THE ALLOCATION OF DECISION RIGHTS AND THE ROLE OF PRIVATE ENFORCEMENT IN FRANCHISING: PERSPECTIVES AND EMPIRICAL EVIDENCE

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TABLE OF CONTENTS

LIST OF FIGURES

LIST OF TABLES

LIST OF ABBREVIATIONS

2SLS	Two Stage Least Squares regression
a.o.	among others
AVE	Avis Europe PLC
BGB	Bürgerliches Gesetzbuch
BGH	Bundesgerichtshof
CEO	Chief Executive Officer
CLAD	Censored Least Absolute Deviations regression
COO	Chief Operating Officer
DFV	Deutscher Franchise-Verband
e.g.	exempli gratia
et al.	et alii
etc.	et cetera
FAC	Franchisee Advisory Council
FFS	Forum Franchise und Systeme
fn.	footnote
GWB	Gesetz gegen Wettbewerbsbeschränkungen
HGB	Handelsgesetzbuch
i.e.	id est
NJW	Neue Juristische Wochenschrift
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary Least Squares regression
p.	page
PCO	Proportion Company-Owned

pp.	pages
s.d.	standard deviation
U.K.	United Kingdom
U.S.	United States of America
VP	Vice President
vs.	versus

"The real secret to McDonald's successful operating system is not in its regimen but in the way it enforces uniform procedures without stifling the entrepreneurship of franchisees."
(Love, 1986: p. 150)

PART A

I. INTRODUCTION

1. Background

A critical function of economic organization is to allocate decision rights in a value-maximizing fashion – those rights being defined as a person's authority to decide on, and to take, action with regard to the accomplishment of a specific task (Picot *et al.*, 2005: p. 233).[1] This function is subject to nontrivial trade-offs. On the one hand, the distribution of knowledge about market conditions and productive adaptation across the members of an organization, and society more generally, is a main factor calling for a partial decentralization of decision rights (Hayek, 1945; Stiglitz, 1994). Alternatively, initially dispersed knowledge had to be gathered by a central planer. Yet, some information is prohibitively costly to communicate because, for instance, of its tacit component, implying that it cannot be codified for transmission at acceptable costs (Polanyi, 1958). Hence, whenever knowledge is costly to convey, i.e., it is specific, decision rights need to be moved to knowledgeable agents (Jensen and Meckling, 1992).[2] The celebrated turnaround of General Motors by its CEO, Alfred P. Sloan, at the beginning of the twentieth century could thus be understood as a result of Sloan delegating discretion to division managers who had the best knowledge about products and their marketing (Milgrom and Roberts, 1992: p. 17).[3]

On the other hand, decentralization also generates control, or agency, costs since the preferences of self-interested employees, the agents, frequently diverge from those of the

[1] According to Jensen and Meckling (1992: p. 9), "decision rights are the basis for saying that individuals have the 'power' to make decisions and to take actions with resources. Power means that a decision made by a party will be operative."
[2] Other authors refer to knowledge which is costly to transfer as "specialized" (Demsetz, 1988) or "sticky" (von Hippel, 1994).
[3] Brickley *et al.* (2004: pp. 280-281, 302-303) provided further examples of successful turnarounds involving a decentralization of decision structures at Brabantia, a large European manufacturer of household products, and Honda Motor Company. Microsoft Corporation is a recent case of reorganization towards more decentralized decision structures (Spiegel Online a, 11/13/2005).

organization, the principal.[4] Agents will then display a tendency to use discretion to their advantage and at the expense of the principal. An effort-averse branch manager of a retail bank may, for example, choose hours of operations to allow for optimal leisure consumption (see Nagar, 2002). In order to ensure that agents' decision-making is in line with the principal's objective function, companies may engage in monitoring (Eisenhardt, 1989a). In the case of General Motors mentioned above, the delegation of rights to divisions was accompanied by improved accounting data, helping the company evaluate managers' actions (Milgrom and Roberts, 1992: p. 17). Yet, monitoring is costly, especially when information asymmetries between the principal and the agents are significant (Brickley and Dark, 1987). Substituting for monitoring, agents' interests can be aligned with the principal by offering incentive schemes (e.g., Zajac and Westphal, 1994). The most effective form of incentive alignment grants those with the right to fulfill specific tasks the residual claim on the net income from their decisions, thereby avoiding problems of misdirected effort (Fama and Jensen, 1983). By making an agent the sole residual claimant, he bears the full wealth effects of his behavior without affecting the welfare of others.

