Regulation of Franchise Termination

By *Iris Soroker**

Justice Danziger's ruling in the Blum case exposes the drama of franchising and necessitates an examination of this important institution at breaking point, when the parties are in conflict and one of them wishes to exit the relationship. The end of the contract rocks the entire contractual boat and is likely to have an impact on the viability of the transaction. The regulation of franchise termination structures the incentives that operate on the parties to the agreement. If we allow the franchisor to terminate the relationship at will, it is likely to obliterate the franchisee's investments, without allowing the latter to reap the fruits of its labor in the best manner possible. On the other hand, a heavy burden on the franchisor is likely to push the franchisee to reduce its investments and exacerbate the "free rider" problem. The power to leave a franchise affects the commercial certainty of the parties; it stretches the range of forces the parties will traverse during the agreement; and it shapes the commercial value of the franchise. In this article I propose a new arrangement on franchise termination. I will start with a review of the judgments in the various iterations of the Blum case and analyze the innovative precedent in these judgments. I will compare the Blum rulings with previous rulings, present an economic analysis of the franchise and propose a statutory arrangement on franchise termination against the background of the insights gained.

I. Introduction

Justice Yoram Danziger's ruling in the fascinating case of *Blum v. Anglo-Saxon* exposes the drama of franchising and necessitates an examination of this important commercial institution at breaking point, when the parties to the franchise agreement are in conflict and one of them wishes to exit the relationship. The end of the contract rocks the entire contractual boat and is likely to have an impact on the viability of the transaction for the parties. Generally, the question arises when the franchisor wishes to remove the franchisee – as happened in the *Blum* case.[1] The question that needs to

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[1] The judgments in the case of Blum v. Anglo-Saxon are as follows: O.M. (District, Tel Aviv) 1356/*05 Blum v. Anglo-Saxon* (published on Nevo Database, 25.5.2016); O.M. (District, Tel Aviv) 1427/05 *Blum v. Anglo-Saxon* (published on Nevo Database, 13.7.2016) (hereinafter, the "First Blum Case"); C.A. 5925/06 *Blum v. Anglo-Saxon – Real Estate Agency (Israel 1992) Ltd.* (published on Nevo Database, 13.2.2008) (hereinafter, the "*Second Blum* Case"); C.C. (District, Tel Aviv) 1959/08 *Blum v. Anglo-Saxon Real Estate Agency* (published on Nevo Database, 1.5.2013) (hereinafter, the "*Third Blum* Case"); C.A. 4232/13 *Anglo-Saxon Real Estate Agency Ltd. v. Blum* (published on Nevo Database, 29.1.2015; C.A. 4563/

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be decided is whether the franchisor may remove the franchisee at will, unilaterally, and if so – under what conditions. The decision on this question – the regulation of franchise termination – is likely to shape the content of the transaction. It structures the incentives operating on the parties to the agreement. If we allow the franchisor to terminate the relationship at will – the franchisor is likely to opportunistically obliterate the franchisee's investments without allowing it to reap the fruits of its labor in the best possible manner. On the other hand, a heavy burden on the franchisor at the stage of exiting the relationship is likely to push the franchisee to reduce its investments in the transaction and exacerbate the "free rider" problem at the expense of the reputation of the chain and the other franchisees. The ease or difficulty in leaving a franchise relationship has a direct connection to the costs of the transaction. It has an impact on the commercial certainty of the parties, stretches the range of forces the parties will traverse during the agreement and it shapes the entire commercial value of the franchise institution.

In this article I would like to propose a new statutory arrangement on termination of a franchise relationship. I will start the discussion with a review of the fascinating judgments in the four different iterations of the *Blum* Case and analyze the legal novelty the judgments offer. I will compare the *Blum* ruling to the previous rulings. Later on, I will present an economic analysis of the franchise relationship and propose a statutory arrangement on franchise termination against the background of insights raised from the economic analysis, and finally I will present my conclusion.

II. The Blum Case

In the Blum Case, Justice Yoram Danziger revolutionized the rules on franchise termination: the old rule, which recognized flexibility when exiting the relationship, was transformed by a literal reading of the contract terms as formulated by the parties. It began like this:

Anglo-Saxon is a national chain of real estate brokers. Eli Blum acted as a franchisee of the chain. The relationship between the parties was set out in a formal agreement in which Blum was granted an exclusive franchise for an unlimited period of time in the city of Herzliya. The chain also granted Blum a license to use its trademarks. Blum undertook to follow its instructions and safeguard the company's reputation. A dispute arose between the parties in 2002 after more than twenty-five years of working together, when Blum asked to sell the franchise to another operator (so that he could allegedly exploit a real estate investment opportunity). Anglo-Saxon made its consent contingent on the franchise contract with the assignee containing new conditions, the main one being a limitation on the duration of the agreement. Blum argued that he was unable to find purchasers to agree to purchase the franchise

13 *Anglo-Saxon Real Estate Agency Ltd. v. Blum* (published o Nevo Database, 29. 1. 2015) (hereinafter, the "*Fourth Blum* Case").

under these conditions. He believed that he had a "proprietary interest" in the franchise and that Anglo-Saxon's demand reduced its value. The dispute led to mutual claims. Anglo-Saxon argued that Blum was abandoning the franchise, and therefore notified him of its intention to terminate the contract. Unsuccessful negotiations were conducted between the parties. After several extensions, Anglo-Saxon notified Blum that the termination of the franchise would enter into effect (within several months). Blum did not agree to his removal. He applied to the court for a declaratory remedy that the franchise termination was wrongful.

The Tel Aviv District Court dismissed Blum's claim.[2] It held that Anglo-Saxon would have been entitled to terminate the agreement upon delivery of reasonable advance notice, and this had been done. The court applied the well-known rule that "It is not the way of nations to make contracts to remain in effect in perpetuity. It is also not desirable economic or social policy to suspend a contract until eternity".[3] It was stated that "this is an agreement based on a relationship of trust, an agreement where the franchisee's conduct has an impact on the profits of the chain and on its name and reputation, and therefore, according to case law, it should not be interpreted as an agreement where the chain denied itself the right to notify of rescission of the agreement within a reasonable period of time".[4] The court added, a *obiter dicta*, that the agreement had been lawfully terminated also against the background of the franchisee's breaches of contract.[5]

This outcome was overturned in the Supreme Court.[6] Justice Danziger held that Anglo-Saxon was in breach of the agreement because it had unlawfully rescinded it. Although a contract for an unlimited period of time may be rescinded upon reason-

[2] *The First Blum Case*, supra note 1.

[3] C.A. 2491/90 Israel Association of Travel Agencies and Consultants v. Panel of Airline Companies Operating in Israel (published on Nevo Database, 3.5.1994).

[4] The *First Blum* Case, supra note 1, paras. 20–21 of Judge Ronen's judgment. The lower court dismissed the franchisee's argument that Anglo-Saxon's right to rescind the agreement is limited to the events stipulated in section 18 of the agreement between the parties. See supra, para. 12 of Judge Ronen's judgment "this concerns cases where the franchisee will be declared bankrupt, dies without suitable heirs, is convicted of a criminal offense, endangers the Anglo-Saxon name or its trademark, he fails to make payments under the terms of the agreement, he closes the business for 30 consecutive days, etc.". In the court's opinion, "Section 18 should be interpreted broadly, in such manner that the loss of the foundation of trust between the parties constitutes a breach of the franchise agreement justifying its rescission by the [chain]". See, supra, para. 23 of Judge Ronen's judgment.

[5] The lower court found an anchor point for Anglo-Saxon's right to terminate the relationship also in the contract itself: it was held that when the franchisor lost its trust in the franchisee in view of the continuous neglect on his part, this should be deemed a breach of contract establishing a right of rescission. See supra, paras. 23–29 of Judge Ronen's judgment.

[6] The *Second Blum* Case, supra note 1.

able notice,[7] nonetheless, "this is only an evidential presumption, a presumption that may be rebutted by other evidence that was intended to help with interpreting the parties' intention where it is unclear, but not to come in its place".[8] The question remains, is the general presumption consistent with the contract, or does the contract possess another arrangement.[9] Justice Danziger carefully examined the provisions of the contract and held that "the agreement lays down several provisions explicitly setting forth the events in which each party may rescind it, as well as the date of rescission in each case".[10] Section 3 of the agreement determined the date of commence-

[7] Justice Danziger cited, in concurrence, the Supreme Court rule. See, C.A. 46/74 *Mordov v. Schechtman*, 29(1) IsrSC 477 (1974); C.A. 442/85 *Zohar v. Travenol Laboratories (Israel) Ltd.*, 44(3) IsrSC 661 (1990).

