-owned thus less prone to the type of free-riding we set out to examine. It should be noted that all conditions were set to make free-riding easier to discern using publicly-available data, thus if the prevailing wisdom regarding GCSs is correct, our test should pick up the differences between states with and without such statutes.

In order to find suitable candidates, we used the well-known Entrepreneur.Com website and generated a list of 10 chains meeting our initial criteria.[87] From this list, we decided to focus on the larger chains, and set our lower threshold to admit only those chains having more than 400 U.S. hotels, for sample size purposes. Where hotel chains consisted of different quality-level tiers (such as discount hotels, suites, and luxury hotels), we assessed each tier as a separate chain, in order to avoid quality-specific attributes being lost and screen for free-riding in disparate circumstances.

Screening for franchisee-owned hotel chains, operating nationally and consisting of more than 400 franchised hotels, led to a sample totaling some 3,800 hotels across three relevant chains: Days Inn,[88] Ramada,[89] and Super 8.[90] If the free-riding hypothesis is valid, we should observe, in *each* of these three sample chains, the following phenomenon: The average level of free riding of all the franchisee units located in 'good cause' states should be higher than the average level of

[87] Baymont Inn & Suites, Centerstone Inns, Hotels & Plaza Hotels, Days Inn, Hospitality Int'l Inc., Knights Inn, Microtel Inn & Suites by Wyndham, Ramada, Super 8, Travelodge, Wingate by Wyndham.

[88] Days Inn has 1,605 units in the Unites States. See http://www.entrepreneur.com/franchises/daysinn/282270-0.html (last visited Feb. 19, 2014).

[89] Ramada has 455 units in the United States. See http://www.entrepreneur.com/franchises/ramada/282743-0.html (last visited Feb. 19, 2014).

[90] Super 8 has 1,751 units in the United States. See http://www.entrepreneur.com/franchises/super8/282845-0.html (last visited Feb. 10, 2014).

free riding of all the franchisee units located in ‘at will’ states. This should lead to higher customer ratings for hotels located in ‘at will’ states compared to ‘good cause’ hotels from within the same chain and quality tier.

In order to ascertain the average level of free riding among the franchises subject to different laws, we took the following three steps for each of the three selected chains across all states: **First**, we located – via an online hotel search engine, called freehotelsearch.com – all the hotels situated in ‘good cause’ states belonging to the chains in question.[91] **Second**, for each hotel found, we searched Expedia.com for customer ratings left by actual guests regarding service, cleanliness, and total satisfaction. These criteria were rated by hotel guests on a scale from 1 to 5, with 1 being the least favorable and 5 being the most favorable. The guest ratings for these criteria serve, in our study, as a proxy for the franchisee’s level of free riding. Free-riding hotels typically will receive low ratings by guests under the service, cleanliness and total satisfaction criteria, as these are difficult to specify in contractual terms making cost-reducing shirking by franchisees more prevalent. Conversely, non-free riding hotels will normally receive higher ratings. **Third**, we calculated average ratings in each criterion and compared across states, contrasting ‘good cause’ vs. ‘at will’ states.

It should be noted that Expedia.com was chosen to serve as our database for guest ratings due to its inherent protection from manipulation by self-interested parties. The common fear with all rating systems is that participants will attempt to ‘game the system’ in order to bolster their reputation and attract potential clients. With online ratings, there is always a risk of business owners inserting positive ratings and false recommendations for their own facilities, and negative ratings for their competitors. On Expedia.com, only those who actually booked a hotel through the site, paid for it, and had their stay verified, can enter a review.[92] The sheer financial cost of

[91] This website uniquely allows searching for Days Inn, Ramada and Super 8 hotels, by the limited boundaries of each U.S. state ; See, for example, http://www.freehotelsearch.com/U_S_A-Days_Inn-chain.html (last visited Feb. 19, 2014)

