Reputation Life Cycle: The Case of Franchising

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ABSTRACT

Law-and-economics conventional analysis contends that franchise termination laws, prohibiting opportunistic termination by franchisor, are superfluous. Well-rooted in traditional law-and-economics opposition to such legislation is the belief that the reputation mechanism serves as a sufficient control against opportunistic termination by franchisors. This article questions the idea that reputation concerns can be a substitute for regulation of franchise relationships. The article argues that the reputation mechanism suffers from an inherent deficiency, which disqualifies it from serving as a substitute for franchise termination legislation. In short, the reputation mechanism often has a limited life cycle consisting of three stages: creation, erosion and collapse. At the early stages of the franchisor organizational life cycle, the reputation mechanism may have some deterring effects on the franchisor. At these stages, the incentive of the franchisor is normally to attract new franchisees and thus the franchisor attaches greater importance being perceived as fair in the eyes of potential franchisees. As the franchisor’s financial resources increase, the effectiveness of the reputation mechanism will be eroded. Particularly, the franchisor’s incentive to attract new franchisees will decrease. Similarly, its incentive to maintain its present franchisees will decline. Instead, the franchisor, having greater financial resources, will gradually shift towards owning the units himself. Following the continuing decrease in the franchisor’s financial constraints and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism may collapse. This may particularly occur when the reputation-related costs decrease to a minimum level, at which they will be lower than the franchisor benefits from opportunistic termination of the franchise contract.

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I. INTRODUCTION

Legal economists have long debated whether the reputation mechanism can serve as a substitute for regulating the behavior of legal entities bound to a contractual relationship. If the importance of maintaining a good reputation in the market can effectively regulate or deter opportunistic behavior by the parties, legal regulation of the contractual relationship is a social waste. Conversely, if the market-based reputation mechanism cannot deter opportunism, regulation of the relationship is more justifiable. Traditional law-and-economics analysis, which has found its way into current legislative practices in the United States, tends to suggest that the reputation mechanism can indeed function as an effective substitute for costly regulation of contractual relationships.\(^1\) One commercial relationship in particular – the franchise relationship – is well-positioned, say legal economists, to be governed by reputation rather than by regulation.

The franchise relationship involves two major legal entities: the franchisor provides its trademark or trade name and a business system, while the franchisee generally pays the franchisor an ongoing royalty and an initial fee.\(^2\) To date, the legal ties of franchise relationships are regulated by a minority of fifteen states in the United States. These states enacted termination laws requiring ‘‘good cause’’ for the termination of a franchise contract by a franchisor,\(^3\) generally defined as the franchisee’s failure to obey the

\(^{1}\) See, for example, Lewis A. Kornhauser, Reliance, Reputation, and Breach of Contract, 26 J.L. & ECON. 691, 703 (1983) (presenting a model in which “reputation will substitute perfectly for a damage rule”); Douglas G. Baird & Robert H. Gertner, Game Theory and the Law 57 & 159-187 (1998) (suggesting that the reputation mechanism can bring about long-term cooperation even if there is no enforceable contract). But see Steven Shavell, Foundations of Economic Analysis of Law, 323-324 (2004) (Arguing that the reputation mechanism is an imperfect substitute for courts).

\(^{2}\) The contract underlying the relationship between the two parties is the “franchise contract.”

\(^{3}\) The fifteen ‘‘good cause’’ states are Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Virginia, Washington, and Wisconsin. See ARK. CODE. ANN. § 4-72-204 (LexisNexis 2009); CAL. BUS & PROF. CODE § 20020 (Deering 2009); CONN. GEN. STAT. ANN. § 42-133f (LexisNexis 2009); DEL. CODE ANN. tit. 6, § 2552(a) (2009); HAW. REV. STAT. ANN. § 482E-6 (LexisNexis 2009); 815 ILL. COMP. STAT.
franchise contract. Under these laws, a franchisor who concludes the franchise contract without a show of good cause must pay the franchisee damages. These franchise termination laws aim to protect franchisees against opportunist treatment by franchisors, who inherently enjoy greater bargaining power. They are designed to protect franchisees from franchisors, who may terminate the franchise contract, opportunistically appropriating the profitable outlet developed by the franchisee. More specifically, an opportunistic franchisor may terminate the contract of an efficient franchisee, who fully complies with the franchise contract, in order to sell the latter’s profitable unit to a new franchisee for higher franchise fees. Alternatively, the franchisor can terminate the contract and manage the successful unit by himself.

4 See ARK. CODE ANN. § 4-72-202(7)(a) (LexisNexis 2009); CAL. BUS & PROF. CODE § 20020 (Deering 2009); CONN. GEN. STAT. ANN. § 42-133f (LexisNexis 2009); HAW. REV. STAT. ANN. § 482E-6(2)(H) (LexisNexis 2009); 815 ILL. COMP. STAT. ANN. 705/26 (2009); IOWA CODE ANN. § 523H.13 (2009); MICH. COMP. LAWS SERV. § 445.1527(27)(c) (LexisNexis 2009); MINN. STAT. ANN. § 80C.17(1) & (3) (2009); NEB. REV. STAT. ANN. § 87-409 (LexisNexis 2009); N.J. STAT. ANN. § 56:10-10 (West 2009); WASH. REV. CODE ANN. § 19.100.180(2)(j) (West 2009); WIS. STAT. ANN. § 135.06 (LexisNexis 2009).

5 Recoverable damages may include the following: (1) a fraction of the franchisee’s tangible assets used with respect to the terminated franchise, including sales outlets and facilities, offices, warehouses, trucks, furnishings, equipment, and accessories; (2) loss of goodwill; and (3) loss of profits. See generally, ARK. CODE ANN. § 4-72-208(b) (2009); CONN. GEN. STAT. § 42-133g(a) (2009); DEL. CODE ANN. Tit. 6, § 2553(c) (2009); 815 ILL. COMP. STAT. § 705/26 (2009); IOWA CODE § 523H.13 (2009); MINN. STAT. § 80C.17(1) & (3) (2009); NEB. REV. STAT. ANN. § 87-409 (LexisNexis 2009); N.J. STAT. ANN. § 56:10-10 (West 2009); VA. CODE ANN. § 13.1-571(a) (2009); WIS. STAT. ANN. § 135.06 (West 2009).