A widespread and increasingly popular organizational form to efficiently partition decision rights between a principal and the agents by assigning to each the appropriate level of residual claims is franchising (Rubin, 1978; Michael, 1996).[5] Franchising denotes a contractual distribution arrangement between an upstream parent corporation, the franchisor, and legally independent downstream firms, the franchisees. In return for an initial fee, the franchisor sells the right to market a product and/or service under his trade name at a specific location and for a pre-specified term to franchisees. Franchisees regularly concentrate their distribution activities exclusively on the franchisor's goods. As opposed to product franchising, business-format franchising not only involves the transfer of the trademark but of an entire business concept to the local entrepreneurs, including operating manuals, marketing plans, and quality control.[6] Disposing of the system-specific know-how, the franchi-

[4] This must not always be the case. Organization theory has long argued that the divergence of interests between a principal and the agents can be reduced ex ante through, for instance, appropriate selection criteria (Ouchi, 1979). See, for the importance of selection in a franchising context, Jambulingam and Nevin (1999). Notwithstanding these policies, problems of adverse selection cannot be solved completely and some vulnerability to post-contractual self-interest seeking usually remains.

[5] See, for information on the growth of franchising in Germany, DFV (2005). See, for the U.S., Lafontaine and Shaw (1998). For special discussions of the origins and the evolution of franchising in Germany, see Tietz (1991: pp. 64-94), Altmann (1996: pp. 15-20), Küster (2000: pp. 7-12), and Steiff (2004: pp. 10-12).

[6] See Klein (1995: pp. 9-12) for differences and similarities between product and business-format franchising. Franchising literature has dealt primarily with the latter category. Academic researchers' relative greater interest in business-format franchising may be a result of its increasing relevance in the economy over the

sor ideally makes decisions with respect to the development and maintenance of the brand name (e.g., site-selection, store layout, product development). He captures the residual claims from these efforts mainly through monthly royalty payments made by franchisees. These royalties are usually calculated as a percentage of each outlet's sales (regularly between four and 10 percent). Since franchisees, in turn, possess valuable specific knowledge about their local markets (Bradach, 1998; Shane, 2005), they typically decide on operating policies such as pricing, local marketing, hiring, and customer service (Windsperger, 2003, 2004).[7] In return, they claim the units' residual profits net of fees.

Making use of residual claims, franchising effectively counters those control problems found in unitary firms, particularly insufficient effort provided by agents (i.e., shirking). For this reason, it constitutes an attractive means to organize economic activity. Yet, franchising is not a panacea either and creates other malincentives whose governance in the face of decentralized decision authority is the subject of this thesis as outlined below.

2. Research question

Residual claimancy implies that each franchisee maximizes his profits without taking into account any negative external effects accruing to the upstream company and other stores. More precisely, the use of a common business concept by all outlets in a chain fosters free-riding by franchisees on investments in the brand expected to be undertaken by peers (e.g., Michael, 2000a). Since "everyone wants to "let George do it", but no one wants to be George" (Goldberg, 1980: p. 349), any network's brand value and therefore competitiveness ultimately risks getting eroded. These malincentives imperil the value which can be derived from leveraging specific knowledge through the delegation of decision rights.

For the inconsistency in objectives cuts both ways, franchisees are also at a risk of opportunistic behavior by the franchisor. Controlling important parts of the system, the principal can potentially redistribute ex post some of the quasi-rents flowing from franchisees' specific investments by, for instance, raising the prices of goods sold to the outlets (Hadfield, 1990). In addition, the company could provide insufficient assistance to stores in order to minimize own costs (Sen, 1993). The risks of franchisor opportunism become

past decades (see fn. 5). Consistent with earlier literature, I also focus on business-format franchising in this dissertation.

[7] Note that "casual observation would suggest that franchisees have little discretion and add few ideas because they are required to operate in the narrow confines of standardized products. (…) However, a closer look reveals that franchisees often have considerable discretion and are responsible for the introduction of many successful ideas" (Minkler, 1992: pp. 244-245).

more severe, the higher the company's control over the chain's operations since franchisees then are increasingly dependent on the franchising firm.