[8] The *Second Blum* Case, supra note 1, para. 38 of Justice Danziger's judgment who cited, in concurrence, the rule laid down. See the *Israel Association of Travel Agencies and Consultants case*, supra note 3, para. 15 of Justice Danziger's judgment: "…The ruling does not determine a substantive rule, only a presumption that has the force of evidence. This presumption has two facets. First, it says that a contract for an unlimited period of time is not a perpetual contract. Second, it says that such a contract may be rescinded unilaterally. However, like a presumption, this presumption also, with its two facets, may be rebutted by evidence. At the end of the day, the presumption is merely to help us determine the intention of the parties, where this intention is unclear. It is not supposed to be in lieu of the intention of the parties, if it is possible to determine the intention of the parties, and to determine such intention on the basis of the evidence. It is also not supposed to exempt from having to find out what the intention of the parties was. It may be that the intention of the parties clearly arises from the circumstances, in which case the presumption will not be necessary or appropriate. For example, it may be that in the circumstances of a specific case it will not be right to say, according to the presumption, that the parties intended to allow a unilateral termination of contract at any time and for any reason. The circumstances are likely to show, for example, an intention that the contract would terminate upon the occurrence of a certain incident, or that one of the parties may terminate the contract if, and only if, certain conditions were satisfied".

[9] On this matter the guidelines adopted were those set down in C.A. 2850/99 *Ben Hamo v. Tene Noga Ltd.*, 54(4) IsrSC 849, para. 8 of the judgment of Justice Strassberg-Cohen (2000): "The conclusion is derived from the nature of the agreement that perpetually denying a manufacturer the option of terminating the relationship with a distributor, which is like forcing a manufacturer to uphold an agreement until perpetuity, is contrary to commercial and legal logic and to commonsense. It is inconceivable to obligate a manufacturer to perform a distribution contract until perpetuity and to be tightly bound by the agreement when special circumstances are created undermining the foundations of the agreement. For example, where the distributor is in breach of the agreement or is in breach of the trust given to it. Such an interpretation is inconsistent with the purpose of the agreement. An examination of the nature and essence of the agreement shows that according to its objective purpose, the object of the clause is to deny Tene any right to rescind the agreement as long as the special circumstances have not been fulfilled. This clause gains significance in light of the rule that provides that a distribution agreement for an unlimited period of time can be rescinded by the manufacturer at his desire, upon giving reasonable notice. Generally, this right is available to a manufacturer bound by a distribution agreement with a distributor at any time and without the necessity for special circumstances. This clause comes along, according to its reasonable interpretation, and excludes the rule and prevents the rescission and enforcement of the agreement by the manufacturer as long as the aforesaid special circumstances have not been fulfilled".

[10] The *Second Blum* Case, supra note 1, para. 41 of Justice Danziger's judgment.

ment of the franchise, without a termination date. Blum himself was permitted to terminate the agreement "at any time" (upon 60 days' prior notice), but at the same time he was prohibited from transferring the franchise to anyone else.[11] Regarding Anglo-Saxon, section 18 of the agreement – this is the section that determined the dispute – specified a list of events in which "the Company may, at its sole discretion, terminate and rescind this Agreement".[12] Justice Danziger interpreted this to be a closed list of events in which Anglo-Saxon could rescind the agreement.[13]

Consistent with his method of interpretation that extolled the language of the agreement, Justice Danziger noted as follows: "I recently expressed my opinion that when the language of the contract is explicit, it must be given decisive weight when interpreting the agreement … and I believe that these comments are also pertinent to the present case before me … In the case forming the subject of this appeal, there is a written contract determining explicit provisions on rescission. It is therefore unnecessary to apply the presumption of the intention of the parties not to be bound by the agreement in perpetuity, and there is also no need to estimate what the intention of the parties was, since it found expression explicitly and accurately in the clauses on

[11] Supra, para. 40 of Justice Danziger's judgment: section 3(b)2 of the agreement provided that "Without derogating from the foregoing in this Agreement, the Operator is hereby granted a right to terminate this Agreement at any time, upon condition that the Company is given 60 days' prior notice of his intention to do so, and in such case the Agreement will be terminated within the aforesaid 60-day period". Section 6(c) of the agreement determined: "… the Operator hereby declares that he is aware that the franchise was granted only to him personally. The Operator may not sell and/or transfer and/or dispose of the franchise or the rights granted to him pursuant to the terms of this Agreement, in any form whatsoever, and also not permit any person and/or other entity to use the aforesaid or share in any consideration or in any manner under license or as a partner or in any manner whatsoever in the franchise granted to him under this Agreement, unless the Company grants its written consent thereto. The Company shall not refuse to give such consent, except upon reasonable grounds …".

[12] Supra. And briefly they are as follows: death of the Operator; a declaration of his bankruptcy; his conviction of a criminal offense; trademark infringement; non-performance of payments; failure to maintain books of account; conducting execution office proceedings against the Operator; in the event the business is closed for 30 consecutive days not by virtue of any strike or force majeure; and "in the event of breach of this Agreement by one of the parties to the Agreement". Section 18(2) of the agreement determined a mechanism for rescission of agreement in the event of the occurrence of one of the following incidents: "In the event of the occurrence of one or more of the events set forth in this section and/or in the event of a breach of this Agreement by the Operator, the Company shall be obligated to deliver to the Operator a written notice to remedy the aforesaid breach within 15 days of the date of the letter before rescission of the Agreement by the Company, except in those events in which such an extension of time will cause the Company grave damage. Grant of such prior notice will not apply with respect to subsections b, c, g, d".

[13] Supra, para. 43 of Justice Danziger's judgment: "The Agreement, which was drafted by Anglo-Saxon … explicitly provides the events in which there will be a right of rescission for each of the parties. According to the provisions of the Agreement, Blum is entitled to rescind the Agreement for any reason whatsoever, while Anglo-Saxon may only do so upon the fulfillment of one of the events stipulated in a closed list of events".

rescission set forth in the Agreement".[14] Danziger did not explain the *contra proferentum* rule because "the rescission clauses … are clear and explicit and from a reading of them it is absolutely clear when and under what circumstances each party may rescind the Agreement. I found no ambiguity in the Agreement or provision that was not clearly drafted, from which it could be inferred that a right to rescind the Agreement for any reason whatsoever was also given to Anglo-Saxon. However, I believe that the fact the Agreement was drafted by Anglo-Saxon … actually reinforces the conclusion that it was not given an equivalent sweeping right of rescission, because had Anglo-Saxon wanted to grant itself a similar right in the Agreement, it is under a presumption that it would have done so. Since it did not do so, it cannot now argue any imbalance between the parties' rights".[15] This meaning, Danziger emphasized, is consistent with "simple commercial logic": "According to this logic, a franchisee works and invests in the development of a franchise for many years, while the franchisor enjoys the fruits of such investment. Therefore, granting the franchisor a sweeping right of rescission will significantly reduce the franchisee's incentive to develop it and may even cause it to hold off acquiring the franchise due to a constant fear of its rescission".[16] Anglo-Saxon was therefore found to be in breach of the agreement because it had sent a notice of rescission which was not explicitly covered in the list of permitted events.

The franchisee, possessing a declaratory judgment, now filed a claim for the remedy of enforcement of the franchise. In the interim, the plot thickened because Anglo-Saxon transferred the franchise to another franchisee. In spite of this, the Tel Aviv District Court accepted Blum's claim for enforcement.[17] It was held that Anglo-Saxon had to return the franchise to the Plaintiff under the original contract. It was emphasized that "the remedy of enforcement is the first and principal remedy

[14] Supra.

[15] Supra, para. 44 of Justice Danziger's judgment. As is known, Justice Danziger is one of the prominent critics of the Aprofim ruling that champions a purposeful interpretation of a contract. See, C.A. 4628/93 *State of Israel v. Aprofim Housing and Enterprise (1991) Ltd.*, 49(2) IsrSC 265 (1995). In a series of leading judgments, Justice Danziger established the approach emphasizing the language of the contract as the superior source for interpretation and application. See, for example, C.A. 5856/06 *Levy v. Norcate Ltd.*, para. 27 of Justice Danziger's judgment (published on Nevo Database, 28. 1. 2008); C.A. 8836/07 *Balmoral Investments Ltd. v. Cohen*, 63(3) IsrSC 557, paras. 35.2–35.8 of Justice Danziger's judgment (2010); C.A. 11039/07 *Eliyahu Insurance Company Ltd. v. Avner Motor Vehicle Accident Victims' Insurance Association Ltd.* (published on Nevo Database, 6. 7. 2011).