[92] Danny King, *Expedia Touts ‘Verified’ Reviews*, *available at* http://www.travelweekly.com/travel-news/online-travel/expedia-touts--verified--hotel-reviews/ (last visited Feb. 19, 2014); Barbara De Lollis, *Expedia.com: We*

posting a falsified review by a franchisee on Expedia.com is prohibitive, thus bestowing credibility on those reviews found online.[93] Furthermore, booking a hotel night through Expedia requires the reviewer to undertake a credit card transaction on Expedia.com. The reviewer therefore does not remain anonymous to Expedia, raising the probability of detection of phony reviews. Ultimately, detection can prove costly for a forging franchisee, as it may cause the levying of government fines, private lawsuits, penalties imposed by the review-hosting platform, and the associated reputational costs.[94] Given that such significant costs may spillover, at least in part, to franchisors, many of them contractually constrain the social media practices of franchisees, thereby increasing the franchisee's forging costs.[95]

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

Verify Our Hotel Reviews, availbale at http://travel.usatoday.com/hotels/post/2011/12/expedia-hotel-guest-reviews-tripadvisor/589698/1 (last visited: Nov. 17, 2013); Expedia, Inc., *Expedia Overhauls Hotel Reviews: Consumers Can Now Sort Verified Reviews by Shared Interest*, *available at* http://mediaroom.expedia.com/travel-news/expedia-overhauls-hotel-reviews-consumers-can-now-sort-verified-reviews-shared-interest- (last visited: Nov. 17, 2013).

93 The same is not true for other common review sites, such as Tripadvisor and others where multiple reviews can be posted by the same (non-paying) individual. Dina Mayzlin et al., *Promotional Reviews: An Empirical Investigation of Online Review Manipulation*, 2 *available at* https://msbfile03.usc.edu/digitalmeasures/mayzlin/intellcont/promoreview_05_08_13_final-1.pdf (last visited: Nov. 17, 2013).

94 *Id*, at 14.

95 *Id*, at 15.

B. Data

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

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

For the Ramada Hotel tier, we identified 112 hotels located in 'good cause' states that had been rated by guests via Expedia.com. These hotels were rated by a total number of 39,276 guests, leading to an average of 351 ratings per hotel. In 'at will' states, 190 hotels in this tier were rated by 54,115 guests, leading to an average of 285 ratings per hotel. At the Ramada Limited Hotel tier, we located 31 hotels in 'good cause' states, rated by 8,598 guests and averaging 277 ratings per hotel. 'At will' states had 51 such hotels, rated by 8,521 guests, for an average of 160 ratings per hotel. Ramada Plaza had merely 9 hotels in 'good cause' states, and 11 hotels in 'at will' states. These were rated by 4,353 guests and 4,381 guests, respectively, averaging 484 (398) ratings per hotel.

Lastly, Super 8. In this chain, we located 631 hotels in 'good cause' states, rated by 69,022 guests, for an average of 109 ratings per hotel. 'At will' states have 928 such hotels, rated by 100,755 guests, for an average of 109 ratings per hotel.

Table 1 summarizes the available data:

	Good Cause States[96]	At Will States[97]
Days Inn		
Number of Hotels	490	989
Number of Reviews	79,060	139,563
Average Number of Reviews per Hotel	161	141
Ramada Hotel		
Number of Hotels	112	190
Number of Reviews	39,276	54,115
Average Number of Reviews per Hotel	351	285
Ramada Limited Hotel		
Number of Hotels	31	51
Number of Reviews	8,598	8,521
Average Number of Reviews per Hotel	277	160
Ramada Plaza		
Number of Hotels	9	11
Number of Reviews	4,353	4,381
Average Number of Reviews per Hotel	484	398
Super 8		
Number of Hotels	631	928
Number of Reviews	69,022	100,755
Average Number of Reviews per Hotel	109	109
Total Hotels	**1,273**	**2,169**
Total Reviews	**200,309**	**307,355**

96 Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, Tennessee, Virginia, Washington, Wisconsin.

