

THE EVOLUTION OF FRANCHISING AND FRANCHISE CONTRACTS: EVIDENCE FROM THE UNITED STATES[†]

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Abstract

This paper briefly summarizes the history and growth of franchising in the United States, and then describes many aspects of the franchising relationship, including how financial terms in franchise contracts have changed over the last quarter century. It also summarizes some other changes that have occurred in franchise contracts as this mode of organization has become more mature. In particular, some sources of franchisor-franchisee conflict have arisen or become more pronounced over time, and contracting practices have evolved to remove, or at least reduce, such conflict. Also, the legal status of some contract clauses has been clarified or challenged by new statutes and court decisions, leading to additional changes in franchise contracts and their terms.

I. INTRODUCTION

According to the *American Heritage Dictionary of the English Language*,¹ the word “franchise” comes from the old French word *franche*, which means “free or exempt.” In medieval times, a franchise was a right or privilege granted by a sovereign power: king, church, or local government.² Sovereigns granted franchises for the right to maintain civil order, collect taxes, and promote various activities such as building roads, holding fairs,

[†] This paper relies heavily on various portions of our book, ROGER D. BLAIR & FRANCINE LAFONTAINE, *THE ECONOMICS OF FRANCHISING* (2005), especially Chapters 1 to 3. In many cases the data presented herein, however, have been updated. We thank Robert Picard for his expert assistance with the large data set we rely on, and the University of Florida, the Ross School of Business, University of Michigan as well as CIBE, University of Michigan, for their support.

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¹ AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE, available at <http://www.bartleby.com/61/48/F0294800.html> (last visited Mar. 14, 2009).

² BLAIR & LAFONTAINE, *supra* note [†], at 3.

and organizing markets.”³ In essence, the sovereign gave an individual or group the monopoly rights over a particular activity in a particular location for a particular period of time. In most cases, a grantee was required to make a payment to the sovereign power in exchange for this right or privilege, usually in the form of a share of the product or profit.⁴ That payment was called a *royalty*, a term still used today.

Today, a franchise agreement is most often understood to be a contractual arrangement between two legally independent firms in which one firm, the franchisee, pays the other firm, the franchisor, for the right to sell the franchisor's product, the right to use its trademarks and business format in a certain location for a certain period of time, or both.⁵ According to Dicke, the use of the word “franchise” to describe a method of doing business or distributing goods and services entered the English business lexicon in 1959.⁶ In fact, governments still grant franchises today in certain industries. This occurs, for example, in the cable television industry in the United States where the rights to be the sole provider of cable services in a given market for a certain time period are sold by local governments to firms usually through what is called a “franchise bidding” process.⁷ In addition, the word “franchise” is used in the sports industry to refer to the right granted by a professional league to operate a team in a particular locale.⁸ Most often, however, the term franchise now refers to a business relationship between legally independent commercial firms.⁹

According to the Federal Trade Commission (“FTC”), the body that has jurisdiction in the United States over federal disclosure rules for franchisors, three elements must be present for a business relationship to be deemed a franchise.¹⁰ First, the franchisor must license a trade name and

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 3-4.

⁶ THOMAS S. DICKE, *FRANCHISING IN AMERICA: THE DEVELOPMENT OF A BUSINESS METHOD, 1840-1980*, 2 (1992).

⁷ See, e.g., Mark A. Zupan, *Cable Franchise Renewals: Do Incumbent Firms Behave Opportunistically?*, 20 RAND J. ECON. 473 (1989); Robin A. Praeger, *Firm Behavior in Franchise Monopoly Markets*, 21 RAND J. ECON. 211 (1990) (discussing “franchise bidding” in the U.S. cable industry); Eduardo M.R.A. Engel, Ronald D. Fischer & Alexander Galetovic, *Least-Present-Value-of-Revenue Auctions and Highway Franchising*, 109 J. POL. ECON. 993 (2001) (analyzing contemporary highway construction franchise contracts granted by a government).

⁸ See, e.g., ROGER G. NOLL & ANDREW ZIMBALIST, *SPORTS, JOBS, AND TAXES: THE ECONOMIC IMPACT OF SPORTS TEAMS AND STADIUMS* (1997) and *Football History*, available at <http://www.football.com/history/index.shtml>.

⁹ See John Stanworth & James Curran, *Colas, Burgers, Shakes and Shirkers: Towards a Sociological Model of Franchising in the Market Economy*, 14 J. BUS. VENTURING 323 (1999) (providing a detailed account of different definitions of commercial franchises used in the academic literature across a variety of fields).

¹⁰ See, e.g., Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289, 292 (1989) (reviewing the legal elements of franchises

trademark that the franchisee operates under, or the franchisee must sell products or services identified by this trademark.¹¹ Second, the franchisor must exert significant control over the operation of the franchisee or provide significant assistance to the franchisee.¹² Third, the franchisee must pay at least \$500 to the franchisor at any time before or within the first six months of operation.¹³ Note that though this definition of franchising is specific to the United States, most definitions used by foreign authorities, including Australia, Canada, and the European Union, rely on similar sets of criteria.¹⁴ In their implementation, however, foreign definitions are often less inclusive than in the United States.¹⁵

The remainder of this article briefly summarizes the history and growth of franchising in the United States, in Sections II to IV. This is followed, in Section V, by a description of several aspects of the franchising relationship, and how contracting practices have changed as this mode of organization has become more mature. In particular, sources of franchisor-franchisee conflict have arisen or become more pronounced over time, and the legal status of some contract clauses has been clarified or challenged by new statutes and court decisions. This, in turn, resulted in some of the changes discussed in Section V. Finally, Section VI contains a summary and some concluding remarks.

II. TRADITIONAL AND BUSINESS-FORMAT FRANCHISING – A BRIEF HISTORY

In its surveys of franchising, the Department of Commerce (“USDOC”) historically has distinguished two types of franchised relationships:

as per the text of various state franchise laws). *See also* Stanworth & Curran, *supra* note 9, at 324-25.

¹¹ Pitegoff, *supra* note 10, at 292.

¹² *Id.*

¹³ *Id.*; *see also* Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. § 436 (1979), (amended in 2007); Final Interpretive Guides, 44 Fed. Reg. 49967 (1979) (explaining that payments for inventory at bona fide wholesale prices for resale are not considered a minimum payment for the purposes of this last requirement).

¹⁴ *See, e.g., Franchising Code of Conduct*, Commonwealth of Australia, 1998; *see also Arthur Wishart Act*, (Franchise Disclosure), S.O. 2000, c. 3, *available at* www.e-laws.gov.on.ca/html/statutes (last visited Mar. 14, 2009); *EEC Block Exemption for Vertical Restraints*, Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices. Note that a definition of franchising is no longer included directly in the *EEC Block Exemption for Vertical Restraints* but a description of the contents of franchise agreements is found in the attached guidelines (text figure 35, 36, 189 ff.) and the know-how definition has remained the same as in the old *EEC Block Exemption for Franchise Agreements*.

¹⁵ BLAIR & LAFONTAINE, *supra* note †, at 5.

traditional (or product and trade name) and business-format franchising.¹⁶ The former is characterized by franchised dealers who “concentrate on one company's product line and to some extent identify their business with that company.”¹⁷ As the term suggests, traditional franchising is the oldest form of franchising. By most accounts, it can be traced to the mid-1800s when the McCormick Harvesting Machine Company and the Singer Sewing Machines Company sold their products through sales agents who were given exclusive sales territories.¹⁸ Initially these firms, like others who used such agents at the time, imposed few restrictions or qualifications on their agents and exerted very little control over them. Over time, however, both companies found they needed more control over these sales agents if they were to protect their respective reputations and brands.¹⁹ The McCormick Harvesting Machine Company responded by establishing company-owned branch houses throughout the United States and Canada.²⁰ These branch houses were given oversight responsibilities for the sales agents in each branch's territory. As a result, the McCormick Company was able to systematize procedures and communications with its agents, thereby transforming them into what are now called “dealers.” The Singer Company addressed the need for control by converting many of the independent agencies into company outlets.²¹ More importantly, it devised a series of recommendations for the remaining agents about how the offices should be run and, for the first time, required detailed financial reporting from these agents. The contracts and methods of control that Singer developed are largely recognized as the forerunners of the modern franchise agreement.²²

¹⁶ ANDREW KOSTECKA, UNITED STATE DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY: 1986-1988 1 (1988).

¹⁷ *Id.*

¹⁸ See DICKE, *supra* note 6 (discussing the history of franchising in the United States, including a detailed account of its evolution at these two companies); see also Thomas G. Marx, *The Development of the Franchise Distribution System in the U.S. Automobile Industry*, 59 BUS. HIST. REV. 465 (1985) (discussing the development of franchising in automobile retailing in the U.S.).

¹⁹ See DICKE, *supra* note 6; BLAIR & LAFONTAINE, *supra* note †, at 5.

²⁰ *Id.*

²¹ *Id.*

²² BLAIR & LAFONTAINE, *supra* note †, at 6. In England, the development of franchising is usually traced to the development of the “tied house system,” namely the ownership of licensed beer retailers by brewers. See D.M. Knox, *The Development of the Tied House System in London*, 10 OXFORD ECON. PAPERS 66 (1958) (discussing the reasons behind the growth of this system in London). However, in a private conversation with Martin Mendelsohn, he pointed out that it is not clear that tied houses can be classified as a form of franchise since the pubs typically do not operate under a common trade name.

Traditional franchising in the United States is comprised largely of automobile dealerships, gasoline service stations, and soft-drink bottlers.²³ In these businesses, the franchisor is a manufacturer who sells finished or semi-finished products to its franchisees. In turn, the franchisees resell these products to consumers or other firms in the distribution chain. Profits for the franchisor/manufacturers in these relationships flow from the markups franchisors earn as part of the wholesale price they charge their dealers for the products. In contrast to business-format franchising, as described below, traditional franchisees do not pay running royalties on their sales.

Though traditional franchising accounted for 72.7% of all sales by franchised chains in 1986, it comprised only one-third of the establishments and one-fourth of the employment in franchised chains during the last year in which the United States government collected and published various statistics on franchising.²⁴ The remaining 27.3% of sales were generated by business-format franchising firms, where the franchisor primarily sells a way of doing business (or a business format) to its franchisees. More specifically, as described by the USDOC, a business-format franchise contract usually “includes not only the product, service, and trademark, but the entire business format itself—a marketing strategy and plan, operating manuals and standards, quality control, and continuing two-way communication.”²⁵

The first true business-format franchise system was created by Martha Matilda Harper.²⁶ This entrepreneur developed her network of Harper Beauty Shops in the early 1890s using a business model that included all the components of a business format as described by the USDOC.²⁷ But despite growing her network to more than 500 shops in the U.S., Canada, and Europe by the mid-1920s, Matilda Harper unfortunately

²³ See ROBERT T. JUSTIS & RICHARD J. JUDD, *FRANCHISING* 1-9 (1998). William E. Metzger is said to have been the first franchisee in automotive retailing; he obtained a franchise to sell steam automobiles from General Motors Corporation in 1898. Coca-Cola sold its first bottling franchise in 1899 according to Coca-Cola Enterprises, available at http://www.cokecce.com/pages/allContent.asp?page_id=88 (last visited Mar. 14, 2009).

²⁴ BLAIR & LAFONTAINE, *supra* note †, at 6; see also, *infra* Table 1 and Section III. The USDOC cancelled the publication of its yearly reports on the state of franchising in the economy (produced by Andrew Kostecka, and entitled *Franchising in the Economy*) in 1988 as part of its privatization program. This publication was the only source of census-type data on franchising in the United States. Efforts by the International Franchise Association (“IFA”) to take over the publication of this annual report on a permanent basis were unsuccessful. In cooperation with FRANdata Corp. and then with PriceWaterhouseCoopers, however, the IFA Educational Foundation has produced several reports whose data we refer to throughout this paper.

²⁵ KOSTECKA, *supra* note 16, at 3.

²⁶ JANE R. PLITT, *MARTHA MATILDA HARPER AND THE AMERICAN DREAM* (2000).

²⁷ KOSTECKA, *supra* note 16, at 3.

did not leave a lasting mark on franchising.²⁸ Other firms, such as the supermarket chain Piggly Wiggly, Hertz Car Rentals, A&W Restaurants, Maid Rite (a hamburger restaurant chain), and Terminix Termite and Pest Control all started franchising in the 1920s and are still involved in franchising today.²⁹ These early entrants were followed in the 1930s by companies in the United States like Howard Johnson Restaurants, Stewart's Drive-In, Arthur Murray Schools of Dancing, and Culligan, and by the Canadian Tire retail chain and its Associate Store program, Merle Norman Cosmetics, and Le Groupe RONA among others in Canada.³⁰ But it was not until the 1950s, with the advent of chains such as Burger King and McDonald's, and the economic boom of the post-war era that business-format franchising fully came into its own in the United States and Canada.³¹ By the mid-1990s, it had also expanded throughout much of the rest of the world.³²

Business-format franchising today encompasses a large number of industries: automotive products and services, computer sales, business aids and services, construction and maintenance, legal, domestic, and child-care services, and non-food retailing as well as the more visible hotel, fast-food, and car rental franchises. In exchange for the business format, franchisees typically pay a relatively small lump-sum fee at the beginning of the contract period and continuing royalties that are a fixed percentage of the franchisee's sales revenues.³³ Business-format franchisees often contribute

²⁸ BLAIR & LAFONTAINE, *supra* note †, at 7.

²⁹ Cf. FÉDÉRATION FRANÇAISE DE LA FRANCHISE, *TOUTE LA FRANCHISE: LES TEXTES, LES CHIFFRES, LES RÉSEAUX* (2003) (explaining that Jean Prouvost, owner of the Lainière de Roubaix, launched his network of Pingouin stores also in the 1920s, thereby initiating the concept of franchised distribution in France). Though this source indicates that the network of stores was developed in the 1930s, the French National Archives states that it was started in 1923, *available at* <http://www.archivesnationales.culture.gouv.fr/camt/fr/egf/lettrel.html> (last visited Mar. 14, 2009).

³⁰ Some networks, such as IGA, le Groupe RONA, and Best Western International, are organized as cooperatives whose role is to provide their franchisees/members with purchasing power and name recognition. The development and organization of these cooperatives is interesting in light of Richard E. Caves and William F. Murphy's view of franchising as a mechanism by which "franchisees hire out the collective and large-scale production of goodwill." Richard E. Caves & William F. Murphy, *Franchising: Firms, Markets, and Intangible Assets*, 109 S. ECON. J. 572, 575 (1976). See also Francine Lafontaine & Emmanuel Raynaud, *Residual Claims and Self Enforcement as Incentive Mechanisms in Franchise Contracts: Substitute or Complement*, in *THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS* 315-36 (Eric Brousseau & Jean-Michel Glachant eds., 2002) (drawing an analogy between food production cooperatives and franchises).

³¹ DICKE, *supra* note 6, at 1.

³² For an overview of the number of franchisors and franchisees in thirty-six countries around the world, see ARTHUR ANDERSEN & CO., *WORLDWIDE FRANCHISING STATISTICS: A STUDY OF WORLDWIDE FRANCHISE ASSOCIATIONS* (1995).