9 Id.
Conventional law-and-economics analysis proposes that franchise termination laws, prohibiting opportunistic termination by franchisor, are superfluous. Deeply rooted in traditional law-and-economics opposition to such laws is the belief that the reputation mechanism can serve as a sufficient control against opportunistic termination by franchisors. Since the incentive of franchisors is to maintain and attract franchisees, their motivation is to uphold a reputation of fairness. Accordingly, out of concern for their reputation, franchisors are not likely to opportunistically terminate the franchise contract.10

This conventional law-and-economics opposition to franchise termination laws has been significantly influential in the development of franchise law in general, as witnessed by state and federal policy making.11 True to today, most states have refused to regulate general franchise termination laws prohibiting opportunistic termination of the franchise contract by franchisor.12 At the federal level, such statutes have also been rejected.13 Yet legislators may be surprised to discover that the theoretical basis for this law-and-economics opposition to franchise termination laws is not quite as solid as one would hope.

This article, then, calls into question the idea that reputation can be a substitute for franchise termination laws. The article argues that the reputation mechanism suffers from an inherent deficiency, which disqualifies it from serving as a substitute for franchise termination laws.

In short, the argument is as follows: The reputation mechanism often has a limited life cycle consisting of three stages: creation, erosion and collapse. At the earliest stage of the

10 See infra Part II.A.
13 For example, in 1998 and 1999, the federal government failed to pass two bills that would have made it unlawful for a franchisor to terminate a franchise contract without good cause. See H.R. 4841, 105th Cong., 2nd Sess. (1998); H.R. 3308, 106th Cong., 1st Sess. (1999).
franchisor’s organizational life cycle, the reputation mechanism is created. Normally, in this initial phase, the franchisor’s incentive is to maintain its previous franchisees and attract new ones. The franchisor wishes to expand the market of its products as rapidly as possible, but yet is financially limited and cannot expand on its own. Given the initial need of the franchisor to attract and maintain franchisees, the franchisor will be compelled to act in a manner which appears fair to present and prospective franchisees. Opportunistic termination of the franchise contract is therefore less likely to occur, as legal economists suggest, at the early stages of the franchisor’s organizational life cycle.

However, following the creation of the reputation mechanism, its effectiveness is likely to be eroded. Particularly, as the franchisor’s financial availability increases, the effectiveness of the reputation mechanism will steadily decrease. As the franchisor’s financial resources increase, the franchisor will gradually shift away from attracting and maintaining franchisees towards operating, on its own, the present and prospective outlets in its chain. This shift mainly derives from the fact that the franchisor normally gains more profits from a franchisor-owned unit than from a franchisee-owned unit. As a result of this shift, the franchisor will be less concerned about being perceived as fair by present and prospective franchisees, which leads us to conclude that termination without good cause is more likely to occur at this stage.

Ultimately, the reputation mechanism may collapse. Following the gradual increase in the franchisor’s financial resources and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism will malfunction. The reputation-related costs will reach a minimum level, which will be lower than the franchisor’s benefits from the opportunistic termination of the franchise contract. When the franchisor will accumulate enough financial resources to operate the whole franchise chain on its own, this outcome is to be expected. At this final stage—and herein lies the crux of the argument—the franchisor’s reputation costs incurred from being perceived as unfair by present and prospective franchisees are likely to be lower than the benefits from opportunistic termination. Opportunistic termination therefore is likely to occur.
Part II of this article will provide the theoretical context by briefly reviewing the debate over the effectiveness of reputation as a substitute for franchise termination laws. First, the arguments in favor of the reputation mechanism, which underlie the disregard in the law-and-economics traditional approach for franchise termination laws, will be introduced. Second, I shall review the scant manifestations of skepticism as to the effectiveness of reputation in preventing opportunistic termination by franchisors. Part III will demonstrate the intrinsic deficiency of the reputation mechanism in preventing opportunism by franchisor, namely the reputation life-cycle. The three major stages of the reputation life cycle will be presented—creation, erosion and collapse—with an eye to uncovering the Achilles heel of the reputation mechanism. While this article focuses predominantly on the (in)effectiveness of reputation in preventing opportunism in franchise relationships, I will conclude by suggesting broader implications of my analysis for the legal administration of other long-term commercial relationships.

II. THE DEBATE OVER REPUTATION

A. Law-and-Economics Conventional Analysis

Legal economists oppose franchise laws that require franchisors to demonstrate good cause for termination of a franchise contract. Essential to legal economists’ resistance to franchise termination laws is the argument that the market-based reputation mechanism can function as a substitute for regulation. More specifically, legal economists argue

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15 Another important argument that underlies legal economists’ resistance to franchise termination laws is that a statutory good cause requirement will increase franchisor termination costs and therefore tempt the franchisee to cheat or at least to free ride. See, Brickley et al., supra note 14, at 104; Epstein, supra note 14, at 314; Matthew Ellman, Specificity Revisited: The Role of Cross-Investments, 22 J.L. ECON. & ORG. 234, 250 n.36 (2006); Richard L. Smith II, Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution, 25 J.L. & ECON. 125, 136 (1982). For a critical analysis of this argument, see generally Benoliel, supra note 11 (arguing that a statutory good cause requirement will enhance joint action, expression of trust, and fair treatment of both contractual parties).
that the reputation mechanism can prevent contract termination without good cause, since such termination will impose reputation-related costs on the franchisor. As Charles Goetz and Robert Scott argue, franchisors will “incur substantial ‘goodwill’ losses if they attempt to exploit a discretionary termination authority.”

Legal economists furthermore specify the reputation-related costs which will prevent termination without good cause. First, a franchisor that will terminate the contract without good cause will encounter difficulties in retaining its other franchisees. The franchisor, as Richard Epstein explains, “has incentives to act in a manner which […] appears to be fair if he wishes to retain his other franchisees.” Second, the franchisor will find it difficult to sell additional franchise units to new franchisees. As Benjamin Klein & Lester Saft explain, “the franchisor is not likely to terminate franchisees merely to confiscate their sunk investments opportunistically because franchisors must be concerned about their reputations when attempting to sell additional franchise locations.” Law-and-economics scholars, therefore, uniformly base their analysis upon