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

C. Results

The folk theorem of GCS literature is that free-riding in 'good cause' states exceeds that in 'at will' states, due to the disciplinary effect of franchisor termination.[98] We should thus expect customer ratings of difficult-to-quantify variables to be higher in 'at will' states, relative to states where GCSs were enacted.

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

Average Rating per Hotel	Good Cause States[99]	At Will States[100]
Days Inn		
Service	3.596	3.615
Cleanliness	3.543	3.538
Total Satisfaction	3.379	3.399
Ramada Hotel		
Service	3.796	3.744
Cleanliness	3.749	3.687
Total Satisfaction	3.581	3.514
Ramada Limited Hotel		
Service	3.635	3.621

98 *See supra* Part III.

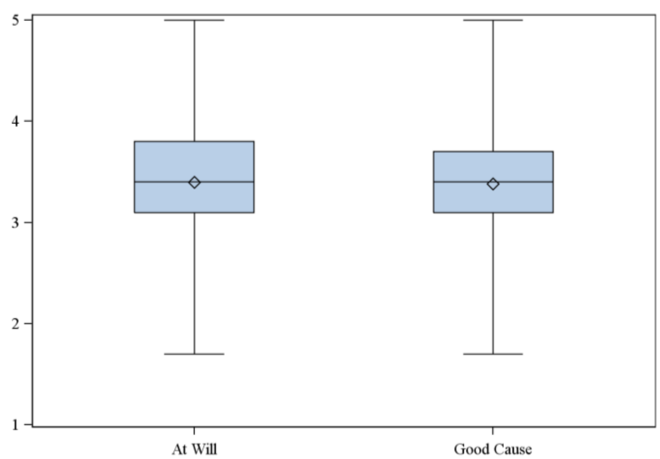
99 Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island, Tennessee, Virginia, Washington, Wisconsin.

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

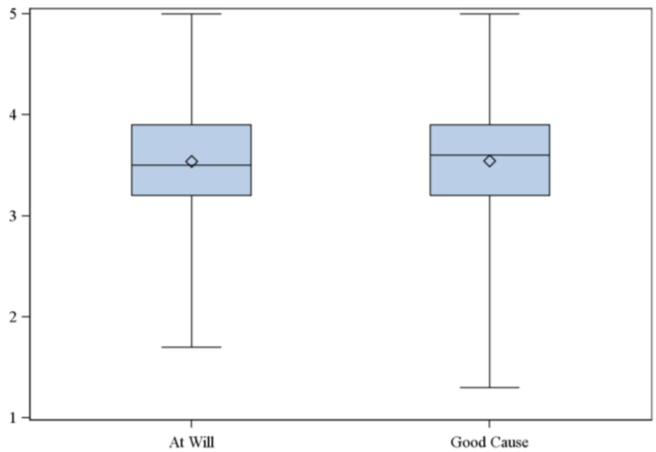
Cleanliness	3.597	3.596
Total Satisfaction	3.452	3.455
Ramada Plaza		
Service	3.844	3.864
Cleanliness	3.867	3.864
Total Satisfaction	3.667	3.709
Super 8		
Service	3.734	3.685
Cleanliness	3.705	3.638
Total Satisfaction	3.540	3.482

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

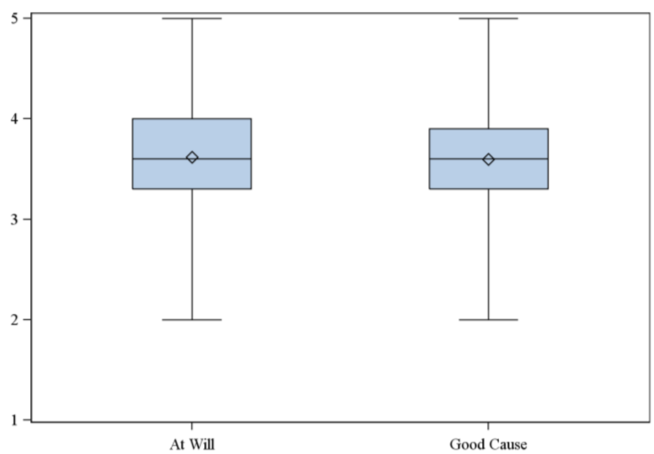
Overall Satisfaction:



