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# How the Cookie Crumbles: The Good Cause Requirement for Terminating a Franchise Agreement

Tracey A. Nicastro

# HOW THE COOKIE CRUMBLES: THE GOOD CAUSE REQUIREMENT FOR TERMINATING A FRANCHISE AGREEMENT

*Uncertainty and ambiguity are the bane of commerce.*[1]

## I. INTRODUCTION

The Illinois Franchise Disclosure Act (IFDA)[2] has been the subject of recent significant litigation.[3] The principle source of controversy has been Section 705/19.[4] This section requires "good cause" for a franchisor to terminate a franchise agreement.[5] This good cause requirement is used in

1. Merrit v. Welsh, 104 U.S. 694, 702 (1881) (Bradley, J.)

2. The Illinois Franchise Disclosure Act is hereinafter referred to as "IFDA." 815 ILL. COMP. STAT. ANN. 705/19 (West 1993).

3. *See* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992). This case will be the springboard for many of the arguments made in this note. Briefly, the facts are as follows: The Sigels owned a Great American franchise called River Valley Cookies, Ltd. The Sigels repeatedly breached the franchise agreement by paying bills late, failing inspections, and underreporting their gross sales which resulted in royalty losses to Great American. Great American terminated the franchise, and the Sigels continued to sell cookies under the franchise name using batter bought elsewhere. Great American sought to enjoin the Sigels from selling the imitation cookies, and the Sigels counterclaimed, charging that their franchise had been terminated in violation of the Illinois Franchise Disclosure Act. The Sigels sought a preliminary injunction against Great American to restore their franchise. The district court granted River Valley's injunction and denied Great American's termination of the franchise, holding that Great American could not show good cause for termination under the IFDA § 705/19. The Seventh Circuit, in an opinion by Judge Posner, reversed the district court and granted Great American's injunction, reasoning that Great American could show good cause.

What is interesting about this particular case are the opposing views presented in the district court opinion and Judge Cudahy's dissent to Posner's opinion. When the case is followed from the magistrate's finding through to the dissent in the appellate court, it becomes apparent that the good cause requirement leaves much room for personal political views in its interpretation.

4. 815 ILL. COMP. STAT. ANN. 705/19 (West 1993). *See River Valley*, 970 F.2d at 279. "As for the Illinois Franchise Disclosure Act, . . . [i]t does require that a franchisor show good cause to terminate a franchise before its expiration . . . ." *Id.*

5. These statutes requiring good cause for termination are hereinafter referred to as "termination laws."

Section 19 of the Illinois Franchise Disclosure Act (IFDA) states:

> §19. Termination of a Franchise. (a) It shall be a violation of this Act for a franchisor to terminate a franchise of a franchised business located in this State prior to the expiration of its term except for "good cause" as provided in subsection (b) or (c) of this Section.
>
> (b) "Good cause" shall include, but not be limited to, the failure of the franchisee to comply with any lawful provisions of the franchise or other agreement and to cure such default after being given notice thereof and a reasonable opportunity to cure such

fifteen states and, because of its ambiguity, poses serious problems.[6] Because of the subjective nature of a good cause standard, the courts have encountered controversy when faced with a franchise termination setting to define exactly what constitutes good cause.[7] This Note will use the IFDA and a recent Illinois case as examples to illustrate the views and problems associated with applying the good cause requirement for franchise termination in those states with the good cause requirement.

The reasons that legislatures have enacted franchise statutes are illustrated in the following hypothetical:

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default, which in no event need be more than 30 days.

(c) "Good cause" shall include, but without the requirement of notice and an opportunity to cure, situations in which the franchisee:

(1) make an assignment for the benefit of creditors or a similar disposition of the assets of the franchise business;

(2) voluntarily abandons the franchise business;

(3) is convicted of a felony or other crime which substantially impairs the good will associated with the franchisor's trademark, service mark, trade name or commercial symbol; or

(4) repeatedly fails to comply with the lawful provisions of the franchise or other agreement.

815 ILL. COMP. STAT. ANN. 705/19 (West 1993).

6. *See* ARK. CODE. ANN. § 4-72-204 (Michie 1991); CAL. BUS & PROF. CODE §§ 20020-20021 (West 1987); CONN. GEN. STAT. § 42-133f (West 1992); DEL. CODE ANN. tit. 6, § 2552 (1993); HAW. REV. STAT. § 482E-6 (1985); 815 ILL. COMP. STAT. ANN. 705/19 (West 1993); IND. CODE ANN. § 23-2-2.7-1 (West 1979); IOWA CODE ANN. § 523H.7 (West Supp. 1993); MICH. COMP. LAWS § 445.1527 (West 1989); MINN. STAT. ANN. § 80C.14 (West Supp. 1992); MISS. CODE ANN. § 75-24-53 (1991) (requiring only a 90-day notice before termination except in specified circumstances such as criminal misconduct, fraud, abandonment, or bankruptcy); MO. ANN. STAT. §§ 407.405 (Vernon 1990); NEB. REV. STAT. § 87-404 (1987); N.J. STAT. ANN. § 56:10-5 (West 1989); VA. CODE ANN. § 13.1-564 (Michie 1993) (requiring "reasonable cause" for termination); WASH. REV. CODE § 19.100.180 (West Supp. 1993); WIS. STAT. ANN. § 135.03 (West 1989) (Wisconsin Fair Dealership Law). *See also* D.C. CODE ANN. § 29-1203 (1991); P.R. LAWS ANN. tit. 10, § 278-278d (Supp. 1990) (requiring "just cause" for termination); V.I. CODE ANN. tit. 12A, § 132 (1982).

7. *See* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992); *see also* P & W Supply Co. v. E.I. DuPont de Nemours & Co., 747 F. Supp. 1262 (N.D. Ill. 1990). In this case, a paint product distributor brought action against manufacturer for violating IFDA requirement of good cause for termination. *Id.* *See also* Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir. 1985). In *Lippo*, the franchisee challenged the company's attempted termination of the franchise under the Petroleum Marketing Practices Act. The court noted that the Petroleum Marketing Practices Act is to be interpreted according to state contract law when applied to franchise agreements. *Id.* at 712.

Illinois common contract law implies covenant of good faith that restricts a franchisor from terminating an agreement without good cause. Dayan v. McDonald's Corp., 466 N.E.2d 958, 973 (Ill. App. Ct. 1984). Interestingly enough, in *Lippo*, Judge Cudahy found that the oil company could not terminate the franchise, while Judge Posner dissented, finding that Mobil had good cause to terminate the franchise. *Lippo*, 776 F.2d at 715-16, 726.

> Alice, a middle class high school graduate, has saved her money and would like to have a business of her own. She decides to buy a cinnamon roll franchise and operates it in the local shopping mall. Her franchise agreement provides that the franchisor may terminate the franchise agreement at will without cause. Alice invests large amounts of time and money into her business, and it shows in the profits. The greedy franchisor, who has been monitoring Alice's profits, decides he wants the profits for himself. The franchisor terminates the franchise agreement and then continues to operate the business himself. Alice has nothing to show for her hard work, and there is nothing she can do because the termination was lawful under the contract.[8]

This story has an unfair, unjust ending. State franchise statutes and the creation of the good cause for termination requirement are designed to eliminate these types of injustices.[9] The problem is that not all terminations result from the opportunism of the franchisor, as Alice's termination did. Other reasons besides greed motivate a franchisor to terminate a franchise.[10] The courts have struggled with the issue of whether these reasons constitute good cause.[11] Obviously, in Alice's case, there was not good cause to terminate the franchise. Unfortunately, most of the cases are not so clear, and this leaves the courts in a dilemma.

There are two views as to how the good cause requirement should be interpreted. The first is the law and economics view, which generally believes these statutes are a futile attempt to redistribute wealth and only result in an increase in franchise costs.[12] The second is the protectionist view, which is concerned with protecting the franchisee.[13] Both of these views have been used by the courts to analyze and interpret the definition of good cause for franchise

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8. This hypothetical was inspired by Kealey Pharmacy v. Walgreen Co., 761 F.2d 345 (7th Cir. 1985). This case is discussed at *infra* notes 136-44 and accompanying text.

9. *See infra* notes 35-44.

10. For example, the franchisee may have materially breached the franchise agreement, putting the franchise tradename in jeopardy. Also, the franchisor may decide to withdraw products from the market for purely economic reasons.

11. *See infra* notes 116-25 and accompanying text.

12. This view is expressed in Judge Posner's opinion in The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992). In general, Posner frowns upon laws that are designed to redistribute wealth. He feels a redistribution cannot be accomplished this way, and by trying to protect the franchisee with this law, it will only result in higher costs to the franchisees because of the onerous terms in the franchise agreement born by the franchisor. *See infra* notes 232-35 and accompanying text.

13. This view is simply that the laws were enacted to protect the franchisee and that they should do just that. Judges with this view are hard pressed to find good cause on the part of the franchisor. *See infra* notes 126-58 and accompanying text.

termination.[14] Ultimately, the cases demonstrate that a judge's political views can greatly affect the interpretation of the good cause clause.

This Note will first review the history and explore the forces behind the enactment of the franchise statutes in Part II.[15] Part III of this Note will focus on the current status of the good cause requirement for termination.[16] Part IV will discuss the resulting problems of the good cause requirement for termination and the two views that have developed in interpreting the good cause clause.[17] Furthermore, Part IV will demonstrate the differing results courts can reach depending on whether they use a protectionist rationale or a law and economics theory as the basis of its interpretation.[18] Part IV concludes by exploring the strengths and weaknesses of applying both the protectionist and law and economic theories to termination laws.[19] Finally, this Note will propose an amendment to the termination laws, which consists of a uniform standard to be applied by the courts when faced with a franchise termination case in Part V.[20] This proposed uniform standard incorporates the strengths of both views to provide the most equitable and efficient outcome in franchise termination cases.

## II. THE DEVELOPMENT OF THE STATE FRANCHISE LAWS

The movement towards the adoption of franchising laws started in the 1970s.[21] In 1971, Delaware and New Jersey were the first states to adopt

14. For an example of both views applied in the same case, see *infra* notes 45-67 and accompanying text (discussing the *River Valley* case).

15. *See infra* notes 21-44 and accompanying text. This note will cover general franchise laws enacted by the states. The reader should be aware that there are other franchise laws applying to specific industries such as petroleum, automobiles, alcoholic beverages, and dealerships. These laws and the cases interpreting them will only be used in this note if they include a good cause for termination standard. For exposure to issues presented in these more specialized areas of franchise law, see John A. Donovan, *Federal Laws Affecting the Rights of a Franchisor to Terminate or Not Renew a Franchise: Automobile Dealers Day in Court Act*, 49 ANTITRUST L.J. 1353 (1980); William R. O'Brien, *Federal Laws Affecting The Right of a Franchisor to Terminate or Not Renew a Franchise: Petroleum Marketing Practices Act*, 49 ANTITRUST L.J. 1371 (1980); J.I. Case Co. v. Early's, Inc., 721 F. Supp. 1082 (E.D. Mo. 1989) (applying the Missouri Dealership Act); American Mart Corp. v. Joseph E. Seagram & Sons, Inc., 824 F.2d 733 (9th Cir. 1987) (applying the Nevada Alcoholic Beverage Franchise Act); Lippo v. Mobil Oil Corp., 776 F.2d 706 (7th Cir. 1985) (applying Petroleum Marketing Practices Act); Scuncio Motors, Inc. v. Subaru of New England, 555 F. Supp. 1121 (D.R.I. 1982) (applying the Rhode Island Dealer's Law and the federal Automobile Dealers' Day in Court Act).