18 Benjamin Klein & Lester F. Saft, The Law and Economics of Franchise Tying Contracts, 28 J. Law & Econ. 345, 356 (1985); Roger D. Blair & Francine Lafontaine, Understanding the Economics of Franchising and the Laws that Regulate It, 26 FRANCHISE L.J. 55, 64 (2006) (“There may be lurking concern that franchisors may abuse their ability to terminate franchise contracts in some opportunistic fashion. Although there is some possibility of such opportunism, there is scant empirical support for it. From an economic perspective, this is not surprising because most franchisors want to expand, and it is hard to attract new franchisees while abusing incumbent franchisees.”); For similar argumentation see also, Epstein, supra note 14, at 315; Lockerby, supra note 14, at 859-60; Pitegoff, supra note 17, at 310; Smith, supra note 15, at 130; Robert W. Emerson, supra note 7, at 586; Alan J. Meese, Regulation of Franchisor Opportunity and Production of the Institutional Framework, 23 HARV. J.L. & PUB. POL’Y 61, 68 (1999); Jonathan Klick et al., Incomplete Contracts and Opportunism in Franchising Arrangements: The Role of Termination Clauses 16 (American Law and Economics Association Annual Meetings, Working Paper 61, 2000), available at
the implicit assumption that franchisors have a *static* incentive: to retain their franchisees and to attract new ones. This assumption, however, is dubious, as will be demonstrated in this article.

**B. Skepticism about Reputation Effectiveness**

A handful of legal scholars manifest skepticism about the effectivity of the reputation mechanism in controlling opportunistic termination by franchisors. One of the earlier challenges to the effectiveness of the reputation mechanism was posed by David Charny, in his innovative article of the early 1990s. Charny argues that the reputation mechanism will not function if the franchisor ceases to use franchisees altogether. He suggests that this may occur once the franchisor “has established a market niche” or when the acquirer in a takeover puts in place a new management team that decides to terminate existing franchises.

Skepticism about the potential for reputation to control opportunistic termination by franchisors was also manifested in a seminal article on franchise contracts by Gilliland Hadfield. To begin with, Hadfield, similarly to Charny, argues that the reputation mechanism will not function if the franchisor stops selling franchisees. She furthermore suggests that this may happen if the franchisor reaches a limit on the number of the franchise units it is able to sell. This limitation may often exist, she maintains, as


20 *Id.* at 434.
21 *Id.* at 435.
23 *Id.* at 978 n. 232.
24 *Id.*
franchisors provide their franchisees with territorial exclusivity.²⁵ Hadfield’s second argument highlights the problematic fact that the reputation mechanism depends upon inferences about the franchisor’s past behavior drawn by potential franchisees.²⁶ As she claims, “the interdependence, the uncertainty, and the length of the relationship, as well as the inexperience of the franchisee all make the identification of franchisor opportunism very difficult.”²⁷

Over the next few years, other scholars joined in the dispute over the effectiveness of the reputation mechanism in the context of franchising. Warren Grimes, for instance,²⁸ argues that a franchisor is likely to be less constrained by reputation concerns in several circumstances. First, if a myth of high profitability surrounds franchising, or certain types of franchising, a franchisor is likely to be less constrained by reputation concerns.²⁹ Second, if the franchisor can counter reputation damage by lowering the franchise fee, the reputation mechanism will be less effective.³⁰ Third, if the franchisor can make less-informed franchisees the target of opportunism, the reputation mechanism is less likely to operate as expected.³¹ Fourth, the reputation mechanism’s effectiveness is dubious if the franchisor has a short-term perspective.³² Finally, if the franchisor misapprehends the extent of reputation damage, the reputation mechanism will be less effective.³³

While we agree with many of the scholarly objections leveled at the reputation mechanism in the past, the next part of this article contends that the reputation mechanism also suffers from an inherent deficiency: its limited life cycle. The three

²⁵ Id.
²⁶ Id.
²⁷ Id.
²⁹ Id. at 130-31.
³⁰ Id. at 131-33.
³¹ Id. at 133-34.
³² Id. at 134-135.
³³ Id. at 135.
major stages of the reputation life cycle will be presented in chronological order: creation, erosion and collapse. A detailed analysis of the life cycle will reveal that the reputation mechanism is often doomed to failure, by its very nature.

### III. REPUTATION LIFE CYCLE

#### A. Stage One – Creation

At the early stages of the franchisor organizational life cycle, the reputation mechanism may have some deterring effects on the franchisor; the franchisor may be particularly discouraged from terminating a franchise contract without good cause. At these stages, the incentive of the franchisor is normally to attract new franchisees (or other types of intermediaries, such as dealers and distributors) and thus the franchisor attaches greater importance being perceived as fair in the eyes of potential franchisees. The initial incentive to attract new franchisees derives from three cumulative factors, which will be explained in greater detail below. First, franchisors ordinarily wish to rapidly expand the market for their products by opening many pioneering outlets in various locations. Second, a young franchisor normally lacks the significant financial resources necessary to promptly expand the market, on its own. Third, new franchisees, attracted by the young franchisor, can effectively support the franchisor in overcoming its initial financial constraints.

Franchisors generally hope to quickly expand the market for their products by opening many pioneering outlets in various locations. Swift expansion generates several benefits for franchisors. To begin with, a franchisor, entering the market early, can snag superior geographic locations, before the market becomes saturated by competitors.  

competitors; followers will face difficulties in gaining possession of the same valuable real estate, already held by the fast franchisor. McDonald’s, for example, effectively preempted precious real estate from its competitors, through favorable leases. Through its early expansion in the relatively novel sector of fast food, McDonald’s benefited from a first-move advantage. In addition, a franchisor who quickly develops its franchise system, may be able to lease or acquire assets, in the early stages of the market, at prices below those that will prevail in later stages, after the market has evolved.

Rapid expansion not only gives franchisors an edge over competitors, but also allows the franchisor to shape the market. A franchisor that expands the market for its products promptly may influence customer preferences. In the early stages of many markets, consumers may not have a strong and precise opinion about their preferred value of the new product ingredients. They may also not have a strong inclination about their preferred combination of the product features. For example, not many customers had a predetermined preference for how carbonated or sweet a cola should be, when Coca Cola first penetrated the market. A successful early franchisor is likely to have a seminal influence on the customer preferences regarding the value of the product features. It may also influence customer preferences as to the combination of the product features. Coca Cola, for example, may have critically impacted the development of customers’

38 Michael, supra note 35, at 65.
39 Lieberman & Montgomery, supra note 35, at 44; Michael, supra note 35, at 65.
40 Michael, supra note 35, at 66.
42 Carpenter & Nakamoto, supra note 41, at 286.
43 Id.
44 Id.; Lieberman & Montgomery, supra note 35, at 46.
45 Carpenter & Nakamoto, supra note 41, at 286.
preferences for colas. The influence on customers’ preferences may ultimately shift customers to favor the pioneer franchisor over later competitors, leading to a market share benefit. Rapid expansion, therefore, is quite beneficial for franchisors. Indeed, empirical studies confirm that swift expansion is advantageous. Steven Michael, examining 137 U.S. franchisors in the restaurant industry, found that a rapid expansion strategy of franchisors leads to superior outlet share and ultimately to higher profitability. Similarly, data covering 188 Spanish franchise chains for an eight-year period show that an early entry strategy of franchisors leads to lower failure risk.