In a review of such inconsistencies in objectives, Ménard (2004: p. 8) recently formulated the fundamental challenge to the management of hybrids – organizational forms such as franchising which pool resources from two legally separate entities and where the action of one actor affects the wealth of the other – as follows:

> "How can they secure cooperation (…) without losing the advantages of decentralized decisions?"

In what follows, I seek answers to this question in a franchising setting. My main proposition, which I test empirically, is that firms rely on private enforcement mechanisms to assure an exercise of decision rights which takes the economic interests of the other exchange partner as a constraint. These mechanisms thus allow enforcing unwritten agreements and informal expectations about cooperative conduct which, in turn, define a relational contract (Baker *et al.*, 2002).[8] In essence, these extra-legal mechanisms function by threatening the value of the future relationship as a punishment for opportunistic behavior. Cooperation then arises endogenously through rewards designed and decided upon within the exchange without resorting to the law.[9] Three specific forms of private enforcement are analyzed: (1) the self-enforcement mechanism (e.g., Klein and Murphy, 1988; Klein, 1995), (2) relational governance (e.g., Poppo and Zenger, 2002), and (3) collective punishment (Greif *et al.*, 1994). Each of these specific types is self-enforcing in the sense that the relationship between the contracting parties is sufficient to trigger cooperation without using the legal system. However, I stick to the terms self-enforcement mechanism, relational governance, and collective punishment to distinguish between them along the meanings attached to each by prior literature.

The focus on private ordering results from the observation that the formal contract – the only alternative form of enforcing the parties' interests in franchising – is an ineligible

[8] Since private enforcement mechanisms are necessary to make relational contracts binding, these two concepts are intertwined. Therefore, I use these terms interchangeably throughout the text.

[9] Legally non-binding agreements sustained by the value of the future relationship are ubiquitous in business and not only relevant in franchising. For instance, informal organization structure, i.e., the way activities are effectively carried out within firms, often differs remarkably from the formal structure as reflected in organization charts (e.g., Blau and Scott, 1962). Japanese supply relationships are an example of between-firm relationships governed predominantly by relational contracts (e.g., Sako and Helper, 1998). Informal understandings also affect transfer pricing (e.g., Eccles, 1985), among other business practices. See, for a review of the role of informal agreements in protecting relationship-specific investments from ex post appropriation, Shelanski and Klein (1995: pp. 348-349).

candidate to answer the question articulated above.[10] The legal document can only set the necessary conditions to leverage decentralized knowledge by allocating decision rights accordingly. It cannot, however, fully assure a cooperative exercise of these rights. This is for two major reasons. First, monetary incentives stipulated in the agreement, such as royalties, are insufficient to fully align the actors' interests. For instance, franchisees' residual claimancy status is rather the source than a solution to many of the incentive problems, notably free-riding (Lafontaine and Raynaud, 2002). Second, leveraging the advantages of decentralized decisions necessarily requires some behavior being left unspecified in the written contract (Foss and Foss, 2002). Given that the precise accomplishment, along with the outcomes, of various tasks is then not agreed upon in advance, the role of courts in efficiently enforcing cooperative behavior is restricted. This is not to say that the formal contract is not important to structure the relationship in broad terms and to supply boundaries. But its capacity to assure cooperation in light of dispersed decision rights is limited. Therefore, the assignment of decision leeway necessitates, I suggest, private mechanisms of reward and punishment. These rely on the information of the parties close to the transaction to evaluate and reward each other's behavior. I forward that private enforcement mechanisms avoid jeopardizing the advantages of decentralized decisions and thereby, though not being the main focus here, secure the strength of hybrid governance modes in the competition between organizational forms altogether (see, on this competition, Michael, 1994).

With the simultaneous consideration of decision rights, as vehicles to leverage specific knowledge, and (relational) reward systems, this dissertation picks up two essential variables of organizational design commonly stressed by the "positive" branch of agency theory (Jensen, 2001; see, for a review, Charreaux, 2002). In this theoretical framework, it is emphasized that the system for allocating decision rights and the system for rewarding and punishing individuals for their performance need to be properly aligned (see, also, Brickley *et al.*, 2004). The specific reward and punishment systems considered here – namely, relational contracts – are by now also part of an agency-theoretic analysis of organizations (see Klein, 2002).[11]

[10] Since franchising involves legally separate economic actors, enforcing the will of the principal by means of hierarchical fiat is excluded. See, on the functioning of the employment contract, Williamson (1996: pp. 97-100). For an interpretation of inter-organizational contracts as hierarchies, see Stinchombe (1990).