³³ BLAIR & LAFONTAINE, *supra* note †, at 7.

an additional fraction of their sales or revenues toward an advertising fund for the chain as a whole.³⁴

In the end, the distinction between traditional and business-format franchising is somewhat arbitrary and a matter of degree. Dnes and Klein, for example, both argue that there is little economic difference between the two, in terms of the type of agreements they rely on and the type of support provided or control exerted by franchisors.³⁵ In regard to theoretical analyses of franchise relationships, the distinction between these two types of franchising indeed is largely irrelevant; researchers have considered both types simultaneously in many studies.³⁶ However, the distinction is important from a descriptive standpoint for two main reasons. First, in many countries outside the United States, traditional franchising is not included in franchising statistics. As a result, the franchising sector appears large in the United States relative to those countries. Second, in the United States, authors often refer to all franchising when they emphasize its economic importance, but only to business-format franchising when describing its growth. This is because business-format franchising has grown much more than traditional franchising in the last few decades. The issue of growth in franchising is discussed further in Section IV.

III. FRANCHISING BY INDUSTRY

According to the USDOC, “[r]etailing dominates franchising, accounting for 87% of all franchising receipts in 1987. The retail sales of all firms associated with franchising reached about \$522 billion in 1987, or 34% of all U.S. retail sales.”³⁷ Table 1, *infra*, shows the sectoral breakdown for sales, the number of establishments, and employment for franchised firms in the United States in 1986 according to the USDOC.³⁸ It also shows average sales per establishment in each sector.

The data in Table 1 confirm that sales through traditional franchising in 1986 were almost three times the level of sales of business-format franchisors. Contrary to what occurs with sales, however, the majority of establishments and jobs were found in business-format franchising. Specifically, as seen in Table 1, the number of establishments was twice as large, and the number of employees was almost three times as large, in business-format as compared to traditional franchising. Thus, as seen in the last column of Table 1, sales per unit and sales per employee were much larger in traditional than in business-format franchising.

³⁴ *Id.*

³⁵ See generally ANTONY W. DNES, *FRANCHISING: A CASE-STUDY APPROACH*, (1992); Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9 (1995).

³⁶ See, e.g., Benjamin Klein, *Transaction Cost Determinants of ‘Unfair’ Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980) and Klein, *supra* note 35.

³⁷ KOSTECKA, *supra* note 16, at 14.

³⁸ *Id.* at 40, 44.

While we no longer have government data on franchising, the International Franchise Association (“IFA”) and Price Waterhouse Coopers have published new reports on the economic impact of franchising in the U.S. economy in both the years of 2004 and 2008.³⁹ The first report contained data relative to 2001, and the second provided the same information for 2005.⁴⁰ According to the first report, in 2001, business-format franchising encompassed 4.3 times as many establishments and employed four times as many workers as traditional franchising did. According to the second report, by 2005, there were 5.7 times more establishments and 4.5 times more jobs in business-format franchising than in traditional franchising.⁴¹

³⁹ IFA Educational Foundation and Price Waterhouse Coopers, *ECONOMIC IMPACT OF FRANCHISED BUSINESSES, PART I* (2004) [hereinafter *ECONOMIC IMPACT PART I*]; and IFA Educational Foundation and Price Waterhouse Coopers, *ECONOMIC IMPACT OF FRANCHISED BUSINESSES, PART II* (2008) [hereinafter *ECONOMIC IMPACT PART II*]. Note that although there are some issues with the data and methodology used to estimate the extent and growth of franchising in this and a later report produced by the same authors, these reports still represent an important effort and source of information on franchising. We therefore benchmark their estimates with some other potential measures.

⁴⁰ See *ECONOMIC IMPACT PART I*, *supra* note 39; *ECONOMIC IMPACT PART II*, *supra* note 39.

⁴¹ See *ECONOMIC IMPACT PART II*, *supra* note 39.

TABLE 1: SALES, ESTABLISHMENTS AND EMPLOYMENT IN
FRANCHISING IN THE UNITED STATES IN 1986

Sector	Total Sales (\$000)	Total Establishment s	Number of Employees *	Sales per Establishmen t (\$000)
Automobile and Truck Dealers	307,256,000	27,600	947,400	11,132
Gasoline Service Stations	86,618,000	120,510	596,400	719
Soft-Drink Bottlers	19,662,000	1,203	126,200	16,344
Total: Traditional Franchising	413,536,000	149,313	1,670,000	2,770
Automotive Products & Serv. (1)	11,300,863	36,763	186,182	307
Business Aids & Services (2)	13,288,254	52,718	669,522	252
Construction, Home Improvement , Maintenance & Cleaning Serv. (3)	4,615,360	18,900	118,991	244
Convenience Stores	11,278,895	15,524	152,688	726
Educational Products & Serv. (4)	935,166	8,625	41,210	108
Hotels, Motels and Campground s	15,983,990	8,203	555,674	1,949
Laundry & Dry cleaning Services	291,802	2,297	9,891	127
Recreation, Entertainmen t & Travel (5)	3,549,025	7,901	27,732	449
Rental	6,155,006	9,528	66,423	646

Services (Auto-Truck) (6)				
Rental	716,019	2,718	14,926	263
Services (Equipment) (7)				
Restaurants	52,273,863	78,203	2,453,621	668
Retailing (Food Non- Convenience) (9)	10,746,011	19,852	214,768	541
Retailing (Non-Food) (8)	23,102,779	45,456	274,663	508
Miscellaneous (10)	1,305,715	6,122	44,486	213
Total	155,542,748	312,810	4,830,777	497
Business Format Franchising				
Total	569,078,748	462,123	6,500,777	1,231
Franchising				

Note: * includes part-time and working proprietors.

(1) Includes Tire, Battery and Accessory Stores; Auto and Truck Wash Services, and Brake and Muffler Repair and Services and some establishments with significant sales of non-automotive products such as Household Appliances, Garden Supplies, etc.

(2) Includes Computer Services, Business Consultants and Brokers, Security, Dentists, Insurance, and Others.

(3) Includes Furniture Repairs, Water Conditioning, Lawn Care, Sewer Cleaning and Carpet Cleaning.

(4) Includes Day-Care Centers and Health and Diet Services.

(5) Includes Travel Agencies, Miniature Golf Courses, and Dance Studios.

(6) Includes Leasing.

(7) Includes Formal Wear.

(8) Includes General Merchandise, Drugs and Cosmetics, Gift Shops, Shoes and Apparel, Hardware, Paints and Floor Covering, Furniture, Draperies and Bedding, Consumer Electronics, and Vending.

(9) Includes Retail Specialty Food Shops, Donut Shops, Ice Cream Stores, Coffee Services, Candy Stores, Bakeries and Supermarkets.

(10) Includes Beauty Salons, Fitness Centers, Wholesale Services and Others.

The data in Table 1, *supra*, also indicates that franchising occurs in a wide variety of retail and service industries in the U.S. economy. Within business-format franchising, most of the sales, units, and employees in 1986 were found in the restaurant sector, which includes well-known chains such as Burger King, KFC, Little Caesar's, McDonald's, Subway, and many others.⁴² According to the IFA and Price Waterhouse Coopers 2008 report, this is still true today, with 35% of all jobs in business format franchises occurring in the quick-service restaurant sector and another 12% in the full-service restaurant sector.⁴³ Using employment as the 2008 IFA and Price Waterhouse Coopers report does, to gage the size of different sectors, the government data (from USDOC) suggests that in 1986, the sector where the second largest amount of franchised business activity took place was the business aids and services sector.⁴⁴ This sector includes firms such as Money Mailer, SignFast, and Snelling Personnel Services. The information in the IFA and Price Waterhouse Coopers 2008 report confirms that this is also still true today.⁴⁵

IV. MEASURING GROWTH IN FRANCHISING IN THE U.S.

We begin by measuring growth over the period from 1972 until 1986 when the availability of census-type data on the number of franchisors, the number of units, and sales by franchised chains from the USDOC makes this straightforward.⁴⁶ Figures 1 and 2, *infra*, show the data on franchising growth relative to GDP growth in two different ways. First, Figure 1 presents information on the evolution of the number of units of business-format and traditional franchised chains, along with data on the evolution of Real GDP, from 1972 to 1986. We use "number of units" instead of "sales" as an alternative way to capture real rather than nominal growth in franchising. Second, Figure 2 jointly addresses the issue of same-unit growth along with growth in number of units by depicting the value of goods sold through franchising as a proportion of Real GDP between 1972 and 1986. Such a ratio gives a "unit free" measure of the extent of franchising, eliminating the need to distinguish between nominal and real figures.⁴⁷

Figure 1 first shows the dramatic *decrease* in the number of units in traditional franchising over this period. This decrease is mostly due to the closing of a large number of smaller gasoline stations that were replaced, as part of the industry's rationalization, by new "pumper" stations that could

⁴² See Table 1, *supra*.

⁴³ See ECONOMIC IMPACT PART II, *supra* note 39.

⁴⁴ KOSTECKA, *supra* note 16, at 40.

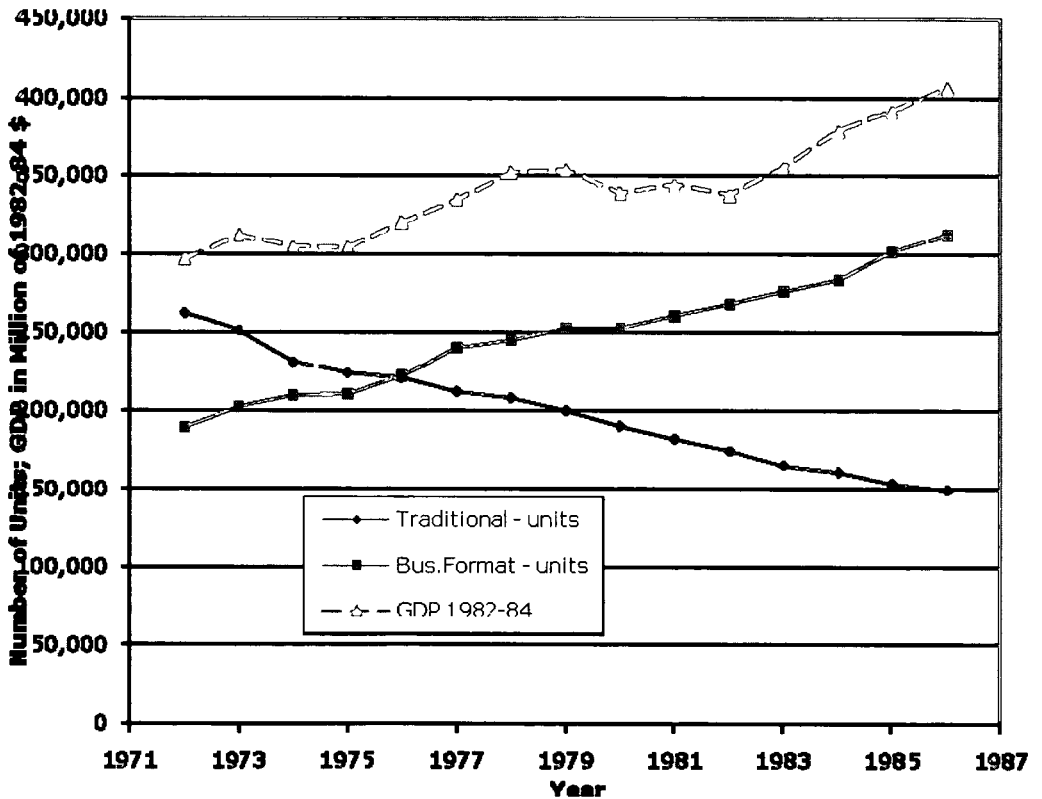
⁴⁵ See ECONOMIC IMPACT PART II, *supra* note 39.

⁴⁶ See Figure 1, *infra*.

⁴⁷ For meaningful comparisons, both franchising sales and GDP need to be measured in the same units, either both in real dollars or both in nominal dollars.

handle much larger volumes.⁴⁸ Figure 1 also shows that the number of units in business-format franchising has grown steadily over this period, as did GDP. As the time trends in the business-format franchising and GDP series are quite similar, it appears that in terms of units, business-format franchising was growing at a rate similar to that of the economy as a whole throughout the period covered by the data.

FIGURE 1: NUMBER OF UNITS AND REAL GDP IN THE U.S.



As discussed *supra*, Figure 1 focuses solely on the number of establishments in franchised chains. The number of establishments in franchised chains is important given that much of the growth in franchising, especially in business-format franchising, is achieved through growth in number of units.⁴⁹ Nevertheless, sales revenues in franchising can increase independently from higher numbers of units if per unit sales volumes are increasing in real terms. This phenomenon explains what happened for

⁴⁸ Andrew Kleit, THE ECONOMICS OF GASOLINE RETAILING: PETROLEUM DISTRIBUTION AND RETAILING ISSUES IN THE U.S. 14 (2003).

⁴⁹ See Figure 1, *supra*.

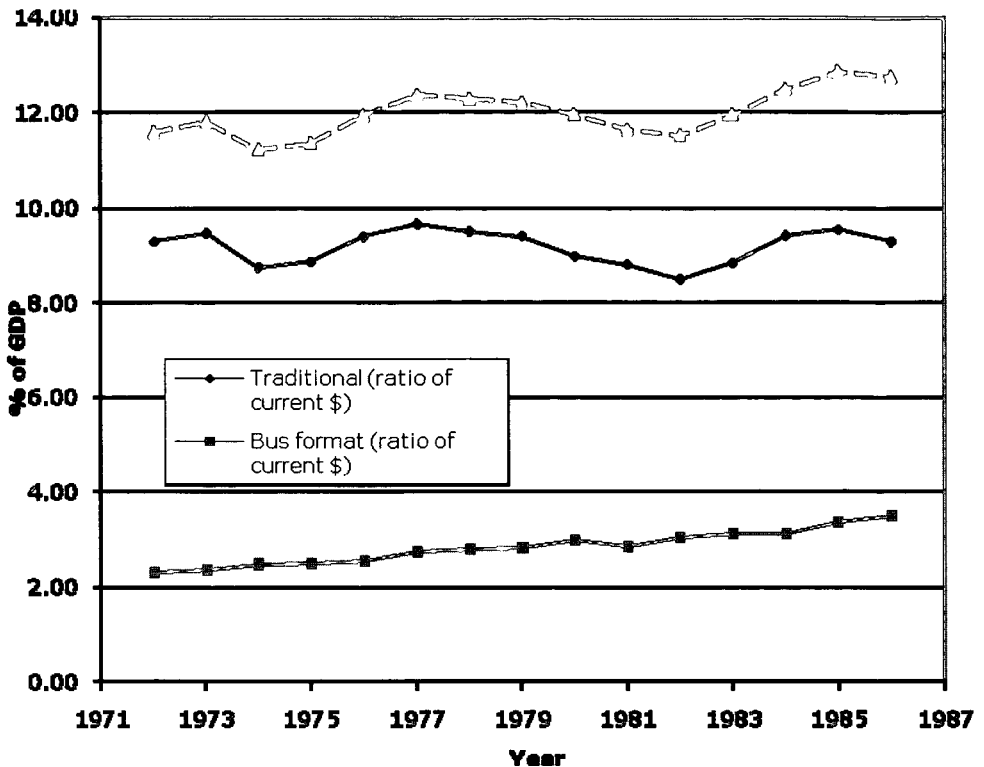
traditional franchising, where total sales increased in real terms throughout the period despite the decrease in number of units.

Figure 2 captures both the growth in the number of units and in sales per unit relative to GDP growth by showing the ratio of franchising sales to GDP. This chart also shows that the value of goods sold through traditional franchising outlets has remained fairly stable overall as a percent of GDP between 1972 and 1986. On the other hand, the value of goods sold via outlets of business-format franchisors has increased from 2.3% to 3.5% of total GDP. When sales through both traditional and business-format franchising are considered together, the value of goods sold through outlets of franchised firms increased from 11.6% to 12.8% of total GDP between 1972 to 1986.⁵⁰ Simple extrapolation from this trend suggests that franchising would represent about 14% of nominal GDP in 2001, and 14.4% of nominal GDP in 2005, which would amount to \$1.79 trillion.⁵¹

⁵⁰ See Figure 2, *supra*.