Nonetheless, despite the advantages, maneuvering an early entrance into the franchise market is difficult. A young franchisor, wishing to rapidly expand the market for its products on its own, normally lacks the significant financial resources needed to fulfill its desire. Opening new outlets is often too costly for a financially immature franchisor. Three significant costs must normally be incurred by the young franchisor: information costs, start-up costs, and management costs.

To begin with, financial resources are required to gather information regarding the local market in which the franchisor may potentially expand. When a young franchisor system expands beyond its original geographic location, it by and large lacks information

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46 Id.; Lieberman & Montgomery, supra note 35, at 46.
49 Juste et al., supra note 34 at 109, 112 & 115.
51 Cf. Lafontaine & Kaufmann, supra note 50, at 99.
regarding other local markets.\textsuperscript{53} Therefore, the franchisor needs to invest capital in searching for and identifying suitable locations.\textsuperscript{54} It should ideally also evaluate the local market conditions of each potential location.\textsuperscript{55} More specifically, the franchisor will have to invest resources in learning about the local marketing strategies, input suppliers, and customer preferences, at each potential location.\textsuperscript{56} These information-gathering costs are likely to augment with increases in the unfamiliarity, diversity, and uncertainty of local markets.\textsuperscript{57}

The franchisor, wishing to expand on its own, will furthermore incur considerable start-up costs in establishing each outlet. The total start-up costs of each outlet can range from $20,000, at a minimum, to over $1,000,000, depending on the franchise chosen.\textsuperscript{58} Costs may involve renting or building an outlet, stocking it with inventory and equipment, and advertising it.\textsuperscript{59} Finally, a franchisor, ready and willing to promptly expand on its own, will incur significant management costs. These costs include the necessary capital needed to select skilled managers to operate each outlet (selection costs).\textsuperscript{60} They also include expenditures for monitoring the managers’ performance (monitoring costs).\textsuperscript{61}

\textsuperscript{54} James G. Combs et al., \textit{A Strategic Groups Approach to the Franchising-Performance Relationship}, 19 J. BUS. VENTURING 877, 880 (2004).
\textsuperscript{55} \textit{Id}.
\textsuperscript{57} \textit{Id} at 243.
\textsuperscript{60} See generally, Scott A. Shane, \textit{Hybrid Organizational Arrangements and Their Implications for Firm Growth and Survival: A Study of New Franchisors}, ACAD. MGMT. J. 216, 218-219 (1996); Seth W. Norton, \textit{An Empirical Look at Franchising as an Organizational Form}, 61 J. BUS. 197, 204 (1998); Combs et al., \textit{supra} note 54, at 880.
Since expanding rapidly is usually too costly for a young franchisor, its initial incentive will be to attract new franchisees.\textsuperscript{62} New franchisees will normally be able to effectively assist the financially immature franchisor in overcoming its initial economic constraints. To begin with, franchisees often incur the information costs needed to find suitable locations for expansion in locations which are unfamiliar to the franchisor.\textsuperscript{63} Notably, franchisees are likely to have valuable information regarding potential local markets, which the youthful franchisor lacks.\textsuperscript{64} This is mainly because they usually reside in the community in which the new unit is planned to be established.\textsuperscript{65}

In addition, franchisees commonly will incur the start-up costs involved in establishing new outlets, including equipment, inventory building and real estate costs.\textsuperscript{66} Franchisees furthermore reduce the management costs needed to operate an outlet. First, they reduce the selection costs needed to recruit qualified managers. Franchisees typically agree to invest heavily in the outlet and to receive a residual claim on the outlet's uncertain profits.\textsuperscript{67} By such consent, franchisees normally signal their management capabilities, compared to salaried managers, who are willing to take the job.\textsuperscript{68} Second, franchisees reduce the monitoring costs needed to scrutinize the performance of managers. Since franchisees invest significant resources in the outlet and have a residual claim on the outlet's profit, they are less likely, compared to salaried managers, to put forth a suboptimal effort level.\textsuperscript{69}

\begin{thebibliography}{99}
\bibitem{62} Rajiv P. Dant et al., \textit{supra} note 50, at 34; Brent L. Baker & Rajiv P. Dant, \textit{Stable Plural Forms in Franchise Systems: An Examination of the Evolution of Ownership Redirection Research}, in \textit{Strategy and Governance of Networks: Cooperatives, Franchising, and Strategic Alliances} 87, 92 (George Hendrikse, Mika Tuunanen, Josef Windsperger & Gérard Cliquet eds. 2008); Shelby D. Hunt, \textit{The Trend Toward Company-Operated Units in Franchise Chains}, 49 J. Retailing 3, 4 (1973); Oxenfeldt & Kelly, \textit{supra} note 35, at 71; Caves & Murphy, \textit{supra} note 50, at 581.
\bibitem{63} Combs et al., \textit{supra} note 54, at 880. Sometimes, franchisors select the location, but then they collect fees from franchisees for this service. \textit{Cf.} Hadfield, \textit{supra} note 2, at 936.
\bibitem{65} Burkle & Posselt, \textit{supra} note 53, at 41. Combs et al., \textit{supra} note 54, at 880; Lafontaine & Kaufmann, \textit{supra} note 50, at 99.
\bibitem{66} Shane, \textit{supra} note 60, at 220.
\bibitem{67} Shane, \textit{supra} note 60, at 220; Norton, \textit{supra} note 60, at 205; Combs et al., \textit{supra} note 54, at 880.
\bibitem{68} \textit{Id.}
\bibitem{69} Brickley & Dark, \textit{supra} note 61, at 404-5; Shane, \textit{supra} note 60, at 221; Combs et al., \textit{supra} note 54, at 880; Watson et al., \textit{supra} note 64, at 28.
\end{thebibliography}
Franchisees support the franchisor in overcoming its initial financial constraints, not only by incurring and reducing significant costs, but also by directly providing the franchisor significant capital. First, if the franchise involves the sale of products by the franchisor to the franchisee, the sale price will usually comprise a mark-up over cost representing the franchisor’s return.\(^70\) In addition, each franchisee ordinarily pays the franchisor an initial lump-sum fee, called a franchise fee\(^71\)—generally ranging between $10,000 and $30,000.\(^72\) Moreover, each franchisee provides a constant and ongoing stream of capital to the franchisor, via royalty rates.\(^73\) Normally, royalty rates are calculated as a percentage of sales revenues.\(^74\) The average royalty rate paid in 2001 was 5.2%, which in real terms translates to about $500 per month.\(^75\) Many franchisees also pay the franchisor advertising fees,\(^76\) to support franchisors in advertising their product or service regionally or nationally.\(^77\) These fees are most often a steady percentage, usually one to two percent, of the franchisee’s monthly sales revenue.\(^79\) Finally, franchisees occasionally pay fees to franchisors for bookkeeping and management consultation services.\(^80\)

