

REGULATION OF FRANCHISOR OPPORTUNISM AND PRODUCTION OF THE INSTITUTIONAL FRAMEWORK: FEDERAL MONOPOLY OR COMPETITION BETWEEN THE STATES?

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Most scholars would agree that a merger between General Motors and Ford should not be judged solely by Delaware corporate law, even if both firms are incorporated in Delaware. Leaving the standards governing such mergers to state law would assuredly produce a race to the bottom that would result in unduly permissive treatment of such transactions.¹ Similarly, if the two firms agreed to divide markets, most would agree that some regulatory authority other than Michigan or Delaware should have the final word on the agreement.² Thus, in order to forestall monopoly or its equivalent, the national government must itself exercise a monopoly—currently through the Sherman Act—over the production of rules governing such transactions.³

This is not to say that the national government should exercise a monopoly with respect to all commercial transactions with some interstate nexus. Assume, for instance,

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1. See HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836-1937 257-60 (1991); Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989).

2. See Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23 (1983).

3. See *Northern Sec. Co. v. United States*, 193 U.S. 197, 343-47 (1904) (rejecting assertion that merger between two interstate railroads should be governed solely by state law); see also *United States v. Union Pacific R.R. Co.*, 226 U.S. 61, 86 (1912) (holding that legality under state law is no defense against Sherman Act liability).

that a contractor from North Carolina promises to build an addition to my house in Virginia before the winter and completes ninety percent of the project—all except the roof—by November 15. Assume further that the contractor threatens not to complete the project, knowing that I cannot find satisfactory substitute performance, and thus secures my “agreement” to an increase in the contract price. Most scholars would agree that state contract law should govern my claims for relief, and that competition between the states regarding the standards governing such conduct would not result in a race to the bottom.⁴ Therefore, no federal monopoly is necessary.

This essay examines a class of cases that stands somewhere between the merger of Ford and General Motors, on the one hand, and the threatened breach by the contractor on the other: franchisor opportunism. These cases are similar to the hypothetical merger or cartel involving Ford and General Motors in that the “offending” parties are large, often multinational corporations that do business in all fifty states. However, they are also like the threatened breach by the contractor in that they involve opportunism in two-party, buyer-seller relationships, opportunism that seems redressable under traditional contract law doctrines. The hybrid nature of such cases presents a puzzle for courts and policymakers who must decide which institution—federal monopoly or competition between the states—should generate the rules governing these transactions.

This essay suggests that the federal government should not, under the aegis of the Sherman Act, displace competition among the states for the production of rules governing purported franchisor opportunism. As shown below, the case for Sherman Act intervention to combat franchisor opportunism turns on the existence of transaction costs, costs

4. See *Alaska Packers' Ass'n v. Domenico*, 117 F. 99, 103 (9th Cir. 1902) (holding that a new “agreement” obtained by threatened breach was unenforceable given pre-existing duty rule); see also *Industrial Representatives, Inc. v. CP Clare Corp.*, 74 F.3d 128, 129-30 (7th Cir. 1996) (stating that implied covenant of good faith is designed to combat opportunism, giving as an example “[t]he movie star who sulks (in the hope of being offered more money) when production is 90% complete, and reshooting the picture without him would be exceedingly expensive”). Indeed, one of the most committed proponents of using the Sherman Act to combat opportunism would not stretch the Act to reach the contractor’s conduct. See Warren S. Grimes, *Making Sense of State Oil Co. v. Khan: Vertical Maximum Price Fixing Under a Rule of Reason*, 66 ANTITRUST L.J. 567, 594 (1998) [hereinafter *Vertical Maximum Price Fixing*].

that would prevent franchisees from protecting themselves in advance by contract or exit. Indeed, the treble-damage remedy of the Sherman Act can be characterized as a liability rule that obviates the market failure that transaction costs would otherwise engender.

Those who have advocated Sherman Act regulation in this context have treated transaction costs as a given—exogenous to the legal system. However, as shown below, these costs are in fact a function of the institutional framework, which is constructed in part by various rules of contract law. By adjusting these common law rules by judicial decision or statute, states can alter the institutional framework, reduce the cost of transactions, and thus undermine the case for Sherman Act intervention.

The mere fact that state courts and legislatures *could* generate rules that deter franchisor opportunism does not mean that they will. Delaware, after all, *could* produce corporate law that deterred all wealth-destroying mergers, though one doubts it would do so.⁵ Still, given state law's potential for preventing franchisor opportunism, advocates of federal intervention in this area must demonstrate that competition between states to produce the institutional framework governing such behavior is beset by a market failure that will produce a race to the bottom. No such demonstration has been made, and preliminary analysis suggests that competition between the states will not, in fact, produce a race to the bottom in this context.

I. THE CASE FOR SHERMAN ACT INTERVENTION

Opportunism by franchisors can take several forms, and consideration of a concrete example that may raise antitrust concerns will help focus the analysis.⁶ Assume that PizzaShack, a multinational franchisor with outlets in fifty states, enters a standard form franchise contract with hundreds of franchisees. Page 11 of the contract, paragraph 63, provides that PizzaShack can require its franchisees to purchase inputs from it at

5. See *infra* note 92 and accompanying text.

6. The ensuing example follows the lead of Professor Grimes. See Warren Grimes, *When Do Franchisors Have Market Power? Antitrust Remedies for Franchisor Opportunism*, 65 ANTITRUST L.J. 105, 142-48 (1996) [hereinafter *Franchisors and Market Power*].

"PizzaShack's discretion."⁷ Further, the contract is silent regarding PizzaShack's right to control its franchisees' prices and to appoint other franchisees near the location of an established outlet. The contract is governed by a ten-year term, and may be terminated "at will" by either party upon thirty days written notice.

Some time after entering into these contracts with its franchisees, PizzaShack invokes its rights under paragraph 63, and announces that, henceforth, all outlets will purchase pizza sauce and dough only from it.⁸ At the same time, the firm announces a new "consumer friendly price policy," which will require many franchisees to roll back their prices on some items.⁹ Failure to adhere to either policy, PizzaShack asserts, will result in termination. Finally, PizzaShack embarks on an aggressive expansion plan, which involves the appointment of new franchisees that "encroach" upon areas previously served by existing outlets.¹⁰

Encouraged by the Supreme Court's decision in *Eastman Kodak Co. v. Image Technical Services, Inc.*,¹¹ some scholars, judges, and numerous franchisees would characterize PizzaShack's strategy as a classic example of franchisor opportunism, opportunism that should be presumed unlawful under the Sherman Act.¹² Consider first paragraph 63—the

7. See *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 433 (3d Cir. 1997) (describing clause providing that Domino's "may in our sole discretion require that ingredients, supplies and materials used in the preparation, packaging, and delivery of pizza be purchased exclusively from us or from approved suppliers or distributors"); *Wilson v. Mobil Oil Corp.*, 984 F. Supp. 450, 452-53 (E.D. La. 1997) (describing requirement that franchisees of Speedee Oil Change Systems, Inc. purchase oil from Mobil Oil Corporation).

8. See *Queen City Pizza*, 124 F.3d at 434 (describing allegations of similar conduct by Domino's); *Little Caesar Enters., Inc. v. Smith*, 895 F. Supp. 884, 887-88 (E.D. Mich. 1995) (describing similar allegations by Little Caesar franchisees).

9. See *Jack Walters & Sons Corp. v. Morton Bldg., Inc.*, 737 F.2d 698, 706-08 (7th Cir. 1984) (recounting claim that manufacturer imposed maximum resale prices on its dealers); *Little Caesar*, 895 F. Supp. at 888-89 (recounting allegation that Little Caesar attempted to place ceiling on franchisees' prices, without contractual basis).

10. See *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 727-28 (7th Cir. 1979) (describing allegations that Fotomat "encroached" on franchisee's territory by placing company stores in franchisee's market areas).

11. 504 U.S. 451 (1992).

12. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 122-23; Jean Wegman Burns, *Vertical Restraints, Efficiency, and the Real World*, 62 *FORDHAM L. REV.* 597, 637-39, 648-49 (1993) (endorsing application of *Eastman Kodak* in dealership context); Robert H. Lande, *Chicago Takes it on the Chin: Imperfect Information Could Play a Crucial Role in the Post-Kodak World*, 62 *ANTITRUST L.J.* 193, 200 (1993) (predicting that *Eastman Kodak* could apply in franchising context). See generally W. David Slawson, *Excluding*

tying contract. To be sure, it is highly unlikely that PizzaShack has any "market power" in a market for franchise opportunities.¹³ Thus, PizzaShack did not, at the time of contract formation, have the ability to "force" franchisees to accept unwanted terms.¹⁴ Still, by the time the new policy was announced, PizzaShack's franchisees were likely "locked in" to their relationships (*i.e.*, they had made investments specific to their status as PizzaShack franchisees).¹⁵ At this point, PizzaShack *is* in a position to exercise a sort of "market power" *vis à vis* its franchisees, by, for instance, enforcing or imposing onerous contractual terms.¹⁶ To be sure, the clause "authorizing" the new policy appeared in the contract from its inception; franchisees thus had notice of it and could have bargained for its removal or modification *before* PizzaShack had them over a barrel. Still, most franchisees probably did not read the clause, or if they did, decided not to invest resources bargaining over it.¹⁷ Thus, it is said, courts should presume the tie unlawful, subject to the assertion of an affirmative defense.¹⁸

Competition Without Monopoly Power: The Use Of Tying Arrangements To Exploit Market Failure, 36 ANTITRUST BULL. 457 (1991) (suggesting that courts should presume ties unlawful because transaction costs facilitate opportunism).

13. See Alan H. Silberman, *The Myths of Franchise "Market Power,"* 65 ANTITRUST L.J. 181, 206 (1996) ("[A] franchisor market power assessment requires reference to all alternatives available to the potential consumer [*i.e.*, the franchisee] in a broad line of business endeavors. In many cases this will extend to the market for franchises of all types or the employment of capital."); Benjamin Klein and Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 356 (1985) (noting the lack of franchisor market power despite trademark); see also *Mozart Co. v. Mercedes-Benz of N. Am., Inc.*, 833 F.2d 1342, 1346-47 (9th Cir. 1987).

14. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 15-17 (1984) (holding that *per se* rule against tying is designed to identify those instances in which seller possesses market power sufficient to "force" purchaser to take unwanted tied product).

15. See *Queen City Pizza*, 124 F.3d at 445-46 (Lay, J. dissenting) (arguing that reasoning of *Eastman Kodak* requires conclusion that franchisors possess market power where franchisees with imperfect information have made relationship-specific investments); *Collins v. Int'l Dairy Queen*, 980 F. Supp. 1252, 1259-60 (M.D. Ga. 1997) (same); Grimes, *Franchisors and Market Power*, *supra* note 6, at 112-16, 125-26.

16. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 112-16, 125-26 (applying reasoning of *Eastman Kodak* in franchising context).

17. See *id.* at 123-25, 127-29, 133-34; *Wilson v. Mobil Oil Corp.*, 940 F. Supp. 944, 953-54 (E.D. La. 1996) ("[I]t is not self-evident to this Court that before-the-fact disclosure of the tie-in means in all cases that information costs are not so high as to preclude accurate lifecycle pricing"); see also Slawson, *supra* note 12, at 482-87.

18. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 142-51; see also Slawson, *supra* note 12, at 494-501 (arguing that, in light of bargaining and information costs, courts should declare ties "*per se*" unlawful, subject to assertion of an affirmative defense). As a doctrinal matter, these scholars would hold that the presence of relationship-specific investments, coupled with lack of pre-investment knowledge of the tie, constitutes "market power" of the sort necessary to establish a *per se* violation. See generally *Eastman Kodak*, 504 U.S. at 471-78 (adopting this approach); *Jefferson*

Similar considerations purportedly require hostile treatment of the maximum resale price maintenance ("rpm") policy.¹⁹ Here again, franchisees have been "locked in" to their relationships with the franchisor.²⁰ Because franchisors can abuse their positions by imposing maximum rpm, such policies should be presumed unlawful, subject to proof that they are, on balance, procompetitive.²¹ Indeed, the case for intervention here is in some sense *stronger* than it was with respect to the tying agreement. There, at least, franchisees could have warned themselves of the potential for opportunism by reading their contracts.²² Nothing in the contract hypothesized here, however, alerted franchisees to the possibility that the franchisor could impose a price ceiling.²³ Franchisees could have protected themselves in advance by negotiating for a clause that granted them explicit protection against such behavior.²⁴ Here again, however, bargaining and information

Parish, 466 U.S. at 11-18 (holding that proof of market power is necessary to establish per se liability). Despite the "per se" label, some courts would allow sellers to assert a business justification defense. See *Mozart*, 833 F.2d at 1348-50.

19. See Grimes, *Vertical Maximum Price Fixing*, *supra* note 4, at 580-81; LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 391 (1977) (arguing that potential for opportunism by franchisors justifies per se rule against maximum rpm). See also Brief for the Service Station Dealers of America as Amicus Curiae Supporting Affirmance at *6-8, *State Oil Co. v. Khan*, 118 S. Ct. 275 (1997) (No. 96-871) (arguing that suppliers use maximum resale price maintenance to exploit dealers' relationship-specific investments); Brief for Minnesota Service Station and Convenience Store Association, et al. as Amicus Curiae in Support of Respondents at *5-10, *State Oil Co. v. Khan*, 118 S. Ct. 275 (1997) (No. 96-781) (same).

20. See Grimes, *Vertical Maximum Price Fixing*, *supra* note 4, at 586-89.

21. See *id.* at 589-604. See generally *State Oil Co. v. Khan*, 118 S. Ct. 275 (1997) (holding that maximum resale price maintenance is judged under rule of reason).

22. See *Queen City Pizza*, 124 F.3d at 441 (rejecting franchisees' claim that tie was imposed by means of market power where contractual requirement was present in initial franchise contract); *Wilson v. Mobil Oil Corp.*, 984 F. Supp. 450, 459-61 (E.D. La. 1997) (same). See generally *Town Sound and Custom Tops, Inc. v. Chrysler Motors Corp.*, 959 F.2d 468, 489-90 (3d Cir. 1992) (en banc) (holding that the antitrust laws adopt a posture of caveat emptor and thus do not view unfair consumer surprise as a cognizable harm).

23. See *Collins v. Int'l Dairy Queen*, 980 F. Supp. 1252, 1259-60 (M.D. Ga. 1997) (finding that franchisor could possess market power under *Eastman Kodak* because franchisor departed from terms of franchise agreement, which contemplated that franchisees could choose independent suppliers); *Queen City Pizza*, 124 F.3d at 448-49 (Lay, J., dissenting) (arguing that imperfect information prevented franchisees from protecting themselves where tying clause was "applied [by franchisor] in such an odd and predatory way").

24. See Lande, *supra* note 12, at 200 ("Absent imperfect information [franchisor] rent extraction would not be a concern, for no franchisee would sign a franchisee agreement that would enable the franchisor unfairly to extract its goodwill."); see also Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 148 (1979) ("[I]f there were adequate . . . foreknowledge . . . [policing and enforcement] costs could be avoided by

costs likely prevent such a strategy.

Unlike the tying contract or the maximum rpm agreement, the purported encroachment is a purely unilateral act, and thus cognizable only under section 2 of the Act.²⁵ At first glance, it would seem that PizzaShack lacks market power in any relevant market, with the result that no claim under this section is possible.²⁶ However, the presence of relationship-specific investments suggests a market consisting of PizzaShack franchisees, of which PizzaShack presumably has a monopoly—literally.²⁷ Absent some legitimate business reason for doing so, appointment of new franchisees that encroach on existing ones should be deemed an abuse of monopoly power and thus void.²⁸

II. CREATING AN INSTITUTIONAL FRAMEWORK THAT MINIMIZES TRANSACTION COSTS

This story of franchisor opportunism is certainly a plausible one. Moreover, the case for antitrust regulation is straightforward—resting, as it does, on a market failure produced by bargaining and information costs.²⁹ When such costs are present, they may produce a “lemons equilibrium” —

contractual stipulations or by declining to trade with . . . agents . . . known to avoid fulfilling their obligations.”).

25. See generally *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984); *United States v. Colgate Co.*, 250 U.S. 300 (1919).