16. *See infra* notes 45-115 and accompanying text.

17. *See infra* notes 116-241 and accompanying text.

18. *See infra* notes 116-241 and accompanying text.

19. *See infra* notes 242-45 and accompanying text.

20. *See infra* part V.

21. James A. Brickley et al., *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 113 (1991) [hereinafter *Economic Effects*].

franchise laws.[22] Since then, fifteen states have enacted similar franchising statutes, each requiring good cause for termination.[23] Iowa is the most recent state to enact such a law.[24] Before this franchise legislation, the courts were left to deal with franchise termination using the "good faith" standards of contract law.[25] Consequently, the legal rules for franchise terminations were viewed as "haphazard" and did not cater to fairness or the needs of the parties.[26]

For example, in *Union Tank Car Co. v. Lindsay Soft Water Corp.*,[27] the dealer agreed to sell the manufacturer's water softeners in exchange for an exclusive franchise agreement.[28] The franchise was terminable by the manufacturer if the dealer failed to meet a purchase quota requirement.[29] The franchisee challenged his franchise termination.[30] The court upheld the termination, and dismissed the franchisee's challenge in one sentence: "Suffice it to say, as above, that [the franchisee] was falling short of its quota requirements and [the franchisor] was well within its right in canceling the franchise agreement."[31]

The court did not consider the effect of either the termination on the franchisee or the manufacturer's motives for terminating the franchise agreement. This case demonstrates how the common law leads to unjust results when applied to franchise terminations. The common law fails to recognize that a franchise agreement is a long-term relationship, which requires more consideration than a typical single-transaction contract.

As a result of the unfairness of a contract based rule, laws such as the

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22. *Id.*

23. *Id.* These states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Michigan, Minnesota, Nebraska, Virginia, Washington, and Wisconsin. *See supra* note 6 for the statutes.

24. Iowa enacted its statute in 1992. IOWA CODE ANN. § 523H.7 (West Supp. 1993)

25. *See, e.g.*, Smoky Mountains Beverage Co. v. Anheuser-Busch, Inc., 182 F. Supp. 326 (E.D. Tenn. 1960); Green Bay Auto Distribs., Inc. v. Willys-Overland Motors, Inc., 102 F. Supp. 151 (N.D. Ohio 1951), *aff'd*, 202 F.2d 151 (6th Cir. 1953); Anheuser-Busch, Inc. v. Jefferson Distrib. Co., 353 F.2d 956 (5th Cir. 1965); Bruno v. Pepperidge Farm, Inc., 256 F. Supp. 865 (E.D. Pa. 1966).

26. Ernest Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465, 469 [hereinafter *Limitations*].

27. 257 F. Supp. 510 (D. Neb. 1966).

28. *Id.* at 512. The Lindsay dealer was given an exclusive right to sell Lindsay products in Omaha, Nebraska, and was also allowed to display and advertise the registered name of Lindsay.

29. *Id.* at 513.

30. Union Tank Car Co. v. Lindsay Soft Water Corp., 257 F. Supp. 510, 515 (D. Neb. 1966).

31. *Id.*

Automobile Dealers' Day-in-Court Act[32] came into being. However, such laws do not apply to franchises in general.[33] Because of the unequal bargaining power between the franchisee and franchisor, contract language usually favored the franchisor as to the terms for franchise termination. Legislators, who were influenced by franchisees, feared that the franchisors would take advantage of unsophisticated franchisees.[34] Specifically, with the problem of termination similar to the previous hypothetical,[35] franchisees feared that once they spent large amounts of money and established a good business, the franchisor would terminate their agreement, take the business, and reap the profits, while the franchisee incurred substantial losses.[36] The disproportionate bargaining power held by franchisors permits these fears to materialize into one-sided franchise agreements that benefit only the franchisor.

In reaction to the problem of unequal bargaining power, fifteen states adopted the good cause requirement for termination.[37] Presumably, the rule came into being because of political pressure. The National Franchisee Association Coalition (NFAC),[38] which represents a variety of industries, particularly the food industry, lobbied state legislatures for the franchise legislation.[39] Opposing the NFAC was the International Franchise Association (IFA),[40] representing the franchisors.[41] The IFA opposed the legislation because it limited the franchisors' freedom of contract.[42] The IFA argued that it "would be difficult at best" to document good cause for the marginal franchise.[43] Also, the IFA argued that the good cause requirement would in effect give the franchisee a perpetual contract and would make it almost impossible for franchisors to control the quality of franchise products.[44]

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32. 15 U.S.C. §§ 1221-25 (1964). This is a federal law which was enacted to protect the interests of automobile dealers.

33. *Limitations, supra* note 26, at 470.

34. *See* Westfield Centre Service, Inc. v. Cities Service Oil Co., 386 A.2d 448 (N.J. 1978). The *Westfield* court, searching for the legislative intent behind the New Jersey Franchise Practices Act, stated, "Where the legitimate economic interests of the franchisor and franchisee are at variance with one another, the franchisor with its grossly disproportionate bargaining power will virtually always prevail." *Id.* at 459.

35. *See supra* note 8 and accompanying text.

36. *Limitations, supra* note 26, at 466-67.

37. *Economic Effects, supra* note 21, at 115. *See supra* note 6 for the state statutes.

38. The National Franchisee Association Coalition is hereinafter referred to as the "NFAC." NFAC is a voluntary organization comprised of franchisees.

39. *Economic Effects, supra* note 21, at 115.

40. The International Franchise Association is hereinafter referred to as the "IFA." The IFA is a voluntary organization comprised of franchisors.

41. *Economic Effects, supra* note 21, at 116.

42. *Id.*

43. *Id.*

44. *Id.* (citing International Franchise Association, Seventh Annual Legal and Government Affairs Symposium—Official Transcript 78 (1974)).

These diametrically opposed organizations set the stage for the subsequent termination laws and related litigation. This litigation, analyzed in the following part of this Note, will display the extent of the controversy.

## III. The Current Status of the Franchising Laws

### A. *Interpretation of Illinois Law*

In the summer of 1992, the Seventh Circuit decided *The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*[45] The primary issue in *River Valley* was whether or not Great American[46] could show good cause[47] to terminate the franchise before the expiration of the franchise contract.[48] The district court found, pursuant to the Illinois Franchise Disclosure Act, that Great American did not have good cause to terminate the franchise.[49] The district court reasoned that the good cause clause centers on a "determination of commercial reasonableness,"[50] and that the grounds argued by Great American to constitute good cause were not shown to be commercially reasonable.[51] The district court's reasoning was influenced by the public policy consideration that the clause was necessary to protect the franchisee and should be applied flexibly.[52]

Reversing the district court, the Seventh Circuit held that Great American *could* show good cause.[53] In an opinion authored by Judge Posner,[54] the

45. 970 F.2d 273 (7th Cir. 1992); *see supra* note 3.

46. The franchisor or The Original Great American Chocolate Chip Cookie Co., Inc. of Delaware.

47. As required in 815 ILL. COMP. STAT. ANN. 705/19 (West 1993); *see supra* note 5.

48. *River Valley*, 970 F.2d at 275, 279. *See also* Judge Cudahy's dissent, *Id.* at 283.

49. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 773 F. Supp. 1123, 1129 (N.D. Ill. 1991).

50. *Id.* at 1128 (citing Dayan v. McDonald's Corp., 466 N.E.2d 958, 973 (Ill. App. Ct. 1984) (stating that in Lippo v. Mobil Oil Corp., 776 F.2d 706, 714 n.14 (7th Cir. 1985), the Seventh Circuit agreed with this interpretation.)) Note that the *Lippo* majority opinion was written by Judge Cudahy with a dissent by Judge Posner. In *River Valley*, Posner then limits *Lippo* as far as he can without explicitly overruling it. *See* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 282 (7th Cir. 1992): "In pooh-poohing their misconduct the Sigels place too much weight on our decision in *Lippo*."

51. *River Valley*, 773 F. Supp. at 1129. Great American argued that the Sigels' were late in paying four invoices. The franchise agreement stated that failure to pay any invoice within ten days of its due date would constitute a default. The invoices at issue were overdue by 19, 35, 33, and 38 days. The court held the ten-day term to be commercially unreasonable and, therefore, failure to comply did not constitute good cause under the contract. *Id.*

52. *See id.* at 1130. The court discusses the public policy embodied in the IFDA.

53. *River Valley*, 970 F.2d at 281.

court cited the IFDA definition of the good cause clause as either "the failure of the franchisee to comply with any lawful provisions of the franchise or other agreement and to cure such default after being given notice thereof and a reasonable opportunity to cure such default, which in no event need be more than 30 days," or "without the requirement of notice and an opportunity to cure, situations in which the franchisee . . . repeatedly fails to comply with the lawful provisions of the franchise or other agreement."[55]

The Sigels repeatedly failed to furnish insurance certificates showing Great American as an additional insured on the policy.[56] They paid four invoices more than ten days after they were due, sent seven checks that bounced, and failed several inspections by Great American's representatives.[57] Also, after Great American terminated the franchise, the Sigels continued to sell cookies made from substitute batter.[58] Each act was in violation of the franchise contract.[59] Furthermore, within a three-year period, the Sigels underreported their gross sales by more than $40,000, which deprived Great American of about $3000 in royalties.[60] Judge Posner concluded, "If ever there were a case of 'repeated' violations, it is this case."[61]

Given the facts, it is probably safe to conclude that Great American had good cause to terminate the Sigel's franchise. However, Posner did not rest the decision on good cause alone.[62] He took the opportunity to express his strong views regarding such laws. Posner concluded the termination law would burden the franchisees to a greater extent than it would benefit them if applied to protect the franchisee.[63] Posner considered the idea that judges are able to redistribute wealth by applying a protectionist view, "one of the most persistent illusions of

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54. Judge Richard Posner is a well-known advocate of the notion of applying economic principles to the law. For a general exposure to his theories of law and economics, see RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW (4th ed. 1992).

55. *River Valley*, 970 F.2d at 279 (citing ILL. REV. STAT. ch. 121½, ¶¶ 1719(b),(c)(4) (1985)). The statute has been republished as 815 ILL. COMP. STAT. ANN. 705/19 (West 1993).

56. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 278 (7th Cir. 1992)

57. *Id.* The inspectors "found oozing cheesecake, undercooked and misshapen cookies, runny brownies, chewing gum stuck to counters, and ignorant and improperly dressed employees." *Id.*

58. *Id.*

59. *Id.*

60. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 278 (7th Cir. 1992).

61. *Id.* at 279.