Cleanliness:



Service:



While the picture seems clear, appearances might be misleading. In order to verify that our results indeed show GCSs have little effect on perceived quality, we employed a variety of econometric methods designed to tease out any differences that might escape initial detection. Since our purpose was to find out whether the 'at will' sample outperforms 'good cause' hotels, we tested by using a Wilcoxon rank-sum test (also known as the Mann-Whitney U test), which examines two given samples to determine whether one is drawn from a population with higher variables.[101] If the folk theorem is correct as the law and economics literature suggests, we would be able to reject the null hypothesis that the populations are identical.

In none of the 5 samples (Days Inn, Ramada Hotel, Ramada Limited Hotel, Ramada Plaza, Super 8)*, and none of the 3 parameters* (Service, Cleanliness, Overall Satisfaction) *examined, did the statistical test return a value showing any advantage to 'at will' states over 'good cause' ones.* Thus, in 15 separate analyses, examining a total of 200,309 reviews in 'good cause' states vs. a total of 307,355 reviews in 'at will' states, **not one** stratum returned a result lending credence to the prevailing wisdom that GCSs increase free-riding.[102] The results therefore cast considerable doubt on the validity of the traditional law and economics analysis of GCSs.

After assessing average ratings in the three categories and failing to find differences between 'at will' and 'good cause' states, we decided to examine further. In order to rule out the possibility of skewed results due to some peculiarity of the online ranking method, we re-assessed each of the 15 tests (5 hotel chains, 3 qualities which proxy for free-riding) by further stratifying according to rating levels. Thus we disentangled the online ratings according to low-to-high strata rather than focusing on average results. This allowed us to examine whether some of rating levels were more sensitive to differences among populations, differences that might escape detection if averaged out by opposite biases in different rating levels. For example, it might be that more significantly low ratings were given to hotels in 'good cause' states than 'at will' states, even if the average ratings were similar due to an opposite bias affecting high ratings.

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101 This test was called for, due to the populations of ratings not being distributed normally. On a scale of 1 to 5, 1's are almost unheard of, while 5's are prevalent. The tails are thus heavy, and non-symmetric. We thus used a non-parametric test, so as to avoid unwarranted assumptions which might skew the results.

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

In order to assess this possibility, we separated each of the 15 strata to groups, ranking low to high ratings according to the numerical scale used by Expedia. Thus, low (or middle, or high) ratings in each group were compared to similar ratings in the other group, rather than aggregated within group averages. We then applied a Chi-Square test and a Fisher's Exact test, but again, failed to find any statistically significant difference among states, along any of the dimensions examined. Below is a sample table, showing the distribution and analysis of ratings for Total Satisfaction regarding Day's Inn hotels (all other tables are available upon request, and show similar results):

Frequency **Percent** **Row Pct** **Col Pct**	**Low**	**Middle**	**High**	**Total**
At Will States	195 13.18 19.72 66.33	643 43.48 65.02 66.02	151 10.21 15.27 71.56	989 66.87
Good Cause States	99 6.69 20.20 33.67	331 22.38 67.55 33.98	60 4.06 12.24 28.44	490 33.13
Total	294 19.88	974 65.86	211 14.27	1,479 100.00

Statistic	**DF**	**Value**	**Prob**
Chi-Square	2	2.4580	0.2926
Likelihood Ratio Chi-Square	2	2.5123	0.2848
Mantel-Haenszel Chi-Square	1	0.9410	0.3320
Phi Coefficient		0.0408	
Contingency Coefficient		0.0407	
Cramer's V		0.0408	

Fisher's Exact Test	
Table Probability (P)	0.0010
Pr <= P	0.2970

Sample Size = 1479

We can thus safely say that not only are average ratings per hotel similar in ‘good cause’ and ‘at will’ states, but that there is no statistically significant difference among any group of reviewers at any level of satisfaction. It is thus safe to say that good cause statutes do not diminish customer satisfaction along any dimension measured. Since ratings for cleanliness, service, and overall satisfaction were presumed to proxy for quality differences associated with free riding, there appears to be no support in our data for the folk theorem that good cause statutes induce free riding and impede franchisor control of on-site quality.