⁵¹ Note that nominal GDP in 2001 in the U.S. was \$10.08 trillion. Under the assumption that franchise retail sales have remained at 34% of all retailing, as they were in 1986, and with retail sales in 2001 at close to \$3.4 trillion, franchise retail sales would amount to about \$1.16 trillion. KOSTECKA, *supra*, note 16, at 14; US Census Bureau, Monthly Retail Trade Survey, Historical Retail Trade Data. Assuming retailing still constitutes about 87% of franchising sales, as it did in 1986, total franchising would amount to \$1.33 trillion, just between the \$1.42 trillion one obtains from simple extrapolation above and the IFA-Price Waterhouse Coopers estimate of \$1.28 trillion. KOSTECKA, *supra*, note 16, at 14. On the other hand, taking the \$1.42 trillion at face value and retaining the ratio of retailing/franchising at 87%, one would infer that franchise sales accounted for 36% rather than 34% of all retail sales in 2001.

FIGURE 2: FRANCHISING SALES AS A PERCENT OF GDP, 1972-1986



These estimates are interestingly quite consistent with those obtained by the IFA and Price Waterhouse Coopers in their 2004 and 2008 reports respectively.⁵² Specifically, their 2004 report puts the total output of franchised businesses, defined as the difference between sales revenue and cost of goods sold, at \$642 billion in 2001.⁵³ Assuming the cost of goods sold represents about 50% of sales in most of the relevant industries,⁵⁴ total sales would be about \$1.28 trillion in 2001. This estimate is somewhat lower than, but still not dramatically different from, the 14% of nominal GDP estimate mentioned above (given that 14% of nominal GDP would amount to total sales of \$14.2 trillion). In their second report,

⁵² See ECONOMIC IMPACT PART I, *supra* note 39; ECONOMIC IMPACT PART II, *supra* note 39.

⁵³ KOSTECKA, *supra* note 16, at 4.

⁵⁴ As the cost of cars and the cost of gasoline are clearly much more than 50% of the sales revenues of car dealers and gasoline stations, this assumption is clearly incorrect in traditional franchising. On the other hand, in more service oriented sectors such as hotels or fast-food, the cost of goods sold is much lower than 50%. We use 50% as a rough measure of cost of goods sold across all these sectors.

the total output of franchised chains in 2005 is estimated at \$880.9 billion.⁵⁵ Assuming again that the cost of goods sold is roughly equal to one-half of sales revenues in the types of businesses that are franchised, this would imply total sales of \$1.76 trillion in 2005 are very close to the results of our extrapolation above.

We conclude that the growth in franchising as a whole has been consistent generally with that of the U.S. economy. In fact, the estimates above suggest that franchising has grown somewhat faster than the overall economy. These estimates indicate that sales through franchised companies, including car dealerships and gasoline stations, could now represent about 14 to 14.5% of GDP, whereas according to the USDOC, they stood at 12.8% of GDP in the mid-1980s.⁵⁶

V. FRANCHISE CONTRACT TERMS AND THEIR EVOLUTION

Franchise contracts stipulate the conditions under which a franchised outlet is to be operated, including the rights and obligations of both parties under the agreement. In this section, we describe the financial terms—franchise fees, royalty rates, ongoing fixed payments, and advertising fees—used in business-format franchising contracts.⁵⁷ We then provide some data on the common non-financial terms of these contracts. We emphasize throughout that, although there are some common elements and common trends in franchise contracting, there is also great variance in the way that different franchisors organize their relationships with their franchisees. This tendency to organize various aspects of their relationship differently is not surprising when one considers the variety of business activities that franchisors are engaged in. It is important to recognize this variety, especially when it comes to evaluating the potential effect of various forms of regulatory intervention.

Economic theory suggests that franchisors should tailor their franchise contract terms for each unit and franchisee in a chain.⁵⁸ In practice, however, contracts are remarkably uniform across franchisees at a point in time within chains. Thus, they are insensitive to variations involving individual, outlet, and specific market conditions. Indeed, a business-format franchisor most often uses a single business-format franchising contract—a single royalty rate and franchise fee combination—for all of its franchised operations that join the chain at a given point in

⁵⁵ See ECONOMIC IMPACT PART II, *supra* note 39.

⁵⁶ KOSTECKA, *supra* note 16; Tables 5 to 9.

⁵⁷ In traditional franchising, the franchisor earns its profit via mark ups when it sells the product to the franchisee. There are no publicly available data on such mark-ups.

⁵⁸ Specifically, for the franchisor to extract the maximum profit from each location, the contract would have to take local market conditions into account. This would necessarily require location-specific contract terms.

time.⁵⁹ For example, in a survey of 130 business-format franchised chains, Lafontaine found that 42% of her respondents offered their contracts on a take-it-or-leave-it basis while 38% allowed for some negotiations, but only for the non-monetary terms.⁶⁰ Thus, uniformity, especially for monetary terms, is the norm.

Within the United States, the Robinson-Patman Act encourages upstream firms to set uniform wholesale prices.⁶¹ This law, however, cannot explain contract uniformity in business-format franchising because the act applies only to the sale of commodities for resale and excludes franchising rights.⁶² Various state-level disclosure rules also may increase the cost of using different contract terms with franchisees. For example, the rules may require franchisors to file new or amended versions of their disclosure documents when the franchisor modifies the terms of its contract for an individual franchisee.⁶³ Nevertheless, these constraints do not appear to be the main reason for the degree of uniformity in financial contract terms that is observed in practice.

Several other factors, however, may help explain the uniformity of financial terms in franchise contracts. First, disclosure requirements do not increase the cost of specifying fees using formulas such as making the franchise fee or royalty rate a function of local population levels, specifying minimum and maximum levels of fees, and so on. In fact, as we describe below, franchisors do use formulaic fees, but only to a limited extent. Second, and most interestingly, franchisors themselves point to other factors as the main justifications for contract term uniformity. When asked why they use a uniform contract, only 22% of the 130 business-format franchisors in Lafontaine's survey indicated that legal considerations were a factor. They chose this answer this infrequently despite being allowed to select as many factors as they wished from a list of factors given to them. On the contrary, 73% of them indicated that contract uniformity is simply desirable because of resulting consistency and fairness toward franchisees.⁶⁴ Another 27% of the respondents cited transaction costs as a main factor

⁵⁹ Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263, 264 (1992).

⁶⁰ Francine Lafontaine, *How and Why Do Franchisors Do What They Do: A Survey Report*, in FRANCHISING: PASSPORT FOR GROWTH & WORLD OF OPPORTUNITY (Patrick J. Kaufmann ed.), Sixth Annual Proceedings of the Society of Franchising, (1992).

⁶¹ Robinson-Patman Act, 15 U.S.C.A. § 13, (West, 2008) (forbidding price discrimination in the sale of commodities by manufacturers or distributors towards resellers where the effect is to reduce competition or tend to create a monopoly). See ROGER D. BLAIR & DAVID L. KASERMAN, ANTITRUST ECONOMICS 290-311 (2008).

⁶² JUSTIS & JUDD, *supra* note 23, at 151.

⁶³ See, e.g., MARTIN D. FERN ET AL., FRANCHISING LAW: PRACTICE AND FORMS, THE FRANCHISOR (1996).

⁶⁴ See Lafontaine, *supra* note 60, at 18.

driving uniformity, stating that such uniformity makes it easier to administer and enforce the contract.⁶⁵

The chain's inability to deal with special circumstances, and the resulting lost franchise sales, was the main disadvantage of uniform financial contract terms cited by franchisors. The existence of this drawback was mentioned, however, by only about one-half of the franchisors.⁶⁶ The other half either stated that they saw no disadvantage in the use of uniform contracts or did not identify any particular disadvantage when asked to do so.⁶⁷

The uniformity of the contract terms offered by a franchisor at a given point in time, on the other hand, allows us to now examine the detail of those contracts. In the remainder of this section, we describe the use and level of different contract terms using data collected from franchisor directories and listings. The database covers all franchisors that appear at least once in the 1981 to 1993 Entrepreneur Magazine's "Franchise 500" surveys or in the 1994 to 2007 editions of the Source Book of Franchise Opportunities, now called Bond's Franchise Guide.⁶⁸ Each year, these publications give detailed profiles for about 1,000 franchising companies. Hence they cover a very significant portion of the industry. Note that the data for a given year are obtained from the next year's survey or directory because this information is published early in the calendar year. In other words, the 2006 data are from the 2007 Bond's Franchise Guide. After 1994, we rely on Bond's Franchise Guide because Entrepreneur Magazine's 1994 survey covered fewer chains than usual, and from 1995 onward, Entrepreneur Magazine stopped reporting advertising fee data. Furthermore, the Bond's Franchise Guide, which has the advantage of providing more details on each of the franchisors it profiles, had become an annual publication by then. Together, these sources provide information

⁶⁵ *Id.*; see also R. Preston McAfee & Marius Schwartz, *Opportunism in Multilateral Vertical Contracting: Nondiscrimination, Exclusivity, and Uniformity*, 84 AM. ECON. REV., 210, 223-25 (1994) (giving an opportunism-based explanation for contract uniformity); Sugato Bhattacharyya & Francine Lafontaine, *Double-Sided Moral Hazard and the Nature of Share Contracts*, 26 RAND J. ECON., 761-781 (1995) (suggesting that the benefit from contract customization may not be large enough to warrant even low customization costs).

⁶⁶ See Lafontaine, *supra* note 60, at 18.

⁶⁷ *Id.* Note that while franchise contract terms offered to potential franchisees at a point in time tend to be uniform, in the course of the franchise relationship, a franchisor may adjust the terms of the contract temporarily to give struggling franchisees a chance to survive. In other words, given that franchisee failure is damaging for the system, franchisors sometimes grant rent relief or reduce required royalties for struggling but otherwise promising franchisees in spite of specific contract terms. See, e.g., DNES, *supra* note 35.

⁶⁸ We exclude from the data the few chains that are in these sources but report either no outlet at all (that is, no company nor franchised outlet) or report no fees (that is, no royalty rate, franchise fee, advertising rate or ongoing fixed payments) in the survey year.

from 1980 through 2006 (except for 1999 and 2002 as the 2000 and 2003 Bond's Franchise Guide were never published) and cover a total amount of approximately 5500 franchisors, including approximately 12% Canadian franchisors.⁶⁹

A. Financial Terms

1. Franchise Fees

The vast majority of franchisors require that their franchisees pay an initial lump-sum fee called a franchise fee.⁷⁰ This fee is paid only once at the beginning of the contract period. Of the various financial contract terms, this one varies the most across franchisees in a given chain. In the fifty-four disclosure documents franchisees have access to, Bhattacharyya and Lafontaine find that this variation arises for three main reasons.⁷¹ First, some franchisors set this fee in a formulaic way, most often based on the size of the territory that a franchisee is awarded or on its market potential. Second, some franchisors require different fees for different types of franchised units, i.e., different franchise options such as a free-standing fast food operation versus a food court version of the same business.⁷² Third, franchisors may require different fees for additional units sold to existing franchisees or for area developers, or set their fee differently for a "conversion" franchise—that is when an existing business joins a chain.⁷³

Figure 3 displays the distribution of (the average) franchise fees charged by 968 franchisors for which we have such data in 2006, expressed in constant 2001 U.S. dollars.⁷⁴ It shows that the vast majority of franchisors charge an initial franchise fee between \$5,000 and \$35,000, and most commonly between \$15,000 and \$30,000. The median fee is between \$20,000 and \$25,000. Very few franchisors, only seven out of 968, charge no such fee. At the other extreme, only seventeen of them request a franchise fee above \$80,000. Overall, franchise fees are quite small relative to the total payments made by franchisees to franchisors. Over the life of

⁶⁹ *Franchise 500*, ENTREPRENEUR MAGAZINE, various years; ROBERT E. BOND, SOURCE BOOK OF FRANCHISE OPPORTUNITIES, various years; and ROBERT E. BOND, BOND'S FRANCHISE GUIDE, various years.

⁷⁰ See Table 3, *infra*.

⁷¹ Bhattacharyya & Lafontaine, *supra* note 65.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ When only a lower bound was given, as in "\$30,000 and up," we use twice the lower bound as an estimate for the upper bound, and then calculate the mean between these two values. This amounts to using 1.5 times the lower bound as our measure of average franchise fee. When only an upper bound is given, as in "up to \$40,000," we use half the upper bound as an estimate for the lower bound, and again calculate the mean. This amounts to using 0.75 times the upper bound as our estimate of the mean franchise fee. Additionally, we use the end of 2001 exchange rate for Canadian dollars to transform the franchise fees of Canadian franchisors into U.S. dollars.

these contracts, franchise fees usually represent only 5 to 10% of the revenues that a franchisor receives from a franchised unit, with the remainder coming from sales-based royalties or advertising fees. For example, suppose a firm charged very typical fees, such as a franchise fee of \$20,000 and a royalty rate of 5%. Then assuming relatively low sales revenues of \$500,000 per year in real terms over a fifteen year contract (the average contract duration according to the USDOC's 1986 data), total royalty payments from franchisee to franchisor would be \$375,000. Thus, the franchise fee would be just above 5% ($\$20,000 / (\$20,000 + \$375,000)$) of the total payments from the franchisee to the franchisor over the life of the contract (assuming no advertising fee).

FIGURE 3: THE DISTRIBUTION OF FRANCHISE FEES IN 2006
(IN THOUSANDS OF 2001 U.S. DOLLARS)

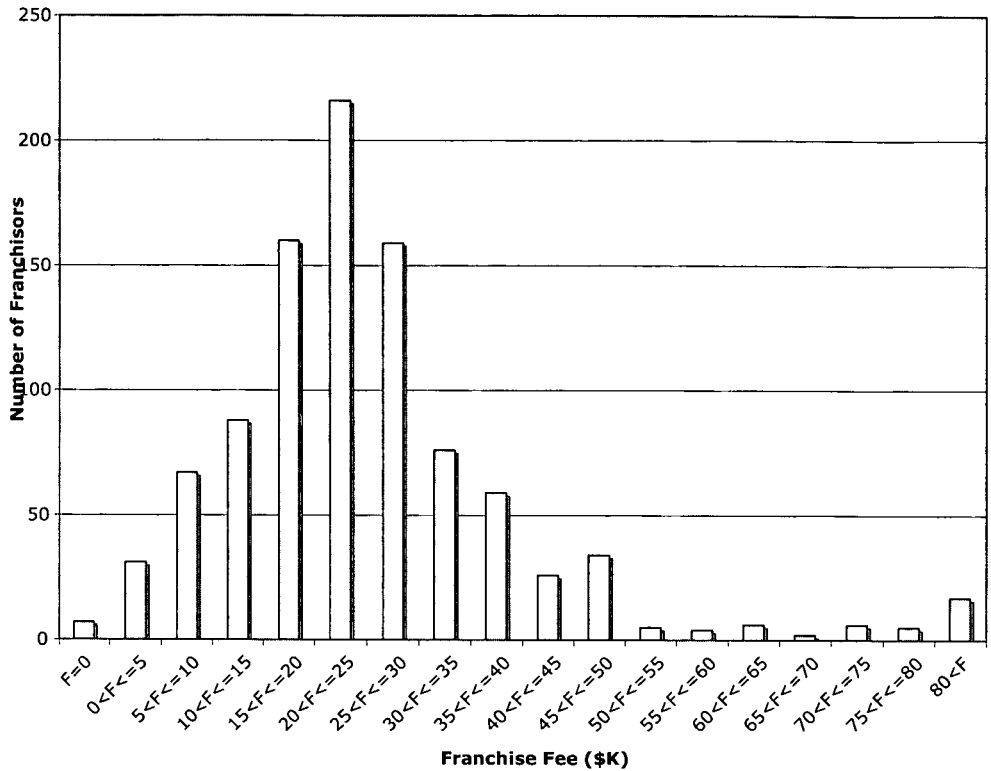


Table 3, *infra*, describes how initial franchise fees have changed since 1980. Column 3 shows that the proportion of firms requesting an initial franchise fee has increased during the 1980s to the point where almost all franchisors now request such payments. But these fees have always been quite popular: only about 10% of the chains did not request them in 1980. The last four columns show the average and maximum franchise fees observed in the data each year since 1980, in nominal and then in real, 2001 U.S. dollars. Not surprisingly, in nominal terms, these fees have increased over this period. In constant 2001 dollars, they increased over most of the 1980s, but had decreased by more than \$7,000 by 2001. In other words, nominal franchise fees did not keep up with the rate of inflation in the 1990s. They have since gone back up to average \$24,000 in 2006, as they were at in the mid-1990s.