62. *Id.*

63. *Id.* *See also infra* notes 224-35 and accompanying text, discussing Posner's view of the redistribution of wealth in greater detail.

judicial power."[64]

The dissent, authored by Judge Cudahy, criticized Posner's disregard for the legislature's intent regarding the franchise statute.[65] Cudahy stated, "Illinois did not enact this law because it thought franchisors were being abused by their franchisees, as the majority seems to believe."[66] Cudahy went on to criticize Posner's application of economics to this case. "Apparently, the legislators had not read enough scholarly musings to realize that any efforts to protect the weak against the strong would, through the exhilarating alchemy of economic theory, increase rather than diminish the burden upon the powerless."[67]

*River Valley* illustrates the problems associated with the termination laws. More specifically, the views of Posner and Cudahy illustrate the law and economics view in contrast to the protectionist view. A close look at the majority and dissenting opinions in *River Valley* illustrates how each view fails to recognize the interests represented by its opposition. Posner does not mention the public policy interests in protecting the franchisee, and Cudahy does not mention the economic interests of the franchisor.

Later, this Note will attempt to reconcile the two views, but in order to completely understand the nature of the problems associated with termination laws, this Note will next focus on the good cause requirement as applied in other states.

### *B. General Interpretations Of State Franchise Statutes*

Like Illinois, other states have had problems interpreting the good cause requirement in their franchise statutes.[68] The IFDA[69] and other state statutes

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64. *River Valley*, 970 F.2d at 282. This notion is discussed in greater detail later; *see infra* notes 224-35 and accompanying text.

65. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 283 (7th Cir. 1992).

66. *Id.*

67. *Id.*

68. *See supra* note 23 for a list of these states. *See also* Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128 (7th Cir. 1990) (holding that internal economic reasons, without bad faith, did not constitute good cause); Davis v. Gulf Oil Corp., 572 F. Supp. 1393 (C.D. Cal. 1983) (finding that termination is for good cause where franchisor is withdrawing from market because of lack of success and where dealers were notified of planned market withdrawal); Aurigema v. Arco Petroleum Products Co., 698 F. Supp. 1035 (D. Conn. 1988) (holding that a unilateral decision to withdraw from market is not good cause to terminate); Freedman Truck Center v. GMC, 784 F. Supp. 167 (D.N.J. 1992) (withdrawing from general market did not violate New Jersey Practices Act); Moore v. American Suzuki Motor Corp., 416 S.E.2d 807 (Ga. Ct. App. 1992) (reversing a directed verdict that franchisor had good cause when franchisee wanted to transfer franchise, as there

make an attempt to define good cause; however, the definitions among the states are inconsistent.[70] Typically, good cause is defined as "the failure of the franchisee to substantially comply" with a franchise contract.[71] A notice requirement with time to cure the defect and specific failures that justify immediate termination without notice are also generally included in the statutes.[72]

A comparison of the statutes reveals that some statutes have a more fully developed definition of good cause than others. For example, the California statute lists eleven specific circumstances that will justify immediate termination.[73] For example, bankruptcy, a felony conviction, material misrepresentation, and mutual agreement are a few grounds for immediate termination.[74] The Arkansas statute describes eight circumstances that will justify termination,[75] six of which justify immediate termination.[76]

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was evidence the franchisor's refusal to transfer was arbitrary); Dunkin' Donuts of America, Inc. v. Middletown Donut Corp., 495 A.2d 66 (N.J. 1985) (finding that franchisor had good cause when franchisee underreported gross sales); Westfield Centre Services, Inc. v. Cities Service Oil Co., 432 A.2d 48 (N.J. 1981) (selling franchisee's business, even though in good faith, was without good cause); Amerada Hess Corp. v. Quinn, 362 A.2d 1258 (N.J. Super. Ct. Law Div. 1976) (holding that franchisee's noncompliance with federal pricing regulations is good cause to terminate); *In re* Groseth Intern., Inc., 442 N.W.2d 229 (S.D. 1989) (refusing to use franchisor's computer system for ordering parts is good cause to terminate).

69. *See supra* note 2.

70. Andrew A. Caffey, *Franchise Termination and Nonrenewal Legislation: Recent Developments and Trends in State Legislation*, 49 ANTITRUST L.J. 1343, 1345 (1980). *See also supra* note 6.

71. Caffey, *supra* note 70, at 1345.

72. *Id.*

73. These circumstances are: 1) bankruptcy; 2) abandonment; 3) mutual agreement; 4) "franchisee makes a material misrepresentation relating to acquisition of franchise business" or "engages in conduct which reflects materially and unfavorably upon the operation and reputation of the franchise business or systems"; 5) noncompliance of law relating to operation of the franchise for 10 days after notification; 6) after curing a noncompliance within 30 days notice under § 20020, franchisee engages in same noncompliance; 7) repeated failure to comply with one or more requirements of the franchise; 8) business or business premises is seized, taken over, or foreclosed by government or by a creditor, provided that final judgment against the franchisee remains unsatisfied for 30 days or a levy of execution has been make upon the license granted by the franchise agreement or upon the property and is not discharged within 5 days; 9) franchisee is convicted of a felony or any other criminal misconduct which is relevant to the operation of the franchise; 10) franchisee fails to pay any franchise fees or other amounts due to the franchisor or its affiliate within five days after receiving written notice of overdue fees; and 11) franchisor makes reasonable determination that continued operation of the franchise by franchisee will result in an imminent danger to public health or safety. CAL. BUS. & PROF. CODE § 20021 (West 1987).

74. Caffey, *supra* note 70, at 1345.

75. These circumstances are: 1) failure to substantially comply with requirements; 2) failure to act in good faith and in a commercially reasonable manner to carry out terms of franchise; 3) abandonment; 4) conviction of an offense punishable by a term of (1) year, substantially related to franchise; 5) an act which substantially impairs the franchisor's trademark or tradename; 6)

Connecticut, Illinois, Minnesota, Nebraska, New Jersey, and Washington have between two and six specific situations listed.[77]

Unless the situation presented before a court fits into one of these explicit justifications for immediate termination, a court is left with the general provision, which is included in all of these statutes.[78] This provision justifies termination[79] for good cause under such circumstances as follows:

> [W]ithout limitation, the failure of the franchisee to (substantially)[80] comply with lawful material provisions of the franchise or other agreement between the franchisor and the franchisee and to cure such default after being given written notice thereof and a reasonable opportunity, which in no event need be more than thirty days, to cure such default . . . .[81]

In situations where the termination does not fall under an explicit circumstance, a court is left to decide whether the franchisee has "substantially" complied with the agreement and whether the provision in the agreement is "material."[82] Ultimately, a court must define "substantially" and "material." Each definition requires a subjective evaluation. Therefore, the inconsistent results are inevitable. Even those states with the most exhaustive list of reasons for immediate termination, such as California, do not eliminate the ambiguity of this provision.[83]

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bankruptcy or assignment of franchise or assets for benefit of creditors; 7) loss of right to occupy the premises; and 8) failure to pay franchisor within 10 days after receipt of notice of past due. ARK. CODE ANN. § 4-72-202 (Michie 1991).

76. Reasons 3-8 listed in *supra* note 75 may be used to terminate a franchise agreement without notice. ARK. CODE ANN. § 4-72-204(c) (Michie 1991).

77. CONN. GEN. STAT. § 42-133f (West 1992); 815 ILL. COMP. STAT. ANN. 705/19 (West 1993); MINN. STAT. ANN. § 80C.14 (West Supp. 1993); NEB. REV. STAT. § 87-404 (1987); N.J. STAT. ANN. § 56:10-5 (West 1989); WASH. REV. CODE ANN. § 19.100.180 (West Supp. 1992).

78. *See supra* note 6.

79. That is termination with a notice requirement of usually 30 days. *See* statutes listed in *supra* note 6.

80. Some statutes add the word "substantially," although this word is not included in the Washington Statute.

81. WASH. REV. CODE ANN. § 19.100.180 (West Supp. 1993). This is just an example of the statutory language, but all of the statutes have language very similar, if not identical, to this language. *See supra* note 6.

82. For a discussion of the factors that the courts use to define these terms, see *infra* notes 84-109 and accompanying text.

83. *But see* CAL. BUS. & PROF. CODE § 20021(f),(g) (West 1987), where the code elaborates on noncompliance and repeated failure after notice.

Later this note will discuss the effects of this ambiguous provision, such as how it leaves room for judicial political views. *See infra* notes 116-241 and accompanying text.

The Delaware Code includes vague termination language. The Delaware statute states, "[T]ermination of a franchise by a franchisor shall be deemed to be 'unjust', or to have been made 'unjustly' if such termination is without good cause or in bad faith."[84] Deleware's law was challenged as void for vagueness in *Globe Liquor Co. v. Four Roses Distillers Co.*[85]

In *Four Roses*, the court held that the section was not void for vagueness because the quoted terms have such "a settled meaning in law" that they set up an intelligible standard of conduct.[86] However, in light of the controversy this clause has produced, it is doubtful that this term has a "settled meaning in law." Similar to the New Jersey termination law, the Wisconsin Fair Dealership Law was also challenged as void for vagueness.[87] The Sixth Circuit held that the Wisconsin statute survived the vagueness challenge because the statutory definition of good cause[88] gave adequate notice of what conduct would violate the law.[89]

The fact that courts are able to grapple with the meaning of good cause does not necessarily mean that the franchisor has adequate notice of how to structure conduct. However, the court will uphold the definition of good cause unless the court finds it hopelessly confusing.[90]

New Jersey and Connecticut case law also give some insight as to what constitutes good cause.[91] For example, the New Jersey courts have found good cause where the franchisee puts the trademark and goodwill of the franchisor in

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84. DEL. CODE. ANN. tit. 6 § 2552(a) (1993).

85. 281 A.2d 19 (Del. 1971), *cert. denied*, 404 U.S. 873 (1971).

86. *Id.* at 22.

87. Boatland, Inc. v. Brunswick Corp., 558 F.2d 818 (6th Cir. 1977). The Wisconsin Fair Dealership Law, section 135.02(4) provides:

> (4) "Good Cause" means:
>
> (a) Failure by dealer to comply substantially with essential and reasonable requirements imposed upon him by the grantor, or sought to be imposed by the grantor, which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of the enforcement; or
>
> (b) Bad faith by the dealer in carrying out the terms of the dealership.

WIS. STAT. ANN. § 135.02(4) (West 1989).

88. Good cause is either 1) bad faith by the dealer in carrying out terms of the dealership, or 2) the dealer's failure to comply substantially with essential & reasonable requirements which are not discriminatory as compared with similarly situated dealers. WIS. STAT. ANN. § 135.02(4) (West 1989).

89. *Boatland*, 558 F.2d at 824.

90. Michael M. Eaton, *State Regulation of Franchise and Dealership Terminations: An Overview*, 49 ANTITRUST L.J. 1331, 1336 (1986).