[16] The *Second Blum* Case, supra, note 1, paras. 45, 50–51 of Justice Danziger's judgment. Justice Danziger was willing to start out on the customary assumption that a fiduciary relationship forms the basis of a franchise, yet, in this case the argument was abandoned by Anglo-Saxon itself: it held on to a right "under law" to terminate the agreement, and not on loss of trust. Furthermore, in the pleadings, Anglo-Saxon stated that it was not alleging any breach of agreement but was relying on "its right to rescind for any reason whatsoever upon reasonable notice". In these circumstances, it was held that "Anglo-Saxon never argued that it had lost its trust in the Petitioner, and in any event did not prove this argument".

[17] The *Third Blum* Case, supra, note 1.

found in the Remedies Law, and only after this, in the order of remedies, is the remedy of damages".[18] The Court found that the agreement with the new franchisee was limited to a maximum period of ten years and therefore the "impossibility of performance limitation" could be overcome[19] by means of "postponed enforcement" to a future date – after the end of the agreement between Anglo-Saxon and the third party. The lower court rejected the argument that franchising is a "personal service" negating enforcement.[20] The "unjust enforcement" limitation was also rejected because the "current trend is to minimize the use of this limitation".[21] Alongside the remedy of enforcement, the Court also awarded damages: readjustment expenses after the franchise was taken, the value of the franchise over ten years until its return to the Plaintiff and also damages for non-pecuniary damage.[22]

Both parties appealed to the Supreme Court.[23] Anglo-Saxon argued (for the most part) against the remedy of enforcement, whereas Blum's appeal concerned (for the most part) the amount of damages. Justice Amit defined both questions to be heard: should enforcement be awarded ten years after the termination of the agreement? How should the damage incurred by the Respondent, if any, as a result of breach of the franchise agreement between him and the Appellant, be calculated?

The remedy of enforcement was denied, both because this was a trust-based personal relationship, and because of the potential damage to the new franchisee that had just come into the picture.[24] Justice Amit also applied the justice in contract enforce-

[18] Supra, para. 40 of Justice Danziger's judgment.

[19] The impossibility of performance limitation is set out in section 3(1) of the Contracts (Remedies for Breach of Contract) Law, 5731 – 1970.

[20] The personal service limitation is set out in section 3(2) of the Contracts (Remedies for Breach of Contract) Law; the *Third Blum* Case, supra, note 1, para. 43 of Judge Bachar's judgment: "This is not actually a direct relationship between the Defendant and the Plaintiff. The Defendant is the owner of property – the franchise – and it is permitting the Plaintiff – the franchisee – to use it for consideration. The Plaintiff is not granting any personal service to the Defendant but is making use of property which belongs to it".

[21] Supra, para. 44 of Judge Bachar's judgment and see also, the unjust enforcement limitation set out in section 3(4) of the Contracts (Remedies for Breach of Contract) Law.

[22] The *Third Blum* Case, supra, note 1, paras. 48 – 68 of Judge Bachar's judgment.

[23] The *Fourth Blum* Case, supra, note 1.

[24] Supra, paras. 12, 15 of Justice Amit's judgment: "We are concerned here with a franchise agreement in which Anglo-Saxon grants the franchisee a right to use its trademark and its brand within a specific territory and defined business methods. Franchising carries with it certain advantages for the franchisee, and inter alia, the fact that it operates under a recognized brand, alongside a nationwide marketing package, assistance with organizational development and creating advanced communication channels within the chain and with customers. Anglo-Saxon receives, in consideration, a one-time payment … and royalties of 10 % of the revenues. The relationship between Anglo-Saxon and the franchisee requires a certain degree of ongoing collaboration and communication: payment of monthly royalties, participation of the franchisee and its employees in training programs and advanced studies conducted by Anglo-Saxon, Anglo-Saxon's supervision over the way the franchisee complies with its standards, reliance on Anglo-Saxon's computer system, collaboration with various franchisees, and so

ment limitation.[25] Weight was given to the long passage of time and the relatively low standard of moral blame accompanying the rescission of the contract by Anglo-Saxon.[26] In lieu of enforcement, Blum had been awarded damages for breach of contract, taking into account the extent of his contributory fault for the damage from the breach. For this purpose, an estimate was made on the value of future profits taken from Blum for the period of his lifetime, with a deduction for the general obligation imposed on an injured party to mitigate his damage, and which was manifested in this case by the franchisee's ability to make a livelihood from an alternative business, in the absence of Anglo-Saxon's business association.[27] By way of estimation, it was held that the contribution of the "Anglo-Saxon" brand to Blum's business activity amounted to 25 %, and therefore Blum was entitled to damages at a rate of 25 % of the estimated future profits taken from him as a result of the cancelation of the franchise.[28]

Anglo-Saxon was therefore found to be in breach of the agreement with the franchisee when it canceled the franchise not in accordance with one of the events specified in the contract. Blum was awarded damages for breach of contract for his life-

forth"; "Included as part of the personal service are contracts based on personal trust … For example, in the manufacturer/distributor-agent agreement, the case law has recognized a fiduciary relationship and cooperation obligating the parties to take into consideration the other party and for one party to advance the interest of the other party. Because of this relationship, it has been held that the agreement cannot be enforced and that it may be rescinded upon reasonable prior notice".

[25] Section 3(4) of the Contracts (Remedies for Breach of Contract) Law.

[26] The *Fourth Blum* Case, supra, note 1, para. 16 of Justice Amit's judgment: "Within the justice limitation, the court will examine the conduct of the parties and their moral blame ("the balance of blame") alongside an examination of their interests and the damage to be incurred by each of them whether or not the contract is enforced ("the balance of damage") … As part of the circumstances of the case, consideration should be given to the passage of time from the start of the dispute between the parties and from the date of rescission of the contract until a ruling…Enforcement of the agreement almost 15 years after Blum notified Anglo-Saxon of his desire to retire from the real estate business, 10 years after the agreement was rescinded, and where in the interim Anglo-Saxon had entered into an agreement with a new franchisee, an additional branch had been opened in Herzliya under the franchisee, the management of Anglo-Saxon had been replaced, many training programs and advanced studies had taken place, and obviously working arrangements and the technology package used in the Appellant's franchisees' work, had changed – all these considerations should all be taken into account".

[27] Supra, paras. 21, 29 of Justice Amit's judgment. In practice, Blum did continue working as an independent realtor in Herzliya in the relevant years: "A true calculation of the damage incurred in consequence of taking away the franchise requires an examination of the report Blum produced before cancelation of the franchise, with a deduction of the profit he made after cancelation of the franchise" and taking into account the fact that Blum continued to operate as a longstanding realtor with his own independent reputation.

[28] Alongside this compensation, the appellate court approved damages for the franchisee for readjustment expenses after the franchise was taken (NIS 15,000), and also for pain and suffering (NIS 100,000). See, supra.

time, with a deduction of his obligation to continue to make an independent livelihood.

III. The Legal Novelty

Justice Danziger's ruling in the case of *Blum v. Anglo-Saxon* constitutes a new milestone in the regulation of franchise termination. Until this judgment, the prevailing rule had allowed each party to terminate an unlimited in time franchise contract upon "reasonable notice", which was normally between a month and a year. The leading judgment was handed down in 1990 in the case of *Moshe Zohar & Co. v. Travenol Laboratories (Israel) Ltd.*[29] This case involved an exclusive distributor who represented a medical equipment manufacturer in Israel. The contract between the litigants was unlimited in time. During the contract there were ownership changes in the manufacturing company, but the distributor was given notice that the relationship would continue as usual. About six years after signing the contract the manufacturer notified of termination of the relationship, upon three months' notice, because it had adopted a distribution policy through subsidiaries. The manufacturer's actual right to terminate the relationship upon unilateral notice was not disputed. "Taking into consideration the pace of commercial life, it is inconceivable that a contract, even one for an unlimited period of time, should bind the parties eternally in a relationship between a manufacturer (or supplier) and the various marketers promoting its sales. There is also another reason for this and that is the mutual trust that such a relationship entails … When one of the parties wishes to discontinue the relationship, there is no rhyme or reason to obligate him to continue with it against his will. The performance of a trust-based relationship cannot be guaranteed by coercion. The problem before us is not, therefore, if the commercial contract, including the contract between the manufacturer and the marketer, that was made for an unlimited period of time, can be rescinded upon giving reasonable notice, but rather what is the reasonable period of time required for the rescission notice".[30]

Regarding the duration of reasonable notice, it has been held that this is a twofold examination: "*first* – a reasonable period of time from the commencement of the relationship until its cancelation. *Second* – the period of time allotted in the notice of cancelation. The first is intended to give the other party sufficient time to make a reasonable profit from the business and cover his expenses of time and labor, and also the expenses disbursed in its performance. In a commercial distribution transaction, it is also necessary to take into account the work, since the fruits of the investment and the work do not come to fruition immediately, but rather only after the passage of time, and sometimes even years. The second is intended to give the other party sufficient time to organize his business prior to termination of the relationship and find other

[29] The *Zohar* Case, supra, note 7.