Given the significant capital that franchisees provide to the youthful franchisor, and their ability to support him in overcoming its financial constraints,\(^81\) one would posit that the

\(^{70}\) Hadfield, supra note 2, at 935.
\(^{71}\) Combs et al., Can Capital Scarcity Help Agency Theory Explain Franchising? Revisiting the Capital Scarcity Hypothesis, 42 ACAD. MGMT. J. 196, 199 (1999); Lafontaine & Kaufmann, supra note 50, at 99; Hadfield, supra note 2, at 935.
\(^{73}\) Hadfield, supra note 2, at 935; Watson, supra note 64, at 25; Lafontaine & Kaufmann, supra note 50, at 99.
\(^{74}\) Blair & Lafontaine, supra note 8, at 62.
\(^{75}\) Id. at 68-9.
\(^{76}\) Id. at 69.
\(^{77}\) Id.
\(^{78}\) Longenecker et al., supra note 59, at 100.
\(^{79}\) Blair & Lafontaine, supra note 8, at 69.
\(^{80}\) Hadfield, supra note 2, at 936. Notably, franchisors sometimes also obtain a commission from approved suppliers of their new franchisees. Id.
\(^{81}\) But see P. H. Rubin, The Theory of the Firm and the Structure of the Franchise Contract, 21 J. L. & ECON. 223, 225-226 (1978) (suggesting that passive investors, such as stockholders, are a superior
initial incentive of the franchisor will be to attract franchisees. This theoretical contention is, in fact, empirically supported. Francine Lafontaine conducted a survey of, among other things, franchisors’ motivation for using franchisees.\textsuperscript{82} The survey was based on the answers given by 130 franchisors, all members of the International Franchise Association, and involved in a variety of businesses.\textsuperscript{83} The majority of the respondents began franchising only recently.\textsuperscript{84} Franchisors participating in the survey explained that they became involved in franchising mainly because it allowed them to expand rapidly, especially because franchisees provide capital to franchisors.\textsuperscript{85} In another survey, conducted by Rajiv Dant, based on 79 founders and representatives of franchisors, similar results were found.\textsuperscript{86,87} Respondents were primarily drawn from the fast food and restaurants, gift and home decorations, hospitality, convenience stores and services franchising sectors.\textsuperscript{88} The majority of respondents classified their business in the introduction or growth stages of its life cycle,\textsuperscript{89} indicating the relative youthfulness of the franchisors.\textsuperscript{90} According to the survey, the top most cited motivations for attracting franchisees were “market entry and growth” and “capital access and profits.”\textsuperscript{91}
B. Stage Two - Erosion

As the franchisor’s financial resources increase, the effectiveness of the reputation mechanism will be eroded. Particularly, the franchisor’s incentive to attract new franchisees will decrease. Similarly, its incentive to maintain its present franchisees will decline. Instead, the franchisor, having greater financial resources, will gradually shift towards owning the units himself. The franchisor will specifically want to progressively open new outlets under franchisor-ownership, which would have been opened as a franchisee-owned outlet, when the franchisor lacked financial resources. In addition, the franchisor’s motivation will be to gradually transform the existing franchisee-owned outlets in his chain into franchisor-owned outlets.

The shift in the franchisor’s incentive stems from the fact that the profits that a franchisor can make, by owning a unit, is normally greater than the profits it can amass through a franchisee-owned unit. True, establishing and maintaining a franchisor-owned unit is costly for the franchisor since it involves information, start-up, and management costs. In addition, a franchisee-owned unit provides the franchisor capital through a lump-sum fee, franchise fees, and other fees. However, in the long-run, a franchisor-owned unit is more profitable for the franchisor than a franchisee-owned unit. With its company-owned and operated units, the franchisor continually keeps all of the profits of the unit,

92 Oxenfeldt & Kelly, supra note 35, at 71; Rajiv P. Dant et al., What We Know About Ownership Redirection in Franchising: A Meta Analysis, 72 J. Retailing 429, 434 (1996); Caves & Murphy, supra note 50, at 581; Gary J. Castrogiovanni et al., Shifting Imperatives: An Integrative View of Resource Scarcity and Agency Reasons for Franchising, 30 ENTREP. THEORY PRACT. 23, 25 (2006); Baker & Dant, supra note 62, at 92
93 See supra Part III.A.
94 See supra Part III.A.
95 Hunt, supra note 62, at 6-7; Hadfield, supra note 2, at 936-7; See also, Paul Tracey & Owen Jarvis, Toward a Theory of Social Venture Franchising, 31 ENTREP. THEORY PRACT. 667, 669 (2007); James G. Combs et al., Franchising: A Review and Avenues to Greater Theoretical Diversity, 30 J. MGMT. 907, 910 (2004);
whereas with franchised units its chief source of profit is a lump-sum fee and ongoing fees computed as a small percentage of the gross revenue.\textsuperscript{96}

The superiority of franchisor-owned units over franchisee-owned units in generating franchisor’s profits is empirically supported. For example, Thomas Ehrmann and Georg Spranger examine the financials of seven large public US-restaurant retail chains through their annual 10-k filings with the US Securities and Exchange Commission.\textsuperscript{97} They examine each franchisor’s gross margin ratios as well as the operating income ratios for franchisor-owned to franchisee-owned units.\textsuperscript{98} For each franchisor analyzed in the study, the single franchisor-owned unit added far more to both the gross margin and to the total operating income than the single franchisee-owned unit.\textsuperscript{99} Similarly, Urban Ozanne and Shelby Hunt find that sales in franchisor-owned outlets in the fast food industry are on average significantly higher than those in franchisee-owned outlets.\textsuperscript{100}

Anecdotal evidence bolsters the contention that franchisor-owned units are superior to franchisee-owned units in generating franchisor profits, as expressed in several classic statements by franchisors. For example, John Jay Hooker famously stated: “As you all know, the name of the game is not really franchising. The name of the game is company stores. I was looking at some figures not too long ago and saw where a big company in American has 1,600-1,700 units, and only 200 of those were company owned, but the 200 company owned units were producing 60 percent of the net after taxes…. [T]he real name


\textsuperscript{98} \textit{Id.} at 40-1.