[11] See, for textbook treatments of relational contracts, Milgrom and Roberts (1992: pp. 259-265), Richter and Furubotn (2003: pp. 276-284), and Picot *et al.* (2005: pp. 127-130).

3. Contribution to the literature

This dissertation advances the franchising literature by bridging two central problems of economic organization (see Milgrom and Roberts, 1992: p. 25), namely, the domains of coordination (i.e., who makes decisions) and motivation (i.e., how to assure decision rights are not abused). Management and organization theory literature on franchising has thus far mainly contributed to the first domain.[12] Bradach (1997, 1998) emphasized that the allocation of decision rights in chains is crucial to meet the management challenges of uniformity and local responsiveness. Relatedly, Kaufmann and Eroglu (1999) pointed out that successful management of networks means striking a balance between standardization and adaptation. However, with their strong focus on coordination, these qualitative studies largely neglected the issue of motivation.

Franchising research from an economics perspective has been mainly constrained to motivation.[13] In this effort, the literature has given special attention to two types of questions. First, how do the characteristics of a chain, for instance, the effort requirements of each channel member, explain monetary contract terms such as royalty rates (e.g., Rubin, 1978; Lafontaine, 1992; Sen, 1993; Vázquez, 2005)? More recently, researchers have also begun to empirically relate these characteristics to the existence of other, non-monetary contract clauses, such as exclusive territories (e.g., Mathewson and Winter, 1994), which distribute property rights and therefore motivational incentives. A second prominent research stream in franchising from a motivation, namely agency, perspective has striven to explain the contract mix of franchised and company-owned outlets within any chain by framing franchising as a means to curb problems of monitoring and control (e.g., Brickley and Dark, 1987; Norton, 1988).[14]

As regards the intersection of coordination and motivation, however, only little evidence is available. An exception to this is Arruñada *et al.'s* (2001) study which provided some evidence on how the provision of quasi-rents to outlets related to the allocation of decision rights in franchised automobile distribution. By focusing on the interface between motivation and coordination as the basic features of organization, this dissertation responds to calls from franchising researchers "to examine empirically how decision rights should

[12] For a review of the franchising literature from various disciplinary perspectives, see Combs *et al.* (2004).
[13] See Dnes (1996) as well as Lafontaine and Slade (1997) for reviews of the economics literature on franchising.
[14] Other theoretical lenses have also been applied to this research question, including most prominently the resource scarcity view (e.g., Oxenfeldt and Kelly, 1968-1969; Caves and Murphy, 1976), but also signaling (Gallini and Lutz, 1992), and search-cost theory (Minkler, 1992). See Dant and Kaufmann (2003) for an empirical test discriminating between these theories.

be allocated to maximize performance" (Elango and Fried, 1997: p. 76). This is an important question since prior evidence indicates that even though franchised systems rely heavily on codification and standardization, tacit and locally dispersed knowledge continue to play an important role in determining success and failure (e.g., Kalnins and Mayer, 2004a).

The empirical results of this thesis show that franchising firms align the system for reward and punishment (i.e., private enforcement mechanisms) with the system for allocating decision rights throughout the chain. Taking the theoretical underpinnings into account, these findings suggest that this alignment is efficient. This is to say that though the empirical tests related to the research question do not include performance measures, normative conclusions may nevertheless be invoked by assuming the efficiency principle to hold. According to this principle, gains can be realized by channel members from changing inefficient arrangements. These should therefore not prevail in the market for long (see Milgrom and Roberts, 1992: pp. 24-25). Even if inefficient firms remain in the marketplace for some time, possibly due to adjustment costs and/or slack resources slowing selection pressures, organizational architectures associated with efficiency should be more frequently observed than inefficient practices.[15] Supporting this view, Shane (2001) reported from a large sample of franchise chains that the management of contracting problems plays an important role for organizational survival. Therefore, the findings of this dissertation bear normative implications possibly of interest to channels currently being organized "inefficiently", but especially for prospective economic actors in franchising.