V. DISCUSSION AND NORMATIVE IMPLICATIONS

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

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

Before we move on to our preferred interpretation of the results, it is important to rule out several factors that, if present, would limit any conclusions drawn. It might be, for instance, that the presence of GCSs does not increase free-riding because contractual terms in such states prevent the effective protection of such statutes. This is ruled out by the mandatory nature of most GCSs, negating any contractual waiver of the rights. Thus, a franchisee who agreed to a contract stipulating ‘at will’ termination in a ‘good cause’ state, would still be protected and could bring suit based on the GCS regardless of contractual language to the contrary.[103] It might be that the opposite is true, that national franchises include ‘good cause’ language in all their contracts, obviating ‘at will’ termination by contractually conceding the case and essentially implementing GCS-like protection even in ‘at will’ states. Such a claim is wrong on two counts: firstly, the facts are different. Examination of the contracts shows that most include at-will termination clauses or other clauses that do not satisfy the statutory “good cause” requirement.[104] Secondly, were this the case, there would be no effective ‘at will’ states, making franchisor resistance to such statutes unnecessary. Since such resistance is strong, there must be a reason franchisors view GCSs as problematic.[105] To this we will return to below, when discussing normative recommendations.

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[103] *See supra* note 10.

[104] For example, according to Days Inns and Super 8 franchise contracts, the franchisor may terminate the agreement for <u>convenience at any time</u> upon six month's advance notice (emphasis added). See Days Inn Franchise Disclosure Document 91, *available at* https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showPoup&documentId={D01E9B8F-E1F5-4937-B901-7079A48A50BA}&documentTitle=42280&documentType=4 (last visited Feb. 17, 2014) (last visited Feb. 19, 2014); See also Super 8 Franchise Disclosure Document 85, *available at* https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showPoup&documentId={4DCCC980-68EE-488C-9DA8-12B151322F53}&documentTitle=41631&documentType=4 (last visited Feb. 19, 2014). *See* also Jonathan Klick et al., *The Effect of Contract Regulation: The Case of Franchising* 8 (George Mason Law & Econ. Research Paper Series, Working Paper No. 07–03, 2006), *available at http://ssrn.com/abstract=951464* (“[M]ost franchise contracts contain at will termination clauses.”) (last visited Feb. 19, 2014).

[105] David A. Eisenberg, *Balancing a Relationship – ’’Good Cause’’ Termination of Franchise Agreements in Michigan*, 72 U. DET. MERCY L. REV. 369, 372 (1995) (“Franchisors argue that the threat of arbitrary termination is the only means by which they can protect themselves from franchisees engaging in potentially

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

We now turn to a more detailed examination of the role of review sites and the criteria for their success as monitoring devices. After delving into their mechanics and characteristics, we shall offer suggestions regarding normative implications.

Online review sites force the free-riding franchisee to bear the costs of his or her shirking, as even first-time visitors have the benefit of information regarding venue quality. Since shirking on

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opprobrious behavior"); David Hess, *The Iowa Franchise Act: Towards Protecting Reasonable Expectations of Franchisees and Franchisors*, 80 IOWA L. REV. 333, 343 (1995) ("Franchisors claim a need for an unrestricted termination power to protect the value of their trademark and to insure a uniform standard of quality among all franchises").

difficult-to-quantify investment in quality is policed by customers, it need not be policed to the same extent as previously required by franchisors. Thus, traditional explanations regarding GCSs inducing free-riding might have been true before, but it seems that online reputation mechanisms have supplanted threats of contractual termination. Of course, our study does nothing to corroborate (and nothing to dispute) the traditional explanations' efficacy prior to the advent of online rankings, and not all industries operate with such reputation mechanisms. Still, given that Expedia is but one of many, and social media such as Facebook make online reputations the rule rather than the exception, these findings are significant.