26. See *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966) (finding that the possession of monopoly power is a necessary element of a monopolization claim); *Times-Picayune Publ'g Co. v. United States*, 345 U.S. 594, 611-13 (1953) (holding that 40 percent of the relevant market is insufficient to show the “market dominance” necessary for a monopolization claim); see also *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 447-48 (1993) (holding that a claim for attempted monopolization requires dangerous probability that defendant will obtain monopoly power).

27. See *Eastman Kodak*, 504 U.S. at 481-82 (holding that the presence of relationship-specific investments created triable issue of fact on question of whether Eastman Kodak had a 100% share of the market of its own spare parts sold to locked-in consumers); Grimes, *Franchisors and Market Power*, *supra* note 6, at 139; *Collins*, 980 F. Supp. at 1258-61 (relying on *Eastman Kodak* to deny franchisor's motion for summary judgment on claim that franchisor monopolized a relevant market of “products sold to Dairy Queen franchisees located in the United States (outside of Texas)”).

28. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 136-41.

29. See KENNETH G. ELZINGA & WILLIAM BREIT, *THE ANTITRUST PENALTIES* 6 (1976) (“[I]n a world of no transactions or information costs (and one in which people did not attempt to act as free riders), the benefits of competitive markets would readily be secured.”); Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J.L. & ECON. 67, 70 (1968) (“Assuming no transaction costs, those who lose from the relative underproduction of monopolies could bribe monopolists to produce more.”).

that is, a deviation from the quality of franchise opportunity that would have been produced in their absence.³⁰ In this context, the treble-damage remedy of the Sherman Act can be seen as a liability rule that discourages the sort of opportunism that might otherwise be prompted by market failure.³¹

The mere fact that one can tell a plausible story of opportunism does not, without more, justify antitrust intervention. The question remains whether the costs of such intervention outweigh its benefits.³² Some have argued that this criterion is not met where franchisor opportunism is concerned. Franchisees are free to evaluate the terms and conditions of franchise contracts, as well as any potential for opportunism that such agreements might create.³³ Franchisees that fear opportunism can protect themselves by negotiating contractual protection or, in the alternative, "exiting" and signing on with a franchisor that has a reputation for trustworthiness.³⁴ This latter course—migrating to trustworthy franchisors—will ensure that franchise opportunities are priced to reflect both their contractual terms and the franchisor's reputation.³⁵ Moreover, to the extent that a franchisor attempts to engage in post-contractual opportunism, it will suffer in the marketplace as its reputation for fair dealing deteriorates, thereby reducing the price that it can command for franchise opportunities in the future.³⁶ While admitting that relationship-

30. See George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 489 (1970); see also Alan J. Meese, *Antitrust Balancing in a (Near) Coasean World: The Case of Franchise Tying Contracts*, 95 MICH. L. REV. 111, 134 n.108 (1996) (noting that a franchise can be analogized "to a durable good, the characteristics of which cannot be observed in advance").

31. See Calabresi, *supra* note 29, at 69-71.

32. See Ronald H. Coase, *The Firm, the Market, and the Law*, in *THE FIRM, THE MARKET, AND THE LAW* 26 (1988).

33. See Silberman, *supra* note 13, at 210-14; Benjamin Klein, *Market Power in Antitrust: Economic Analysis After Kodak*, 3 SUP. CT. ECON. REV. 43, 50-51 (1993); Roger D. Blair & John E. Lopatka, *The Albrecht Rule After Khan: Death Becomes Her*, 74 NOTRE DAME L. REV. 123, 167 (1998) (arguing that opportunistic imposition of resale price ceiling should not be scrutinized under the Sherman Act because "[t]he return the dealer expects for performing distribution services is the very heart of the transaction with her supplier The dealer has both a keen incentive and ability to protect herself contractually from subsequent opportunism on the part of the supplier.").

34. See Klein, *supra* note 33, at 50-53.

35. See *id.* at 57 (stating that "dealers [are] presumably adequately compensated for the residual risk they voluntarily assumed in the contractual arrangement"); see also Meese, *Antitrust Balancing In A (Near) Coasean World*, *supra* note 30, at 133-41 (arguing that the price of a franchise opportunity will reflect contractual terms).

36. See George A. Hay, *Is the Glass Half-Empty or Half-Full?: Reflections on the Kodak*

specific investments can create the potential for abuse, those scholars who argue against federal intervention also point out that such investments might serve useful purposes as “hostages” that franchisors may use to deter opportunism by franchisees.³⁷ Indeed, the sort of contractual devices most often deemed opportunistic—tying arrangements and maximum rpm—can be methods of controlling franchisee opportunism.³⁸ Treating “hostages” designed to enforce such agreements as a source of market power that renders these contractual provisions presumptively unlawful may do more harm than good.³⁹

This critique of using antitrust law to thwart franchisor opportunism is powerful, maybe even compelling. Even if this critique fails, however, there is another, more fundamental problem with the case for Sherman Act regulation in this context. That is to say, even if the sort of opportunism described earlier is plausible, and even if some form of intervention is necessary to prevent it, proponents of Sherman Act regulation have not explained why *federal* intervention is necessary. More precisely, these advocates have ignored the role that state law can and does play in reducing transaction costs and subsequent market failures.

As noted earlier, the possibility of opportunism depends upon bargaining and information costs that prevent franchisees

Case, 62 ANTITRUST L.J. 177, 185-88 (1993); *Parts and Elec. Motors, Inc. v. Sterling Elec., Inc.*, 866 F.2d 228, 236 (7th Cir. 1988) (Posner, J., dissenting).

37. See Klein, *supra* note 33, at 62-63. See generally Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 523, 575-80 (1981) (arguing that shirking by franchisees is a paradigmatic example of opportunistic behavior).

38. See Klein & Saft, *supra* note 13, at 350-54; Alan J. Meese, *Price Theory and Vertical Restraints: A Misunderstood Relation*, 45 UCLA L. REV. 143, 165-66 (1997) (describing how maximum rpm can prevent franchisee opportunism) [hereinafter Meese, *Price Theory and Vertical Restraints*]. See generally Silberman, *supra* note 13, at 212-13 (suggesting that restraints in franchise contract can be part of the bundle of rights that maximizes value of franchise opportunity); Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 227-28 (1978).

39. See Klein & Saft, *supra* note 13, at 352-53 (arguing that, by outlawing effective vertical controls, courts may induce franchisors to seek additional relationship-specific investments from franchisees, thus making franchisees even more vulnerable to opportunism). One could mitigate the harmful effects of antitrust intervention in this context by relaxing the standards employed to evaluate the justifications that a franchisor might advance for such a change in policy. See generally Meese, *Antitrust Balancing In A (Near) Coasean World*, *supra* note 30, at 129-45 (arguing for a relaxation of the standards employed to evaluate affirmative defenses to tying contracts that are otherwise per se unlawful); Klein & Saft, *supra* note 13, at 352-53. Still, such a regime would outlaw all such contracts that could not be justified, regardless of whether they produced any real anticompetitive effect.

from protecting themselves in advance by contract or exit.⁴⁰ In a world beset by such costs, a franchisor can insert onerous clauses in the franchise contract without suffering in the marketplace (i.e., without any reduction in the price it might command for the opportunities it sells).⁴¹ Moreover, the franchisor can engage in various forms of post-contractual opportunism unhampered by any agreement franchisees would have negotiated absent transaction costs.⁴²

Although this story is plausible, it depends upon a particular institutional framework and the transaction costs that this framework might create.⁴³ Consider first the tying clause, inserted in the initial franchise contract. Proponents of Sherman Act regulation of franchisor opportunism assume that such a clause would be binding, regardless of whether the franchisee was aware of it and regardless of how onerous it is. Certainly this is true under the original Restatement of Contracts, which provided that parties had a "duty to read" their contracts and thus were bound to any terms contained therein.⁴⁴ In a "duty to read" regime, the possibility of such opportunism could be real and may justify Sherman Act regulation.

Such a story is far less plausible if one substitutes a different regime of contract law to govern the transaction—namely, the Second Restatement. Under this regime, any clause in a standard form contract that is outside the reasonable expectation of the parties will not be enforced, absent subjective assent by the party to be bound.⁴⁵ Thus, a franchisor

40. See *supra* notes 18, 23-24 and accompanying text.

41. See *supra* notes 13-18 and accompanying text.

42. See *supra* notes 16, 19-20 and accompanying text.

43. See Ronald H. Coase, *The Institutional Structure Of Production*, 82 AM. ECON. REV. 713, 714 (1992). This essay uses the phrase "institutional framework" as shorthand for what Professor Coase calls "the institutional structure of production" (i.e., "institutional arrangements which govern the process of exchange").