91. These two states seem to have much litigation on the subject and will serve as examples to illustrate the inconsistency that results when the good cause requirement is applied.

jeopardy,[92] the franchisee has committed fraud as to the profits earned,[93] and the franchisee transfers the franchise.[94] The New Jersey statute did not specifically list these reasons as grounds for good cause to terminate a franchise agreement. Instead, the New Jersey courts interpreted the general language of the statute to include these reasons as falling within the definition of good cause.[95]

In contrast, a Connecticut court held that a franchisor's unilateral decision to withdraw from the market was not good cause for termination.[96] Neither was the franchisor's restructuring of sales found to be good cause.[97] However, in *Freedman Truck Center v. GMC*,[98] the District Court of New Jersey found that a franchisor's nondiscriminatory, general market withdrawal did not violate the New Jersey Franchise Practices Act.[99] The court's decision was guided by the "evil the legislature sought to eliminate," and the court identified this evil as the "abuse of the franchise relationship through the franchisor's stronger bargaining position."[100] The court found this evil was absent when there existed a full-scale market withdrawal.[101]

Analyzing the aforementioned situations together, it appears that courts focus on different factors[102] to determine whether good cause to terminate a franchise agreement exists. The New Jersey decisions discussed above illustrate that courts look at a range of factors to define good cause. This range varies from the damage to the franchisor[103] to the purpose of the statute and the

92. Amerada Hess Corp. v. Quinn, 362 A.2d 1258 (N.J. Super. Ct. Law Div. 1976).

93. Dunkin' Donuts of America, Inc. v. Middletown Donut Corp., 495 A.2d 66 (N.J. 1985).

94. Simmons v. GMC, 435 A.2d 1167 (N.J. Super. Ct. App. Div. 1981), *cert. denied*, 443 A.2d 712 (N.J. 1981).

95. *See Amerada Hess*, 362 A.2d at 1266; *Dunkin' Donuts*, 495 A.2d at 75; *Simmons*, 435 A.2d at 1177.

96. Aurigemma v. Arco Petroleum Products Co., 698 F. Supp. 1035 (D. Conn. 1988).

97. Carlos v. Philips Business Systems, Inc., 556 F. Supp. 769 (E.D.N.Y. 1983), *aff'd* 742 F.2d 1423 (2d Cir. 1983).

98. 784 F. Supp. 167 (D.N.J. 1992).

99. *Id.* at 170-73.

100. *Id.* at 171.

101. *Freedman Truck Center*, 784 F. Supp. at 172. The court stated,

> [T]he court finds the possibility for the type of abuse identified [infra] . . . largely absent from a full-scale market withdrawal. When a franchisor withdraws entirely from a market, it cannot appropriate the goodwill of a terminated dealer by diverting its business to favored franchisees. Nor is there a risk here of the franchisor driving an unconscionably hard bargain: there is simply no bargain to be made . . . in general, the direct conflicts of interest present in discriminatory franchise termination are absent when a franchisor elects to exit a market.

*Id.*

102. Hereinafter referred to as "consideration factors."

103. *See supra* notes 92-95 and accompanying text.

motive behind the franchisor's decision to terminate, as in *Freedman Truck Center.*[104]

The case law demonstrates the variety of factors the court may consider to determine whether good cause existed to terminate a franchise.[105] The case law emphasizes the lack of consistency in the weight given each of the consideration factors. Some courts have chosen to balance the economic[106] and legal[107] conditions confronting the franchisor with equities[108] favoring the franchisee.[109]

One commentator reviewed special industry laws,[110] such as the Automobile Dealers' Day-in-Court Act,[111] and noted that when specific factors are listed in the statute, they usually focus on the interests and circumstances of the franchisee and the public welfare.[112] Usually, the statute ignores the needs of the franchise agreement and the interest of the franchisor.[113] To balance the interests of the parties, one study[114] suggests courts consider the following factors to ensure that both parties' interests are being weighed equally:

(1) the investment made by the franchisee;

(2) permanency of the franchisee's investment;

(3) whether it is injurious or beneficial to the public welfare for the franchisee to be terminated;

(4) the franchisee's or franchisor's failures, if any, to comply with the

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104. *See supra* notes 96-101 and accompanying text.

105. *See supra* notes 92-100 and accompanying text.

106. Economic conditions that confront the franchisor include a decline in profits, increase in costs, or decrease in demand that comes from either the general market forces or from the specific acts of the franchisee.

107. Legal conditions that confront the franchisor include the contracts the franchisor is a party to, including the agreement with the franchisee and with other parties, and the laws such as the franchise laws that affect the franchisor's business.

108. The fact that the legislature has passed a law to protect the franchisee gives rise to equities favoring the franchisee.

109. Ann Hurwitz, *Franchisor Market Withdrawal: "Good Cause" for Termination?*, 7 FRANCHISE L.J. 3 (1987). This is the type of balancing that this note will propose. However, very few courts balance the interests of both parties. *See supra* notes 91-101 and accompanying text.

110. For an example of special laws for the petroleum industry, see Hurwitz, *supra* note 109, at 26.

111. *See supra* note 32.

112. Hurwitz, *supra* note 109, at 26.

113. *Id.*

114. *Id.*

terms of the franchise;

(5) the cost to the franchisor of being required to continue an unprofitable operation or to pay damages to the franchisee to terminate the operation;

(6) existing economic and marketing conditions, including anticipated future changes;

(7) the franchisee's ability to obtain alternative sources of supply and the franchisor's agreement to waive any rights it may have to enforce post-termination covenants of the franchisee;

(8) the franchisor's intention to continue to conduct business in the subject market, in competition with or in place of its former franchisee;

(9) the franchisee's ability to dispose of its inventory and equipment at a fair value if continued operations are not viable; and

(10) any evidence of bad faith on the part of either party.[115]

This study argues that these factors give proper weight to the interests of the franchisor and the needs of the franchise relationship, instead of only focusing on the effects on the franchisee.

## IV. Problems with the Good Cause Requirement

The most frequent criticism of the good cause provisions and the factors weighed by the courts to establish good cause is that they do not take into account the existing relationship in a franchise agreement and ignore the interests of the franchisor.[116] There is a mutual benefit and dependency inherent in the relationship between the franchisor and the franchisee.[117] The franchisor has an interest in being able to initiate change in marketing activity to respond to changes in market condition and consumer demand.[118] The current laws do not provide the flexibility needed for the franchisor to run an efficient business.[119]

The court decisions leave the franchisor without clear guidance as to how these laws will be applied to individual cases or whether the franchisor's

115. Hurwitz, *supra* note 109, at 26.
116. *Id.* at 25.
117. *Id.*
118. *Id.* at 26.
119. *Id.*

decision to terminate the franchise agreement will be upheld.[120] Neither the franchisor nor the franchisee knows whether the terms of the franchise agreement will be enforced by the courts. Further, the franchisor does not know what standard the court will apply to find good cause for termination of a franchise agreement. Therefore, both the franchisor and franchisee are left with uncertainty as to how the courts will view the franchise relationship.

The ambiguity produced by these laws leads to conflicting ideas and decisions and leaves room for judicial interpretations based on the judge's individual values, such as Posner's economic analysis.[121] It is doubtful that the legislatures intended such subjectivity to run rampant throughout franchise law, especially in light of the fact that these franchise laws were enacted to protect the interests of the franchisee.[122] Furthermore, applying a law and economics approach, such as Posner's, to a franchise termination will usually not work to protect these important franchisee interests.[123]

Next, this Note will explore each view of how the good cause requirement should be interpreted. These two schools of thought are the leading views used by judges to decide franchise termination cases. The first view this Note will discuss is labeled the protectionist view,[124] followed by a discussion of the law and economics view.[125]

### A. *The Protectionist View*

The protectionist view of applying good cause for termination statutes advocates that the judge should focus on the intent behind the legislation, which

120. *Id.*

121. *See supra* note 3.

122. *See* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 283 (7th Cir. 1992). Judge Cudahy's dissent states:

> Illinois did not enact this law because it thought franchisors were being abused by their franchisees, as the majority seems to believe. Apparently, the legislators had not read enough scholarly musings to realize that any efforts to protect the week against the strong would, through the exhilarating alchemy of economic theory, increase rather than diminish the burden upon the powerless. I agree that the thumb of judges ought not be placed on the scales of justice. But judges have no obligation to ignore the numerous thumbs already put down on the side of economic power, nor the thumb of the legislature on the other side.

*Id.*

123. *Id.*

124. This can be seen as the view of Judge Cudahy and those who agree that the laws were enacted to protect the franchisee and that they should be applied flexibly to achieve their goal.

125. This can be seen as the view of Judge Posner and those who agree that judges cannot redistribute wealth by applying laws to favor one group of parties to a contract, such as franchisees, and laws should not interfere with the autonomy gained with the freedom to contract.

is to protect the franchisee from being taken advantage of by the franchisor.[126] This view, illustrated by Judge Cudahy's dissent in *River Valley*, focuses on the loss of the franchisee resulting from a termination and ignores the interests of the franchisor. Judge Cudahy stated: "[T]he majority's decision puts the Sigels out of business . . . . It seems to me obvious—painfully so—that the Sigels have far more to lose than does the Cookie Company."[127]

The force behind good cause requirements is the fear that the franchisee will be unsophisticated in business and, therefore, fall prey to the powerful franchisor.[128] The franchisors are powerful because they possess all the necessary information concerning the franchise.[129] The franchisee is joining a pre-existing system and entering into a contract that gives the franchisor control of nearly every aspect of the business.[130] When this contract includes a broad termination provision, the franchisee is left with very little if any control of the franchise.[131] Even those opposed to overregulation of the franchise agreement, including the good cause requirement, admit the existence of a need to protect the franchisee.[132] Every state recognizes this basic protectionist view and has enacted some form of franchise legislation.[133]

Those who give weight to this view do not see a problem with giving up some efficiency for the benefit of creating and interpreting laws with equity considerations.[134] Protectionists view the good cause requirement as a way of making sure the franchisor will not terminate the agreement in order to reap the profits of the established franchise, which the franchisee has expended time and money to establish.[135] By applying the law broadly, in a case-by-case manner,

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126. *See generally River Valley*, 970 F.2d at 282-83 (Cudahy, J., dissenting).

127. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 283 (7th Cir. 1992). Judge Cudahy is advocating that the Sigels should have at least been granted the preliminary injunction to maintain the status quo before a trial on the merits, and it seems the majority has already passed on the merits and decided that Great American has good cause to terminate. Justice Cudahy focuses only on what the Sigels have to lose. Great American also stands to lose by the Sigels putting Great American's tradename in jeopardy by violating the contract. For a more in-depth discussion of quality control costs, *see infra* notes 205-23 and accompanying text.

128. Mark Pruitt, *Disclosure and Good Cause Legislation: "Where's the Beef" in Franchise Regulation?*, 90 COMMERCIAL L.J. 563 (1985).

129. *Id.* at 564.

130. *Id.* at 564, 565.

131. *Id.*

132. *Id.*

133. *Id.* at 563 n.9 (citing Business Franchise Guide ¶¶ 3000-3530, 4000-4530, 5000-5490 (CCH 1992)).

134. Pruitt, *supra* note 128, at 563. *See also supra* note 3 (Judge Cudahy's dissent in *River Valley*).

135. Pruitt, *supra* note 128, at 567.

the franchisee will be protected from a powerful, greedy franchisor.