[30] Supra, para. 5(b) of Justice Netanyahu's judgment.

sources of profit. When the notice is not reasonable within one of the two above periods (or both), the canceling party has to compensate the other party for the damage incurred in consequence of this".[31] In that case it was held that the distributor is entitled to loss of profits for one year.[32]

The *Zohar v. Travenol Laboratories* case determined a clear rule: where there is a distribution agreement for an unlimited period of time, each party may terminate it at will, provided that reasonable notice is given to the other party. This rule reflects the view that "a perpetual obligatory relationship should not be enforced between parties to a contract … And even more so in the case of a contract based on a fiduciary relationship or on personal ties … and this was also explicitly determined with respect to a distribution contract".[33] The courts did not regard this rule as a purely factual and rebuttable presumption, but rather as a norm determining modes of conduct: "although the right of a party to an agreement, where no date has been determined for its termination, to leave it after giving notice to the other party, is based on an interpretation of the contract, this is a norm expressing a general presumption".[34]

The ruling in *Zohar v. Travenol Laboratories* became accepted case law. Under it a franchisor was permitted to terminate an agreement with a franchisee upon delivery of reasonable notice, the concrete duration of which was decided according to the circumstances of the case.[35] The judgment of the Supreme Court in the case of

[31] Supra, para. 6 of Justice Netanyahu's judgment.

[32] Opinions were divided over the legal cause of action according to which the duration of time of reasonable notice should be determined. Justice Netanyahu (in the minority opinion on this matter) applied the laws of unjust enrichment. See supra, para. 10 of Justice Netanyahu's judgment. On the other hand, according to Justice Barak (with whom Justice Orr and Justice Bejski concurred), it was desirable to determine the reasonableness of the notice at the level of contract law. See supra, at 705–706. The duration of the period was determined by taking into consideration the manufacturer's bad faith (which caused the distributor to believe that the relationship would continue), and also taking into consideration the relatively low price per product unit and the short business turnover requiring a relatively longer time to make a profit.

[33] C.A. 355/89 *Estate of Hinawi v. National Brewery Ltd.*, 46(2) IsrSC 70, para. 15 of Justice Cheshin's judgment (1992).

[34] C.A. 47/88 *Hershtik v. Yakhin Hakal Ltd.* 47(2) IsrSC 429, para. 6 of Justice Dorner's judgment (1993). See also, L.C.A. 1516/05 *Lamit Holdings Ltd. v. Menache H. Eliachar Ltd.*, para. 5 of Justice Grunis' judgment (published on Nevo Database, 22.2.2005): "The well-established rule issued from this court is that an agreement for an unlimited time can only be rescinded by each of the parties to it, provided that notice thereof was given a reasonable time in advance".

[35] See for example, *Israel Association of Travel Agencies and Consultants* case, supra, note 3, para. 19 of the judgment of Justice Zamir. In that case a notice of one month was approved: "… Even if the contract was rescinded by right, and the rescission was carried out in good faith, it is still an obligation, with a contract for an unlimited period of time, to give notice on rescission of the contract a reasonable time before the date determined in the notice on termination of the contract. This is the reasonable notice obligation. This obligation may be concluded from the intention of the parties to the contract, who did not intend to allow the unilateral rescission of the contract, unless the rescission was preceded by reasonable notice. And this obligation may also be derived from the general obligation under section 39 of the

Blum v. Anglo-Saxon did not toe the familiar line. Justice Danziger set the discussion on the question of terminating a franchise in a contractual setting and elevated the language of the franchise agreement.[36] In the judgments handed down after the *Blum* case the rhetoric is pronounced that the right of contractual parties to rescind a contract for an unlimited period of time stems from a purely factual presumption, and this is rebuttable. This is no longer regarded as a norm of conduct, but as a tool to identify the intention of the parties – and this is decided according to the wording of the contract.[37]

Contracts (General Part) Law, 5733 – 1973 to act in a customary manner and in good faith. One way or another, this obligation received a stamp of approval from the court … Reasonable time, in any event, depends on the nature of the contract in the specific circumstances, including the reasons and circumstances of the rescission of the contract … Inter alia, it is necessary to consider in any event the effect of the rescission on the situation of the parties. It is particularly important to consider if the party injured by the rescission needs time to prepare for the rescission or to mitigate the extent of the damage, or to organize an alternative arrangement. In the final reckoning, when determining reasonable time, the aspiration should be to a desirable balance of the extent of the damage of the two parties between themselves". See also, C.A. 9099/96 *Yedioth Ahronoth v. Firstenberg*, 53(5) IsrSC 1, para. 23 of Justice Tirkel's judgment (1999). In that case a year warning was determined: "… The court had to determine the period of the advance notice according to the circumstances of the case … I believe that an advance notice period of two years … is too long, mainly taking into account the fact that the contractual relationship between the litigants lasted only a relatively short period of about a year and a half. Alongside this consideration, weight should be attributed to the investments of time and of money the Respondents invested, the fruits of which have not yet been seen … In view of these considerations, it seems to me that the court's decision should remain in effect … In other words, an advance notice period of one year".

[36] It should be noted that Blum's motion for a further hearing was dismissed. See C.F.H. 1075/15 *Blum v. Anglo-Saxon Real Estate Agency (Israel –1992) Ltd.* (published on Nevo Database, 9. 3. 2015).

[37] See, for example, these judgments: C.A. 3496/08 *Extra Institute for Vehicle Licensing Ltd. v. National Vocational Training College Sachnin Ltd.* (published on Nevo Database, 16. 11. 2010) – the presumption that the contract was not made in perpetuity is rebuttable; O.M. (District Tel Aviv) 576/07 *Leader Toys Ltd. v. The Little Tikes Company* (published on Nevo Database, 9. 6. 2013) – where the parties have determined in the contract the way it should be terminated, this agreement should be respected; C.C. (District, Beersheba) 7300/*06 Noam Barash Ltd. v. Ma'ariv Modi'in Publishing House Ltd.* (published on Nevo Database, 26. 2. 2012) – there is a presumption that a contract not signed on time may be canceled upon reasonable notice; C.C. (District, Tel Aviv) 2228/06 *A.E. Inbar Holdings and Real Estate Ltd. v. Naish International, Inc.* (published on Nevo Database, 6. 6. 2013) – the parties to a contract for an unlimited time can rescind it upon reasonable notice; C.C. (District, Haifa) 56169-03-11 *Korem v. Anana Ltd.* (published on Nevo Database, 15. 10. 2013) – the presumption that a contract is not made in perpetuity applies with respect to any commercial contract; C.C. (District, Jerusalem) 45359-05-11 *Haim Levy Vehicle Agency and Jerusalem Regional Garage* (1998) Ltd. v. Carasso Motors Ltd. (published on Nevo Database, 11. 6. 2014) – rebutting the presumption on the intention of the parties to terminate a contractual relationship for an unlimited period of time, by delivery of reasonable notice – requires actual evidence; C.C. (District, Tel Aviv) 1593/09 *GEFEG-NEKAR antriebssysteme GmbH v. Mitronix Ltd.* (published on Nevo Database, 11. 1. 2016) – the right of each party to a contract to terminate it if it is for an unlimited period of time – is subject to the interpretation of the contract in relation to the intention of the parties.