\textsuperscript{99} \textit{Id.} at 41.

\textsuperscript{100} \textit{SENATE SELECT COMM. ON SMALL BUSINESS, 92D CONG., 1ST SESS., REPORT PREPARED FOR THE SMALL BUSINESS ADMINISTRATION: THE ECONOMIC EFFECTS OF FRANCHISING} 87 (Comm. Print 1971) (written by Urban B. Ozanne & Shelby D. Hunt); Hunt, \textit{supra} note 62, at 7.
of the game is owning the stores yourself.”101 Similarly, Lawrence E. Singer, who was the president of Royal Castle System Inc. has noted: “We make more profit, per company-operated unit, than we could possibly make in franchising. This fact has been acknowledged by many of the franchise operators.”102

Given the superiority of franchisor-owned units over franchisee-owned units, the effectiveness of the reputation mechanism is likely to be eroded when the franchisor’s financial constraints decrease. As the resources needed for establishing and operating units become more attainable by the franchisor, foregoing the higher levels of profit attained through franchisor ownership ceases to be necessary.103 Indeed, empirical studies indicate that as the franchisor’s financial resources increase, the reputation mechanism erodes. These studies particularly confirm that as the financial availability of the franchisor increases, its incentive will gradually shift away from attracting new franchisees and maintaining the present ones, towards owning prospective and present outlets.104 For example, Rajiv Dant and Patrick Kaufmann examine the changes in ownership patterns of franchise systems as the franchisor financially matures.105 They

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102 Lawrence E. Singer, *To Franchise or Not – How to Decide, Con: Why Company-Owned Units* in FRANCHISING TODAY: 1966 – 1967 24 (Charles L. Vaughn & David B. Slater eds. 1967). Likewise, William Ware of PKI Foods, Inc. stated: “More profits can be gained from company-owned stores. A break-even analysis of operations in the 225,000 to 300,000 range shows this fact to be very true. Since our stores average 270,000 per unit per year and some clear between 50,000 and 100,000 it becomes evident that our stores are more profitable than if franchised.” William Ware, *To Franchise or Not – How to Decide, Con: Why Company-Owned Units* in FRANCHISING TODAY: 1966 – 1967 29 (Charles L. Vaughn & David B. Slater eds. 1967).


utilize a national mail survey of the franchised fast food restaurant industry franchisors,\textsuperscript{106} and analyze a total of 152 questionnaires filled out by franchisors.\textsuperscript{107} The questionnaire asks the franchisor respondent to provide details of ownership patterns, unit reacquisition activity, new units sale activity, and franchisor’s resource availability position.\textsuperscript{108} The questionnaires were most frequently completed by presidents, CEOs, or founders of the franchise.\textsuperscript{109} The typical franchisor commenced its operation in 1966, sold its first franchise in 1974, and had about 200 outlets.\textsuperscript{110} Dant and Kaufmann’s study confirms the validity of the hypothesis that the greater the franchisor’s internal access to financial, informational, and managerial resources, the more likely the strategic tendency toward company ownership of outlets.\textsuperscript{111} The strategic tendency toward company ownership of outlets is measured by two factors. First, the inclination of franchisors to substitute \textit{existing} franchisee-owned outlets with franchisor-owned outlets (\textit{retrospective substitution}), was considered.\textsuperscript{112} This inclination is captured mainly by comparing (a) the number of franchisee-owned units reported by the franchisor to have been permanently converted into franchisor-owned units and (b) the number of franchisor-owned units reported by the franchisor to have been permanently converted into franchisee-owned units.\textsuperscript{113} The strategic tendency toward company ownership is furthermore measured by the propensity of franchisors to open \textit{new} outlets under franchisor-ownership which would have been opened as a franchisee-owned outlet earlier in the franchisor’s history (\textit{prospective substitution}).\textsuperscript{114} This tendency is calculated by comparing (a) the current year’s pattern of new units opening activity to (b) the pattern of ownership as established

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by previous year’s composition of franchisor-owned units versus franchisee-owned units.\textsuperscript{115}

Empirical support for the erosion of the reputation mechanism in several key industries was also established in a study by Rajiv Dant and Audhesh Paswan. Dant and Paswan cull data from successive volumes of \textit{Franchising in the Economy} to test, among other things, the shifts in ownership patterns of franchise systems as the franchisor financially matures,\textsuperscript{116} spanning the period of 1977 through 1986.\textsuperscript{117} They find that in the rentals (equipment) industry, and hotels, motels and campground industry, as the financial resource availability of franchisor increases, there will be greater incidence of ownership redirection favoring the franchisor.\textsuperscript{118} Ownership redirection, in this context, was captured by the inclination of franchisors to substitute existing franchisee-owned outlets with franchisor-owned outlets. This inclination is measured mainly by comparing the number of franchisee-owned units converted to franchisor-owned units with the number of franchisor-owned units converted to franchisee-owned units.\textsuperscript{119}

Another empirical study, conducted by James Combs and David Ketchen, indicates that as the financial resources of the franchisor increase, the reputation mechanism erodes.\textsuperscript{120} Combs and Ketchen’s sample is drawn from the restaurant industry during the years 1989 through 1993,\textsuperscript{121} and their study relies mainly on franchisor’s annual reports and Compact Disclosure, a comprehensive database of public firms.\textsuperscript{122} Examining data from 91 restaurant chains, Combs and Ketchen empirically confirm the hypothesis that the less a franchisor encounters difficulties stemming from a lack of capital, the less the