The protectionist view is best illustrated by examining cases on the issue of good cause. In *Kealey Pharmacy & Home Care Services, Inc. v. Walgreen Co.*,[136] the franchisor-defendant decided to terminate all of its dealership agreements because "the dealers were producing an inadequate rate of return."[137] Thirteen drugstores sued Walgreen challenging the termination as without good cause under the Wisconsin Fair Dealership Law (WFDL).[138] The Seventh Circuit Court of Appeals held that Walgreen did not have good cause to terminate the agreements.[139] The court found that the Wisconsin legislature intended the WFDL to "be liberally construed and applied to promote its underlying remedial purposes and policies."[140] Walgreen argued that the law did not apply to nondiscriminatory blanket terminations.[141] However, the court found relevant the fact that Walgreen intended to maintain and increase its own stores in the same area in competition with plaintiffs.[142] This fact served as evidence that those franchisees who helped build the Walgreen reputation were taken advantage of by the franchisor.[143] The court followed the protectionist view by applying the law liberally to protect the franchisee from being exploited by the franchisor.[144]

The Supreme Court of New Jersey also followed the protectionist view to decide a franchise termination case. In *Westfield Centre Service, Inc. v. Cities Service Oil Co.*,[145] the court held that a franchisor who terminates in good faith and for a bona fide reason, other than a breach by the franchisee, violates the good cause requirement of the New Jersey Franchise Practices Act.[146] In *Westfield*, the franchisor decided to sell the property that the franchisee was leasing because it was no longer economically feasible to maintain such a lease.[147] The court, finding the protectionist application of the law consistent

136. 761 F.2d 345 (7th Cir. 1985).

137. *Id.* at 347.

138. *Id.* The Wisconsin Fair Dealership Law, WIS. STAT. § 135.01 (1932), is hereinafter referred to as "WFDL."

139. *Kealey Pharmacy*, 761 F.2d at 350.

140. Kealey Pharmacy & Home Care Services, Inc. v. Walgreen Co., 761 F.2d 345, 349 (7th Cir. 1985).

141. *Id.* at 350.

142. *Id.*

143. *Id.*

144. *Id.*

145. 432 A.2d 48 (N.J. 1981).

146. *Id.* at 57.

147. *Id.* at 52.

with the intent of the legislature, held for the franchisee-plaintiff.[148]

Finally, in *Wright-Moore Corp. v. Ricoh Corp.*,[149] the Seventh Circuit held that a franchisor's internal economic reasons for termination do not constitute good cause under the Indiana franchise statute.[150] The court considered only the plain meaning of the statute, which stated that good cause included "any material violation of the franchise agreement."[151] There was no evidence that the plaintiff-franchisee breached the franchise agreement.[152] The court found that the defendant-franchisor did not have good cause to terminate the franchise even though there was no bad faith found on the part of the franchisor.[153] The court stated that to hold otherwise would render the statute ineffective.[154]

These three decisions illustrate the application of the protectionist view.[155] All of these cases involved a unilateral economic decision by the franchisor to terminate.[156] None of the good cause statutes specifically address this circumstance as a valid basis for termination of the franchise.[157]

The protectionist view ignores the practical effects of the termination laws and the interests of the franchisor. When a judge focuses on the motive behind

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148. *Id.* at 54. The court cited the legislative statement,

> New Jersey would do the same in this bill which, through the courts, would rule out arbitrary and capricious cancellation of franchises while preserving the right of franchisors to safeguard their interests through the application of clear and nondiscriminatory standards. The bill would protect the substantial investment—tangible and intangible—of both parties in the various franchises. It would rule out economic coercion as a business tactic in this most sensitive field.

*Id.*

149. 908 F.2d 128 (7th Cir. 1990).

150. *Id.* at 137.

151. *Id.*

152. *Id.*

153. *Id.*

154. Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 137 (7th Cir. 1990).

> [F]ranchise statutes are designed to prevent franchisors from extracting quasi-rents from franchisees. They are designed to ensure fair dealing between the parties. If the business reasons of the franchisor were sufficient, the protection of the statute would be meaningless since it is in the franchisor's short term business interest (and therefore good cause) to act opportunistically.

*Id.*

155. There are also decisions that find a franchisor's unilateral economic decision to terminate as good cause. Obviously, the protectionist view did not prevail in these cases. *See* Freedman Truck Center v. GMC, 784 F. Supp. 167 (D.N.J. 1992); American Mart Corp. v. Joseph E. Seagram & Sons, Inc., 824 F.2d 733 (9th Cir. 1987) (applying the Nevada Alcoholic Beverage Franchise Act).

156. *See supra* notes 136-54 and accompanying text.

157. *See supra* note 6.

the statute, which is to protect the franchisee, the judge will usually not find good cause for any reason other than the franchisee's substantial breach of the franchise agreement.[158] However, the reason a franchisor is terminating the agreement may be a valid economic reason without a self-serving motive. For example, the demand for the franchised product may be so low that it is no longer profitable to continue the business.

Next, this Note will discuss the opposing view, which applies the economic principles to the franchise termination laws while ignoring the interests of the franchisee.

*B. The Law and Economics View*

The law and economics view considers the practical economic effects of the good cause requirement for termination. This view considers these clauses as a restraint on the freedom to contract,[159] arguing that termination laws remove some benefits[160] that normally flow from a franchise agreement by overregulating the contractual allocation of power necessary for a healthy franchise system.[161] This view also argues that termination laws increase the cost of quality control[162] in the franchise systems.[163] Finally, as advocated

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158. *But see* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992), discussed in *supra* note 3, where the franchisee breached the agreement, and the district court still did not find good cause.

159. Pruitt, *supra* note 128, at 564. The freedom of contract is fundamental. The Constitution prohibits states from passing laws that impair "the Obligation of Contracts." U.S. CONST. art. I, § 10. However, once a law has been passed, that law becomes a part of all contracts governed by that law. These laws are still limiting the freedom of autonomous legislation. Consider this scenario: A person living in a low income area wants to buy a refrigerator. The only place that will sell him one offers financing at an outrageous rate, say 30%. The legislature passes a law limiting the financing rate in low income areas to, say 15%, thinking that this will give those with low income the ability to purchase essential items, such as refrigerators. However, the effect of the law is to drive all the refrigerator sellers out of the low-income areas because they cannot afford to finance refrigerators at 15%—the risk is just too high in these areas. The result is exactly the opposite of what the legislatures intended. Now, no one in the low-income area can buy a refrigerator unless they travel outside the area.

160. The benefits flow both ways. The franchisor is able to distribute its name and product to a large geographical area without expending the resources to open its own outlets. The franchisee is able to open a business that is well established and benefit from the reputation. Both parties enjoy cost reductions in advertising because the cost is shared among many.

161. Donald Horwitz & Walter Volpi, *Regulating the Franchise Relationship*, 54 ST. JOHN'S L. REV. 217 (1980) (asserting that legislation which upsets the delicate balance of the franchise relationship strikes at the very heart of franchising).

162. Quality control is the mechanism by which franchisors protect the reputation of their tradename. Franchisors have an incentive to "free ride on the trademark," *see infra* note 214 and accompanying text, and produce products that are below the standard of quality set by the franchisor. *See Economic Effects, supra* note 21, at 104. Franchisors set specific guidelines and conduct inspections to control the quality the franchisees are producing.

by Judge Posner in *River Valley*, termination laws cannot achieve the redistribution of wealth[164] from franchisor to franchisee that they are intended to produce.[165] Posner believes that termination laws work only to increase the costs to the franchisees because the franchisors will charge more to be compensated for the onerous terms.[166] This Note will now explore these three arguments in detail.

1. The Freedom of Contract and the Freedom to Breach a Contract: The Doctrine of Efficient Breach

The freedom of contract, which allows parties to order their own affairs, maximizes the welfare of individuals and of society.[167] One argument against termination laws is that they interfere with the parties' freedom of contract.[168]

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163. *See Economic Effects, supra* note 21, at 104-10 for an economic model that proves that termination clauses increase quality control. *See also infra* notes 205-23 and accompanying text.

164. *See supra* note 12.

165. This was argued in *River Valley* by Posner. *See* The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 275-82 (7th Cir. 1992). *See also infra* notes 224-35 and accompanying text.

166. This conclusion is derived from all three arguments above. It is the conclusion reached in *River Valley* by Posner. *River Valley*, 970 F.2d at 282. Posner does not mention quality control for freedom of contract in the opinion, but clearly these are factors that contribute to the conclusion that the costs will by increased for the franchisees in the end.

By limiting the freedom to contract, the termination laws limit the ability of the franchisor to pass some of the risk to the franchisee. Risk costs money. Under these laws, the franchisor and franchisee are not allowed to bargain for risk. (Of course, they do not bargain without the laws either; *see infra* notes 175-76 and accompanying text.) It only makes sense that the franchisor will charge the franchisee for the risk the law makes the franchisor bear.

Likewise, the increased cost in quality control will be passed on to the franchisee. Under these laws, there is less of a chance that a franchise will be terminated. There is less threat to the franchisee, which logically leads to lower quality of products. The franchisor will have an increase in costs for quality control. An increase in costs will be passed on to the franchisee.

Posner's conclusion, that these laws will not redistribute wealth from the franchisor to the franchisee, is most likely correct because the franchisees do end up paying for the onerous terms. If you don't believe the franchisors will pass on the cost, consider this: You sell flowers. You pay $1.00 for pink tulips and you charge $2.00 each. The extra dollar pays your salary and overhead. Now, assume there is a law passed that requires you to wrap all pink tulips in plastic before you sell them (to protect those people allergic to pink tulips). The cost of wrapping each flower is 25¢. Are you going to continue to charge $2.00 for each tulip and take 25¢ less in your salary out of the kindness of your heart? Of course not. You are going to charge at least $2.25 for each pink tulip after the law is passed. When the law increases your cost, you pass it on to the consumer. As the termination laws increase the franchisor's cost, the franchisor will pass it on to the franchisee. This hypothetical would be affected by the elasticity of demand for tulips. However, this issue is beyond the scope of this note. This example is oversimplified to illustrate that at least some of the increased cost of production will be passed on to the consumer.

167. Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 CORNELL L. REV. 617, 620 (1983).

168. Pruitt, *supra* note 128, at 564, 568, 570.

Opponents of termination laws argue that such laws are a form of overregulation and that franchisees are amply protected by franchise disclosure statutes, which are aimed at curing the informational imbalance[169] existing between the franchisor and franchisee during the sale of franchises.[170]

Also, opponents of the termination laws argue that by using the common law of contract, courts can prevent inequitable results dependent upon the particular fact situations before them.[171] For example, courts have characterized the franchise as a fiduciary relationship and required the franchisor to prove good faith and fair dealing.[172] Furthermore, in similar contexts, courts have applied the doctrine of unconscionability and declared the termination-at-will clauses invalid.[173]

The proponents of the law and economics view argue that in contrast to across-the-board regulation imposed by termination statutes, disclosure statutes and the common law of contract may be better ways of dealing with the unequal

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169. This imbalance comes from the franchisor knowing all of the information about the franchise business, such as costs, profits, and success rates of franchises in certain geographical areas. The franchisee is entering a pre-existing system and will only know what the franchisor chooses to tell the franchisee. These statutes require that certain information be given to the franchisee before the franchisee signs a contract.