44. See RESTATEMENT (FIRST) OF CONTRACTS § 70; *Sanger v. Dun*, 3 N.W. 388, 389 (Wis. 1879) ("It will not do for a man to enter into a contract, and, when called upon to abide by its conditions, say that he did not read it when he signed it, or did not know what it contained."); see also JOHN D. CALAMARI & JOSEPH PERILLO, *THE LAW OF CONTRACTS* 376-77 (4th ed. 1998) (describing "Traditional Rule" on the duty to read); Stewart Macaulay, *Private Legislation and the Duty To Read—Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 VAND. L. REV. 1051, 1052-55 (1966) (same).

45. See RESTATEMENT (SECOND) CONTRACTS § 211(3) (stating that standard terms are not binding when the proponent of the contract "has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term"); RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. f (stating that buyers "are not bound to *unknown* terms which are beyond the range of reasonable

could not enforce a tying clause that a court might deem unduly onerous unless it had called the clause to the franchisee's attention, explained it, and obtained the franchisee's subjective assent to it.⁴⁶

Such a regime can lower the transaction costs that accompany the negotiation of the franchise contract and encourage opportunism. Franchisees who sign standard franchise contracts can rely upon the franchisor to insert only those clauses that are within the reasonable expectation of the parties, and thus, they need not expend resources carefully scrutinizing the agreement.⁴⁷ Franchisors that want to enforce questionable terms must disclose them. This disclosure will produce information and reduce the franchisee's costs of identifying such clauses. If an unduly onerous clause is disclosed it will be priced, thus deterring the franchisor from adopting it in the first place.⁴⁸ If administered as advertised,

"expectation") (emphasis added); CALAMARI & PERILLO, *supra* note 44, at 389-90; John E. Murray, Jr., *The Standard Agreement Phenomenon In The Restatement (Second) of Contracts*, 67 CORNELL L. REV. 735, 765-79 (1982).

46. For an application of this principle in the franchising context that pre-dates the adoption of the Second Restatement, see *Weaver v. American Oil Co.*, 276 N.E.2d 144 (Ind. 1971) (refusing to enforce oppressive term in a standard franchise contract when the franchisor had not obtained the franchisee's subjective assent to the term).

47. The authors of section 211 apparently recognized that this provision could serve such a purpose. See RESTATEMENT (SECOND) OF CONTRACTS, § 211 cmt. b ("One of the purposes of standardization is to eliminate bargaining over details of individual transactions, and that purpose would not be served if a substantial number of customers retained counsel and reviewed the standard terms."); see also Meese, *Antitrust Balancing In A (Near) Coasean World*, *supra* note 30, at 139 n.132 (suggesting that section 211 can lower transaction costs).

Over a decade before section 211 was adopted, Professor Macaulay recognized that relaxation of the duty to read could facilitate trust between the parties and obviate the necessity of careful scrutiny of a standard agreement:

Perhaps more often transactional policy will call for overturning or modifying a written document (by reforming or construing it) in the light of the bargain-in-fact of the parties. While a case can be made for self-reliance, part of decent social and business conduct is trust. In many negotiation situations all of the pressures push for friendly gestures rather than a suspicious line-by-line analysis of the writing. The buyer of home siding can believe the president of the home remodeling company when he says his siding will not rust or crack; the buyer does not have to parse the text of the lengthy and technical printed form and spot the integration clause at his peril.

Macaulay, *supra* note 44, at 1061 (footnote omitted). Cf. Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEG. STUD. 1, 4-5 (1978) (arguing that when "there is a . . . gap in the contract—a court concerned with economic efficiency should impose the risk on the better information-gatherer . . . [B]y allocating the risk in this way, an efficiency-minded court reduces the transaction costs of the contracting process itself") (footnote omitted).

48. See Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 29-31 (1993) (observing that rules that induce

then, section 211 operates as a sort of liability rule that can reduce transaction costs that might otherwise prevent franchisees from locating and pricing onerous terms.⁴⁹

The realization that section 211 can reduce the transaction costs that might otherwise produce a lemons equilibrium in contractual terms is merely an application of a larger principle recognized by Professor Coase and others—namely, that the extent and nature of transaction costs are not exogenous to the institutional framework but are instead a function of it. As Professor Coase put it in his Nobel lecture:

[T]he rights which individuals possess, with their duties and privileges, will be, to a large extent, what the law determines. As a result, the legal system will have a profound effect on the working of the economic system and may in certain respects be said to control it. . . . It makes little sense for economists to discuss the process of exchange without specifying the institutional setting within which the trading takes place.⁵⁰

Indeed, Professor Coase himself anticipated the analysis of section 211 laid out above. In describing the various steps the state could take to reduce the cost of transacting and thus eliminate market failure, Coase said:

Since, by and large, people choose to perform those actions which they think will promote their own interests, the way to alter their behaviour in the economic sphere is to make it

disclosure of contractual terms will lead terms to be priced); Armen Alchian & Harold Demsetz, *The Property Rights Paradigm*, 33 J. ECON. HIST. 16, 21 (1973) (showing that interference with price system increases bargaining costs); F.A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 526-27 (1945) (noting that price system impounds information and reduces the cost of transacting).

49. See Meese, *Antitrust Balancing in a (Near) Coasean World*, *supra* note 30, at 139 n.132; Craswell, *supra* note 48, at 10-12, 49-51 (arguing that “liability rule” refusing to enforce unreasonable terms can prevent occurrence of lemons equilibrium in contract terms); see also Richard Craswell, *Tying Requirements in Competitive Markets: The Consumer Protection Issues*, 62 B.U. L. REV. 661, 697-98 (1982) (arguing that ties that arise due to market failure should be addressed via disclosure remedies). Cf. Salil Kumar, Comment, *Parts and Service Included: An Information-Centered Approach to Kodak and the Problem of Aftermarket Monopolies*, 62 U. CHI. L. REV. 1521, 1538-44 (1995) (proposing rule whereby disclosure of competitive terms by durable goods monopolist precludes liability under Kodak).

50. Coase, *Institutional Structure*, *supra* note 43, at 717-18; see also Victor P. Goldberg, *Production Functions, Transaction Costs, and the New Institutionalism*, in READINGS IN THE ECONOMICS OF CONTRACT LAW (Victor P. Goldberg ed. 1989) (“Transaction costs are those costs most likely to differ under alternative institutional arrangements.”); Ronald H. Coase, *The Choice of the Institutional Framework: A Comment*, 17 J.L. & ECON. 493, 493 (1974) (“[T]he way in which property rights are defined can affect the costs of transactions, [and] any change in those rights will affect the transactions that are carried out . . .”).

in their interest to do so. The only means available to the government for doing this (apart from exhortation, which is commonly ineffective) is a change in the law or its administration. The forms such changes may take are many. They may amend the rights and duties which people are allowed to acquire or are deemed to possess, or they may make transactions more or less costly by altering the requirements for making a legally binding contract.⁵¹

Section 211 follows Professor Coase's admonition. Franchisors can only acquire the right to control a franchisee's purchasing decisions when such control is reasonable, or when the franchisee has explicitly agreed to cede such control. Moreover, by "altering the requirements for making a legally binding contract"⁵²—that is, by changing the definition of "agreement"—the provision reduces the franchisee's cost of identifying and pricing a potentially onerous term. Thus, section 211 reduces transaction costs and discourages franchisors from inserting onerous clauses.

Section 211 is not the only adjustment of contract law that can alter the institutional framework and reduce the cost of transacting. Fraud and unconscionability doctrines can perform similar functions.⁵³ This is not to say that adjustment of the institutional framework can reduce to zero the costs of negotiating and enforcing franchise agreements. Short of an outright subsidy, no rule of law can eliminate the cost of reading an agreement or dickering over its terms. Still, by its nature, pre-contractual opportunism involves insertion *and* subsequent enforcement of terms that appear beyond the reasonable expectation of the parties. By declining to enforce such clauses absent disclosure and assent, courts that follow section 211 or similar rules can reduce to zero the franchisee's cost of identifying an unduly onerous contractual term *that is legally enforceable*. Thus, even in the "real world," where bargaining and information costs are present, reforms in the

51. Coase, *The Firm, the Market, and the Law*, *supra* note 32, at 27-28.

52. *Id.* at 28.