TABLE 3: FRANCHISE FEES, 1980 TO 2006

Year	N	% of franchisors with franchise fee	Mean Fee Nominal U.S. \$K	Mean Fee, 2001 (Real) U.S. \$K	Maximum Fee Nominal U.S. \$K	Maximum Fee 2001 (Real) U.S. \$K
1980	952	89.8	13.0	27.9	300.0	644.8
1981	1017	92.0	14.7	28.7	450.0	876.7
1982	1136	93.0	15.1	27.8	250.0	458.8
1983	1102	94.6	15.4	27.5	82.5	146.7
1984	843	95.3	16.7	28.5	100.0	170.5
1985	887	96.7	17.8	29.3	112.5	185.2
1986	1032	97.0	18.2	29.4	250.0	404.0
1987	1036	97.5	19.0	29.6	150.0	233.8
1988	1005	98.5	20.0	29.9	120.0	179.6
1989	1041	98.8	20.6	29.4	127.5	182.1
1990	1082	98.7	20.7	28.0	110.0	149.1
1991	1008	98.8	20.6	26.8	125.0	162.5
1992	981	99.1	21.0	26.5	128.0	161.6
1993	1075	99.1	20.0	24.5	125.0	153.2
1994	1071	98.8	20.0	23.9	128.0	153.0
1995	1090	99.2	20.2	23.5	131.3	152.5
1996	1079	99.2	20.8	23.5	128.0	144.5
1997	1015	99.1	20.9	23.1	128.0	141.2
1998	971	99.2	21.6	23.5	300.0	326.0
2000	959	99.2	22.3	23.0	300.0	308.5
2001	1125	99.2	22.2	22.2	300.0	300.0
2003	970	99.2	23.8	22.9	300.0	288.8
2004	981	99.3	25.5	23.9	300.0	281.3
2005	981	99.1	26.5	24.0	300.0	272.0
2006	968	99.3	27.4	24.0	300.0	263.5

Note: Minima are always zero. Data for 1999 and 2002 are unavailable as the 2000 and 2003 *Bond's Franchise Guide* was not published for those years.

2. Royalty Rates

In addition to collecting an initial franchise fee, business-format franchisors typically require franchisees to make ongoing payments throughout the life of their contracts.⁷⁵ In most, but not all franchise systems, these payments are calculated as a percentage of sales revenues.⁷⁶ In the *Profile of Franchising*, the IFA and the FRANdata Corporation

⁷⁵ BLAIR & LAFONTAINE, *supra* note †, at 6-8.

⁷⁶ *Id.*

reported that 1006 franchisors, or 82% of their sample, requested some form of percentage royalties.⁷⁷ They found that sixty-one franchisors, or 5% of their sample, instead charged a flat dollar amount per time period on an ongoing basis, and twenty-two of them, or 2%, required a fee per unit sold or per transaction (such as a fee per audit for an accounting firm, or per room for a hotel).⁷⁸ Finally, sixty-two franchisors, or 5% of the firms in their sample, charged no royalties at all.⁷⁹ Among the 1,006 franchise systems that operated under a percentage royalty, the report goes on to mention that this fee was based on sales revenues for 932 franchisors, while it was based on gross margins for another six franchisors.⁸⁰ The remaining fifty-two franchisors, almost all from the personnel, real estate, travel agency, and business services sectors, used some other basis that the authors do not describe.⁸¹

A number of franchisors that charge a percentage rate also specify some minimum level of royalty payments. Such minimum payments are the norm in other industries that use percentage fees, such as in retail leasing.⁸² It is, however, difficult to ascertain the extent to which minimum royalty payments are used in franchising. To our knowledge, the only source of such information is Lafontaine's survey, where forty of the 123 franchisors that levied royalties said that franchisees must pay some minimum dollar amount when their sales are too low.⁸³

Finally, a few franchisors that charge percentage fees rely on an increasing or decreasing scale, making the percentage rate itself a function of sales levels.⁸⁴ Of the 117 franchisors that levied percentage royalties in Lafontaine's survey, ninety-three charged a constant royalty rate no matter what level of sales franchisees achieve, while eighteen franchisors used a decreasing scale for royalties: that is a royalty rate that declines as outlet sales reach certain target levels, and two used an increasing scale.⁸⁵ Both the use of minimum royalty payments and of royalty rates that change as sales reach given targets suggest that a number of franchisors find it useful

⁷⁷ IFA EDUCATIONAL FOUNDATION & FRANDATA CORP., THE PROFILE OF FRANCHISING, VOLUME III (2000) [hereinafter PROFILE OF FRANCHISING 2000].

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ One could speculate that this alternative basis for royalties would be some form of net revenues to the franchisee as these sectors are ones where sales revenues to the franchise are not the same thing as total receipts.

⁸² See, e.g., B. Peter Pashigian & Eric D. Gould, *Internalizing Externalities: The Pricing of Space in Shopping Malls*, 41 J.L. & ECON. 115 (1998); William C. Wheaton, *Percentage Rent in Retail Leasing: The Alignment of Landlord-Tenant Interests*, 26 REAL ESTATE ECONOMICS 185, 185-204 (2000) (describing the structure of retail leases).

⁸³ See Lafontaine, *supra* note 60, at 25.

⁸⁴ *Id.*

⁸⁵ *Id.*

to introduce some non-linearity in their contract terms. Our data suggest moreover that the use of varying rates may be on the rise: in 1980, only forty-nine of the 938 franchisors for which we have royalty rate data indicated a range of possible rates, whereas 114 franchisors (out of 1023) gave a range in 1990, and 149 franchisors (out of 1085) gave one in 2001. The proportion for 2006, at 138 out of 988, is slightly greater still. Bhattacharyya and Lafontaine's detailed look at fifty-four disclosure documents suggests that most royalty rate ranges reflect either decreasing or increasing scales, or a policy of granting lower royalty rates for the first few years of the franchisee's business.⁸⁶

Figure 4, *infra*, shows the distribution of the average sales based royalty rate for the 931 franchisors for which we have this information in 2006.⁸⁷ It shows that royalty rates typically vary between 3 and 7%, and that more than 28% of the franchisors (or 266 of them) charged the modal, which is also the median, royalty rate of 5% percent. Interestingly, 8% of business-format franchisors (seventy-five of them) do not require the payment of any royalties at all.⁸⁸ Examples include Fantastic Sam's, Snap-on Tools, Ben and Jerry's Ice Cream, and I Can't Believe It's Yogurt. Some such franchisors, like Fantastic Sam's, instead require franchisees to pay a fixed amount per week or month for the duration of the contract—we explore this further below. Others obtain revenue from sales of goods to their franchisees, just like traditional franchisors do.⁸⁹

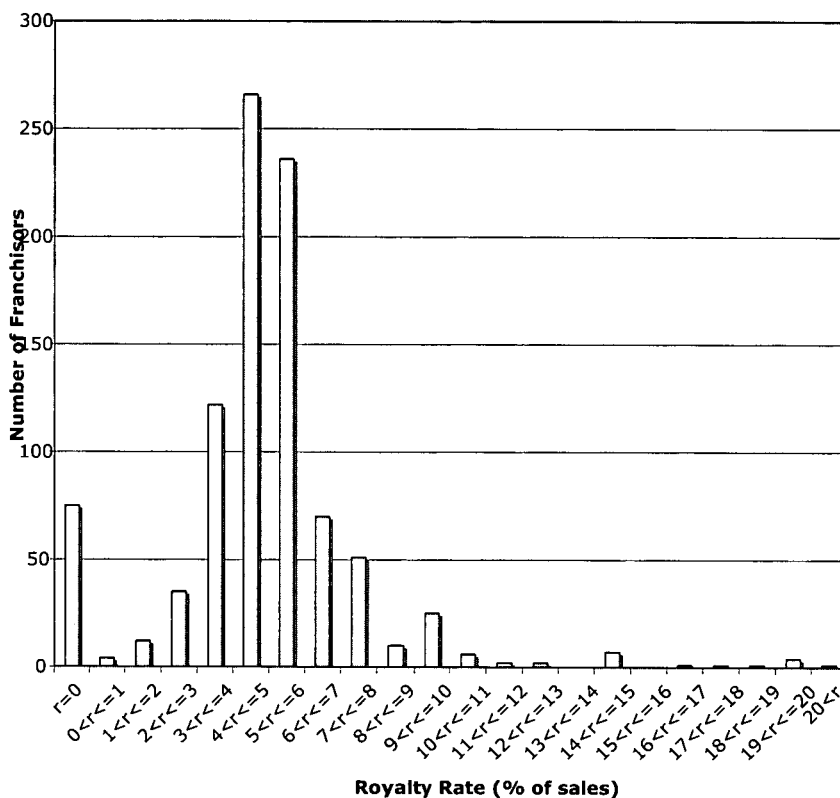
⁸⁶ Bhattacharyya & Lafontaine, *supra* note 65.

⁸⁷ Franchisors whose royalty rate was above 25% were excluded from the sample. The data source does not always indicate whether the rates are applied to sales revenue, to gross margins, or to profits. For the vast majority of franchisors, the rates are a percentage of sales. However, percentage rates above 25% suggest the use of an alternative basis, and I do not want to compare these with the sales-based rates or include them in our reported averages. Again I use the mean value whenever a range of royalty rates was given in the data source. I also impute minima and maxima when these are not stated using the methodology described earlier for franchise fees.

⁸⁸ See Figure 4, *infra*.

⁸⁹ See Ram C. Rao & Shubashri Srinivasan, *Why are Royalty Rates Higher in Service-Type Franchises*, 4 J. ECON. & MGMT. STRATEGY 7 (1995) (arguing that retail franchised chains charge lower royalty rates than those in services industries because the former have an alternative mechanism at their disposal to extract revenues from their franchisees, namely they can sell inputs to franchisees at a markup). See also Lafontaine, *supra* note 90 (providing discussion and related evidence).

FIGURE 4: THE DISTRIBUTION OF ROYALTY RATES IN 2006



At the other extreme, a few franchisors do charge as much as 25% in royalties.⁹⁰ As noted above, we eliminated from our sample those franchisors that charged even higher royalty rates on the presumption that these likely were levied on gross margins or profits rather than sales. Unfortunately, our data source does not specifically indicate whether the rates are applied to sales revenue, to gross margins, or to profits. Thus, firms with royalty rates of 15, 20, or 25% in our data may also be extracting a proportion of profit or gross margins rather than sales. Having communicated with some of these franchisors, however, we know that these high rates also can be percentages of sales royalties as well. Thus, we chose to include them in our analyses as long as their rates were not above 25%. We simply note that such high rates leave little for franchisees to pay expenses and still earn normal profits. These businesses then tend to be concentrated in home-based, low overhead types of activities.⁹¹

⁹⁰ See Figure 4, *supra*.

⁹¹ As such businesses tend to be service rather than retail based, the high royalty rates that arise in low overhead businesses also explain part of the pattern noted by Rao & Srinivasan, *supra* note 90.

Table 4 shows how the usage of sales royalty and the average rate charged have changed from 1980 to 2006. Of course, the proportion of franchisors using sales royalties was quite high even in 1980. Nonetheless, it increased steadily until it reached about 92% of franchisors in the early and mid-1990s, where it has stayed since. In *The Franchise Agreement*, Udell documented that 76% of the fast-food firms in his sample required the payment of percentage royalties, usually between 2 to 5% of sales, suggesting that the reliance on percentage fees may have increased through the 1970s as well.⁹² In the early 1970s, the United States Court of Appeals for the Ninth Circuit held that a franchisor mandating the purchase by the franchisee of its marked up products that were severable from the trademark itself was a violation of the Sherman Anti-Trust Act.⁹³ This likely encouraged a switch toward more royalty fees from the early 1970s onward.

Table 4 also shows that the average royalty rate has increased slightly, from about 4.5% in 1980 to 5.2 or 5.3% in 2006, in part because the proportion of firms with zero royalty rates decreased (see column 6). Finally, column 7 shows the number of franchisors that do not request any percentage royalty but instead charge ongoing fixed fees. The data indicate that, in the early 1980s, approximately one out of every four franchisors that did not request a percent royalty payment charged ongoing fixed fees. By the late 1980s, however, one out of every two such firms used ongoing fixed fees instead of sales-based fees. Thus, by the early 1990s, and since then, 96% of franchisors charged royalties, either as a percentage or ongoing fixed fees, whereas only 89% of franchisors did so in 1980.

⁹² Gerald G. Udell, *The Franchise Agreement*, CORNELL HOTEL AND RESTAURANT ADMINISTRATION QUARTERLY, Aug. 1972, at 13, 14.

⁹³ Siegel v. Chicken Delight, 448 F.2d 43 (9th Cir. 1971).

TABLE 4: ROYALTY RATES, 1980 TO 2006

Year	Number of franchisors in the data	% of N with non-zero sales royalty	Mean Royalty Rate	Maximum Royalty Rate	# of franchisors with zero royalty rate	# of franchisors with no royalty but positive ongoing payments
1980	938	85.7	4.5	22.5	134	28
1981	1016	87.1	4.6	22.5	131	30
1982	1141	87.9	4.7	25	138	37
1983	1093	88.9	4.7	25	121	46
1984	821	87.3	4.8	25	104	37
1985	853	90.6	5	22	80	29
1986	988	90.4	4.9	25	95	31
1987	1006	90.4	4.9	25	97	39
1988	963	91.7	5	22	80	37
1989	993	91.2	5	22	87	46
1990	1023	90.8	5	22	94	49
1991	948	91.4	5	22	82	44
1992	928	90.9	5	22	84	40
1993	1035	90.4	5	25	99	52
1994	1035	89.9	5	22.4	105	55
1995	1045	90.7	5	22.4	97	54
1996	1045	91.2	5.1	22	92	47
1997	982	91.6	5	22	82	44
1998	942	91.3	5.1	22	82	44
2000	927	92.0	5.2	22	74	37
2001	1085	91.9	5.2	22	88	48
2003	935	91.7	5.2	22	78	40
2004	940	91.4	5.2	22	81	43
2005	942	91.4	5.3	22	81	43
2006	931	91.9	5.3	22	75	39

More details on the amount of ongoing fixed fees are found in Table 5, *infra*. Specifically, this table shows the frequency with which such fees have been used, and the amounts requested, between 1980 and 2006. Column 3 shows the total number of firms requesting such fees, and the proportion of the sample they represent, regardless of what other fees the franchisor may charge. The data in this column confirm that ongoing fixed fees are the exception rather than the rule. The proportion of firms that rely on ongoing fixed payments is low and has remained quite stable, around 6 to 7%, since at least the mid-1980s. Moreover, a comparison of the number of franchisors that use fixed payments with the number of franchisors that charge a zero royalty rate *and* use such fees, per column 7 of Table 4,

of Table 4, reveals that one-third to one-half of the franchisors that rely on ongoing fixed payments collect those along with non-zero royalty payments.