170. Pruitt, *supra* note 128, at 566. Seventeen states have enacted these information regulation laws. *See* ARK. CODE ANN. § 4-72-207 (Michie 1991); CAL. CORP. CODE § 31000-31516 (West 1977 & Supp. 1994); FLA. STAT. ANN. § 817.416 (West 1976); HAW. REV. STAT. § 482E-1 to -12 (1985); 815 ILL. COMP. STAT. ANN. 705/1-705/44 (West 1993); IND. CODE ANN. § 23-2-2.5-1 to -51 (West 1989 & Supp. 1993); MD. BUS. REG. CODE ANN. § 14-229 (1992); MICH. COMP. LAWS ANN. § 445.1501-.1546 (West 1989 & Supp. 1993); MINN. STAT. ANN. § 80C.01-.22 (West 1986 & Supp. 1993); N.Y. GEN. BUS. LAW, § 683 (McKinney 1984); N.D. CENT. CODE § 51-19-01 to -17 (1989 & Supp. 1993); OR. REV. STAT. § 650.005 to .085 (1991); R.I. GEN. LAWS § 19-28.1-1 to 19-28.1-34 (Supp. 1993); S.D. CODIFIED LAWS ANN. §§ 37-5A-1 to -87 (1986 & Supp. 1993); VA. CODE ANN. § 13.1-557 to -574 (Michie 1983); WASH. REV. CODE ANN. § 19.100.010-.940 (West 1989 & Supp. 1993); WIS. STAT. § 553.01 -.78 (West 1982).

171. Pruitt, *supra* note 128, at 565. The courts may even impose a good cause standard without a statute. *See* Shell Oil Co. v. Marinello, 307 A.2d 598 (N.J. 1973), *cert. denied*, 415 U.S. 920 (1974) (finding that franchisor had no legal right to terminate its relationship with the franchisee except for good cause).

172. *See, e.g.*, Arnott v. American Oil Co., 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (holding that the fiduciary duty of good faith and fair dealing is inherent in a franchise relationship and that the franchisor breached the duty by terminating franchise without good cause). *See generally* Harold Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971) (discussing the application of fiduciary principles to franchising).

173. *See, e.g.*, Ashland Oil, Inc. v. Donohue, 223 S.E.2d 433, 440 (Va. 1976) (construing a franchise contract as a contract for the sale of goods and holding the termination provision unconscionable under the Uniform Commercial Code); *cf.* Zapatha v. Dairy Mart, Inc., 408 N.E.2d 1370, 1375 (Mass. 1980) (finding franchise contract not to be contract for the sale of goods but applying doctrine of unconscionability by analogy).

bargaining power in franchise relationships.[174] However, most franchise agreements are long-term, standard form contracts,[175] and the franchisee has little or no power to bargain with the franchisor for more favorable terms.[176] The fact that the franchisees have no input as to the terms of the agreement leads to the conclusion that there is virtually no freedom of contract on the side of the franchisee.[177]

Nonetheless, the proponents of the law and economics view argue that the efficiency gains associated with the increased use of standard form contracts can justify their use notwithstanding the unequal bargaining power.[178] Standard form contracts greatly reduce transaction costs[179] associated with contracting.[180] Transaction costs would greatly increase if a new agreement

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174. Pruitt, *supra* note 128, at 565.

175. There are two types of standard form contracts. The first is the type used in commercial transactions as a result of extensive prior negotiations by the parties and is used to facilitate trade conduct such as bills of lading and contract of sale in commodity markets. This type is used by parties who have fairly equal bargaining power.

The second type of standard form contract is the type used in situations where market power is in the hands of a few. These types of standard form contracts are not a result of negotiation. They are dictated by the party with the superior bargaining power. These could by labeled as "take it or leave it" contracts. *See* M.J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords,* 26 U. TORONTO L.J. 359, 363-64 (1976).

176. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 946 (1990).

*But see* William C. Whitford, *Ian MacNeil's Contribution To Contracts Scholarship*, 1985 WIS. L. REV. 545, 554 (1985) (arguing there may be ways to provide participation in forming standard form contracts; for example, in Germany there is bargaining between drafters of standard form contracts, typically trade associations of manufacturers and sellers and organizations representing the adhering parties). The National Franchisee Association Coalition and the International Franchise Association mentioned earlier in the note (*see supra* notes 38, 40) could bargain together to draft fair standard form contracts instead of lobbying the legislatures to make regulatory laws.

177. W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 530 (1971) (arguing "that the overwhelming proportion of standard form contracts are not democratic because they are not, under any reasonable test, the agreement of the consumer or business recipient to whom they are delivered").

178. Trebilcock, *supra* note 175, at 364.

179. Transaction costs are the costs associated with reaching an enforceable agreement. For example, the costs of gathering information, bargaining, monitoring, and communicating are all transaction costs.

This term is usually associated with the Coase Theorem which states that "as long as there are no obstacles to transactions between affected parties, bargaining will ensume an efficient allocation of resources regardless of how property rights are initially assigned." DAVID BARNES & LYNN A. STOUT, CASES & MATERIALS ON LAW & ECONOMICS 53 (West 1992).

However, the key to understanding the Coase Theorem is to accept that there are no transaction costs. This is almost always a false assumption, but the costs may be greatly reduced by standard form contracts.

180. Trebilcock, *supra* note 175, at 364.

had to be negotiated and drafted every time a relatively standard transaction was executed.[181] As costs are saved by way of streamlining the franchise agreements, the franchisor will pass a portion of the cost savings on to the franchisee and both parties will benefit from the use of the standard form contract.[182]

Another important and relevant issue in contract law and economic theory is the doctrine of efficient breach.[183] The doctrine states that a breach of contract is more efficient than performance when the costs of performance exceed the benefits to all parties.[184] The notion behind the doctrine of efficient breach is that economic efficiency is best served when resources are allocated to their highest-valued use.[185] Applying the doctrine to the franchise relationship, a franchisor should terminate the agreement and pay the franchisee damages for the breach when the franchise resources are more valuable to another party.[186] However, it is important to note that damages associated with terminating a franchise may exceed standard economic loss.[187] There are emotional costs involved as well; the franchisee may be losing a career when the franchise is terminated.[188]

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181. *Id.*; Whitford, *supra* note 176, at 553. "Individual negotiation of every contractual detail would take too much time." Whitford also notes that because these details are not negotiated the majority of commentators encourage judicial and legislative oversight of some terms. Trebilcock, *supra* note 175, at 364.

182. This conclusion is safe assuming there is competition among franchises, and this is probably a safe assumption. For example McDonald's, Burger King, Wendy's and Hardee's, etc., are all competing for the potential franchisee who wants to open a fast food hamburger restaurant. Competition creates a powerful incentive for franchisors to pass cost savings on to the potential franchisee.

183. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 290 (1988).

184. *Id.*

185. *Id.* Highest-valued use means that the resources are being used by the party which places the higher value on the particular resource. This value given by the party may be above or below the market value. What is important is that the resource be moved to the party who values it the most.

186. When practically applying the doctrine of efficient breach, it is important to keep in mind the transaction costs. *See supra* note 179. This doctrine assumes that a party is able to determine the correct costs and benefits that would come from breaching, but in most cases this would be very difficult. In order for the doctrine to work, the court would have to be able to determine the damages to the franchisee. There are also other costs, such as attorneys fees, that are ignored by the doctrine. For a critical view of the doctrine of efficient breach, see *infra* note 194.

187. Whitford, *supra* note 176, at 55.

188. *Id.* Deciding to breach a contract for the one-time transaction, such as a sale of goods to a customer, is different than breaching a long-term franchise contract. If *A* contracts to sell *B* 100 widgets at $1.00, and then *C* offers to buy the widgets for $1.50 each, *A* will want to breach the contract, pay damages to *B* (up to 49 cents per widget), and then sell the widgets to *C* for $1.50 each. This is a one time transaction, and we do not feel much sympathy for *B* because we consider widgets a pretty common product. *B* will be able to get 100 widgets from someone else.

But consider the franchisee whose contract is terminated. It is not the same as a single

The law affects the doctrine of efficient breach by the type of rule it uses to protect the contract right for performance possessed by the franchisee.[189] If the law protects the right with a property rule[190] the court will grant the franchisee specific performance and not allow the franchisor to terminate.[191] If the law protects the right with a liability rule,[192] the court will grant the franchisee damages.[193] Applying a liability rule is essential to the doctrine of efficient breach.[194] If a property rule was applied, the franchisor would never be able to terminate, whereas a liability rule would allow the franchisor to terminate the franchise and then pay damages, thus allowing the resources to be moved to their highest-valued use.[195]

In general, the law almost always applies the liability rule instead of the

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transaction contract. The franchisee can never buy this exact product (this franchise) from anyone else. In the franchise situation, there is a relationship formed, and there is much more to lose than a single contract for 100 widgets.

189. BARNES & STOUT, *supra* note 179, at 216.

190. Applying a property rule would give the franchisee a property right in the franchisor's performance. The franchisor would have to continue the franchise unless he could convince the franchisee to give up his right. *See id. See also* Campbell Soup Co. v. Wentz, 172 F.2d 80 (3d Cir. 1948). Campbell Soup contracted with Wentz to buy Chantenay red cored carrots for their soups for a price of $30 a ton in June of 1947. Consequently, the market price went up to $90 a ton at the time the carrots were harvested and Chantenay red cored carrots were virtually unobtainable. Wentz decided to breach the contract and sold the carrots for a higher price to a third party (which in turn sold the carrots to Campbell). The court granted Campbell specific performance, reasoning that these goods were special and unavailable on the open market. *Id.* In effect, the court granted Campbell a property right in Wentz's performance and forced Wentz to sell the carrots to Campbell.

191. BARNES & STOUT, *supra* note 179, at 216.

192. Applying a liability rule would not give the franchisee a property right in the franchisor's performance, but would only make the franchisor liable for the damages to the franchisee because of the term.

193. BARNES & STOUT, *supra* note 179, at 216.

194. *Id.*

> "Even if the breach is deliberate, it is not blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promise of actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn't want to bring about such a result."

*Id.* (quoting Judge Posner in Patton v. Mid-Continent Systems, Inc., 841 F.2d 742, 750-51 (7th Cir. 1988)).

This doctrine has been criticized by Professor Ian MacNeil because all transaction costs are impossible to measure, and it is easy to focus on only those transaction costs that support the result the analyst wants to reach. MacNeil does not feel it is worth the judicial effort to figure out the true transaction costs, because this in itself produces even more costs which are not accounted for in the doctrine. *See* Ian MacNeil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

195. BARNES & STOUT, *supra* note 179, at 216.

property rule.[196] Thus, the equitable relief of specific performance is only applied in extreme circumstances, and damages are awarded instead.[197] The franchising laws differ as to the remedies they allow for termination without good cause.[198] For example, the Hawaii statute only provides for damages upon a termination without good cause.[199] Likewise, the Delaware code provides that the franchisee may recover damages and that the franchisee may obtain a permanent injunction from termination against the franchisor.[200] However, the Delaware Supreme Court held in *Paradee Oil Co. v. Phillips Petroleum Co.*[201] that the statute does not grant the franchisee the absolute right to injunctive relief.[202]

Because of the preference for damages as a remedy, this legal remedy is most often applied in franchise termination cases.[203] Although the law on its face protects the franchisee from termination without good cause, the franchisor is still able to efficiently breach, or terminate, the franchise and pay the franchisee damages, which may not fully compensate the franchisee.[204]

2. The Increase in Quality Control Costs

Economists argue that termination laws are a restraint of the franchisor's

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196. This is because the law favors awarding damages instead of injunctions. Injunctions are not granted unless irreparable injury is shown. "If money damages will be 'adequate' then the injury is not irreparable and will not be prevented." DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES 336 (1985). Also, injunctive relief is considered to be an intrusion on a person's liberty. For more discussion on this subject, *see id.* at 325-97.