\textsuperscript{115} \textit{Id.} at 68.
\textsuperscript{116} Dant & Paswan, \textit{supra} note 52, at 90.
\textsuperscript{117} \textit{Id.}
\textsuperscript{118} \textit{Id.} at 93, 96 & 99.
\textsuperscript{119} \textit{Id.}
\textsuperscript{120} Combs et al. \textit{supra} note 71.
\textsuperscript{121} \textit{Id.} at 199.
\textsuperscript{122} \textit{Id.} at 199 & 201.
franchisor will rely on expansion through franchising as opposed to franchisor ownership.\footnote{\footnote{Cf. Combs et al., \textit{supra} note 71, at 199 & 202. For similar results and dataset, see Vera L. Hoover, David J. Ketchen, Jr. & James Combs, \textit{Why Restaurant Firms Franchise: An Analysis of Two Possible Explanations}, 44 \textit{Cornell Hotel and Rest. Admin. Q.}, 9, 14 (2003); See also, James G. Combs & David J. Ketchen, Jr., \textit{Explaining Interfirm Cooperation and Performance: Toward a Reconciliation of Predictions from the Resource-Based View and Organizational Economics}, 20 \textit{STRAT. MGMT. J.} 867, 872 & 880 (1999).}}

\textit{C. Stage Three - Collapse}

Following the continuing decrease in the franchisor’s financial constraints and the decrease in its incentive to maintain and attract new franchisees, the reputation mechanism may collapse. This may particularly occur when the reputation-related costs decrease to a minimum level, at which they will be lower than the franchisor benefits from opportunistic termination of the franchise contract. Such a low level is reached when the franchisor accrues sufficient capital to manage the whole franchise chain on its own. At this stage, the franchisor’s reputation costs from being perceived as unjust by present and prospective franchisees are likely to be lower than the benefits from opportunistic termination. Termination without good cause therefore is likely to occur.

An analysis of case law on dealership and distributorship relationships, which are often governed by franchise termination laws, arguably reveals the collapse of the reputation mechanism, following gradual improvement in a franchisor’s financial availability. An early illustrative case is \textit{Kealey Pharmacy & Home Care Serv. v. Walgreen Co.}\footnote{761 F.2d 345, 347 (7th Cir. 1985).}

Between the years 1972 and 1979, Walgreen sold a wide variety of drugs, beauty aids, and household commodities to consumers through a nation-wide system of both Walgreen-owned stores and dealers using the Walgreen brand-name.\footnote{Kealey Pharmacy & Home Care Service, Inc. v. Walgreen Co., 539 F. Supp. 1357, 1360-1361 (W.D. Wis. 1982), aff’d, 761 F.2d 345 (7th Cir. 1985).} The dealers independently owned drugstores pursuant to a standard dealership agreement with Walgreen.\footnote{\textit{Kealey Pharmacy & Home Care Servs}, 761 F.2d, at 347.} Throughout the contractual relationship between Walgreen and its dealers, the dealers provided capital to Walgreen in two chief ways. First, the dealers paid for
merchandise which they purchased from Walgreen.\textsuperscript{127} In addition, the dealers provided capital to Walgreen, indirectly, by promoting the Walgreen name, image, and reputation in their local communities.\textsuperscript{128} Arguably, Walgreen relied on these dealers, instead of having only Walgreen-owned stores, since the dealers could provide Walgreen with significant financial resources needed to promote Walgreen products, which Walgreen lacked at that stage. During the contractual relationships of Walgreen with its dealers, Walgreen’s net sales were almost constantly increasing.\textsuperscript{129} For example, Walgreen’s net sales in 1972 were $863,334,000,\textsuperscript{130} whereas by 1979, Walgreen’s net sales had jumped to $1,344,542,000.\textsuperscript{131} Figure 1 outlines Walgreen’s increase in net sales between 1972 and 1979.

![Figure 1: Walgreen’s Net Sales: 1972-1979 (in thousands)](image)

In 1980, following the constant increase in Walgreen’s annual net sales, it arguably reached a stage in its organizational life cycle in which it had enough financial resources at its disposal to operate all the stores on its own. Indeed, in that year, Walgreen decided to adjust its marketing strategy. In particular, Walgreen made a decision to cease its reliance on dealers.\textsuperscript{132} Instead, Walgreen chose to maintain and increase its own stores in

\textsuperscript{127} Kealey Pharmacy & Home Care Serv. v. Walgreen Co., 607 F. Supp. 155, 158 (W.D. Wis. 1984), aff’d in part, vacated in part, 761 F.2d 345 (7th Cir. 1985).
\textsuperscript{128} Kealey Pharmacy & Home Care Serv., 607 F. Supp. at 159. For example, all of the prescription drugs which the dealers sold included the words “Walgreen Agency”. Id.
\textsuperscript{130} WALGREEN CO., 1972 ANNUAL REPORT (1972), available at LEXIS.
\textsuperscript{131} WALGREEN CO., 1979 ANNUAL REPORT (1979), available at LEXIS.
\textsuperscript{132} Kealey Pharmacy & Home Care Service, Inc. 539 F. Supp. at 1361.
the same geographic areas where the dealers had already helped build up Walgreen reputation and image. At this stage, the reputation mechanism collapsed. Walgreen was no longer interested in relying on the financial resources provided by the dealers, and thus had no reason to fear a blow to its reputation. Termination without good cause was likely to occur. In fact, Walgreen terminated its dealership agreements with its dealers without making any showing that the dealers failed to comply with the requirements imposed upon them by Walgreen.

Another important case which reveals the collapse of the reputation mechanism, following a gradual improvement in the franchisor’s resource availability is *Atlantic City Coin & Slot Serv. Co. v. IGT*. International Game Technology (IGT) designs and manufactures electronic gaming devices. During 1983 and 1997 IGT expanded its products in New Jersey, Maryland, and the Caribbean's using an exclusive distributor. Throughout the contractual relationship between the IGT and the distributor, the latter provided significant financial assistance to IGT. More specifically, the exclusive distributor invested significant financial resources in promoting the IGT name, expanding a sales force, expanding a marketing facility, expanding a storage area for IGT products, and leasing warehousing, which was devoted to storing, testing, and servicing of IGT gaming devices. Arguably, IGT relied on its distributor, instead of distributing its products on its own, since the exclusive distributor could provide significant resources necessary to promote IGT products—resources which IGT lacked at that early stage. Throughout the contractual relationship of IGT with its exclusive distributor, IGT annual total revenues were almost constantly increasing. For example, in 1983, IGT total revenues were $60,032,000.
Revenues were $60,032,000,\textsuperscript{140} whereas by 1997, IGT total revenues had jumped to $743,970,000.\textsuperscript{141} Figure 2 demonstrates graphically IGT’s increase in total revenues between 1983 and 1997.