The next four columns in Table 5 show the average amounts involved, per month, both in nominal and in real (2001) U.S. dollars, first across all firms in the data (columns 4 and 5) and then for those firms that use these types of fees only (columns 6 and 7). Focusing on the latter, it is clear that the average fee charged by firms that utilize these fees has remained about the same in nominal terms over much of this period, though it has increased somewhat in the last few years. Hence, in real terms, there has been a steady and important reduction in the amount of fixed ongoing payments from an average of approximately about \$1000 per month to approximately \$500 per month by 2001, a trend that is now being reversed. The downward trend, however, was due mostly to the disappearance of a few franchisors that charged very high ongoing fees. When one examines the size of these fees on average for all franchisors (i.e., across all firms in the data as per columns 4 and 5), one finds that, in real terms, the average monthly amounts collected increased slightly in the mid-1980s and then decreased. By 2001, these fees were back to about the same level on average as they were in the early 1980s. Consistent with the larger amounts charged per columns 6 and 7, by 2006, the average fixed payments overall seem to have risen slightly.

TABLE 5: ONGOING FIXED PAYMENTS, PER MONTH, IN 2001 U.S. DOLLARS

Year	N	# of franchisors (and % of N) with ongoing fixed payments	Mean fixed fee, all franchisors (nominal)	Mean fixed fee, all franchisors (real, 2001 \$)	Mean fixed fee when used (nominal)	Mean fixed fee when used (real, 2001 \$)
1980	1089	40 (3.7)	17.7	38.0	481.2	1034.2
1981	1100	46 (4.2)	17.0	33.2	407.5	793.9
1982	1220	58 (4.8)	19.9	36.5	418.7	768.4
1983	1169	75 (6.4)	36.4	64.8	567.7	1009.4
1984	880	63 (7.2)	39.2	66.9	548.2	934.4
1985	926	55 (5.9)	33.4	54.9	562.1	925.2
1986	1075	60 (5.6)	38.6	62.4	692.4	1118.9
1987	1075	69 (6.4)	33.0	51.5	514.4	801.9
1988	1023	61 (6.0)	32.3	48.4	542.5	812.2
1989	1059	64 (6.0)	29.3	41.9	485.2	692.9
1990	1096	71 (6.5)	35.5	48.0	547.4	741.7
1991	1017	64 (6.2)	37.3	48.5	601.9	782.7
1992	992	61 (6.1)	33.5	42.3	545.3	688.3
1993	1088	86 (6.8)	33.5	41.1	493.2	604.5
1994	1090	90 (7.3)	35.7	42.6	486.0	580.8
1995	1096	93 (7.8)	41.2	47.9	531.7	617.9
1996	1092	84 (6.7)	31.4	35.4	469.3	529.7
1997	1022	82 (6.9)	29.3	32.3	421.5	465.1
1998	995	76 (7.6)	36.0	39.1	470.8	511.5
2000	984	67 (6.8)	33.5	34.5	492.4	506.4
2001	1158	82 (7.1)	34.1	34.1	481.6	481.6
2003	994	77 (7.7)	35.3	33.9	455.3	438.2
2004	1002	80 (8.0)	46.7	43.8	584.5	548.0
2005	998	78 (7.8)	45.5	41.3	582.5	528.2
2006	980	73 (7.4)	47.2	41.5	634.3	557.2

3. Advertising Fees

In addition to charging an initial franchise fee and running royalties, many franchisors also stipulate in their contracts that the franchisee must contribute monies to support national, regional and/or local advertising. For local advertising, the contributions are often stated as minima: the franchisor requires that the franchisee spend at least x percent of its sales revenues, or at least \$x, on local advertising. For advertising fees generally, franchisors often state in their disclosure documents that the rates may be changed later, or, for those that do not require an advertising contribution, that an advertising fund may be instituted later, at the

discretion of the franchisor. Franchisors thus leave themselves much leeway in this part of their financial dealings with franchisees. Contrary to franchise fees, which may vary across franchisees in a chain, this leeway relates to the franchisor's ability to make changes over time rather than to treat different franchisees differently.⁹⁴

Like royalty payments, advertising fees are most often calculated as a constant proportion of the franchisees' sales revenues. But as with royalty payments, advertising fees are also sometimes specified as a fixed monthly or weekly amount, or calculated as a function of the number of transactions. In the *Profile of Franchising 2000*, the IFA and the FRANdata Corp. found that 634 (or 52%) of the 1221 franchisors for which they had advertising fee data required that franchisees pay a percentage of their sales toward advertising.⁹⁵ The remaining franchisors either required no contribution at all (340, or 28%), contributions only to local or regional advertising funds (149, or 12%), a flat fee (66, or 5% of them), or a per transaction fee (13, or 1% of the sample).⁹⁶ The remaining few firms used some other unspecified basis to calculate the advertising requirement.

Figure 5 shows the distribution of the advertising fees as a percent of sales for the 890 firms in our data with advertising fee information in 2006. This distribution first confirms what was reported in the *Profile of Franchising 2000*, namely that many franchisors (225, or 25% of the franchisors in the data in 2006) do not charge any advertising fee.⁹⁷ Advertising fees also are rather low relative to royalty rates. Of the firms that charge an advertising fee, the majority (412 out of 665, or 62%) set it at a level of 2% or less. Almost all firms set this fee below 5%, the modal (and median) royalty rate. These patterns are consistent with those reported in the *Profile of Franchising 2000*, where 68% of the firms that used a percentage of sales advertising fee in 1998 charged 2% or less, while 98% of them requested fees below 5%.⁹⁸

⁹⁴ See Bhattacharyya & Lafontaine, *supra* note 65, at 761.

⁹⁵ PROFILE OF FRANCHISING 2000, *supra* note 77, at 154.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.* at 160.

FIGURE 5: DISTRIBUTION OF PERCENT OF SALES ADVERTISING FEES, 2006

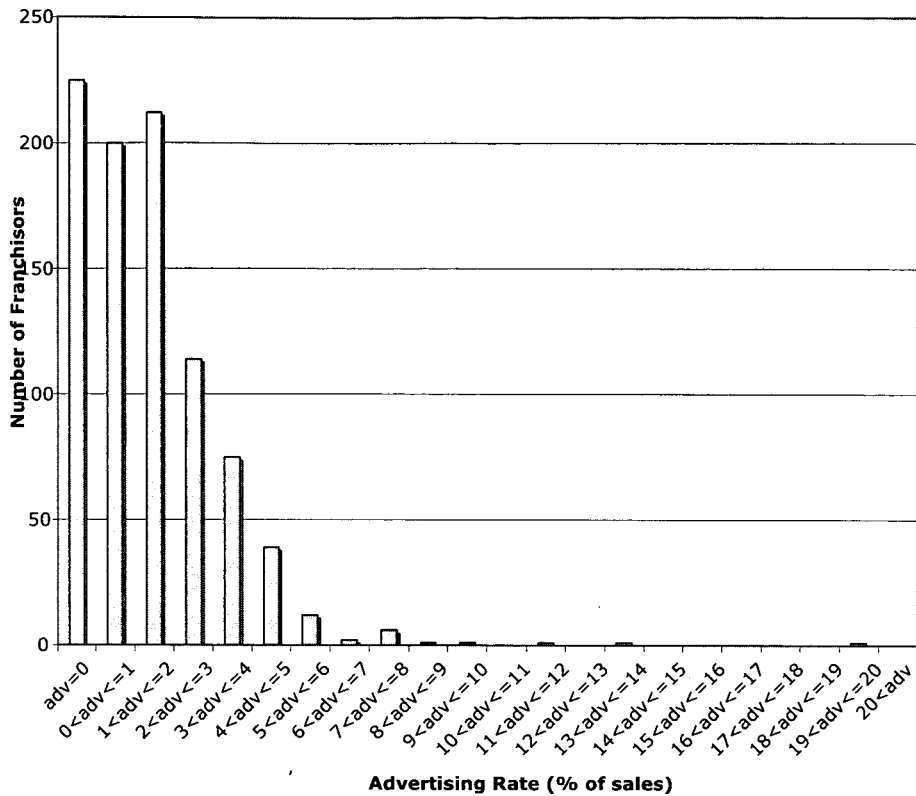


Table 6 shows how the frequency and amounts of advertising fees have changed between 1980 and 2006.⁹⁹ The mean advertising fee has gone up substantially, but column 6 shows that this again is due to the increasing number of firms that request such fees. The average advertising fee charged by users of such fees, on the other hand, has not changed over time. The last two columns of this table also show that the number of franchisors that charge ongoing fixed payments represents an increasing proportion of all franchisors with no advertising fee. This is because the number of franchisors requesting ongoing fixed payments has remained quite stable while the number of franchisors that do not specify a separate advertising fee has decreased substantially over the period of the data.

⁹⁹ A steadily increasing number of franchisors also report a range of advertising fees in the data rather than a single value. As we did for the other fees, we rely on the average rate in those cases where a range is given, and we impute minima and maxima when these are not stated explicitly.

TABLE 6: ADVERTISING RATES, 1980 TO 2006

Year	N	% franchisors with > 0 adv. rate	Mean	Max	# franchisors with adv. rate = 0	# of franchisors with adv. rate = 0 but positive fixed payments
1980	925	44.2	1.1	13.0	516	37
1981	1026	48.5	1.2	16.3	528	46
1982	1167	52.5	1.3	16.3	554	55
1983	1114	54.9	1.3	16.3	502	71
1984	830	58.3	1.4	13.0	346	59
1985	873	60.1	1.5	10.0	348	48
1986	1024	64.7	1.6	13.0	361	53
1987	1043	65.2	1.6	12.0	363	65
1988	986	68.4	1.7	13.0	312	55
1989	1018	67.6	1.6	15.0	330	56
1990	1046	68.9	1.6	15.0	325	61
1991	972	68.2	1.6	14.0	309	57
1992	952	66.7	1.5	10.0	317	55
1993	1038	68.1	1.6	10.0	331	67
1994	1021	67.0	1.5	10.0	337	74
1995	1007	67.9	1.5	10.0	323	76
1996	979	71.2	1.6	10.0	282	65
1997	926	70.5	1.6	10.0	273	61
1998	894	71.9	1.7	10.0	251	66
2000	876	72.7	1.7	10.0	239	59
2001	1028	71.9	1.7	14.0	289	69
2003	903	72.1	1.7	20.0	252	66
2004	907	72.4	1.7	20.0	250	71
2005	903	73.0	1.7	20.0	244	69
2006	890	74.7	1.8	20.0	225	64

Finally, while advertising fees are often specified and administered separately from royalty payments, from a franchisee's perspective it is the sum of these fees that really matters—this sum determines the portion of each dollar of sales revenue that must be sent back to the franchisor. It is also the sum of these percentage-of-sales fees that then affects the franchisee's decisions at the margin. Moreover, from the franchisor's perspective, advertising expenditures are not bound by the amount collected specifically for this purpose. In chains that do not specify such a fee, franchisors still spend money on advertising. In other words, not all franchisors necessarily draw a clear distinction between royalty revenue

and advertising related funds, especially early in our sample period.¹⁰⁰ For these reasons, in Figure 6, *infra*, we present the distribution of the sum of royalty and advertising rates in 2006.

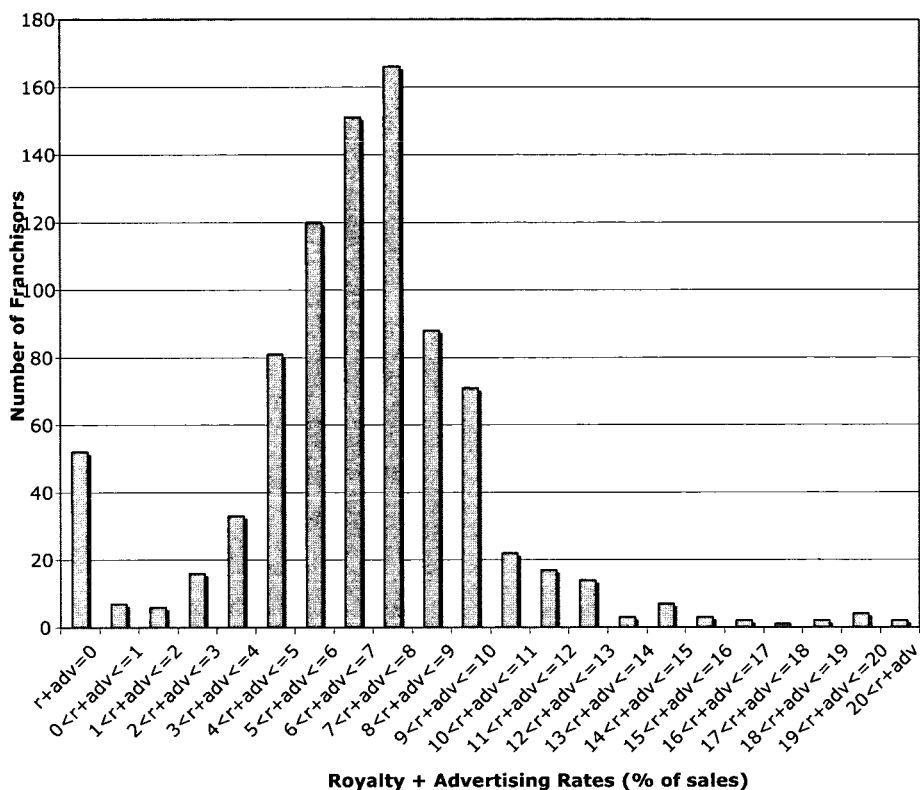
This figure shows that most franchisees paid somewhere between four and ten cents of every dollar of sales in the form of royalties and/or advertising fees to their franchisor in 2006, with a median total rate of 7% and a modal rate of 8%. Only fifty-two franchisors (6%) do not charge any royalty or advertising fee based on sales. On the other hand, few franchisors (twenty-one out of 868) require contributions that add up to more than 15% of a franchisee's sales revenues.

In *The Economics of Franchising*, Blair and Lafontaine discuss how high total rates are used relatively more frequently in service industries such as education, health and fitness, personal services, the automotive and the maintenance sectors.¹⁰¹ Franchisors in retail businesses, in contrast, tend to rely on relatively lower total rates. The data suggest that franchisors that choose a low royalty rate do not "make it up" by choosing a comparatively high advertising rate, or vice versa. In fact, high royalty and advertising rates generally go hand in hand.

¹⁰⁰ See generally Robert E. Stassen & Robert A. Middelstaedt, *Do Franchise Systems Advertise Enough? U.S. Restaurant Expenditures and Performance 1989 to 1998*, 10 J. MARKETING CHANNELS - (2002) at 3-18; BLAIR & LAFONTAINE, *supra* note †, at 69-78, Chapter 9 (providing background information on advertising fees and advertising in franchising).

¹⁰¹ BLAIR & LAFONTAINE, *supra* note †, at 75.

FIGURE 6: ROYALTY AND ADVERTISING RATES, 2006



4. Additional Remarks Concerning Financial Contract Terms

In *The Dynamics of Franchise Contracting: Evidence from Panel Data*, Lafontaine and Shaw found that while franchise fees and royalty rates vary across franchisors, they remain quite stable over time within franchised chains.¹⁰² In fact, franchisors do not systematically increase or decrease their royalty rates or franchise fees as they become better established, whether this is measured in number of years in franchising or in terms of total outlets. The tendency instead is to keep the fees, especially the percentage-of-sales fees, relatively constant. Thus, the uniformity in fees described earlier across franchisees within a chain also applies over time within a chain. Second, the theoretical literature on franchising implies that everything else constant, and in particular holding constant the value of the franchise, sales-based fees and initial franchise fees should be negatively correlated.¹⁰³ In other words, if the franchise fee is high, the running royalty will be low, and vice versa. The reason, of course, is that

¹⁰² Francine Lafontaine & Kathryn L. Shaw, *The Dynamics of Franchise Contracting: Evidence from Panel Data*, 107 J. POL. ECON. 1041, 1041 (1999).