197. *Id.*

198. *See supra* note 6.

199. HAW. REV. STAT. § 482E-6(3) (1985).

200. DEL. CODE ANN. tit. 6, § 2553(a) (1993).

201. 320 A.2d 769 (Del Ch. 1974), *aff'd* 343 A.2d 610 (Del. 1975).

202. *Id.* at 775.

203. *But see* Chrysler Motors Corp. v. Nebraska Motor Vehicle Indus. Licensing Bd., 274 N.W.2d 862 (Neb. 1979) (upholding the Motor Vehicle Board's denial of application by Chrysler to terminate franchise). By upholding the decision of the board, in effect the court was granting the franchisee an injunction against termination.

204. *See* David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 375, 435-36 n.188 (1990) (arguing that legal intervention would not prevent efficient breach of the franchise contract).

Note that the laws often provide that a franchisor buy inventory, supplies, equipment, and furnishings from the franchisee, but this most likely will not fully compensate the franchisee. The Hawaii statute provides for damages to good will, *see supra* note 199, but the franchisee may still not be compensated for the loss of his career.

Note also that the laws may have some deterrent effect on termination, but this is unlikely. There has been no proof of this; instead, the effect seems to be that franchisors simply do not franchise as much in states with these statutes according to the Brickley study, discussed *infra* notes 217-23 and accompanying text.

freedom to protect its tradename, thus leading to an increase in cost for quality control by the franchisor.[205] Under most circumstances, the franchisor's trademark and goodwill are its most valuable assets.[206] Termination laws take the power to protect these assets away from the franchisor.[207]

For example, the IFDA requires that the franchisee be given notice and at least thirty days to cure a defect.[208] It is not inconceivable that a franchisee could do significant damage to the franchisor's goodwill within that thirty-day time period.[209] For example, in *River Valley*,[210] the franchisee was using other cookie dough and selling it under the franchisor's name.[211] Customers were associating Great American's trademark with cookies that were not made by Great American.[212] Breaching specific conduct provisions which regulate the quality of the product sold by the franchisee could result in great detriment to the franchisor. The notice requirements of the termination laws leave franchisors with no option but to wait for thirty days while their names are being associated with low quality.[213]

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205. *Economic Effects*, *supra* note 21, at 101.

206. Pruitt, *supra* note 128, at 568.

207. *Id.* (arguing that the termination laws disrupt the bargain struck between franchisors and franchisees, thus hampering the franchisors ability to protect their trademarks).

208. The Illinois Franchise Disclosure Act requires the franchisor to give the franchisee notice of a defect and "a reasonable opportunity to cure the defect" of at least 30 days. 815 ILL. COMP. STAT. ANN. 705/19 §19(b) (West 1993). Most of the states with termination laws also have a notice and time-to-cure provision; *see supra* note 6.

209. The asset of good will is a vulnerable asset. Many opinions may be formed about the quality of food or service within a month, which is a significant amount of time.

210. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992). *See also supra* note 3.

211. *River Valley*, 970 F.2d at 282.

212. Fortunately for Great American, the dough the Sigels were using was not that of a lower quality than Great American dough. *See id.* at 283 (Cudahy, J., dissenting).

213. For example, the IFDA does not allow the franchisor to terminate immediately unless the situation is one of the four specifically mentioned. These immediate termination situations were discussed earlier in this note. *See supra* notes 73-77 and accompanying text. The four situations in the IFDA are: 1) assigning the assets of the franchise to creditors; 2) abandonment; 3) a felony conviction; and 4) repeatedly failing to comply with a lawful provisions of agreement. 815 ILL. COMP. STAT. ANN. 705/19 § 19(c) (West 1993). The statute does not explain what "repeatedly" means in subsection (c)(4). The first time a franchisee sells substitute products will probably not justify immediate termination under the IFDA. Thus, the franchisor must wait at least 30 days while the substitute products are being sold.

Of course, it may be possible for the franchisor to obtain an injunction to keep the franchisee from selling the substitute products. In fact, in *River Valley*, Great American sued the Sigels under the Lanham Act, 15 U.S.C. § 1117, alleging that the Sigels' continued unauthorized use of its trademark violated Great American's rights under the Act. Posner granted Great American's injunction on appeal. *River Valley*, 970 F.2d at 282.

For other examples of franchisees violating franchise agreements and putting the franchisor's trademark in jeopardy, see Robertson v. Mobil Oil Corp. 778 F.2d 1005 (3d Cir. 1985) (misleading highway motorists about gasoline prices); Baskin-Robbins Ice Cream Co. v. D & L Ice Cream Co., Termination laws reduce the threat of a termination and have the effect of giving the franchisee an incentive to act as a "free rider."[214] The free rider effect reduces the quality of products or services provided because it is less expensive for a franchisee to "substantially comply" as required by the statutes than to totally comply as required by the franchise contract.[215] A reduced threat of termination in turn increases the costs of controlling quality for the franchisor.[216]

A recent study[217] examined the effects of the termination laws on non-

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576 F. Supp. 1055 (E.D.N.Y. 1983) (selling generic brand ice cream in trademark containers); Wisser Co. v. Mobil Oil Corp., 730 F.2d 54 (2d Cir. 1984) (selling substitute gas from trademarked pumps).

214. *Economic Effects, supra* note 21, at 104. *See also* Hadfield, *supra* note 176, at 949-51 and Pruitt, *supra* note 128, at 568-69.

The concept of "free riding" is associated with goods that benefit everyone once they are paid for. The party paying for the goods has no way to keep the benefits to herself, and others have the incentive to use the goods without paying for them. Those who do not pay for their consumption are called "free-riders"; *see* COOTER & ULEN, *supra* note 183, at 109.

"Free riding" would occur for public goods if we were not all forced to pay for them with our taxes. For example, consider our nation's defense. If we did not have a tax system, a few might take it upon themselves to pay for our defense, and the rest of us would "free ride" on their investment, because once a national defense system is set up, it protects the whole country, not just the few who pay for it.

This concept can be applied to some private investments as well. *A*, *B*, *C*, and *D* live on a mile-long dirt road. *A* and *B* decide they would like to pave the road. They approach *C*, and *C* decides it is a great idea and tells *A* and *B* he will share in the costs. Finally, *A*, *B*, and *C* approach *D*, who also thinks it is a great idea, but *D* realizes that the road will be paved whether he pays for it or not. *D* also realizes that *A*, *B*, and *C* cannot exclude *D* from using the road after it is paved. *D* decides not to contribute to the cost of paving the road. *D* is a "free rider" on the investment of his neighbors.

Likewise, "free riding" happens in the franchise relationship. The franchisor has a tradename which he sells to franchisees. The better the reputation of the tradename, the more franchises the franchisor will sell. The franchisees, on the other hand, have only an interest in increasing their profits at their particular store. Some franchisees will produce high quality products and the rest of the franchisees will have an incentive to cut corners and produce lower quality products. The low-quality producing franchisees count on the fact that other franchisees are protecting the reputation of the tradename. These low-quality producing franchisees are free-riding on the investments of the high-quality producing franchisees.

215. Pruitt, *supra* note 128, at 568.

216. *Economic Effects, supra* note 21, at 104.

217. *See Economic Effects, supra* note 21. This study, done by Brickley, Dark, and Weisbach in 1991, provides three alternative models of how termination laws affect franchising. The first is that the termination laws increase the cost of quality control. It also suggests that the laws transfer wealth from the franchisor to the franchisee. Transfer of wealth is discussed later in this note, *see infra* notes 224-35 and accompanying text.

The second model predicts that the laws will reduce the amount of franchising, because the laws protect the naive franchisees and reduce profits earned by franchisors in states with termination laws.

The third model predicts that the laws will increase franchising by providing a boiler plate repeat[218] and repeat industries[219] and found that for repeat industries, termination laws have little effect on the probability of a unit being franchised.[220] However, in non-repeat industries, the chances that a unit will be franchised is significantly less in states with termination laws.[221] The study concludes that franchisors are less likely to franchise in a state with termination laws because it costs the franchisor more for quality control in these states.[222] The study seems to support the economic view that termination laws are inefficient because they increase the cost of franchising and prevent the parties from reaching an "optimal contract."[223]

3. Judge Posner's View and Its Criticism

Posner advocates that the role of the court is to promote efficiency by predicting[224] and mimicking[225] the market.[226] His approach to statutory

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contract clause which will reduce the costs of contracting. This topic is discussed earlier in this note, and it is concluded that this is unlikely because costs of contracting from negotiations are low, if not non-existent, in a franchise agreement. They are usually standard form contracts, and the franchisee has no power to negotiate the termination terms; *see supra* notes 175-77 and accompanying text.

218. Restaurants, hotels, campgrounds, and auto-rental agencies are examples of non-repeat industries.

219. These industries are those that cater to repeat business, for example, lawn-care companies.

220. *Economic Effects, supra* note 21, at 125. The "probability of a unit being franchised" refers to the likelihood that an industry will have franchises in a particular state. The study compared this probability of franchising in termination law states with the probability of franchising in non-termination law states and found that laws had no effect for repeat industries.

Presumably, this is so because the franchisees of repeat industries have incentive to provide quality services and products as their business relies on the same customers returning to their franchise. This leads to lower costs in quality control for the franchisor, and thus, the laws do not effect their decision to franchise in a particular state because the nature of a repeat industry will keep quality control costs low.

221. *Id.* Contrasted with repeat industries, non-repeat industries do not rely on the same customers returning. Consider the hotels, restaurants, and gas stations along the highways. These businesses rely on one-time customers, travelling through town, that usually have no choice but to patron their businesses. The incentive to free-ride on the trademark is high in these cases, and this increases the franchisor's costs of quality control in states with termination laws. It is no surprise that franchisors are less probable to open a franchise in a state with a termination law.

222. *Id.* at 26. The authors suggest that some companies may substitute company ownership for franchising in states with termination laws.

223. *Id.*

224. Posner and others in the Chicago School of Economics believe that the market works to promote efficiency. By predicting, Posner means looking at the market and seeing how the market would affect the dispute at hand it if were not in court but instead in an unregulated, competitive market.

225. After predicting how the market would affect the dispute before him, Posner grants decisions that produce the same outcome the market would produce.