53. By penalizing intentional fraud, for instance, states can ensure that purchasers need not take (wasteful) precautions to verify a seller's representations, thus reducing the cost of transactions. See *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1546 (7th Cir. 1990); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 527-28 (7th Cir. 1985). Similarly, by banning oppressive contractual terms under the doctrine of unconscionability, states can obviate the necessity of wasteful pre-contractual investigation.

institutional framework can prevent the sort of pre-contractual opportunism that might otherwise arise and change the content of the agreements produced by negotiation between franchisor and franchisee.⁵⁴

This is all well and good when applied to pre-contractual opportunism. But what about the sort of post-contractual opportunism discussed earlier?⁵⁵ What if, for instance, a franchisor announces a maximum rpm policy after the contract has been signed, and after the franchisee has made relationship-specific investments? Section 211 would have no bearing on such a policy, which has been clearly announced to franchisees, who must adhere to it under threat of termination. In this context, the transaction costs that prevent franchisees from protecting themselves in advance are, in fact, exogenous, suggesting that some form of antitrust intervention is necessary. Similar considerations would seem to counsel antitrust intervention to combat unreasonable encroachment.

It is true that a franchisor that wished to enforce a new maximum rpm policy, or to encroach on its existing franchisees, would find no opposition from section 211. The franchisor would, however, have to contend with other background rules of contract law, most notably the covenant of good faith. This covenant, implied in all contracts, prevents either party from taking steps that deprive the other party of its legitimate expectations under the agreement.⁵⁶ Indeed, some states have essentially codified this covenant in franchisee protection statutes that prevent termination except for "good

54. See Coase, *Institutional Structure*, *supra* note 43, at 716-18 (explaining that legal institutions can affect transaction costs and thus the nature of transactions that take place).

55. See *supra* notes 37-42 and accompanying text (discussing various forms of post-contractual opportunism).

56. See, e.g., *Hentze v. Unverferht*, 604 N.E.2d 536, 539 (Ill. App. Ct. 1992) (finding that the implied covenant of good faith forbids "opportunistic advantage-taking or lack of cooperation depriving the other contracting party of his reasonable expectations") (citations omitted); *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 727-28 (7th Cir. 1979) (stating that according to California law, the covenant of good faith prevents the franchisor from destroying "the right of the other party to enjoy the fruits of the contract"); *Burger King Corp. v. Agad*, 941 F. Supp. 1217, 1221 (N.D. Ga. 1996) (applying Florida law to find that "[t]he implied covenant of good faith and fair dealing requires that 'a party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties'"); RESTATEMENT (SECOND) OF CONTRACTS § 205; U.C.C. §§ 1-203, 2-103(1)(b).

cause."⁵⁷ Assume, for a moment, that a franchisor announces a price ceiling, and terminates a franchisee for failing to adhere to it. Assume further that the price set by the franchisor was unreasonably low and could not be justified as an attempt to prevent opportunistic price gouging by franchisees.⁵⁸ Such behavior by the franchisor would deprive the franchisee of at least a portion of the profits it expected to derive under the agreement in question and could thus breach the good faith covenant.

A similar analysis would apply if the franchisor were to appoint franchisees that encroached on the location of established franchisees, or if it opened its own outlets that encroached in this manner. If the creation of these outlets deprived the franchisee of its legitimate expectations under the agreement, such a deprivation would offend the good faith covenant.⁵⁹

Implied covenants do not trump express contractual terms.⁶⁰ An act expressly authorized by an agreement cannot, by

57. See *Moore v. Tandy Corp.*, 819 F.2d 820 (7th Cir. 1987) (reading Wisconsin Fair Dealership Law to apply only where dealer has made relationship-specific investments); *Grand Light & Supply Co., Inc. v. Honeywell, Inc.*, 771 F.2d 672, 677-78 (2d Cir. 1985) (reading Connecticut Franchise Act similarly); *Burns*, *supra* note 12, at 617-24 (describing such statutes and their requirements).

58. See *Meese, Price Theory And Vertical Restraints*, *supra* note 38, at 165-66 (describing how price-cutting dealers can lure customers away from other dealers who have invested heavily in marketing). Such price gouging by franchisees could violate their undertaking of good faith, and thus be grounds for termination. Cf. *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 975 (Ill. App. Ct. 1984) (finding that a termination for failure to satisfy quality standards was in good faith, regardless of what other motives franchisor may have had).

59. See, e.g., *Vylene Enterprises, Inc. v. Naugles, Inc. (In re Vylene)*, 90 F.3d 1472, 1477 (9th Cir. 1996); *Scheck v. Burger King Corp.*, 798 F. Supp. 692, 694-700 (S.D. Fla. 1992); *Photovest Corp.*, 606 F.2d at 728. See generally Marc A. Wites, *The Franchisor As Predator: Encroachment and the Implied Covenant of Good Faith*, 7 FLA. J.L. & PUB. POL'Y 305 (1996). But cf. *Burger King Corp. v. Weaver*, 169 F.3d 1310, 1317-18 (11th Cir. 1999).

60. See, e.g., *Hentze*, 604 N.E.2d at 539 (stating that good faith covenant is implied "absent express disavowal [C]ontract terms implied in law cannot supplant express terms of a contract.") (citations omitted); *L.A.P.D., Inc. v. General Elec. Corp.*, 132 F.3d 402, 403-04 (7th Cir. 1997); *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 877-78 (5th Cir. 1989) (applying Michigan Law); *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480, 485 (5th Cir. 1984) ("The implied obligation to execute a contract in good faith usually modifies the express terms of the contract and should not be used to override or contradict them."); see also U.C.C. § 1-102(3) (stating that parties may "by agreement determine the standards by which the performance of such [good faith] obligations is to be measured if such standards are not manifestly unreasonable"); Ill. Rev. Stat. 1981, ch. 121 1/2, 704.3 (defining "good cause" for franchise termination as, among other things, "failure of the franchise to comply with any lawful provision of the franchise or other agreement").

definition, deprive the other party of its expectations.⁶¹ Because parties can contract around it, the implied covenant of good faith plays much the same role with respect to post-contractual opportunism that section 211 can play where pre-contractual opportunism is involved. By treating various forms of opportunism as a breach, this covenant reduces the bargaining and information costs that would otherwise prevent franchisees from protecting themselves in advance by contract or exit.⁶² For instance, if a franchisor wishes to impose an onerous price ceiling, it must secure the right to do so in an explicit agreement with the franchisee. Similarly, if a franchisor wishes to encroach on a franchisee's operations in a way that destroys its reasonable expectations, it must obtain an agreement to do so in advance.⁶³ Any attempt to obtain such an agreement could be made subject to the provisions of section 211.⁶⁴ Thus, franchisees need not anticipate each conceivable act of franchisor opportunism and preclude it by contract. Judicious application of the good faith covenant, then, can produce an institutional framework that blocks the opportunism that might otherwise occur under a different framework with higher transaction costs.

I do not mean to suggest that all states have constructed institutional frameworks that minimize, to the extent possible, the transaction costs that can engender franchisor opportunism. Nor should readers take this essay as an endorsement of each state law doctrine described above. Determining whether a clause is within the parties' "reasonable expectations" or

61. See *Super Valu Stores, Inc. v. D-Mart Food Stores, Inc.*, 431 N.W.2d 721, 726 (Wis. Ct. App. 1988) ("[I]t would be a contradiction in terms to characterize an act contemplated by the plain language of the parties' contract as a 'bad faith' breach of that contract.").

62. See *Kham & Nate Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) ("'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.").

63. See *Scheck*, 798 F. Supp. at 699-700 ("If a franchise agreement gives the franchisor the right to build (or permit building) another store next door to the one earlier permitted, it had better say so in clear terms. If it does not—if the franchisor has not given unto itself the right to be predatory—then it should be prepared to defend its position on a good faith—that is, reasonable conduct—basis."); *Carlock v. Pillsbury Co.*, 719 F. Supp. 791, 819-20 (D. Minn. 1989) (rejecting franchisee's claim that mass distribution of Haagen-Dazs products breached covenant of good faith where contract expressly provided that franchisor could distribute such products "by any method"); *Cook v. Little Caesar Enters., Inc.*, 972 F. Supp. 400, 409-10 (E.D. Mich. 1997).