¹⁰³ BLAIR & LAFONTAINE, *supra* note †, at 80.

these are alternative mechanisms for extracting profit from the franchisee, and there is only so much such profit. As we saw earlier, sometimes franchisors rely on fixed payments in lieu of a percentage royalty or advertising fee, in which case the use of fixed payments and percentage fees is by definition negatively correlated. More generally, however, the negative relationship between fixed fees and royalty rates has been quite elusive.¹⁰⁴ Of course, the lack of an observed negative relationship may arise from differences in contract terms that affect both fees in similar ways and are not controlled for in these analyses. But even looking at changes within firms, Lafontaine and Shaw find no relationship between total percentage fees and initial franchise fees.¹⁰⁵ In fact, the empirical evidence suggests that franchise fees are set quite independently from sales-based fees.¹⁰⁶ The absence of a negative relationship between the two types of fees suggests that the franchise fee may not be set at a level to extract all of the economic profit that franchisees earn.¹⁰⁷ This would occur if franchisors mostly set their initial franchise fee to compensate them for the costs incurred in setting up the outlet.¹⁰⁸

Finally, studies of franchise practices outside the United States suggest that the basic types of fees, the extent to which they are used, and their levels are similar to those described above for the United States. For example, the many Canadian franchisors that are included in the data described above set the same types of fees and set them at levels that are quite similar to those chosen by U.S. franchisors. Pénard, Raynaud and Saussier examined the fees used by more than 200 franchisors in France and found that most of them also use percentage of sales royalties and initial franchise fees, though the latter appear to be slightly lower in

¹⁰⁴ See, e.g., Lafontaine, *supra* note 59, at 263; Patrick J. Kaufmann & Rajiv P. Dant, *The Pricing of Franchise Rights*, 77 J. RETAILING 423, 424 (2001); Kabir C. Sen, *The Use of Initial Fees and Royalties in Business Format Franchising*, 14 MANAGERIAL & DECISION ECON. 175, 189 (1993).

¹⁰⁵ Lafontaine & Shaw, *supra* note 102, at 1041.

¹⁰⁶ James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511, 511 (2002) (finding some evidence that franchisors headquartered in termination states charge significantly higher royalty rates combined with a lower franchise fee).

¹⁰⁷ See generally Patrick J. Kaufmann & Francine Lafontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J.L. & ECON. 414 (1994); Lafontaine & Raynaud, *supra* note 30, at 317 (arguing that downstream profit combined with monitoring and termination rights, on the one hand, and residual claims on the other hand, are complementary incentive mechanisms in franchised chains, i.e. they are used to reinforce one another); Steven C. Michael & Hollie J. Moore, *Returns to Franchising*, 2 J. CORP. FIN. 133 (1995) (citing evidence that franchisees earn economic profit at least in some franchised systems and for discussion of the reasons why franchisors many choose to leave profit with their franchisees).

¹⁰⁸ BOND, BOND'S FRANCHISE GUIDE 24 (2008 ed.), *supra* note 69.

France.¹⁰⁹ Frazer shows that while the same types and levels of fees are used by franchisors in Australia, there is a greater reliance on ongoing fixed payments as 17% of the firms in her sample of 262 franchisors rely on such payments compared to just 7% of franchisors doing the same in our data.¹¹⁰ Finally, Seaton's data show that the fees of 161 franchisors in the United Kingdom in 1998 are very similar on average, and follow the same general distribution, as the ones found here for U.S. and Canadian franchisors.¹¹¹ Moreover, the conclusions about the lack of correlation between the fees and their stability over time also apply to non-U.S. franchisors. Specifically, Gagné, et al., establish a lack of negative correlation in fees for franchisors operating in Québec, Canada,¹¹² while Seaton's analyses indicate that the fees used by franchisors in the United Kingdom are also not negatively correlated and do not change much over time either.¹¹³

B. Non-Monetary Contract Terms

Aside from the set of financial contract terms described above, franchise contracts contain numerous clauses governing the obligations of both parties during and after the contract period, including clauses relating to the location of the franchise, how the franchisee is expected to operate the franchise, whether or not the franchisee has an exclusive territory, who owns or leases the property, the duration of the agreement and the circumstances under which the franchisor or franchisee may terminate it, when and where the franchisee may open another business, and so on. We describe some of these contractual obligations and clauses in what follows.¹¹⁴ Since there is much less data on contractual obligations and

¹⁰⁹ Thierry Pénard, Emmanuel Raynaud & Stéphane Saussier, *Dual Distribution and Royalty Rates in Franchised Chains*, (2002), available at <http://www.isnie.org/ISNIE02/Papers02/penardraynaudsaussier.pdf>. For more information on advertising fees in franchising in France, see FEDERATION FRANÇAISE DE LA FRANCHISE, *supra* note 29.

¹¹⁰ Lorelle Frazer, *Motivations for Franchisors to Use Flat continuing Franchise Fees*, 15 J. CONSUMER MARKETING 587, 589 (1998).

¹¹¹ See Jonathan S. Seaton, *An Analysis of UK Franchise Contracting 1989-1999*, 24 MANAGERIAL & DECISION ECON. 25, 27 (2003).

¹¹² See generally Robert Gagné, Simon Pierre Sigüe, & Georges Zaccour, *Droit d'Entrée et Taux de Redevance dans les Franchises d'Exploitation au Québec*, 74 L'ACTUALITE ECONOMIQUE/REVUE D'ANALYSE ECONOMIQUE 651, (1998).

¹¹³ Seaton, *supra* note 111, at 33-34.

¹¹⁴ A few franchise contract clauses, such as choice of law or mandatory arbitration clauses, relate to interpretation and enforcement rather than defining the franchise relationship itself or its economic underpinnings. Readers interested in learning more about such contract clauses, or about franchise law, would do well to consult a legal treatise such as W. MICHAEL. GARNER, *FRANCHISE AND DISTRIBUTION LAW AND PRACTICE* (Thompson West 2002). See also PHILIP F. ZEIDMAN, *SURVEY OF FOREIGN LAWS AND REGULATIONS AFFECTING INTERNATIONAL FRANCHISING* (American Bar Association 1989) (providing an overview of laws that affect franchising in a number of

clauses and in particular on changes in these over time, we focus more on describing their use and less on their evolution over time. However, non-financial contract terms are also those that franchisors have adjusted at times in response to, or as ways to avoid or reduce, franchisor-franchisee conflict. We therefore discuss their evolution in light of such conflict and legal ramifications.

1. *Mandatory Purchase Requirements*

Table 7 shows the frequency of mandatory purchase requirements¹¹⁵ in business format franchising in 1988 and 1989, the only years for which information on such requirements is available.¹¹⁶ Not surprisingly, the data show that franchisors involved in various types of retailing, including those in the health and fitness sector and food retail, tend to impose such requirements rather frequently. In contrast, franchised chains that sell services, such as those in the business, hotel and motel, rental, and real estate services sectors, typically do not require that franchisees buy any inputs from them.

One study examined the disclosure documents of 100 restaurant and fast-food franchisors to provide more detailed evidence on tying in these sectors.¹¹⁷ Of the 100 chains whose documents were analyzed, thirty imposed a requirement that the franchisee purchase some product from the franchisor.¹¹⁸ Franchisors that used purchase requirements were found disproportionately among the chicken, pizza, sandwiches, seafood and sit-down restaurant chains while very few hamburger and hot dog chains and Mexican restaurants had such requirements.¹¹⁹ Among the thirty firms with purchase requirements, he found that on average the amount of purchases that were required represented about 8.4% of all the wholesale purchases of the franchisees.¹²⁰ Most of the franchisors in the chicken, pizza and seafood

different countries); Jonathan Klick, Bruce Kobayashi & Larry Ribstein, *The Effect of Contract Regulation: the Case of Franchising* (George Mason Law & Economics Research Paper No. 07-03, 2006), available at <http://ssrn.com/abstract=951464> (last visited Mar. 14, 2009) (analyzing the effect of termination laws on the use of these clauses).

¹¹⁵ Such requirements are often termed tying (or tie-in) requirements. The franchise license is sold to a franchisee on the condition that he or she also buys the specified items from the franchisor. The license is the tying good while the required items are the tied goods. See BLAIR & LAFONTAINE, *supra* note †, at 139.

¹¹⁶ *Id.* at 140-41, citing BOND (1989, 1990-91 eds.), *supra* note 69. The data was obtained for 1988 and 1989. As only a subset of the firms in Entrepreneur Magazine's *Franchise 500* – the main source of data for 1988 and 1989 – also appear in the corresponding Bond publication, the sample sizes for this variable are reduced to 643 and 630, respectively.

¹¹⁷ Steven C. Michael, *The Extent, Motivation, and Effect of Tying in Franchise Contracts*, 21 *MANAGERIAL AND DECISION ECON.* 191 (2000).

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

fast-food sectors, however, only imposed requirements for spices, batter, or sauces.¹²¹ Firms with the largest proportions of wholesale purchases subjected to a tie tended to be those that sold some proprietary products, such as batter for pancake houses, bread for sandwich shops (e.g., Subway), or ice cream for family restaurants (e.g., Brigham's and Howard Johnson).¹²²

This result, that franchisors now rarely impose purchase requirements for non-proprietary product, is most likely due to the *Siegel v. Chicken Delight* decision mentioned earlier.¹²³ This decision led to a systematic decrease in the amount of franchisee profit that franchisors could extract via purchase requirements, and a likely corresponding increase in royalty rates, as mentioned above.

TABLE 7: MANDATORY PURCHASE REQUIREMENTS

Sector	1988			1989		
	N	Firms With	Percent	N	Firms With	Percent
Automotive	56	13	23.2	54	14	25.9
Business	96	19	19.8	93	14	15.1
Contractors	18	7	38.9	20	7	35.0
Cosmetic	14	3	21.4	17	4	23.5
Education	8	1	12.5	12	5	41.7
Fast Food	119	51	42.9	112	45	40.2
Health & Fitness	20	11	55.0	12	6	50.0
Home Furnishings	14	4	28.6	14	4	28.6
Hotels & Motels	9	1	11.1	5	1	20.0
Maintenance	45	12	26.7	47	16	34.0
Personal						
Services	52	14	26.9	56	14	25.0
Real Estate	15	1	6.7	17	5	29.4
Recreation	11	4	36.4	11	5	45.5
Rental	15	2	13.3	18	3	16.7
Restaurants	37	16	43.2	39	18	46.2
Retail Food	22	13	59.1	22	12	54.5
Retail Other	92	22	23.9	81	24	29.6
Total	643	194	30.2	630	197	31.3

2. Territorial Protection

A number of franchisors offer exclusive territories to franchisees, that is, they guarantee that they will not open another unit within a certain

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Siegel*, 448 F.2d at 46.

area around the franchisee's business.¹²⁴ Until the United States Supreme Court's decision in *Continental T.V. v. GTE Sylvania Inc.*, such territorial guarantees would have been *per se* illegal under U.S. antitrust laws.¹²⁵ Since then, however, non-price vertical restraints, such as exclusive territories, have been analyzed under the rule of reason.¹²⁶ Table 8, *infra*, shows the frequency with which franchisors in different industries offer an exclusive territory to their franchisees according to the *Profile of Franchising 2000*.¹²⁷ Any form of exclusive territory, described by geography, population, miles, or number of vehicles, is counted as a yes in this table.

Table 8 shows that the majority of franchisors offer some form of territorial protection to their franchisees. Since the industry (or sector) definitions are rather broad, the average frequency of territorial protection surely masks a good deal of within-sector variance. Despite this, Table 8 also shows substantial variation in the use of exclusive territories across industry sectors. In particular, in franchising sectors such as personnel services, franchisees specifically purchase the right to be the sole provider of personnel for businesses that operate in a specified territory. The same tends to be true in education related and service businesses more generally. Thus, most franchisors in those industries include territorial protections in their contracts. But even in mobile businesses, exclusivity is not a given. In one example, a franchisee in the mobile windshield repair industry found that his franchise agreement did not guarantee him any exclusive territory.¹²⁸ At the other extreme, in sectors such as lodging, food, retail, and fast food, there is no explicit territory embedded in the definition of the

¹²⁴ This is common, for example, in the beer industry. Wholesale beer distributors usually are granted exclusive territories that contractually protect them from dual distribution (or non-traditional encroachment) as well as from distributors in adjacent territories. These arrangements have been found to be efficient in the sense of promoting greater sales. See Tim R. Sass & David S. Saurman, *Efficiency Effects of Exclusive Territories: Evidence from the Indiana Beer Market*, 34 *ECON. INQUIRY* 597, 597 (1996); Tim R. Sass & David S. Saurman, *Mandated Exclusive Territories and Economic Efficiency: An Empirical Analysis of the Malt-Beverage Industry*, 36 *J.L. & ECON.* 153, 154 (1993) [hereinafter Sass & Saurman, *Mandated Exclusive Territories*].

¹²⁵ *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 58 (1977).

¹²⁶ See The Petroleum Marketing Practices Act, 15 U.S.C. §§ 2801-2806 (2007) at the federal level (pertaining to special industry state laws in automotive and liquor distribution provide territorial protection to dealers); Richard L. Smith II, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 *J.L. & ECON.* 125 (1982) (citing evidence that the resulting territorial exclusivity for car dealers has led to higher car prices and lower service, namely fewer hours of operation, for customers). See also Sass & Saurman, *Mandated Exclusive Territories*, *supra* note 124, at 154 (showing that territorial exclusivity has pro-competitive consequences in the beer industry).

¹²⁷ *PROFILE OF FRANCHISING 2000*, *supra* note 77, at 185.

¹²⁸ Lee H. Murphy, *Close Quarters Irrk Franchisees*, *CRAIN'S CHICAGO BUSINESS*, June 12, 2000, at SB8.

business, and a larger proportion of franchisors choose not to offer any exclusive territory.

TABLE 8: EXCLUSIVE TERRITORIES

Sector	Number of Franchisors	Number with Exclusive Territories	%
Automotive	93	67	72
Baked Goods	29	20	69
Building & Construction	80	71	89
Business Services	64	46	72
Children Products and Services	33	29	88
Education Products and Services	19	17	89
Fast Food	219	151	69
Lodging	60	21	35
Maintenance Services	90	62	69
Personnel Services	33	31	94
Printing	18	14	78
Real Estate	36	21	58
Restaurants	106	83	78
Retail Food	57	28	49
Retail Non-food	139	97	70
Service Businesses	109	87	80
Sports and Recreation	30	27	90
Travel	11	2	18
Total	1226	874	71

Source: PROFILE OF FRANCHISING, 2000, *supra* note 77, at 184. Exclusive territories are defined as per item 12 of UFOC. Any territory, described by geography, population, miles, or number of vehicles counts as a yes. No means territory is limited to the store.