In the hotel industry, the focus of our empirical study, online review sites have become a widespread phenomenon. Sites such as Expedia, Tripadvisor, and Orbitz allow travelers to write reviews and rate the hotels in which they have stayed. Empirical studies systematically show that online hotel reviews written by travelers influence travelers' booking decisions. For example, Gretzel, Yoo and Purifoy conducted a survey among 7,000 Tripadvisor.com users in order to examine several factors including the impact of travel reviews on travelers' trip planning processes.[106] According to the survey, 91.8% of respondents avoided places or services due to the content of online reviews posted by other travelers.[107] Similarly, an experimental study conducted by Aurelio Mauri and Roberta Minazzi tested, *inter alia*, whether travelers consult comments of other travelers before booking a hotel.[108] The experiment shows that respondents' hotel purchasing intentions indeed increased where there was a prevalence of positive comments, and decreased in the face of negative ones.[109] Similar results were obtained by others in numerous studies.[110]

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106 Ulrike Gretzel et. al., Online Travel Review Study: Role and Impact of Online Travel Reviews *4, *available at* http://www.tripadvisor.com/pdfs/OnlineTravelReviewReport.pdf (last visited Feb. 19, 2014).

107 *Id*. at *25.

108 Aurelio G. Mauri & Roberta Minazzi, *Web Reviews Influence on Expectations and Purchasing Intentions of Hotel Potential Customers*, 34 INT'L J. OF HOSPITALITY MGMT. 99 (2013).

109 *Id*. at 102-104.

110 Beverley A. Sparks & Victoria Browning, *The Impact of Online Reviews on Hotel Booking Intentions and Perception of Trust*, 32 TOURISM MGMT. 1310 (2011); Qiang Ye et al., *The Influence of User-generated*

Empirical studies show more than the influence of reviews on purchase decisions, they also demonstrate that hotel revenues are significantly impacted.[111] In one study by Chris K. Anderson, a one-percent increase in online reputation measures led to a 0.54 percent increase in occupancy, and a 1.42 percent increase in hotel revenues.[112]

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

Online review sites are not alone in supplanting 'at will' termination in franchise contracts. Adam Badawi has shown that informal mechanisms operate alongside formal ones and at-will termination is far from the only way to make franchisees conform to quality standards.[113] In the classic "carrot and stick" terminology, where the "stick" of contractual termination is difficult to effectuate, a "carrot" emerges – such as using promises of additional franchises to incentivize

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Content on Traveler Behavior: An Empirical Investigation on the Effects of E-word-of-mouth to Hotel Online Bookings, 27 COMPUTERS IN HUMAN BEHAVIOR 634 (2011); Online Consumer-Generated Reviews Have Significant Impact on Offline Purchase Behavior, *available at* http://www.comscore.com/Insights/Press_Releases/2007/11/Online_Consumer_Reviews_Impact_Offline_Purchasing_Behavior (last visited Feb. 19, 2014).

[111] E.g., Qiang Ye et. al., *The Impact of Online User Review on Hotel Room Sales*, 28 INT'L J. OF HOSPITALITY MGMT. 180 (2009) showed that a 10 percent increase in travel review ratings, increased online bookings by more than five percent.

[112] Chris K. Anderson, *The Impact of Social Media on Lodging Performance*, 12(15) CORNELL HOSPITALITY REPORT, (November 2012). See also, MICROS eCommerce, How a Higher TripAdvisor Ranking Can Help Hotels Book More Room Nights, *available at* http://blog.microsecommerce.com/index.php/uncategorized/how-a-higher-tripadvisor-ranking-can-help-hotels-book-more-room-nights/ (last visited Feb. 19, 2014).