IV. About Blum and Zohar and Everything in Between

The comparison between the two leading judgments reveals substantive differences. Moshe Zohar was awarded a pecuniary remedy in the form of loss of profits for a period of one additional year. In contrast, Eli Blum was awarded a pecuniary remedy in the form of loss of profits for the duration of his lifetime (with a deduction of the duty to mitigate the damage). In the case of *Zohar*, the legal guideline was that the manufacturer is entitled to terminate the distribution relationship by giving "reasonable notice". In the case of *Blum*, the legal starting point was the opposite: the chain could not terminate the franchise, and therefore it had to compensate the franchisee for the unauthorized removal of the contractual entitlement. *Prima facie*, this gap may be explained on the basis of the difference between the franchise agreements: in both cases the contracts were indeed for an unlimited period of time; however, in Blum's case, in contrast to Zohar's case, one of the sections of the contract specified events which granted Anglo-Saxon the explicit right to rescind the agreement. This section was interpreted literally, as denying the termination of a franchise upon reasonable notice without giving reasons, or termination deriving from actual damage to the element of trust.[38] It was held that Anglo-Saxon certainly knew how to protect itself as drafter of the contract, when it specified in the contract those events entitling it to the right of rescission.[39]

I would like to propose that the attempt to distinguish between the two judgments on a purely factual basis – misses the full legal picture. The differences in the results cannot be reconciled only from differences in drafting between the contracts, rather there are differences in policy and perspective. The starting point of the court in each

[38] On this matter, see the *Second Blum* Case, supra, note 1, para. 43 of Justice Danziger's judgment: "There is no need to exercise the presumption on the intention of the parties not to be bound by the agreement for eternity and there is also no need to estimate what the intention of the parties was, since it is explicitly and accurately expressed in the sections on rescission determined in the agreement".

[39] Supra, para. 44 of Justice Danziger's judgment: "… I believe that the fact that the agreement was drafted by Anglo-Saxon (or someone on its behalf) actually reinforces the conclusion that it was not given an equivalent sweeping right of rescission [to Blum's right], because had Anglo-Saxon wanted to grant itself a similar right in the Agreement, it is under a presumption that it would have done so. Since it did not do so, it cannot now argue any imbalance between the rights of the parties". It should be noted that the contractual interpretation that was adopted exacerbated the relative position of the drafter: both in comparison to the franchisee, who held an explicit right to terminate the agreement "at any time, on condition that he gives the company prior notice". See, supra, para. 40 of Justice Danziger's judgment; and also, in comparison to the general law formulated in the *Zohar* case, supra note 7, and under which it may be assumed that whoever enters into a contract without a time limit wishes to keep hold of a right to terminate the contract upon reasonable notice. It is therefore possible to challenge the given interpretation and suggest that in section 18 the chain wanted to specify the specific events for the purpose of guiding the franchisee and the prevention of doubt, but without ruling out the general possibility of leaving the relationship upon delivery of reasonable notice. As may be recalled, this was also the interpretation given by the lower court.

case was different: the ruling in the case of *Zohar v. Travenol Laboratories* applied a norm according to which a party to a contract for an unlimited period of time holds in its possession a Hohfeldian power of release against the other party, unless the contract explicitly rules this out. On the other hand, the court in the case of *Blum v. Anglo-Saxon* approached the contract without any preconceived notions and applied it as it was, according to its words.[40] According to Justice Danziger, the contract which was drafted by the parties optimally and exclusively reflects their intention. Any external intervention is likely to upset the contractual balance that is reflected in the language of the contract.[41] Justice Danziger's ruling gives the parties to a franchise the incentive to properly define, in the contract itself, their rights and obligations, before they embark on the franchise journey.

V. Franchise Termination: Economic Analysis

The regulation of franchise termination is expected to affect the content of the transaction and the franchise structure. The Nobel prize winner for Economic Sciences, Oliver Williamson, laid down a theoretical foundation for the analysis of structures of transactions through the prism of the incidental transaction costs. In a monumental work from 1979, Williamson proposed that there is a direct connection between the incidental transaction costs and the business structure the parties would form.[42] The business costs are all those costs incidental to realization of the transaction: gathering information, negotiations, enforcement costs. Williamson argued that a transaction is effective when its structure minimizes its costs. According to the intensity of the transaction costs, the transaction structures will vary in range between a simple promise (where costs are relatively low) up to the acquisition of ownership in the activity forming the subject of the transaction (where transaction costs are high). Three types of costs are likely to be burdensome for the parties: specific investments;

[40] Justice Danziger noted that the literal interpretation is consistent with the commercial logic of a franchise contract. See the *Second Blum* Case, supra, note 1, para. 45 of Justice Danziger's judgment: "…In franchise agreements, the franchisee works and invests in the development of the franchise for many years, while the franchisor enjoys the fruits of such investment. Therefore, granting the franchisor a sweeping right of rescission will significantly reduce the franchisee's incentive to develop it and may even cause it to hold off acquiring the franchise due to a constant fear of its rescission".

[41] Supra. Obviously, his approach is not unique to franchise contracts, but is part of his overall interpretational perspective that grants priority to the language of the contract, out of respect for the wording adopted by the parties. See, for example, the *Levy* case, supra, note 15, para. 27 of Justice Danziger's judgment; C.A. 7379/06 *G.M.H.L. Construction Company 1992 Ltd. v. Tahulian*, para. 1 of Justice Naor's judgment (published on Nevo Database, 10. 9. 2009); C.A. 9551/04 *Asfan Construction and Development Ltd. v. State of Israel*, paras. 23 – 24 of Justice Danziger's judgment (published on Nevo Database, 12. 10. 2009); the Balmoral Investments Ltd. case, supra, note 15, paras. 24 – 25 of Justice Danziger's judgment.

[42] See, *Williamson*, Transaction-Cost Economics: The Governance of Contractual Relations, Journal of Law and Economics 22 (1979), p. 233 et seq.

bounded rationality; and fear of opportunism on the part of the other contracting party. Where specific investments were invested in a transaction, they restrict mobility and create the dependency of the contracting party on the other party. Bounded rationality exists where the future conceals uncertainty (particularly with continuing transactions) and the ability to plan them is impaired. This is so when the player before you is random or one-time (in contrast to a "ecurring player") and it may therefore not shy away from extortive measures. Where the intensity of these costs is low, we will expect to see "weak" business structures, to the point of being satisfied by a simple promise or "modest" contract. On the other hand, if the intensity of the transaction costs is high, strong and tight transaction structures may be observed. The parties will try and create perseverance incentives with the other party, to make the transaction worthwhile and any breach of it not worth the trouble. It may be assumed that such a transaction will be set out in a contract filled with mutual clauses and combined obligations. The parties are likely to further demand performance guarantees and determine private litigation mechanisms (such as arbitration). In extreme cases, where the value of the transaction cannot be safeguarded by contract, we will observe the structure of vertical integration: the contract will be converted by the acquisition of ownership, because of the contracting entity's fear of opportunism and its desire to ensure for itself maximum control of the activity forming the subject of the transaction.

The transaction costs theory was recognized in the economic literature analyzing the institution of franchising. Economists have identified a connection between the franchise structure and the double-sided moral hazard the parties find themselves in: on the one hand, the franchisee fears opportunistic conduct on the part of the franchisor, who may discard him at a "high point" and not allow him to reap the fruits of his investment. On the other hand, the franchisor fears the franchisee will abuse the sale power of the trademark the franchisor brings with it to the relationship. The franchisee is likely to cut back on the quality of the services he provides to the bare minimum, while benefiting from the investments of the chain and the other franchisees. This phenomenon is known as the "free rider problem". The moral hazard of the contracting parties in a franchise institution is mutual and will push them to attempt to build a transaction to minimize the hazard to both of them. The franchise structure will be effective when it provides an incentive to both parties to optimally invest in the transaction. Obviously, the intensity of the hazard that each assumes is not necessarily symmetrical. For example, in the case of a new transaction, the level of investment required from the franchisee will be relatively higher and his hazard will increase. On the other hand, if this is a transaction characterized by one-time customers, this is likely to be an incentive for the franchisee to reduce the quality of the services, and this is the franchisor's moral hazard.[43]

[43] See the clear and illuminating analysis in *Argyres/ Bercovitz*, The Impact of Efficiency and Bargaining on Contract Structure: Evidence from Franchising, Atlanta Competitive Advantage Conference 2010 Paper.