It is undeniable that exclusive territories provide some security to franchisees, or at least communicates to them more clearly how the franchisor's future plans may affect them. It is perhaps not surprising then that Azoulay and Shane find that a contractual guarantee of an exclusive territory significantly increases the likelihood that new franchised chains survive beyond their first few years in business.¹²⁹ They interpret their finding to mean that territorial protection is so important to franchisees that

¹²⁹ Pierre Azoulay & Scott Shane, *Entrepreneurs, Contracts, and the Failure of Young Firms*, 47 MGMT. SCI. 337, 337 (2001).

those franchisors that fail to offer such protection from encroachment¹³⁰ are unable to attract franchisees, which then leads to their failure.¹³¹

In a 1993 study of territorial restrictions described in chains' disclosure documents, the FRANData Corp. found that only twenty-six of the largest fifty restaurant franchisors offered some territorial exclusivity.¹³² This is much lower than the 80% reported for the sit-down restaurant industry in Table 8, and still lower than the 69% reported for the fast-food industry.¹³³ In contrast, for a set of 170 new franchisors from a variety of business sectors, Azoulay and Shane found 83.5% offering exclusive territories as compared to an overall rate of 73% in Table 8.¹³⁴ Together, these data imply that larger franchisors, for whom claims of encroachment are more likely to be an issue, yet have a lower tendency than average to offer territorial protection. New franchisors, in contrast, offer protections more often than average, potentially to counteract the likely negative effect of their newness and small size on franchisee recruiting. Anecdotal evidence further supports this conclusion: while Ray Kroc offered territories to early McDonald's franchisees, he reduced the size of the territories over time and then eliminated them entirely by 1969.¹³⁵

The desire to maintain flexibility in developing a franchised system is the main reason franchisors give for not granting exclusive territories to franchisees.¹³⁶ But the need for flexibility as the market grows is not the only source of encroachment friction. Azoulay and Shane report that the main concern of franchisors that did not offer exclusive territories was that "exclusivity would allow franchisees to hold them up through underdevelopment."¹³⁷ They cite the rationale of one franchisor: "If they (franchisees) can't afford new stores and they don't operate well, they will slow down our growth if we can't put someone else in the area."¹³⁸ In other words, development may be postponed due to liquidity constraints or, even worse, because a particular franchisee is not talented or ambitious enough

¹³⁰ Encroachment occurs when a new unit of the same chain is located "too close" to an incumbent unit. "Too close," in turn, means that the incumbent's business is impaired. For a thorough analysis of encroachment issues in franchising see BLAIR & LAFONTAINE, *supra* note †, at Chapter 8.

¹³¹ Azoulay & Shane, *supra* note 129, at 355.

¹³² FRANData Corp. study cited in *Encroachment Issues in the Restaurant Industry*, FRANCHISE UPDATE, (2nd Quarter 1994), at 14.

¹³³ Table 8, *supra*.

¹³⁴ See Azoulay & Shane, *supra* note 129, at 344.

¹³⁵ JOHN F. LOVE, MCDONALD'S: BEHIND THE ARCHES 274 (1986).

¹³⁶ See, e.g., Frank Mathewson & Ralph Winter, *Territorial Restrictions in Franchise Contracts*, 32 ECON. INQUIRY 181, 192 (1994) (model emphasizing the role of exclusive territories in determining the starting point of future renegotiation processes in franchise relationships).

¹³⁷ Azoulay & Shane, *supra* note 129, at 353.

¹³⁸ *Id.*

to operate more stores. Such concerns clearly make it harder for franchisors to provide guarantees at the start of the franchise relationship. The problem, however, is not insurmountable. In particular, grants of exclusive territories can be made contingent upon some objective measures of franchisee performance. This is fairly common, for example, in master franchise agreements—these contracts not only provide territorial guarantees to the franchisee, they also stipulate a development schedule within the territory in question. Thus, the franchisor evaluates the franchisee's performance using the number of outlets opened as the performance measure, and the territorial guarantee is predicated on this number reaching specific target values over time. The drawback of course is that these targets may be unrealistic thereby causing the master franchise agreement to fail.¹³⁹ A more flexible approach would involve more regular assessment of the market and its potential. In any case, franchisors should state explicitly what they consider to be reasonable sales and profit levels per outlet, and franchisees should know that new outlets will be added when outlet sales in the region go above these levels.¹⁴⁰ These types of safeguards for franchisors and franchisees go much beyond the simple grant of a territory and are more closely aligned with other types of practices that franchisors currently use to minimize tension over geographic and other forms of expansion.

3. *Clauses Relating to Non-Traditional Encroachment*

In its study of the fifty largest fast-food franchisors in the United States, FRANdata Corp. found that twenty-six offered exclusive territories.¹⁴¹ These twenty-six, however, all reserved some rights to themselves, even within the franchisee's territory.¹⁴² Most common were franchisor rights to develop franchises under different trade names (eighteen of the twenty-six franchisors) and the right to develop institutional locations, such as those in stadiums, hospitals, airports, etc. (nine of the twenty-six franchisors).¹⁴³ Further, among the full set of fifty franchisors, thirty-one explicitly reserved the right to sell their products through alternative channels.¹⁴⁴

¹³⁹ See Arturs Kalnins, *Overestimation and Venture Survival: An Empirical Analysis of Development Commitments in International Master Franchising Ventures*, 14 J. ECON. & MGMT. STRATEGY 933, (2005) (attributing the frequency of failure of master franchise agreements in international markets to development schedules that are too aggressive.).

¹⁴⁰ Of course, franchisors again will need to be wary of franchisees providing low effort to keep their outlet sales below the level that will lead the franchisor to want more outlets.

¹⁴¹ FRANdata Corp, *supra* note 132, at 14.

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.*

These different rights that franchisors embed in their contracts make it clear that they feel a need to reserve for themselves the right to respond to new market opportunities or challenges as they see fit. This is because a franchised chain's long-term survival and growth is intrinsically tied to the franchisor's market strategy as well as its capacity to adapt to changing circumstances. But franchisees may not benefit at all from the resulting changes and, if they do, they may not benefit equally. For example, when Popeye's acquired Church's Fried Chicken, some Popeye's franchisees sued their franchisor, America's Favorite Chicken Co., because the new strategy of the firm was to specialize the two chains: Popeye's for quality and Church's for value.¹⁴⁵ The plaintiff Popeye's franchisees were in markets where they believed a value strategy like that of Church's would be more profitable.¹⁴⁶ The court found for the franchisor, however, as the terms of the contract were quite clear: the franchisor could run outlets under different marks in the franchisee's territory.¹⁴⁷ Moreover, the court noted that the franchisor believed its strategy was best for the two chains and said that even if America's Favorite Chicken's "marketing strategy for the Popeye's system ha[d] made [the franchisee] less competitive" in his market, it did not constitute bad faith.¹⁴⁸

Claims of non-traditional encroachment, however, do not arise only in merger situations. They can come up any time franchisors react to market opportunities in ways that either do not benefit, or directly impinge, on their franchisees' businesses. Examples have included franchisors that: (1) use alternative channels such as supermarkets or the internet; (2) serve national accounts or business customers directly without resorting to franchisees; (3) establish outlets in non-traditional settings; or (4) operate competing brands obtained through acquisition or internal development. In all cases, franchisees worry about losing business to these alternatives while franchisors argue that the increased visibility of the brand brings additional customers and prevents competing brands from entering into the same markets. When the same franchisor develops competing brands, the franchisor usually relies on arguments of efficiency, or may argue that the offerings of the different franchise concepts target different market segments and thus complement one another. Whether the development of these alternative channels and other brand development activities turn out to be good or bad for an individual outlet, or even the chain, will again depend on the specific market situation and the way in which the franchisor organizes these activities.

The precedents established in legal disputes over geographic encroachment generally apply to non-traditional encroachment. Specifically, the courts have ruled that where a franchisor has expressly

¹⁴⁵ Clark v. America's Favorite Chicken Co., 110 F.3d 295 (5th Cir. 1997).

¹⁴⁶ *Id.* at 296.

¹⁴⁷ *Id.* at 297-99.

¹⁴⁸ *Id.* at 298-99.

reserved in the contract the right to distribute its product through alternative channels, the provision is enforceable. For example, in the land-mark *Häagen-Dazs* cases, franchisees sued after Pillsbury decided to start mass distribution of its ice cream via supermarkets.¹⁴⁹ The franchise agreement, however, provided that “the Haagen-Dazs trademark owner [i.e. Pillsbury] has the right and may distribute products identified by the Haagen-Dazs trademarks through not only Haagen-Dazs shops but through any other distribution method which may from time to time be established.”¹⁵⁰ Given the specific terms of this agreement, the court found in favor of Pillsbury. Similarly, in the case of *America’s Favorite Chicken Co.*, *supra*, the court ruled for the franchisor given that the franchise agreement explicitly reserved the right of the franchisor to compete with its franchisees under different marks.¹⁵¹

The advent of the internet raises a number of new opportunities for both franchisors and franchisees. The effects of this new way of reaching customers in some segments of the retail and service industries, such as travel services and accounting services, are yet to be fully understood. Two recent arbitration decisions reemphasize how the language of the contract is paramount in determining the respective rights and duties of franchisors and franchisees. In *Emporium Drug Mart Inc. v. Drug Emporium Inc. of Denton*, an arbitration panel decided that an online drug store was in fact an actual drug store, and that its operations encroached on the exclusive territories granted to franchisees in the franchise agreement.¹⁵² Similarly, an arbitration panel found that H&R Block franchisees were harmed by the company’s new internet tax preparation activities, and given their contractual right to an exclusive territory, the franchisees may have claims for damages against H&R Block.¹⁵³

As in the case of traditional encroachment, many franchisors have also instituted programs where internet sales are made through local franchisee-owned shops or other mechanisms in which franchisees share in the revenues or profits generated.¹⁵⁴ In fact, the arbitration panel in *Drug Emporium* ordered the franchisor to direct customers to local stores instead

¹⁴⁹ See *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, (D. Minn. 1989) and *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146 (S.D.N.Y. 1989).

¹⁵⁰ *Carlock*, 719 F. Supp. at 802-03.

¹⁵¹ *Clark*, 110 F.3d at 297. For more on the issues raised by mergers or acquisitions in the context of franchising, see, e.g., AMERICAN BAR ASSOCIATION, *MERGERS & ACQUISITIONS OF FRANCHISE COMPANIES* (Leonard D. Vines ed.) (1996).

¹⁵² *Emporium Drug Mart Inc. v. Drug Emporium Inc. of Denton*, No. 71 114 00126 00 (Am. Arbitration Assoc., Dallas, Texas, Sept. 2, 2000).

¹⁵³ PRESS RELEASE, GOLDSTEIN LAW GROUP, ARBITRATION PANEL FINDS THAT BLOCK FRANCHISEES HARMED BY BLOCK’S INTERNET TAX PREPARATION ACTIVITIES MAY HAVE CLAIMS FOR DAMAGES AGAINST BLOCK (January 15, 2003), available at <http://www.goldlawgroup.com/files/new-block-press-release-1-15-03.pdf>.

¹⁵⁴ BLAIR & LAFONTAINE, *supra* note †, at 233.

of shipping directly to those respective customers living in franchisees' exclusive territories.¹⁵⁵

Above all, whether for internet sales or for other channels, the decisions above again point to the importance of explicit language covering every alternative channel in franchise agreements so that both parties are clear as to what is permitted and what is not.

4. *Advertising and Promotion*

As described in Section III, most franchisors today require that franchisees contribute a proportion of their sales towards advertising expenses. Interestingly, the reliance on separate advertising fees was not always so popular. In 1980, the majority of franchisors charged neither sales-based nor fixed advertising fees.¹⁵⁶ This change towards more frequent usage of explicit advertising fees in franchise contracts today seems to reflect in part, a form of contract evolution; whereas franchisors used to specify royalties only and use some of the royalty revenues for advertising purposes, the majority of them now explicitly separate the royalty and the advertising requirements. James A. Brickley surmises that the increased reliance on separate fees may be a response to a franchisor moral hazard¹⁵⁷ problem in that franchisors may have an incentive to use funds for unrelated purposes if they are not slated specifically for advertising.¹⁵⁸ Indeed, as he points out, some franchise contracts specify that moneys collected via the advertising fee cannot be commingled with other funds.¹⁵⁹ Yet even such efforts to separate the funds may not resolve franchisor opportunism problems. In their respective studies, Kabir C. Sen, Robert Stassen and Robert Mittelstaedt, and Francine Lafontaine and Kathryn L. Shaw all examine the relationship between advertising fees and actual advertising expenditures.¹⁶⁰ These authors find only a weak positive or no correlation between the two. Of course, advertising outlays need not

¹⁵⁵ Before the order was even implemented, Drug Emporium sold its web site to HealthCentral.com. Shortly thereafter, it underwent a bankruptcy restructuring and was acquired by another drug store chain.

¹⁵⁶ See Table 6, *supra*,

¹⁵⁷ Moral hazard generally refers to situations where a more informed person takes advantage of a less informed person by taking some unobserved action that is different from what the uninformed party would have preferred. See, e.g., JEFFREY M. PERLOFF, MICROECONOMICS 637 (4th ed. 2007). In the present case, the assumption is that the franchisor has an informational advantage over its franchisees.

¹⁵⁸ James A. Brickley, *Incentive Conflicts and Contractual Restraints: Evidence from Franchising*, 42 J.L. & ECON. 745 (1999). Brickley, however, mostly views these fees as a constraint on franchisee behavior, which he argues and finds empirically are related to the extent of sales externalities among outlets; that is, chains with more externality problems (more non-repeat business) must impose such requirement more often.

¹⁵⁹ *Id.* at 751, n.15.

¹⁶⁰ Sen, *supra* note 104; Stassen & Mittelstaedt, *supra* note 100; Francine Lafontaine & Kathryn L. Shaw, *Targeting Managerial Control: Evidence from Franchising*, 36 RAND J. ECON. 131 (2005).

be contemporaneous with the collection of fees. These studies have tried to account for this factor by looking at advertising expenditures over long periods, between five and ten years. Moreover, some of the funds may be spent on regional or local advertising or promotional efforts not captured in the data the authors rely upon. Finally, for many franchisors, especially those with low or no fees, advertising outlays need not be limited by the amount of fees collected specifically for this purpose. Thus, it is perhaps not surprising that there is little correlation between estimated outlays and percentage fees.

There is much variance in the way franchisors specify their advertising requirement; how they divide it among national, regional, and local expenditures; and what the franchisor exactly commits to. Some franchisors establish an advertising fund while others do not. In its franchise contract, Bruegger's Bagels, for example, requires that:

Franchisee shall contribute weekly to the advertising Fund established by Franchisor for the System two percent (2%) of the Gross Sales of the Franchised Bakery.

....

In addition to its contribution to the Fund, Franchisee shall spend monthly for local advertising and promotion two percent (2%) of the Gross Sales of the Franchised Bakery.

....

Franchisee acknowledges that the Fund and any earnings thereon will be used to maximize general public recognition, acceptance, and patronage of BRUEGGER'S Bakeries, and that Franchisor is not obligated, in administering the Fund, to make expenditures for Franchisee which are equivalent or proportional to Franchisee's contribution, or to ensure that any particular franchisee benefits directly or pro rata from expenditures by the Fund. Franchisee acknowledges that its failure to derive any such benefit will not serve as a basis for a reduction or elimination of its obligation to contribute to the Fund.¹⁶¹

This language makes it clear that the franchisee must pay 2% of gross sales for national advertising and that it is up to the franchisor to decide how best to expend these funds. By acknowledging the uncertain benefits to be derived from this advertising, each franchisee agrees that he may be paying more than the advertising is worth to them. Based on the plain language of the contract, the franchisee surrenders any right to

¹⁶¹ Bruegger's Bagels New Bakery Franchise Agreement, as incorporated in its 2000 Disclosure Document cited by BLAIR & LAFONTAINE, *supra* note †, at 251.

complain about the quality or geographic allocation of the franchisor's promotional efforts.