4. Approaches and perspectives

The core of this dissertation (PART B) contains four modular chapters woven together by the idea of private enforcement effectively safeguarding against a non-cooperative exercise of decision rights. Figure 1 graphically displays the framework integrating these sections. The left hand side of the figure acknowledges the importance of analyzing rights assignment from both the franchisor's and franchisees' perspectives separately. That is, the allocation of rights to franchisees creates hazards, in need for mitigation, for the franchisor and vice versa. The column headings classify the studies in this dissertation by their research

[15] Similar research approaches are used in the literature on strategy-structure fit. Van de Ven and Drazin (1985) as well as Venkatraman (1989) proposed that finding evidence of a covariation between strategy and structure types consistent with theoretical predictions implies a performance enhancing fit between both. Most empirical studies followed this empirical design by testing whether a particular strategy is related to a theoretically corresponding structure while abstracting from performance tests with respect to a criterion variable (see Schewe, 1998: pp. 195-196).

approach, i.e., cross-sectional vs. longitudinal. Cross-sectional and longitudinal methods provide fundamentally different insights which complement each other in our understanding of the policies adopted by firms. A synopsis of the four studies' research designs and results is provided in the following.

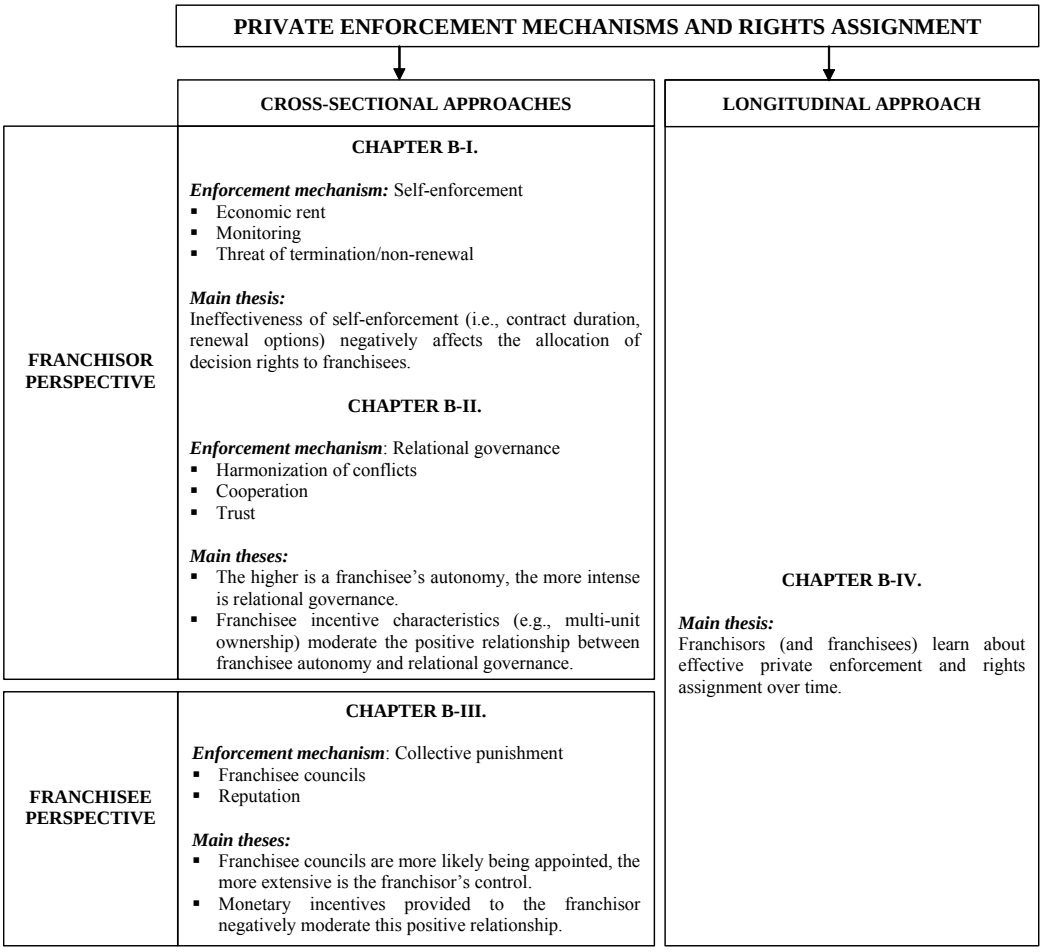

Figure 1. Integrative framework

Chapter B-I.