The contract duration and determination of methods of termination express how the parties contend with the problem of the double-sided moral hazard. Generally, it may be assumed that a long-term contract is intended to compensate a contracting party for a significant investment in the transaction. The more specific the investment – and the harder it is for the contracting party to move its investment to another activity – the more it will want to protect its investment against arbitrary removal. A prolonged franchise is likely to protect the franchisee against opportunistic removal by the franchisor.[44] On the other hand, if the contract grants the franchisor a right of removal of the franchisee at its discretion, it may be assumed that it was designed to allow it to closely supervise the franchisees and prevent free rider conduct on their part. Even if the franchisor does not exercise the right of removal, the fact it has such a right is likely to discipline the franchisee and encourage it to do its best. The franchisor's power to terminate the franchise at will is understood as self-regulation, allowing the chain to act against shirking.[45]

On the face of it, a franchise contract negotiated and formulated between business people may be considered a masterpiece of balances between diverging interests. However, on many occasions this is merely the relative bargaining power of one of the parties allowing it to draft the contract in a way that tilts in its favor. Sometimes, the franchisee is the "strong" party benefiting from the reputation of a successful marketer, particularly if there is territorial marketing and the franchisee has a local reputation. Also, a professional association is likely to support the franchisee and strengthen it by negotiating with the franchisor. However, in a normal situation, the chain will be the heavyweight since it owns the trademarks, holds a network of branches and is equipped with professional activity and support mechanisms. Often these are standard contracts dictated to the franchisee by the chain, without it being able to significantly affect the terms of the contract. Indeed, in *Blum's* case the court noted that the drafter of the contract was Anglo-Saxon – the chain. In that same case the contract was interpreted in a manner limiting the chain's power of release; however, if we assume that generally the chain would know how to draft the contract in the best manner possible for it, a literal interpretation of the contract is actually unlikely to protect the franchisee, despite the fact it is the relatively weaker party. Indeed, the power differences between the parties are likely to move the contract from the effective equilibrium and tilt it in favor of the chain.

Justice Danziger's interpretational approach assumes that the contract constitutes an optimal tool for reflecting the commercial intention of the franchisor and franchisee. However, an economic analysis of the contractual device shows it to be far from being a perfect solution. The contract is indeed a powerful legal device in commercial relations, but it suffers from the problem termed the "problem of the incomplete con-

[44] Supra, at 15.

[45] *Klick/Kobayashi/Ribstein*, Federalism, Variation and State Regulation of Franchise Termination, Entrepreneurial Business Law Journal 3 (2009), pp. 358–360.

tract".[46] In this area we can also utilize Oliver Williamson's theory, when he argued that the rationality of the individual is always partial, in view of mankind's inability to gather information, remember information and make repeated use of it without mistake, and also against the background of shortcomings in the language in which contracts are drafted.[47] Bounded rationality embeds an inherent disability in the contract and on this account it will always be partial and deficient. The parties entering into a contract have limited information; they cannot predict every future event, think in advance about optimal solutions and clearly see every situation that may arise. The language is also limited. Different terms are ambiguous and a specific word may be interpreted in a different manner in different contexts and in different times. As a result, the parties are unable to write a contract in advance that will cover all the options they may actually encounter. The harder the future is to predict, and the more complex the contract, the harder it will be to be specific when drafting the contract. Furthermore, the contract is likely to become undesirable in the future to one of the parties due to a change of circumstances. What is currently perceived to be "good" will not necessarily be so in the future.[48]

This problem is obviously exacerbated where there are continuing contracts intended to create a framework for a commercial relationship. The franchise contract is such a contract. General conditions require a franchisee "to make best efforts" or "to do its best" – and such similar phrasing – that were intended to allow future flexibility, but they suffer from extreme vagueness. Also, where various undertakings can be defined in advance, even in this case, interpretational questions are likely to arise. Hermalin, Katz & Craswell state that there is always a need for interpretation of a contract for its implementation, because of inherent problems associated with this device: vague language; bounded rationality; and the problem of asymmetrical information – creating an imbalance in the power balance between the contracting parties.[49]

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[46] On bounded rationality, see in brief: *Waldman/Jensen*, Industrial Organization: Theory and Practice, p. 56 et seq.; *Carlton/Perloff*, Modern Industrial Organization, p. 380 et seq.

[47] *Williamson*, Markets and Hierarchies, Analysis and Antitrust Implications: a Study in the Economics of Internal Organization, pp. 21–23.

[48] Worthy of note in this context is the doctrine of a "relational contract", allowing the application of criteria of cooperation and mutual consideration to continuing trust-based relationships; this is in recognition of the fact that they help the parties produce a maximum mutual benefit from the relationship. See, for example *Mautner*, "How is Israel's Contract Law Developing?", Tel Aviv University Law Review 34 (2011), p. 527 et seq.

[49] *Hermalin*, the Handbook of Law and Economics, pp. 63–94. Four inherent limitations in a contract: first, it is difficult to create a perfect contract in advance. Second, making a contract involves, by its nature, transaction costs, such as the costs of negotiations and the need to agree and define in advance solutions to various future situations. Third, there are enforcement costs; the contract is not always respected by the contracting parties. Litigation is expensive and is not necessarily effective. Finally, enforcement by means of the market is limited. Although the infringing contracting party is likely to weigh the cost of damage to his reputation as a result of a breach of contract, the damage to reputation may be small, and in any event less than the benefit expected in consequence of the breach. See, *Klein/Crawford/Alchian*,

The problem of the incomplete contract thwarts the possibility of faithfully relying on the words of the contract as the perfect source to reflect the value of the commercial weight the parties wish to achieve. Indeed, the contractual device is a powerful device for self-regulation of transactions: nonetheless, it is impossible to ignore the fact that the words of the contract – mainly with continuing contracts – suffer from their own inherent disability. This disability requires us to relate to the wording of the contract with a hint of suspicion.[50]

VI. Regulation on Termination of a Franchise Relationship

I would like to propose new regulation of the franchise relationship in a manner to help the parties achieve an effective balance and equitably protect the relational interests. The proposed regulation will be set out in dedicated legislation: "The Franchise Law" (dispositive) that will establish the right of each party to terminate the franchise contract upon delivery of reasonable notice to the other party, subject to presentation of reasonable justification for termination of the relationship.[51] This arrangement balances between freedom of contract and the interest (private and public) to honor contracts as drafted by the parties, on the one hand, and market failure deriving from frequent power differences and from the need to protect the weak party against the opportunism of the other party, on the other hand. The option of each party becoming released from the relationship upon "reasonable justification" respects business freedom in contractual trust-based relationships and is consistent with the dynamism of commercial and marketing life. It denies the coercion of long-term relationships on parties who "no longer get along". However, it is correct to make the contracting party's power of release subject to a duty to give reasons presenting "reasonable justification" for the termination of the relationship – such as that the other party's level of performance is not optimal. This rule is expected to moderate attempts at abuse of the power to release that prevents opportunism. On the

Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, Journal of Law and Economics 21 (1978), p. 297 et seq.

[50] It is interesting, in this context, to take into consideration section 242 of the Draft Civil Code, 5771-2011, H.H. (Gov.) 595 proposing to impose a duty of trust not only in situations where a person is managing the assets of another person, but also in broader situations where an element of trust is required in a continuing relationship, including mutual undertakings and mutual dependence. This may be regarded as recognition of the view that contractual power is not perpetual but is limited by the basic values of the legal system, on the basis of principles of trust and fairness.