McDonald's, of course, also recognizes the value of advertising and demands that its franchisees spend a significant sum on this activity.¹⁶² In 1990, the McDonald's franchise system spent approximately \$80-90 million to produce television and radio commercials and \$245 million to purchase national media time—mostly on network television.¹⁶³ Advertising on the national, as well as the local level, is organized by cooperatives.¹⁶⁴ Each franchisee member of the national cooperative must pledge the same contribution rate (1.65% in 2003).¹⁶⁵ Local cooperatives are formed by restaurant owners in various geographic locations who join together and decide on local promotions and advertising campaigns. In 1990, these cooperatives spent approximately \$190 million on advertising, most of which was spent on local television time.¹⁶⁶ The franchise contract stipulates that franchisees must spend at least 4% of their sales revenue in total on advertising:

McDonald's employs both public relations and advertising specialists who formulate and carry out national and local advertising programs for the McDonald's System. Franchisee shall use only advertising and promotional materials and programs provided by McDonald's or approved in advance, in writing, by McDonald's [. . .] Franchisee shall expend during each calendar year for advertising and promotion of the Restaurant to the general public an amount which is not less than four percent (4%) of Gross Sales [. . .] for such year. Expenditures by Franchisee to national and regional cooperative advertising and promotion of the McDonald's System, or to a group of McDonald's restaurants which includes the Restaurant, shall be a credit against the required minimum expenditures for advertising and promotion to the general public.¹⁶⁷

Thus, McDonald's controls the quality of the advertising and the minimum amount that each franchisee must spend. Note, however, that

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ McDonald's Uniform Franchise Offering Circular [hereinafter McDonald's Circular], 2003, at 63.

¹⁶⁵ *Id.* at 64.

¹⁶⁶ See Testimony of David B. Green, McDonald's Senior Vice President for Marketing, (June 5, 1993), available at <http://www.mcspotlight.org/people/witnesses/advertising/green.html> (last visited Mar. 14, 2009).

¹⁶⁷ McDonald's Circular, *supra* note 164, at 106.

none of the advertising moneys are paid to McDonald's corporation. Instead, the funds are administered directly by the advertising cooperatives and are subsequently independently audited. The franchisee has the freedom to participate in these cooperative advertising efforts with other franchisees, but he or she cannot choose to expend less than the 4% stated in his or her franchise agreement on advertising and promotion. In practice, however, franchisees who want to be considered for additional units or even contract renewal are expected to participate consistently in the national and local cooperatives. Company-owned restaurants may also elect to be members of these cooperatives.

A number of franchisors also establish programs that allow them to share some of the cost that franchisees incur for local or regional advertising. Specifically, according to Dant and Berger, almost 75% of franchisors in the auto products and services industry, and 86% of the franchisors in the fast-food industry, engage in some form of cooperative advertising program with their franchisees.¹⁶⁸

Finally, franchisors leave themselves substantial leeway to make changes over time in their contracts when it comes to advertising contributions. For example, Stassen and Mittlestaedt report that in its 10-K report, Wendy's states "the Company may increase the total advertising and promotions contribution to 5% ... if such increase is approved by an affirmative vote representing 75% or more of all domestic Wendy's restaurants."¹⁶⁹ Though the contribution to the national advertising fund was 1.5% through 1999 at Applebee's, the 10-K report for that year stated "the required contribution to the national advertising fund will increase to 2.1% of gross sales in 2000, and may increase from 2.1% to a maximum of 2.5% in 2001. Beginning in 2002, the required contribution will be 2.5% of gross sales."¹⁷⁰ Furthermore, "[t]he Company can increase the combined amount of the advertising fee and the amount required to be spent on local advertising and promotional activities to a maximum of 5% of gross sales."¹⁷¹ Of course, raising the amount that franchisees must devote to advertising at any point in time is likely to cause some conflict in a franchise system.

5. Contract Duration

In their survey of franchisors, IFA and the FRANData Corp. found that the average duration for franchise contracts is 10.3 years.¹⁷² Table 9, *infra*, shows the mean duration of the initial contract and its standard deviation across sectors in the first and last year for which we have duration

¹⁶⁸ Rajiv P. Dant & Paul D. Berger, *Modeling Cooperative Advertising Decisions in Franchising*, 47 J. OPERATIONAL RES. SOC'Y 1120, 1122 (1996).

¹⁶⁹ Stassen & Mittlestaedt, *supra* note 100, at 10.

¹⁷⁰ *Id.* at 10.

¹⁷¹ *Id.*

¹⁷² PROFILE OF FRANCHISING 2000, *supra* note 77, at 116.

information in our data, namely 1993 and 2001. This table shows that our data exhibits a very similar duration on average to what was found in the IFA sample, and that the mean duration of the contract has remained about the same over time as well.

In addition, Table 9, *infra*, illustrates the substantial variation in the duration of these contracts across sectors. For example, the average contract length in the sit-down restaurant industry is 14-plus years, which is twice as long as in the real estate sector. Moreover, contract length varies more within some sectors than others, as indicated by the differences in the standard deviation of contract duration across these sectors. Thus, different franchisors offer contracts of substantially different lengths in the recreation sector; the standard deviation of contract length in this industry is almost as large as the mean contract duration. On the other hand, for franchisors in the contractor and rental sectors, the standard deviation is only three or four years around a mean duration of roughly nine years. The data also suggest that there has not been any trend toward shorter or longer contracts on average in franchising, within sectors or over time, except perhaps in the Hotel and Motel sector. Finally, Table 9 includes information on the number of firms in our data in each of the two years covered in the table, and it documents the low frequency with which franchisors choose to rely on an infinite or indefinite contract duration.

It is important to realize that these average durations hide some interesting, discrete patterns in the data. Specifically, contract length mostly varies in 5-year increments.¹⁷³ In 2001, 20% of the franchisors in our data offered 5-year contracts, 53% used 10-year contracts, 7% offered 15-year contracts, and 14% percent relied on 20-year contracts. Thus, 94% of all franchise contracts offered in 2001 fell within one of these four durations. The corresponding total in 1993, and the proportions of franchisors offering the different length contracts, are all very similar to their 2001 counterparts.

Looking at this from the perspective of franchised outlets and weighing the contract duration of each franchisor by the number of franchised units they have, the discrete patterns remain. The 1158 franchisors in the data in 2001 operated a total of 329,803 franchised units.¹⁷⁴ Of these units, 91% were under a 5, 10, 15, or 20-year contract. The proportion of contracts for each duration, however, are quite different. Specifically, the proportion of 20-year contracts is much higher—37%—while the others are smaller: the proportions of 5, 10, and 15-year contracts

¹⁷³ See James A. Brickley et al., *Contract Duration: Evidence from Franchising*, 49 J.L. & Econ. 173 (2006).

¹⁷⁴ This total represents the number of franchised units of these chains that year, not their total number of units. According to KOSTECKA, *supra* note 16, at 40, business format franchised chains operated a total of 246,664 franchised units in 1986. Thus while our data does not include all franchisors in 2001, it undoubtedly includes the vast majority of franchised outlets.

are 13, 37, and 4%, respectively. In other words, the data imply that larger franchisors tend to offer 20-year contracts much more frequently than the overall population of franchisors does, while franchisors with fewer franchised outlets rely more on contracts of shorter duration. These same patterns were found also in the 1993 data.

TABLE 9: INITIAL FRANCHISE CONTRACT DURATION, PER SECTOR

	1993				2001			
	Number of Obs.	Mean	Standard Deviation	#infinite, indefinite	Number of Obs.	Mean	Standard Deviation	#infinite, indefinite
Automotive	70	12.2	4.9	1	76	12.6	5.2	3
Business	132	11.0	6.7	6	118	11.0	6.4	4
Contractors	39	8.3	3.6	1	52	8.8	2.9	0
Cosmetic	27	9.9	3.8	1	22	9.5	3.2	1
Education	27	8.0	3.7	0	39	8.3	3.4	0
Fast Food	212	12.1	4.6	3	229	12.3	4.9	2
Health & Fitness	31	8.8	3.7	1	27	9.0	3.9	1
Home Furnishings	24	10.0	6.4	0	25	9.1	3.9	0
Hotels & Motels	22	12.9	6.2	0	19	16.7	5.2	0
Maintenance	76	9.4	5.2	0	98	9.7	4.7	3
Personal Services	88	9.3	4.1	2	86	9.1	4.1	3
Real Estate	22	7.9	4.0	1	35	7.1	2.7	0
Recreation	18	10.3	9.1	1	18	10.4	8.2	2
Rental	26	9.6	3.4	0	26	8.6	3.6	2
Restaurants	70	14.0	4.7	0	70	14.7	4.7	0
Retail Food	40	8.9	2.4	3	42	9.6	3.9	1
Retail Other	128	9.5	4.5	2	129	9.5	3.6	1
Total	1,052	10.6		22	1,111	10.7		23

James A. Brickley, Sanjog Misra, and R. Lawrence Van Horn analyze the factors that affect the duration of initial franchise contracts.¹⁷⁵ Consistent with our comparison of duration at the franchised unit level versus franchisor level, these authors find that larger chains and franchisors with more years of experience tend to use longer-term contracts.¹⁷⁶ And although firms rarely change the duration of their contracts, the authors find some tendency toward longer-term contracts over time within firms.¹⁷⁷ Finally, they show that contract duration is positively related to the amount of physical and human investment (weeks of training) that franchisees must make in the business.¹⁷⁸

6. *Renewal and Termination*

Franchise contracts usually stipulate an option to renew along with the duration of the potential renewal period(s).¹⁷⁹ In their survey of franchise contracting practices, IFA and the FRANdata Corp. found that 91% of franchise contracts included an option to renew, and that the renewal period lasted for an average of 8.2 years.¹⁸⁰

While most franchisors offer franchisees an opportunity to renew their contracts, what matters to franchisees is the likelihood that their contract will indeed be renewed. This probability not only affects the profits they themselves can expect to earn from their franchise, it also affects the resale value of their franchise. Although the USDOC does not report renewal and termination rates in traditional franchising, it does show that renewal was the norm at the time at least for business-format franchising.¹⁸¹ Of the 12,999 agreements up for renewal in 1986, 12,073, or 93% were renewed.¹⁸² Of the 926 that were not, 359 were cases where the franchisee did not want a new contract; 374 were cases of mutual agreement not to renew; and 193 were cases where franchisors refused to renew.¹⁸³ Contract terminations are more common: 3075 agreements were terminated by franchisors in 1986, while 3914 were terminated by franchisees, and another 372 franchises were terminated by mutual agreement.¹⁸⁴ According to the same source, these 7361 terminations correspond to a 3% termination rate in 1986, given the 246,664 franchised outlets in operation. The USDOC further documents that more than half of the terminations instigated by franchisors were due to franchisee non-

¹⁷⁵ Brickley et al., *supra* note 173.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ For a more complete overview of renewals and terminations and the conflict that may result, see BLAIR & LAFONTAINE, *supra* note †, at Chapter 10.

¹⁸⁰ PROFILE OF FRANCHISING 2000, *supra* note 77, at 110, 116.

¹⁸¹ KOSTECKA, *supra* note 16, at 53.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

payment of fees or financial default.¹⁸⁵ Moreover, franchisors approved all but ninety-four of the 4202 requests for ownership transfers—bequests or sales of the franchise to new owners—that they received from franchisees in 1986.¹⁸⁶

Darrel L. Williams used the Characteristics of Business Owners (“CBO”) database compiled by the United States Census Bureau to study termination rates.¹⁸⁷ He found 1001 franchise contracts with full-time owner involvement and at least one employee in 1987 in these data.¹⁸⁸ In this sample, he observed a termination rate of 15.7% over a 4-year period, including terminations instigated by franchisees and franchisors.¹⁸⁹ Consistent with the figures from the USDOC on terminations and ownership transfers, Williams further found that slightly more than 50% of the franchise contract terminations in his data were motivated by the desire of the franchisor or franchisee, to transfer ownership to another franchisee.¹⁹⁰ One-third of all contract terminations resulted in the outlet being closed.¹⁹¹ Most importantly, the types of outlets that were most subject to termination were the underperformers, suggesting that franchisors use termination to enforce performance standards or eliminate poor locations.¹⁹²

In sum, the data show that franchise contracts usually are quite long term, with a very high tendency for the relationship to continue beyond the original term. When they do not continue beyond that point, it is often at the request of the franchisee that the relationship is terminated. Evidence suggests further that contract termination by franchisors serves a disciplining, or enforcement, role in these relationships, rather than being a manifestation of opportunistic behavior on the part of the franchisors.

VI. CONCLUSION

Franchising is not an industry, but a form of business organization used by a variety of firms involved in various types of retail and small-scale service industries. This form of organization usually entails the use of sales-based royalties and franchise fees, along with exclusive marks. But beyond these similarities, we also find a great deal of variety in the contracting practices of different franchisors. This is not surprising given

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ Darrell L. Williams, *Franchise Contract Termination: Is there Evidence of Franchisor Abuse?* in TENTH ANNUAL PROCEEDINGS OF THE INTERNATIONAL SOCIETY OF FRANCHISING (Ann Dugan, ed.) (1996).

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.*

the different business activities of franchised firms, and the specific challenges that individual firms in these sectors face. Thus, our first goal in this paper was to describe the variety of contracting practices across franchising firms, and relate it, at least partly, to the different types of business activities in which these firms were engaged.

Our second goal was to show how franchise contract terms also can change over time. Individual franchisors regularly try new business and contract practices, either because their business plan calls for a different approach from those used to date, or because they simply thought of something different they could try to do. At times, they also modify their contracts in response to some external factors—including changes in regulatory environment and new market opportunities—which affect how they can or want to do business. On the regulatory front, for example, the *Chicken Delight* decision, *supra*, led to a systematic increase in sales-based royalties throughout franchising. We also have seen a trend towards explicitly separating royalty rates and advertising fees over the last two decades. Disputes over territorial rights in the quick-service restaurant sector and in hotel chains have led many of the firms in these industries to include much more detailed territory definitions in their contracts. They have also led franchisors to develop more systematic review processes for new sites and policies for allocating new units to owners of close-by outlets, thereby resolving at least part of the conflict. In industries where encroachment via alternative channels has been more problematic (e.g., sales through supermarkets or via the internet), some franchisors have worked on ways to channel part of the sales or profits to the local franchisee while others have opted to stay out of the alternative channels.

Experimentation is part and parcel of the evolution of any mode of organization, and franchising is no exception. This is especially true because franchising in reality is not just one form of organization, but rather a whole spectrum of possibilities, from fairly simple licensed distributorships to complete turn-key businesses where franchisees receive detailed and regularly updated operations guidelines. Presumably, what works well in each system is retained and refined; what does not work well is discarded. Moreover, franchisors continuously face new challenges and opportunities.¹⁹³ Those that best respond to these challenges and opportunities remain successful, while many others stop franchising, fail to grow, or go out of business altogether. In other words, franchising is a varied and dynamic phenomenon. Unfortunately, this also makes it

¹⁹³ One contracting issue that we did not address above and that could be of interest relates to the use of resale price maintenance. It does not appear at this point that franchisors have modified their contract much at all in response to the *State Oil Co. v. Khan*, 522 U.S. 3 (1997) decision. Now that the United States Supreme Court has also returned minimum resale prices to the rule of reason in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S.Ct. 2705 (2007), it will be interesting to see if this will generate renewed interest in price controls in franchise contracts in the U.S.

difficult to develop appropriate regulatory regimes to address franchisor-franchisee conflict. Our hope is that a description of these relationships will permit a better assessment of the likely cost and benefit of different types of regulatory interventions across all the different types of industries where franchising exists, or in the future, may be used.