64. See *supra* notes 45-47 and accompanying text.

second-guessing one or the other parties' business decisions can be a tricky business; substitution of imperfect judicial oversight for imperfect markets will not invariably produce a net social improvement.⁶⁵ Such caution is particularly appropriate in the franchising context, where apparently "unfair" arrangements, including termination, may serve useful purposes that are difficult to explain to courts.⁶⁶ The claim made here is a more modest one. The case for Sherman Act intervention depends upon the presence of transaction costs, which prevent franchisees from protecting themselves—through negotiation or exit—from onerous, legally-binding contractual terms or post-contractual opportunism. Transaction costs do not exist in a vacuum, but they are instead a function of the institutional framework constructed by the background legal regime, particularly the law of contracts. The case for Sherman Act regulation of franchisor opportunism, then, necessarily depends upon a conclusion that, despite state law regimes, transaction costs are still so high as to engender opportunism. If, on the other hand, the institutional framework is such that transaction costs are low, the case for antitrust intervention evaporates.⁶⁷

III. PRODUCTION OF THE INSTITUTIONAL FRAMEWORK: STATE COMPETITION OR FEDERAL MONOPOLY?

The realization that state law can reduce transaction costs and deter opportunistic behavior has important implications for attempts to employ the Sherman Act in the franchising context. As previously noted, proponents of Sherman Act regulation of franchisor opportunism would erect a presumption that such costs are present and can engender opportunism whenever a franchisee has made relationship-specific investments.⁶⁸ If transaction costs are a function of state law, however, it would seem that franchisees should bear the burden of establishing the existence of such costs, taking into

65. See Craswell, *supra* note 48, at 49-51; Coase, *The Firm, the Market, and the Law*, *supra* note 32, at 20-28; Frank H. Easterbrook, *Allocating Antitrust Decisionmaking Tasks*, 76 GEO. L.J. 305 (1987).

66. See Benjamin Klein, *Transaction Cost Determinants of Unfair Contractual Arrangements*, 70 AM. ECON. REV. 356, 358-60 (1980).

67. See *supra* note 29 and accompanying text (explaining that opportunism depends upon the existence of transaction costs).

68. See *supra* notes 27-28.

account the entirety of the institutional framework generated by the state whose law would otherwise govern the transaction or relationship in question.⁶⁹ For instance, franchisees who claim that they are victims of pre-contractual opportunism should shoulder the burden of establishing that the contractual provision in question is enforceable under whatever contract law governs the transaction.

This realization also raises a more fundamental question about the proper allocation of regulatory authority between states and the federal government. If the case for Sherman Act intervention depends upon the presence of transaction costs, and if states are capable of reducing such costs by changing the rules that make up the institutional framework, why is Sherman Act regulation of purported opportunism necessary? Put another way, the Sherman Act is only one particular method—and a rather inflexible method at that—of combating market failure. Why prefer it to whatever remedy or remedies that a state may choose to impose? Why, for instance, should federal courts, operating under the aegis of the Sherman Act, second-guess a state court's treatment of a clause obligating a franchisee to purchase inputs only from the franchisor? Or, if a franchisor should encroach on a franchisee's territory without justification, why second-guess the remedy that a state court might order for breach of the covenant of good faith implied by the common law or codified in a state franchisee-protection statute?⁷⁰ Presumably, states strive to construct institutional frameworks that minimize the costs associated with commercial transactions, including the costs of opportunism and judicial intervention to prevent it. Why not rely upon competition between these states to generate the most effective institutional frameworks for reducing the transaction costs that can engender opportunism in purchase and sale transactions? After all, this is the approach that antitrust would take in the case of the opportunistic building contractor described earlier, even if such conduct were otherwise within the scope of

69. See *Eastman Kodak, Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 466-67 (1992) ("Legal presumptions that rest upon formalistic distinctions rather than actual market realities are generally disfavored in antitrust law.").

70. See, e.g., *Illinois Motor Vehicle Franchise Act*, 815 ILL. COMP. STATS. 710/13 (West 1995) (providing treble damages for "willful or wanton" misconduct as defined by the Act).

Federal Commerce power.⁷¹ Absent a showing that such behavior injures third parties, such as consumers, there is no direct restraint of interstate commerce with the result that federal intervention is unwarranted.⁷²

To be sure, the mere fact that state law *can* reduce the sort of transaction costs engendering opportunism does not mean that it *will* reduce such costs. As this essay noted at the outset, Delaware *could* develop a body of corporate law that prevented anticompetitive mergers, although one suspects that it would not. Instead, Delaware would most likely compete with other states to offer corporate law that would maximize corporate profits, and, in so doing, would approve transactions that exported costs to other states.⁷³ Indeed, the whole reason for *federal* antitrust regulation is that states may be unable or unwilling to combat anticompetitive conduct that imposes costs on out-of-state consumers, consumers who cannot protect themselves by bargaining with the offending state.⁷⁴ Thus,

71. See *supra* note 4 and accompanying text; see also *Russell v. United States*, 471 U.S. 858, 862 (1985) (holding Congress may punish arson of apartment building under the commerce power); Grimes, *Vertical Maximum Price Fixing*, *supra* note 4, at 594 (conceding that Sherman Act should not reach opportunism by building contractor). It is very hard to distinguish the contractor's opportunism from that of a franchisor that encroaches on a franchisee's territory. Such encroachment involves abuse of the franchisor's monopoly over a market consisting of the franchisee's opportunity. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 139. Similarly, the contractor's threatened breach involves abuse of its monopoly in a market defined as the completion of my house.

72. See *Hunt v. Crumboch*, 325 U.S. 821, 826 (1945) ("[The Sherman] Act does not purport to afford remedies for all torts committed by or against persons engaged in interstate commerce."); *United States v. Joint Traffic Ass'n*, 171 U.S. 505, 518-69 (1898) (Sherman Act forbids only those contracts that directly raise the price of interstate transactions); see also Meese, *Antitrust Balancing in a (Near) Coasean World*, *supra* note 30, at 145-48 (describing an (implausible) scheme whereby franchise system obtains market power *vis à vis* consumers via raising rivals' costs strategy). Moreover, it seems unlikely that opportunism will raise consumer prices. See Hay, *supra* note 36, at 187 (arguing that opportunism via franchise tying contracts will reduce franchise sales in light of competition from other franchise systems).

73. See HOVENKAMP, *supra* note 1 and accompanying text.

74. See *Northern Sec. Co.*, 193 U.S. 197, 345-46 (1904) ("No State can, by merely creating a corporation, or in any other mode, project its authority into other States, and across the continent, so as to prevent Congress from exerting the power it possesses under the Constitution over interstate and international . . . commerce.") (emphasis added), *Addyston Pipe & Steel Co. v. United States*, 175 U.S. 211, 231-32 (1899) ("If it should be held that Congress has no power and the state legislatures have full and complete authority to thus far regulate interstate commerce by means of their control over private contracts between individual or corporations, then the legislation of the different States might and probably would differ in regard to the matter, according to what each State might regard as its own particular interest.") (emphasis added); see also Easterbrook, *Antitrust and the Economics of Federalism*, *supra* note 2, at 38-40.

Sherman Act regulation of multi-state mergers satisfies James Wilson's criteria for federal intervention, as the "object of government" extends "beyond the bounds of a particular state," given the existence of transaction costs that prevent out-of-state consumers from bargaining with states that would otherwise regulate such conduct.⁷⁵ If competition between the states can lead to suboptimal corporate law, perhaps it might also lead to suboptimal contract law. Or perhaps such competition will prevent states from adopting statutory regimes that remedy any shortcomings in the common law. If the competitive process that generates the institutional framework within which parties transact is itself fraught with a market failure, then conditions are ripe for interstate exploitation and Sherman Act regulation may be appropriate.⁷⁶

Competition between the states to generate legal regimes is not always characterized by a market failure. Some scholars have made a strong case that state competition has produced optimal rules of corporate law, for instance.⁷⁷ Such rules provide the background regime governing a special form of relational contract—the corporate charter.⁷⁸ Proponents of employing the Sherman Act to regulate opportunism, then,

75. As James Wilson put it at the Pennsylvania ratifying convention:

Whatever object of government is confined in its operation and effects, *within the bounds* of a particular state, should be considered as belonging to the government of that state; whatever object of government extends, in its operation or effects, *beyond the bounds* of a particular state, should be considered as belonging to the government of the United States.