[51] From the aspect of legislative technique, *prima facie* a proposed solution may be formulated by way of adding a dedicated chapter to the Contracts (General Part) Law. However, Israeli legislation in the area of specialized contracts is organized in dedicated laws, such as the Insurance Contract Law, 5741-1981; the Contract for Services Law, 5734-1974; the Sale (Apartments) Law, 5733-1973; the Gift Law, 5728-1968. It is worthwhile to follow this legislative method and also in connection with a franchise contract, to set out its arrangements in a dedicated law.

other hand – it prevents being absolutely chained to a continuing commercial relationship. Such a rule is expected to encourage each party to improve its activity and improve its efforts in favor of the entire endeavor – otherwise the other party will be justified in removing such party. Of course, under freedom of contract, the parties will be able to contract out of the rule and determine a contractual regime at their choice; however, when doing so, they will be faced with a prevailing legislative norm and they will have to contract out of this *explicitly.* That is to say, to take this into consideration and give expression in the costing. Therefore, despite the fact this is a dispositive rule, it will serve as a guide and direct the behavior at the time of making the contract, and also as the default in the absence of any other individual contractual arrangement.[52]

In the United States, some states enacted laws obligating the franchisor to present "good cause" as a ground for the removal of a franchisee.[53] Generally, this is not federal legislation, and treatment of this issue remained at the discretion of the legislatures in the various states. Statutes of this kind obligate the franchisor to give the franchisee advance notice of any intention of removal, and also a reasonable opportunity to remedy the alleged defect. The assumption behind such legislation is that franchise contracts are generally standard contracts dictated by the manufacturer and are therefore drafted in its favor. The purpose of regulatory intervention is to restore the balance of power at the moment of separation and prevent the arbitrary removal of a franchisee who has worked hard and invested in nurturing the franchise. The laws enacted in this area are likely to define what is "good cause" for terminating the relationship (such as a trust problem on the part of the franchisee or trademark infringement) and can leave implementation to the discretion of the court, according to the circumstances of the case. Empirical research published in 2016 showed that US courts generally confirm that the franchisor had good cause for terminating the rela-

[52] Worthy of note in this context is the code of ethics formulated by the Israel Franchise Promotion Center, based on the customary arrangements in the United States and Europe; "Code of Ethics for Franchises" https://bit.ly/2V3tFJ6 (hereinafter, the "Code of Ethics") and also: the Knesset – Research and Information Center, *Managing Businesses under the Franchise Method – Chances, Risks and Arrangements* (2005), see the link to the document: fs.knesset.gov.il/globaldocs/MMM/196e88ab-8e32-e811-80de00155d0a0235/2_196e88ab-8e32-e811-80de-001555d0a0235_11_7032.pdf. The Code of Ethics refers to the pre-contractual relationship and also to the ongoing contractual relationship between a franchisor and franchisee. Companies signing the Code of Ethics receive a quality standard granted by the Israel Franchise Promotion Center. The Code does not regulate the legal aspect of termination of the contractual relationship but lays down a mode of ethical conduct: for example, section 6 of the Code of Ethics provides that a franchise agreement will regulate payment terms, the duration of the franchise and the conditions for sale of the franchise by the franchisee. Adoption of the Code of Ethics is likely to prevent contractual disputes arising in the future.

[53] *Barkoff/Fittante/Gardner Jr./Selden*, Fundamentals of Franchising, pp. 196–202. For a comparative analysis of the state laws in the United States, including the "good cause" requirement, see *Klick/Kobayashi/Ribstein*, Federalism, Variation and State Regulation of Franchise Termination, Entrepreneurial Business Law Journal 3 (2009), pp. 360–366.

tionship.[54] The act of removal will not be approved in those cases where the removal is unrelated to the franchisee's conduct, or in other circumstances making it unjust (such as where the franchisee made significant investments in nurturing the franchise). This research shows that the "good cause" rule is applied with restraint. Its function is to prevent abuse of the franchisee. This rule is also perceived as advancing the interest of fairness, important for the effective structuring of the contractual franchise.[55]

Legal and economic researchers presented the question, what is the effect of legislation obligating the franchisor to present "good cause" as a condition for removal of the franchisee. Some believe that fettering the franchisor's discretion will likely increase free riding on the part of the franchisee, because it is protected against removal at the franchisor's will. This approach regards the power of removal to be an effective mechanism of self-enforcement and emphasizes that there is value in the franchisor supervising franchisees to prevent abandonment and free riding. The fear is that a legal regime that makes it hard for a franchisor to remove a franchisee at its absolute discretion will be abused by the franchisee and lead it to reduce its marketing efforts and investments in the franchise to a bare minimum. On the other hand, there is literature that emphasizes the risk that exists in granting a sweeping right of removal. Arbitrary removal, without cause, is likely to be carried out in abuse of the franchisee's investments and harm its economic interest. Not only is this unfair, but in the long-term this is actually likely to destabilize the transaction structure and damage the efficacy of the franchise institution.[56]

Empirical research undertaken in the hotel industry in the United States examined the connection between a legal regime requiring "good cause" as a condition for ter-

[54] See, for example, the articles of Robert W. Emerson (one of the prominent authors on this topic): *Emerson*, Franchise Terminations: "Good Cause" Decoded, Wake Forest Law Review 51 (2016), p. 103 et seq.; *Emerson*, Franchise Goodwill: Take a Sad Song and Make it Better, University of Michigan Journal of Law Reform 46 (2013), pp. 375–378.

[55] *Lisus/Ship*, Restrictions on Unilateral Termination of Franchise Agreements, Canadian Business Law Journal 49 (2010), p. 113 et seq. It is interesting to note that also in a legal regime that does not contain a "good cause" requirement for rescission of the contract, flexible review tools may be utilized whose purpose is to moderate the right of rescission and prevent arbitrary and opportunistic rescission. In their article, the authors describe the case law in Canada that generally allows a franchisor to terminate the franchise relationship only upon giving reasonable notice, without the requirement to present any justification, as derived from the component of trust forming the basis of the relationship. The authors propose that this is not an absolute right of rescission because it is subject to moderating rules: interpretation of the contract and also the duty to exercise contractual rights in good faith.

[56] For an economic analysis of the laws in the United States obligating the franchisor to present "good cause" for removal of the franchisee, I will refer, for example, to *Brickley/Dark/Weisbach*, The Economic Effects of Franchise Termination Laws, The Journal of Law and Economics 34 (1991), p. 101 et seq.; *Beales III./Muris*, The foundations of franchise regulation: Issues and evidence, Journal of Corporate Finance 2 (1995), p. 157 et seq.

minating a franchise and the performance level of the franchisees.[57] The research sought to examine the claim that a "good cause" regime is likely to make the exit costs borne by the franchisor more expensive, thereby weakening the franchisee's entrepreneurial incentives and increasing free riding. The research referred to hotels belonging to a chain with branches spread out nationwide. The researchers reviewed the data appearing on tourism websites about guest satisfaction in hotel chains spread out in different states, where only some of them had enacted laws requiring "good cause" for removal of a franchisee. The findings of the research showed that no link can be found between the level of visitor satisfaction from the hotel – that is, the franchisee of the chain, and the question whether the legal regime in the state where the franchisee was operating includes a "good cause" statute. It was found that the main impediment currently restraining franchisees in the hotel industry against opportunistic conduct is the ranking of the hotels on the websites, on which guests report and share their experiences with the public. The researchers suggested that there is no empirical basis for assuming that the "good cause" requirement weakens the franchisee's marketing incentives or increases the problem of free riding, or at least not in markets in which there are other significant policing factors.

My proposal for the regulation – applying the criteria of "reasonable justification" for termination of a franchise – is based on considerations of distributive justice and of aggregate efficiency. At the level of *distributive justice*, the call to justify ending the relationship prevents opportunistic release. It creates a flexible link that mediates between the contracting parties in an effective way. The fear of opportunism is mutual: on the franchisee's part, there is fear that the franchisor will rescind the contract at a high point – after the franchisee has already made considerable investments in the franchise – thereby contributing to the chain's reputation, but it has not yet seen the fruits of its labor. This was *prima facie* the situation in the case of *Zohar v. Travenol Laboratories*, where a distributor operated for several years to penetrate a new product in the Israeli market but was removed by the manufacturer while on the verge of successful transactions. Also, on the franchisor's part, there is fear that the franchisee will "pull a fast one" at its expense: it will benefit from the chain's current reputation and trademarks, without significantly contributing anything to its reputation. Franchising raises the problem of free riding by the franchisee, because concurrent use is made of the chain's trademarks by several participants: the franchisor and its franchisees. Each participant is expected to reap a benefit from its counterpart's contribution to the chain's reputation. In the long-term, a mutual contribution of each participant is expected to bear the aggregate profit of the chain; however, in the short-term the franchisee is likely to reduce its personal investments, in an attempt to lean on the marketing efforts of another franchisee.[58] The franchisor's right to remove a

[57] The research was conducted by two researchers from Israel: *Ayal/Benoliel*, Good-Cause Statutes Revisited: An Empirical Assessment, Indiana Law Journal 90 (2015), p. 1177 et seq.

[58] The problem of free riding in connection with the franchise institution was analyzed in the article *Klein/Saft*, The Law and Economics of Franchise Tying Contracts, Journal of Law and Economics 28 (1985), pp. 349–351.

shirking franchisee is likely to curb the problem of free riding; but if we recognize it in its sweeping form – we are likely to create a problem on the other side: we will push the franchisor to the temptation of opportunistic exploitation of the franchisee's investments.