226. Paula M. Taffe, Note, *Imputing The Wealth Maximization Principal To State Legislatures*, 63 CHI.-KENT L. REV. 311, 317 (1987) [hereinafter *Wealth Maximization*].

interpretation is a balance of the public interest in maximizing social wealth[227] against the interest groups'[228] views behind the law.[229] He is, however, opposed to enforcing "amorally redistributive" and "systematically perverse" interest group statutes.[230] Posner wants to avoid giving interest groups more than entitled under the bargain by construing interest group statutes narrowly.[231]

Posner's approach can be seen quite clearly in *River Valley*.[232] More specifically, Posner saw the statute as "amorally redistributive" and applied the IFDA narrowly.[233] In *Amoco Oil Co. v. Ashcraft*,[234] as well as in *River Valley*, he argued:

> [T]he more difficult it is to cancel a franchise, the higher the price that franchisors will charge for franchises. So in the end franchisees will pay for judicial liberty and everyone will pay for the loss of legal certainty that ensues when legal principles are bent however futilely to redistributive ends.
>
> The idea that favoring one side or the other in a class of contract disputes can redistribute wealth is one of the most persistent illusions of judicial power. It comes from failing to consider the full consequences of legal decisions. Courts deciding contract cases cannot durably shift the balance of advantages to the weaker side of the market; they can only make contracts more costly to that side in the future because franchisors will demand compensation for bearing onerous terms.[235]

Many criticize Posner because of his disregard for the legislative intent and equitable considerations when applying a law he believes will not result in the

227. Social wealth is the aggregate wealth of society, or the sum total of individual wealth.

228. Interest groups are those groups that lobby the legislature to pass laws that further the groups' interest. In the franchise situation, the groups are the NFAC and the IFA, discussed *supra* notes 38-44 and accompanying text.

229. *Wealth Maximization*, *supra* note 226, at 317 n.45: "[T]he public interest and interest group theories are theories about the content of legislation, the former predicting that it will be efficient (always bearing in mind that efficiency may require some public redistribution of wealth), the latter that it will be amorally redistributive." *Id.* (citing Richard Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 268 (1982)).

230. *Wealth Maximization*, *supra* note 226, at 317.

231. *Id.* at 318. *See* RICHARD POSNER, THE FEDERAL COURTS: CRISES AND REFORM 262-72 (1985).

232. The Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273 (7th Cir. 1992)

233. *Id.* at 282.

234. 791 F.2d 519, 522 (7th Cir. 1986).

235. *River Valley*, 970 F.2d at 282.

most efficient outcome.[236] Posner writes, "[T]he economist is interested in methods of preventing future accidents."[237] Professor Laurence Tribe characterizes this application of economics to law as the "ex ante approach."[238] Tribe criticizes this approach as more interested "in creating sound rules to govern the behavior of the world at large," instead of achieving "justice among the parties actually before [the court]."[239]

Others argue that Posner is also violating the judicial role in relation to the legislature, thus raising federalism concerns.[240] Finally, critics argue that Posner's decisions are too complex and incomprehensible and fail to provide non-experts certain guidelines that may be applied in future cases.[241]

By applying the law and economics view, the practical effects of the laws on the franchise agreement are recognized, but the purpose of the laws, to protect the franchisee, is not considered. In contrast, the protectionists consider only the purpose of the laws and fail to recognize the practical effects. Each view's strength is the other's weakness.

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236. *See Wealth Maximization, supra* note 226, at 334.

237. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 22 (3d ed. 1986).

238. Laurence Tribe, *Constitutional Calculus: Equal Justice or Economic Efficiency?*, 98 HARV. L. REV. 592, 593 (1985).

239. *Id.* Tribe states,

> [S]ophisticated judges who 'appreciate' the economic system are pulled toward an ex ante approach, in which a court is interested less in doing justice in the case at hand than in creating sound rules to govern the behavior of the would at large . . . . That is, if courts seek to do justice among the parties actually before them by merely slicing up the pie fairly, they must forfeit the opportunity to expand the pie as a whole by formulating an appropriate forward-looking and general legal rule.

*Id.*

240. This topic is beyond the scope of this note. *See Wealth Maximization, supra* note 226, at 342, where the author discusses Posner's decision in Remus v. Amoco Oil Co., 794 F.2d 1238 (7th. Cir.), *cert. dismissed*, 479 U.S. 925 (1986). In *Remus*, Posner held that whether franchisees where affected by franchisor's decision to change its credit card structure was not important under the Wisconsin Fair Dealership Law. He reasoned that the legislature could not have intended the statute to keep franchisors from making overall wealth-maximizing changes in their business. *Remus*, 794 F.2d at 1241.

The author states, "Judge Posner's reasoning in Remus raises judicial role and federalism concerns. If the State of Wisconsin chooses to protect its small businessmen at the expense of efficiency, it may do so." *Wealth Maximization, supra* note 226, at 342.

241. *Id.* at 334. If it is true that Posner's rules of law are difficult to apply in subsequent cases, then Posner is accomplishing nothing by his economic analysis. As Professor Tribe observed, Posner is interested in providing general rules for future disputes instead of doing justice in the case at hand, *see supra* notes 236-39 and accompanying text. If Posner's critics are correct, he is accomplishing nothing because he is not doing justice in the individual cases before him, nor is he providing rules because no one is able to apply them.

### C. Strengths and Weakness of Both Views

The protectionists focus only on the interests of the franchisee and conclude that termination laws are designed to protect the franchisee without considering the practical effects if carried to an extreme. By applying the protectionist view, the franchisee is essentially granted a perpetual contract.[242] This view fails to recognize that, by favoring the franchisee interests only, the freedom of contract is hindered and quality control costs are increased.[243] However, the strength of the view is that it considers the intent of the legislature, which the law and economics view ignores.

The economic view focuses only on the practical effects of the laws. The proponents of this view conclude that the laws are inefficient without considering the equitable concerns behind the laws.[244] Posner does not favor applying these laws broadly, because he believes that judges are powerless to effect transfers of wealth from the franchisor to the franchisee.[245] This view fails to recognize that the laws may not be trying to transfer wealth to the franchisee, but instead they are trying to transfer power. That is, these laws transfer some of the superior bargaining power the franchisor so often possesses.

Despite all of the valid economic arguments regarding an increased cost for franchising as well as an increased inefficiency, the economic view fails to recognize the benefit of such laws. Termination laws may increase costs for franchisees, but the increase is not without some return. The franchisees are receiving insurance that their businesses will not be terminated at the whims of opportunistic franchisors.

By examining the law and economics and protectionist views, it is clear that both views should be used when applying the good cause standard in order to achieve the most equitable and efficient outcome.

## V. A PROPOSED UNIFORM STANDARD: APPLYING BOTH VIEWS TO TERMINATION LAWS

This Note proposes a uniform standard to be applied by the courts when faced with a franchise termination. The uniform standard is in the form of a statutory amendment to the termination laws. As the statutes exist, the courts are left to make the good cause decisions without much guidance. The result, as illustrated in *River Valley*, is two views that seem to be pulling in opposite

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242. *See supra* notes 42-44.
243. *See supra* notes 167-223.
244. *See supra* notes 230-39.
245. *See supra* notes 232-35.

directions. This Note proposes a statute that balances the strengths of each view.

The following proposed uniform standard should be amended to the termination statutes:

*Consideration Factors to Determine Good Cause*

This state recognizes that the franchise agreement as a unique relationship which requires special considerations in order to preserve the benefits that normally flow from the franchise relationship. The purpose of this termination statute is to protect the franchisee from an opportunistic franchisor while recognizing the economic concerns of the franchisor and the franchise relationship. The following factors are to be considered, in the order presented, when the court is faced with a franchise termination challenged as being without good cause:

1. The Franchisor's Motive for Terminating the Franchise

If a preponderance of the evidence indicates that the franchisor is unreasonably exercising superior coercive power to unfairly prejudice the franchisee by terminating the franchise, good cause will not be found, and no further inquiry is necessary.

If an unreasonable exercise of the franchisor's power is not shown by a preponderance of the evidence, then proceed to section 2.

2. Analysis of Impact of Franchisee Breaches on Franchisor Tradename

If a preponderance of the evidence indicates that the franchisee engages in conduct clearly detrimental to the franchisor tradename, in violation of the franchise agreement, the franchisor shall have good cause. Such conduct could include, but shall not necessarily be limited to, the terms included within the individual franchise contracts as negotiated between the parties.

If violations by the franchisee, which are clearly detrimental to the franchisor tradename, are not shown by a preponderance of the evidence, then proceed to sections 3 and 4 and consider them concurrently.

3. Investment-Backed Expectations of the Franchisee

If a preponderance of the evidence indicates that the franchisee's investment-backed expectations will be substantially interfered with, the franchisor may not have good cause. Such consideration shall include but not be limited to the initial investment made by the franchisee, the period of time the franchisee has been in business, and the representations made by the franchisor concerning the profits the franchisee should expect to receive for the investment.

4. Prevailing Market Conditions and the Economic Concerns of the Franchisor

If a preponderance of the evidence indicates that the franchisor is terminating the franchise because it is no longer economically feasible to conduct the franchise, the franchisor may have good cause if the factors in favor of the franchisee, listed in section 3, do not outweigh the factors in favor of the franchisor listed in this section. Such factors shall include, but not be limited to, the prevailing market conditions, the financial stability of the franchise system, and the costs imposed on the franchisor if required to continue operations of the franchise system.

This proposed amendment incorporates the intent behind the statute, which is to protect the franchisee interests and ensure that the franchise will not be terminated by a self-interested franchisor. The standard also incorporates the economic concerns presented by the law and economics view, by recognizing the franchisor's needs to protect its tradename and to respond to changing market conditions. By incorporating both views into a standard of factors to be applied to franchise terminations, the result will be both equitable and efficient.

The threshold inquiry is that of the franchisor's motive behind the termination, because these statutes were enacted precisely to protect the franchisee from terminations motivated by the self-interest of the franchisor. If the franchisor wishes to terminate in order to take over the business itself, this clearly does not constitute good cause to terminate, and there should be no further inquiry. If it is not shown that the franchisor is exercising its superior power to its own advantage, then it is necessary to look at the conduct of the franchisee. If the franchisee is breaching its agreement in a way that is detrimental to the franchisor's tradename, then the franchisor does have good cause to terminate the franchise. This inquiry considers the interests of the franchisor in protecting its tradename. By including this inquiry in the good cause standard, the concerns of the law and economics view will be addressed, and the franchisor will have greater control over quality.

The first two inquiries are to be considered first because they address the most important concerns of the two views. If either one of those situations are present, good cause is easy to determine. The third and fourth inquiries address the economic concerns of both the franchisor and the franchisee. These are also important concerns, but they should not carry as much weight as the first two. When the situations presented in the first two inquiries do not exist, the economic expectations of the franchisee, the prevailing market conditions, and the economic concerns of the franchisor should be considered. The concerns of both parties should be weighed; however, good cause should only be found if the factors in favor of the franchisor outweigh the factors in favor of the franchisee. In other words, the balance should be struck in favor of the franchisee when the interests of both parties appear equal. Although it is not efficient to ignore the interests of the franchisor, it is important to remember that these statutes were enacted to protect the franchisee, not the franchisor. By considering the interests of both parties in the franchise agreement, the purpose of the statute may be carried out without sacrificing all efficiency.

## VI. CONCLUSION

Franchise termination laws, which require good cause for termination, are difficult to apply to franchise termination disputes because good cause is not adequately defined within the statutes. The ambiguity of the term "good cause" leads to an application of the law which is affected by the judge's view of the termination law. As a result, two views about termination laws have developed. The protectionist view focuses on the intent of the legislature and ignores the economic interests of the franchise relationship. The law and economics view focuses on the economic effects of the termination laws and ignores the intent of the legislature. This Note proposes a uniform standard to be added to the termination statutes which incorporates the strengths of both views. This uniform standard alleviates the ambiguity of good cause and properly considers the interests of both parties to the agreement. Only by weighing the interests of both parties in the franchise relationship will the result be both equitable and efficient.

Tracey A. Nicastro