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

investment in quality. In his study, Badawi focuses on liquidated damages, which streamline contractual enforcement and operate similarly to the type of 'at will' termination we study here, but finds that their use is limited, and negatively correlated with informal mechanisms. In other words, "carrots" might be preferable to "sticks", especially where customers can punish franchisees directly.[114] Where online review sites operate effectively, the "stick" is wielded by the marketplace, making courts and formal proceedings dispensable. Since formal and informal mechanisms are seen as substitutes, franchisors do well to avail themselves of positive reinforcements such as promising future business growth and additional franchise opportunities, while leaving punishment to anonymously-operating customers who post negative reviews online.

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

While we focused on franchise operations and the role of good cause statutes, the insight gained goes further. Where the online world provides for customer interaction, exploitation of non-repeat customers may be a losing prospect. When information is freely available and customer

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

dissatisfaction can be conveyed online, businesses of all sorts need to adapt to a world where the one-shot consumer is a disappearing species. The fear that good cause statutes impede franchise operations and induce free riding is thus overstated, especially in the online world.

Still, franchisor groups are notoriously opposed to GCSs, and attempts to enact such statutes are usually stifled.[115] If our conclusions are correct, what would explain this attitude? First, opposition to GCSs might be a path-dependent result, explained more by what was once true than what is relevant today. If 'at will' termination once operated as an important factor constraining free-riding, past resistance to GCSs is understandable. Given that most public debates on the matter predate effective review sites being widely available, we might be seeing the lasting impression of a dying world.

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

Third, the simplest explanation might be the most true: that franchisors oppose GCSs since these impede not just contractual monitoring, but also their ability to exploit the franchisees within their network. Franchisor opportunism was described above as consisting of three related behaviors: raising fees and requiring additional purchases, revoking licenses in order to re-sell them to new franchisees at higher prices, and revoking licenses in order to repossess the site and

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[115] See *supra* Part II.

run it as a company-owned franchise.[116] ‘At will’ contracting is less necessary today (in specific industries) than it formerly was, from the perspective of constraining franchisee opportunism (free-riding on the brand), but it retains its power as a forcing mechanism. Proponents of GCSs thus have another weapon in their rhetorical arsenal when arguing for enactment: franchises manage to do equally well in regards to quality with or without GCSs. If there are distributional reasons to prefer protection of weaker party, and franchisees are assumed to have less bargaining power, GCSs might very well be the answer.

Of course, the result we show is too narrow to provide argumentation for GCSs as a whole. Some industries can rely on review sites, others cannot. One might consider tailoring the law to specific industries based on the effectiveness of online reviews and others might argue that this is too regulation-intensive and simple “yes or no” answers work better. In any case, one argument can no longer be made: that ‘at will’ contracting is indispensable and “franchisee protection laws increase shirking and free-riding.”[117] The customers of hotels in our sample say otherwise.

VI. Conclusion

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

In this paper we empirically investigate the conventional economic analysis of GCSs. We do so by attempting a direct comparison between the level of franchisee free riding in ‘good cause’ states and ‘at will’ states. Online reviews of hotels written by guests allow us to measure franchisee free riding with reasonable precision. Examining a sample of three hotel chains –

[116] *See supra* Part II.

[117] *See* supra note 80.

Days Inn, Ramada, and Super 8 – we find no significant differences in the level of free riding in 'good cause' states versus 'at will' states in any of these chains. These results question the validity of the conventional economic analysis of GCSs.

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

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

Our results call for a novel sub-distinction, overlooked so far in the debate over GCSs. Industries with non-repeat customers should be divided into 2 major groups: Industries subject to effective consumer interaction via social media (including, but not limited to, effective online review sites), in which the risk of free riding is relatively low, and industries without such customer interaction, in which the risk of free riding may be higher. Within the first group, the necessity of an at-will contract as a control mechanism against free riding is questionable. This conclusion opens the door for reconsideration of the adoption of GCSs, even in industries with non-repeat customers, as appropriate mechanisms for limiting franchisor opportunism and protecting individual franchisees from unequal bargaining terms.