James Wilson, Speech in the Pennsylvania Ratifying Convention (Nov. 21, 1787), in *DEBATES ON THE ADOPTION OF THE FEDERAL CONSTITUTION* 424 (Jonathon Elliot ed., 2d ed. 1888) (emphasis added).

76. See Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & ECON. 461, 461 (1974) (stating that "not only will people pursue their self-interest within the rules; they will also allocate the resource toward *changing* the rules toward their own benefit"); *id.* at 472-74, 483-86 (arguing that firms may prefer and lobby for "regulation" via regime of private contract as it empowers them to foist inefficient terms on consumers).

77. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 14-31 (1993) (arguing that empirical studies suggest that competition between the states produces a "race to the top" in the production of corporate law); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); see also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2427-28 (1998) (arguing that competition between the states would produce optimal securities law).

78. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991) (describing corporation as "nexus of contracts" between shareholders, creditors, and management); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1620 (1989) (characterizing corporation as a relational contract).

bear a burden of showing that competition between the states will result in a race to the bottom where rules governing franchisor opportunism are involved. No one, it should be noted, has attempted to make such a showing.⁷⁹

One could imagine how such a race might take place. Certain states might decide to become "franchisor havens," adopting legal regimes that maximize the profitability of franchisor opportunism. Franchisors, in turn, might move their headquarters to such states, and insert in the governing franchise contract a clause choosing the haven's law.⁸⁰ To stem the exit of franchisors, other states might respond, adopting regimes that are equally hostile to franchisees. Indeed, even if such states did not respond, a few haven states might still succeed in imposing their law on the rest of the country, so long as franchisors moved their headquarters there. Indeed, if particular institutional frameworks can facilitate franchisor opportunism, franchisees are best characterized as third-party victims, unable to protect themselves from the effects of jurisdictional competition.⁸¹ If so, then states will not internalize the full effects of the institutional frameworks they generate and may be tempted to pursue a strategy of exploiting out-of-state franchisees.

Several arguments, however, suggest that competition among the states will not result in a race to the bottom with respect to the institutional framework governing the franchise

79. Some scholars have recognized that franchisor opportunism may give rise to liability under various state law doctrines. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 140 n.131; Burns, *supra* note 12, at 617-30 (surveying trends in judicial review of fairness in franchisor-franchisee transactions). These scholars have not, however, argued that competition between the states to provide such remedies will be beset by market failure. See Grimes, *Franchisors and Market Power*, *supra* note 6, at 140 n.131 (stating only that many state law remedies have "proved unsatisfactory to franchisees").

80. See *Scheck v. Burger King Corp.*, 756 F. Supp. 543, 545 (S.D. Fla. 1991) (enforcing clause that adopted Florida law despite plaintiff's argument that "most of the transactions between [plaintiff] and Burger King have taken place in Massachusetts"); *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 487 (1985) (finding that Michigan franchisee had sufficient minimum contacts with Florida to confer jurisdiction on Florida courts where franchisor was headquartered in Florida and franchise contract provided that Florida law would govern the transaction).

81. Cf. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1921-22 (1991) (arguing that allowing the incorporating state to choose rules governing shareholder liability to tort victims will produce a race to the bottom).

relationship.⁸² As an initial matter, any “race to the bottom” story depends upon certain empirical assumptions about the sophistication—or lack thereof—of franchisees. If franchisees are sophisticated, they will read their contracts and determine which law governs the agreement.⁸³ As a result, choice of law clauses will be priced, and franchisors that choose the law of a franchisor haven will suffer accordingly.⁸⁴ Indeed, few things would signal more overtly that a franchisor intends to embark on a course of opportunism than the adoption of the law of a haven state.⁸⁵

In the real world some franchisees—maybe even a majority—might be unsophisticated, at least as the term is used here. One might seize on this realization and conclude that franchisee exit will not constrain franchisors and thus will not thwart a state’s pursuit of a race to the bottom strategy. Such a conclusion, however, would be unduly hasty. Markets may function effectively—that is, approximate the result that would occur absent transaction costs—even if some or even most of the participants are unsophisticated.⁸⁶ A franchisor that adopted the law of a haven state would forgo all of the revenue—and expertise—associated with potential sales to

82. Professors Kobayashi and Ribstein address the separate but related question of whether states will attempt to export costs by adopting legal regimes that promote franchisee opportunism at the expense of out-of-state franchisors. See Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 339-47 (Francis H. Buckley ed. 1999). According to these authors, franchisors can use choice of law clauses to escape “oppressive” regimes that unduly benefit franchisees. See *id.* at 342. They do recognize the possibility that a state may attempt to “become a haven for miscreants,” and that franchisors may write contracts “that choose a ‘proprietary’ jurisdiction whose laws are not subject to a significant political constraint.” *Id.* at 346. But, they assert that “these special cases should be handled by the law of fraud or by specific regulation.” *Id.* The sort of race to the bottom described here, however, does not involve fraud, but instead simply enforcement of choice of law clauses “as written.” Moreover, the assertion that states can defeat such opportunism by “specific regulation” seems to beg the question whether states would adopt such regulation in light of the threat of franchisor exit.

83. For an argument that franchisees will read and understand such agreements, see Larry Ribstein, *Choosing Law By Contract*, 18 J. CORP. L. 245, 257 (1993) (“[I]n long-term contracts such as franchises and distributorships, the price is set in each case by negotiations among sophisticated and knowledgeable parties who have the ability and incentive to read the contract carefully or hire an attorney to do so.”).

84. See *id.*; Winter, *supra* note 77, at 275-76.

85. See Ribstein, *Choosing Law*, *supra* note 83, at 257 (“Indeed, suspicious negotiators may assume the worst from the designation of a particular state’s law and overdiscount for the clause.”).

86. See Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 637-39 (1979).

sophisticated franchisees, and this loss might outweigh any potential gains from opportunism.⁸⁷

At first glance, the suggestion that a substantial portion of franchisees will read and price their choice of law clauses may seem implausible. After all, this essay previously conceded, for the sake of argument, that exit by franchisees may not be sufficient to ensure optimal contractual terms.⁸⁸ It is one thing, however, for a franchisee to read an entire contract, seeking clarification of or haggling over individual terms. It is much simpler for a franchisee to locate the choice of law clause and thus determine whether the contract is governed by the law of a haven state. If some states did attempt to pursue a haven strategy, choice of law clauses might take on some of the attributes of brand names, signaling to potential franchisees the trustworthiness of a franchisor.

Here again, the nature of the competition between states for corporate charters may provide an analogy. Very few investors read corporate charters; even fewer are familiar with the details of Delaware Corporate Law. Nevertheless, economic studies demonstrate that the price of a firm's securities does reflect the law of the state of incorporation. More precisely, firms that incorporate in investor-friendly states see their shares rise in

87. See *id.* at 637-39, 649-51. A franchisor could avoid the loss of sophisticated franchisees by discriminating between sophisticated and unsophisticated franchisees, that is, agreeing that sophisticated franchisees would be governed by law other than that produced by the haven state. See Goldberg, *supra* note 76, at 485 (arguing that proponent of form contract can "contract term discriminate" and thus perpetuate lemons equilibrium in contract terms). The execution of such a scheme, however, would face two significant hurdles. First, franchisors would have to distinguish franchisees that will read and understand their contracts from those that will not. Simply offering all franchisees contracts with haven state law and then negotiating with those who object may not be an effective strategy, as sophisticated franchisees will realize that such a strategy is occurring and thus lose trust in the franchisor. Second, franchisors and sophisticated franchisees would have to develop some basis for adopting law different from that of the haven state. These parties could always adopt the law of the sophisticated franchisee's domicile, relegating unsophisticated franchisees in that jurisdiction to the law of the haven state. However, if this (non-haven) jurisdiction has adopted an approach similar to section 211, the clauses choosing haven law will likely not be enforceable, as the contracts in question will no longer be "standard." See RESTATEMENT (SECOND) OF CONTRACTS § 211(2) ("Such a writing is interpreted whenever reasonable as treating alike all those similarly situated, without regard to their knowledge or understanding of the standard terms of the writing."); *id.* at cmt. b. ("[Purchasers] trust to the good faith of the party using the form and to the tacit representation that like terms are being accepted regularly by others similarly situated."). Indeed, if a franchisor represented that a contract was "standard" when it was not, fraud may vitiate the agreement.