The criterion of "reasonable justification" gathers the two parties around a focal point that obligates each party to give a reckoning of account about the reason for withdrawal from the relationship: withdrawal deriving solely from the opportunistic exploitation of the other party's investments will not be deemed justifiable and will not be approved. There is naturally a necessity to analyze what "reasonable justification" is in termination of the relationship. On this matter we can learn from the US experience that has accumulated incidental to the operation of statutes requiring "good cause": in a normal situation we will examine whether there was any fault on the part of the other party justifying the rescission, even if the incident did not amount to a "breach" of contract, wherein the following events were recognized, such as non-performance of payments or timely reports; failure to meet the chain's standards; a decline in the anticipated sales volume or acceptable performance requirements; sale of competing products; transfer of franchise without the manufacturer's consent; and causing damage or injury to the chain's reputation.[59] There are cases where also without any fault on the part of the franchisee, the manufacturer can terminate the relationship, such as where it has been decided to discontinue a certain production line or exit the market.[60] On the other hand, a manufacturer will not be able to justify removal of the franchisee by its desire to open its own store, if proven that the franchisee had made investments and contributed to the building of the reputation in the area.[61]

In my opinion, it is unnecessary and impossible to exhaustively define in a statute those events that will constitute "reasonable justification". The advantage in a requirement of reasonable justification is the flexibility it offers, enabling it to be suited to specific circumstances. It is therefore desirable that this is left to jurisprudential development from case to case. The important point lies in understanding that the rule of "reasonable justification" does not grant "immunity against dismissal" or "employee tenure". This is a dynamic melting pot for a discussion on the relative interests of the parties. The decision will be made against the background of the nature of the franchise, the ranking of the chain's reputation, the level of the franchisee's investment in nurturing the investment, the duration of the agreement and the total mutual conduct of the parties. Such conduct is not foreign to us: it is familiar from the field of long-term commercial relational contracts to which we apply the legal principle of good faith, with the purpose of reaching just results.[62] Also, a fran-

[59] *Barkoff/Fittante/ Gardner Jr./Selden*, Fundamentals of Franchising, pp. 196–202 .

[60] *Barkoff/Fittante/Gardner Jr./Selden*, Fundamentals of Franchising, pp. 200–201.

[61] *Barkoff/Fittante/Gardner Jr./Selden*, Fundamentals of Franchising, p. 201.

[62] See, for example, C.A. 9609/01 *Mul Hayam (1978) Ltd. v. Segev* (published on Nevo Database, 28. 3. 2004); C.A. 9874/05 *Tel Aviv Yafo Municipality v. Goren* (published on Nevo

chise contract is a relational contract, to which it is desirable to apply a flexible contract law balancing between freedom of contract and the interest of protecting the weak party and preventing injustices deriving from market failures.[63]

The proposed regulation is also supported by considerations of *pure economic efficiency*: the franchise structure is efficient when it encourages both parties to optimally invest in a transaction. The reasonable justification requirement is expected to encourage both parties to optimally invest in the relationship. A contracting party who knows that it may not be removed except for "reasonable justification" will be able to invest with greater confidence in the transaction. On the other hand, a legal regime allowing arbitrary removal for no cause exposes the contracting party to uncertainty and perpetual danger that will deter it from making investments. The franchisee is likely to be pushed into minimizing the marketing efforts to a bare minimum and refraining from spending reliance expenses that are likely to be reduced to nothing.[64] The requirement of reasonable justification does indeed make it more burdensome for the franchisor at the withdrawal stage, but only to some degree: this is not a grant of absolute immunity preventing the rescission of the franchise. And furthermore, the reasonable justification requirement actually advances the interest of the franchisor to operate the franchise to its satisfaction. If it is able to arbitrarily remove the franchisee, this would indeed make it easier for it at the exit point, but it is likely to affect it in the course of the relationship – by weakening the marketing incentives operating on the franchisee. The reasonable justification requirement is expected to act like a whip of encouragement, stimulating the franchisee to refrain from shirking and to do its best.

The parties will obviously be able to contract out of the reasonable justification requirement, since they control the transaction they formulated. It is customary to assume that parties to a franchise develop a reasonable expectation that the relationship will continue; a franchise is not a relationship involving a simple one-time exchange of consideration, but is based on working together in the long-term.[65] How-

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Database, 12. 8. 2009). Also, in the case of franchise contracts, the right to rescind is subject to the duty of good faith as a general legal principle; see, for example, C.C. (District, Tel Aviv) 1092-08 *Nestel v. Yedioth Achronoth Ltd.* (published on Nevo Database, 27. 12. 2010).

[63] For an analysis of a commercial agency relationship as a relational contract, see for example, *Grosskopf*, Dividing the Surplus upon Termination: The Case of Relational Contracts, American Business Law Journal 48 (2011), p. 1 et seq.

[64] This is the position expressed by Justice Danziger in the appeal in the *Second Blum* Case, supra, note 1, para. 45 of Justice Danziger's judgment: "…a franchisee works and invests in the development of a franchise for many years, while the franchisor enjoys the fruits of such investment. Therefore, granting the franchisor a sweeping right of rescission will significantly reduce the franchisee's incentive to develop it and may even cause it to hold off acquiring the franchise due to a constant fear of its rescission".

[65] Uri Benoliel suggests analyzing the franchise relationship according to the behavioral economics theory, assuming that at the basis of the relationship is the reasonable expectation of the parties of a continuing relationship, *Benoliel*, The Expectation of Continuity Effect and

ever, the franchisor is likely to request for itself absolute discretion to terminate the relationship – for example, in cases where it is difficult to quantify and estimate the franchisee's performances, or because it fears the excessive freedom of the franchise relationship and also where there is an increased fear that disputes will arise between the franchisor and the franchisee. In these cases, the franchisor will be able to set out explicitly in the contract the right to terminate the relationship "by choice".[66] We will search in the contract for explicit language granting the franchisor the power of unconditional release. It can be expected that keeping such a strong contractual right will be costed in the transaction price and find expression in its terms, in view of its economic significance to the franchisee.

VII. Conclusion

Justice Danziger's ruling in the case of *Blum v. Anglo-Saxon* invites a renewed review of the regulation on terminating a franchise. The question how a franchise for an unlimited period of time will terminate is critical, because of its effect on the transaction structure and on the total value of the franchise institution. Kaplow and Shavell argued that the value of an entitlement is measured not according to the heading or legal classification, but rather according to the way in which we protect it at the stage of sequestration.[67] This is also the case with the rights of the parties to a franchise contract: the degree of ease or burden upon terminating a franchise has an impact on the economic value of the franchise. A review of the case law shows that this question generally arises incidental to an attempt on the part of the franchisor to terminate the relationship and remove the franchisee. "Easy" removal *prima facie* benefits dynamic commercial life, although it is likely to damage the interest of the franchisee and the dimension of fairness in the transaction. On the other hand, making the methods of removal burdensome is likely to increase the transaction costs at the stage of terminating the relationship, and in any event also at the stage of entering into the relationship because the franchisor will want to take extreme care at the time of choosing the franchisee. However, making the removal stage burdensome means protection of the franchisee; this is likely to increase the interest of certainty and therefore also the investment incentives and marketing on the part of the franchisee.

Justice Danziger's approach connects the parties to the language of the franchise contract. A literal reading of the contract respects the freedom of choice of the contracting parties in shaping the terms of the transaction, although its effectiveness is contingent on the existence of an efficient and faultless market. This assumption goes

Franchise Termination Laws: A Behavioral Perspective, American Business Law Journal 46 (2009), p. 139 et seq.

[66] *Spencer*, The Regulation of Franchising in the New Global Economy. pp. 110–111.

[67] In their monumental work, *Kaplow*/*Shavell*, Property Rules versus Liability Rules: An Economic Analysis, Harvard Law Review 109 (1996), p. 713 et seq.

wrong when there are significant power differences between the parties, biasing the wording in favor of one of the contracting parties at the expense of the other. My proposal is to adopt a Franchise Law regulating the termination of a franchise by a binding rule to present "reasonable justification" for terminating the relationship: where a franchisor wishes to terminate an agreement for an unlimited period of time, it will have to indicate a reasonable justification for the act of termination. The reasonable justification rule is optimal because it staves off opportunistic conduct, and yet its restraint is proportional. The parties will be able to contract out of the rule: however, contracting out of a dispositive law requires the parties to act mindfully and forge a common desire to exclude the norm determined in the law. In the absence of explicit contracting out – the "reasonable justification" rule will apply as the default to decide the dispute.

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