![Figure 2: IGT Annual Total Revenue: 1983-1997 (in thousands)](image)

In 1997, following the constant increase in IGT annual total revenues, it arguably reached a stage in its organizational life cycle in which it had access to enough financial resources to replace its exclusive distributor with IGT-owned distribution system. As was to be predicted, in that year, IGT’s decided to discontinue its relationship with its exclusive distributor.\textsuperscript{142} Instead, IGT chose to promote and sell its product on its own.\textsuperscript{143} At this stage, the reputation mechanism collapsed, for IGT was no longer interested in relying on distributors. Termination without good cause was likely to occur. Indeed, IGT terminated its distribution agreement with its exclusive distributor in 1998, without alleging wrongdoing by its distributor to justifying the termination.\textsuperscript{144} Rather, IGT praised the exclusive distributor’s performance just prior to terminating the relationship.\textsuperscript{145} Good cause supporting the contract termination was noticeably absent.\textsuperscript{146}

\textsuperscript{140} International Game Technology - IGT, 1983 Annual Report (1983), available at LEXIS.
\textsuperscript{141} International Game Technology – IGT, Form K-10 for Fiscal Year Ended September 30, 1997.
\textsuperscript{142} Atlantic City Coin & Slot Serv. 14 F. Supp. 2d at 658-659.
\textsuperscript{143} Id. at 659.
\textsuperscript{144} Id. at 658-659.
\textsuperscript{145} Id. at 658.
\textsuperscript{146} Id. at 658.
The collapse of the reputation mechanism is likewise evidenced in the story culminating in the *Day Distrib. Co. v. Nantucket Allserve, Inc.* case.\(^{147}\) Nantucket Allserve, Inc. (Nantucket) produces a line of upscale sodas known as Stewart’s.\(^{148}\) At the early stages of the organizational life cycle of Nantucket, its resource availability was apparently limited. One of Nantucket’s founders, Mr. Scott, was so financially strapped that he slept in his car during the summer of 1991.\(^{149}\) At that early stage, Nantucket distributed its products through distributors;\(^{150}\) the distributors provided financial resources to Nantucket mainly by purchasing a high volume of Nantucket sodas.\(^{151}\) Arguably, Nantucket chose such a marketing strategy due to its financial inability to distribute its products on its own. At this organizational stage in Nantucket’s life cycle, the reputation mechanism was relatively effective. Nantucket had to rely on distributors, and therefore was restrained from acting opportunistically towards its distributors.

Nantucket’s financial situation improved dramatically over the years. Revenues soared from $200,000 in 1991 to about $30 million in 1996.\(^{152}\) In addition, in 2002, the successful Nantucket group was purchased by Cadbury Schweppes Plc, a British beverage giant,\(^{153}\) for an undisclosed sum, estimated at $100 million.\(^{154}\)

Following the acquisition of Nantucket by Cadbury, Nantucket presumably reached a stage in its organizational life cycle in which it had enough financial resources to discontinue its reliance on distributors and perform all the distribution functions on its own. In fact, one year following the acquisition of Nantucket by Cadbury, they both

\(^{148}\) Id. at *1.
\(^{150}\) *Day Distrib. Co.* 2008 U.S. Dist. at *2. Two of the distributors began as sub-distributors of Nantucket but later became distributors of Nantucket. *Id.*
\(^{151}\) *Id.* at *2.
\(^{152}\) Halasz, *supra* note 149. In 1996, Nantucket was ranked 13\(^{th}\) in *Inc’s* fastest-growing U.S. private company list. *Id.*
\(^{153}\) Corpfin Worldwide, 8/28/2008, Nantucket Allserve Inc, available at LEXIS. Notably, Cadbury bought Nantucket through Snapple Beverage Group, a wholly-owned subsidiary of Cadbury. *Id.*
\(^{154}\) *Cadbury Schweppes*, WALL STREET JOURNAL 6 (Mar. 26, 2002).
began exploring the possibility of discontinuing distributors.155 Instead, Nantucket and Cadbury decided to distribute Stewart’s directly rather than to rely on distributors.156 At this stage, the reputation mechanism collapsed; termination without good cause was likely to occur. Unsurprisingly, Nantucket took its distribution operations in-house and terminated the agreements with its distributors.157 Apparently, Nantucket did not terminate the agreement due to the distributors’ failure to comply with their contractual requirements.158 Good cause supporting a termination was presumably absent.159

IV. CONCLUSION

This article questioned the effectiveness of the reputation mechanism in deterring opportunistic termination by franchisors. It also cast doubt upon the traditional law-and-economics assumption that reputation can be a substitute for franchise termination laws.

While this article focuses on franchise relationships, its conclusions can have broader implications. The assumption that reputation can serve as a substitute for regulation of long-term commercial relationships must be re-examined. As we have demonstrated, the concern for one’s reputation in long-term commercial relations often has a limited life cycle. A firm in the early stages of its organizational life cycle usually lacks internal financial resources needed to achieve its business goals; therefore, it is spurred on to enter into contractual relationships with other firms that can assist it in overcoming its financial constraints. To illustrate, a financially immature firm, wishing to erect a factory,

155 Day Distrib. Co. 2008 U.S. Dist. at *5. Two clarifying notes: Firstly, Cadbury Schweppes Americas Beverages, one of the defendants in the Nantucket case, was a subsidiary division of Cadbury in the U.S. Secondly, court refer to Nantucket Allserve and Cadbury Schweppes Americas Beverages as “Cadbury,” following the practice of the parties. Id. at *2.
156 Id. at *5.
157 Id. at *1.
158 It seems unlikely that all distributors concurrently failed to comply with Nantucket and Cadbury’s requirements.
may have an initial incentive to enter into a partnership or a joint venture agreement with other firms, in order to recruit necessary capital. At this stage the reputation mechanism has some deterring effects, since the young firm is economically dependent upon its contractual partners. However, as the financial availability of the immature firm improves, it becomes less dependent on its contractual partners. The firm’s incentive will shift towards owning and operating the business on its own, which will increase its profits. At this inevitable stage, the effectiveness of reputation in preventing opportunism will decline and the reputation mechanism may ultimately collapse.