88. See *supra* notes 34-37 and accompanying text.

price, while those that incorporate in states that are hostile to investors see their shares fall.⁸⁹ Similarly, unduly onerous choice of law clauses in franchise contracts may be priced even if some franchisees are not sophisticated.

Let us assume for a moment that franchisees cannot protect themselves from a race to the bottom and that transaction costs are such that choice of law clauses will not be priced. Even if this is the case, other considerations suggest that no race to the bottom will occur. To begin with, a state can only pursue a "franchisor haven" strategy with the cooperation, actual or implicit, of other states. Assume, for instance, that Florida were to adopt an opportunism-friendly legal regime. Other states could respond by attempting to replicate Florida's rules, to stem the flow of franchisor headquarters located in their states; some might do so. But what about those states that have no franchisor headquarters and no meaningful prospect of attracting them?⁹⁰ These states, it seems, will face pressure to adopt institutional frameworks that favor franchisees. Some of this pressure will be political in nature—franchisees will agitate for legal reform and the appointment of sympathetic judges.⁹¹ Other pressure will be market-based, as sophisticated franchisees may exit a jurisdiction that adopts a framework that facilitates opportunism. Political and market pressures will not always point in the same direction. Political pressure by incumbent franchisees may generate rules that are designed to promote *franchisee* opportunism.⁹² Market pressure by those who are not yet franchisees, on the other hand, will generate rules that enhance the value of franchise opportunities generally. Still, both types of pressure will militate *against* the

89. See ROMANO, GENIUS OF AMERICAN CORPORATE LAW, *supra* note 77, at 14-24, 67-68.

90. These states, for instance, may have high taxes or inhospitable regulatory environments. Moreover, those states that move first to become franchisor havens may realize advantages that other states cannot overcome. See William J. Carney, *The Political Economy Of Competition For Corporate Charters*, 26 J. LEGAL STUD. 303, 307-08 & n.16 (describing Delaware's first-mover advantages in the competition for corporate charters).

91. See *id.* at 309 (arguing that "legislators will be tempted to be more responsive to local interest groups, including labor, management, and creditors" in states unable to attract the chartering business of foreign enterprises).

92. See, e.g., Kobayashi & Ribstein, *supra* note 82, at 339-41; James A. Brickley & Fredrick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401, 406-07 (1987) (describing free-riding and opportunistic behavior by franchisees).

generation of rules that facilitate opportunism by franchisors.

The adoption of a pro-franchisee regime will be futile if franchisors can impose other regimes on franchisees by contract. Thus, states that produce frameworks friendly to franchisees must couple the creation of such regimes with a refusal to enforce clauses that opt out of the framework.⁹³ By refusing to enforce a franchisor's choice of law, such pro-franchisee states can attenuate the gains a franchisor might realize by moving its headquarters to a haven state.⁹⁴ Pursuit of such a strategy by a sufficient number of states will reduce the gains a franchisor might realize by moving its operations to a haven state, and thus reduce the possibility that franchisors will incur the significant cost of such migration.⁹⁵ States, in turn, will experience diluted incentives to become havens in the first place.⁹⁶

Those who are familiar with the nature of competition for corporate charters may wonder whether franchisee-friendly states could really "hold out" over the long run. After all, under the so-called "internal affairs doctrine," states generally enforce a corporation's choice of law, even with respect to issues involving shareholders within the forum state.⁹⁷ States that depart from this rule run the risk of driving businesses that are incorporated elsewhere out of the state.⁹⁸ Ultimately, one might think, competition among the states might lead "hold out" states to abandon their positions and enforce franchisors' choice of law clauses, lest a franchisor withdraw its system from the state.

There is, however, an important difference between

93. See Kobayashi & Ribstein, *supra* note 82, at 342-43 (reporting that several states have passed statutes explicitly voiding contractual choice of law clauses that attempt to circumvent application of a state's franchise statute to an in-state franchisee).

94. See Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 LAW & CONTEMP. PROBS. 161, 179-80 (1985) (explaining that states can "reduce the appeal of Delaware incorporation by creating the possibility that [their] corporation law will supplant the law of Delaware").

95. Cf. Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 375-76 (1992) (arguing that propensity of some states to impose domestic corporate law on firms incorporated elsewhere will attenuate the incentives of firms to reincorporate in other states).

96. Cf. *id.* at 376 (noting that "the competition for out-of-state charters will be substantially impeded" if states apply their own law to firms incorporated in other states).

97. DeMott, *supra* note 94, at 163-64.

98. See Carney, *supra* note 90, at 312.

corporations and franchise systems that suggests that “hold out” states will not readily decide to enforce franchisor choice of law decisions. Where a state substitutes its own corporate law for that of the incorporating state in a derivative action, for instance, it necessarily affects the relationship between the firm’s management and *all* of its shareholders.⁹⁹ By seeking to impose burdensome rules on an entire firm, states might drive the business out of the state in question.¹⁰⁰ On the other hand, a state may limit the effects of its franchising regulation by refusing to apply its law to franchisees that operate in other states.¹⁰¹ Such regulation places a far less onerous burden on franchisors than would a decision by one state to apply its law to a Delaware corporation.¹⁰² As a result, failure to enforce a franchisor’s choice of law is not likely to lead the franchisor to remove the franchise system from the jurisdiction. Pro-franchisee states may credibly “hold out” against attempts to construct franchisor havens.

The pursuit of a “hold out” strategy by some states will attenuate whatever incentives a state may have to pursue a haven strategy. Moreover, in deciding whether to pursue such a strategy, a state would have to weigh its benefits against at least two distinct costs. First, if a state adopts an institutional framework that produces a lemons equilibrium in the terms contained in franchise contracts involving out-of-state franchisees, this framework will presumably produce lemons equilibria in contracts—both franchise and non-franchise—between the state’s own citizens. Second, a state that adopts such a system will render its own citizens vulnerable to opportunism by trading partners in other states. Foreign firms, perhaps located in states that do not have frameworks

99. A state that chooses to substitute its law for that of the incorporating state can only do so at the behest of a domestic shareholder. Still, this shareholder could bring a derivative action on behalf of the corporation as a whole, and recover damages (payable to the corporation) accordingly.

100. See Carney, *supra* note 90, at 312.

101. See Kobayashi & Ribstein, *supra* note 82, at 342-44 (arguing that states can retain franchisor headquarters by limiting the application of pro-franchisee law to its own citizens).

102. Moreover, franchisors can minimize the extent of this burden by terminating their franchisees and integrating forward in the state in question, thus avoiding altogether any state regulation of the franchising relationship by contract law or otherwise. Such integration may produce inefficiencies, unless the previous level of independent outlets was driven by a franchisor’s pursuit of an opportunism strategy. Still, these inefficiencies may be less costly to the franchisor than exiting altogether.

conducive to opportunism, could adopt contracts that choose the haven state's law and pursue a strategy of opportunism to the detriment of the haven state's citizens.

Thus, unless a state could adopt an institutional framework that discriminated between cases involving in-state franchisors and all others, pursuit of a franchisor haven strategy would produce negative consequences for a state's own citizens.¹⁰³ These consequences, in turn, would even further attenuate the net benefits to be realized by such a strategy, and may even make such a strategy unprofitable. Thus, the possibility that competition among the states will lead states to pursue a franchisor haven strategy seems quite remote. The more likely result of such competition, it seems, would be a dual equilibrium, in which some states adopt statutes specific to the franchise industry that facilitate opportunism by franchisees,¹⁰⁴ while other states adopt regimes that minimize the possibility of opportunism.

IV. CONCLUSION

The case for Sherman Act regulation of franchisor opportunism depends upon the presence of transaction costs. These costs do not exist in a vacuum but are instead a function of the institutional framework, a framework constructed by, among other things, rules of contract law. Competition between the states and not a federal monopoly should produce this framework.

103. Cf. Richard Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717, 1735 (1982) (noting that states will be reluctant to adopt inefficient common law rules merely because they subsidize special interests).

104. Limiting the reach of such statutes to the franchising context would be a method of discriminating between the out-of-state franchisors burdened by the statutes, on the one hand, and the rest of the states' citizens, on the other.