Consistent with the main proposition of this dissertation, chapter B-I. is based on the premise that franchisors can secure franchisees' cooperation while leveraging the advantages of decentralized decisions by using the self-enforcement mechanism (e.g., Klein, 1995). This mechanism is one of the two most intensely studied private enforcement devices in franchising (the second prominent mechanism, i.e., relational governance, is discussed in B-II.). The self-enforcement mechanism operates by granting store-owners a compensation which exceeds what they could earn outside of the relationship (i.e., economic rents). The threat of relationship termination should then ensure behavior in line with the principal's

economic interests since the premium stream would be lost by franchisees upon termination. In the German legal framework, however, mid-agreement termination of franchise contracts is constrained. Therefore, chains have to rely on the threat of *non-renewal* to punish opportunistic behavior by outlets. Depending on the duration of the contract, systems may then be affected differently by these constraints on mid-agreement termination (i.e., inter-chain level of analysis). That is, the longer the time to expiration, the less immediate are sanctions and the less effective is the self-enforcement mechanism. The main point of this chapter is that legal constraints on termination affect the vertical distribution of decision rights. Based on a sample of 159 German business-format franchisors, I found evidence consistent with expectations that franchisors offering long-term contracts restrict franchisees' rights more severely than chains issuing short-term contracts. Contractual renewal options, which impede the franchisor's leeway not to renew a contract, had similar negative effects on delegation. Overall, the findings follow the logic that "if you cannot punish cheating, you need to reduce opportunities for cheating". The analysis shows that though relational contracts seek solutions to trading hazards within the relationship, their effectiveness in securing cooperation is not independent of the law.

Chapter B-II.

In this chapter, then, instead of adopting an inter-chain level of analysis, I consider the dyadic relationships between a franchisor and each individual franchisee within the chain (i.e., intra-chain level of analysis). Again, in line with the main theme of this dissertation, chapter B-II. investigates how a franchisor can secure cooperation of individual franchisees when these are granted autonomy in decision-making as a means to leverage their specific knowledge. More precisely, I explore the role of relational exchange norms – or, more generally, of relational governance (e.g., Poppo and Zenger, 2002) – as controls in light of downstream autonomy. Norms are patterns of actual behavior enforced through mechanisms of reward and punishment within repeated interactions. I concentrate on three important norms each reflecting the relational quality within any dyad: harmonization of conflict, cooperation, and trust. Since these norms are costly to set up, the franchisor's demand for them should be intense only where franchisee autonomy is high, all else equal. The empirical results from a sample of 208 franchisor-franchisee relationships from 11 systems provided strong support for the presumption that chains accompany outlet decision-making independence by cultivating common expectations of behavior between the parties. More interestingly though, I also found that relational governance becomes more important to

accompany autonomy, the weaker a franchisee's structural incentives are aligned with the franchisor. The moderating roles of five incentive characteristics which have previously been proposed to affect the divergence of interests in the dyad were considered: (1) multi-unit ownership, (2) age of the franchisor-franchisee relationship, (3) geographic distance between the outlet and the company's head office, (4) a franchisee's past economic success, and (5) the level of intra-chain competition perceived by the outlet-owner. The empirical findings confirm the important role idiosyncratic channel members' characteristics play in the appropriate design of control mechanisms.

Chapter B-III.

In the previous chapters, both the self-enforcement mechanism and relational governance – the most prominent private enforcement devices discussed in the literature – are analyzed as instruments serving the parent company to secure cooperation by outlets. But how do franchisees privately enforce the obligations of the franchisor given that the threat of punishment by a single agent is relatively inconsequential for the company? Acknowledging the fact that any network is characterized by top-down power asymmetries, I shall develop the argument that internal mechanisms to assure fair dealings by the franchisor need, if to be effective, coordinated and collective punishment by all franchisees within a chain. This coordination is achieved through institutions such as franchisee councils. These bodies thus enable outlet-owners to collectively sanction the franchise company and to trigger cooperation in the first place. The private enforcement rationale stresses that traditional arguments pointing to franchisee councils as vehicles for monitoring are insufficient to explain how cooperative conduct of the chain is induced. The main reason is that the company's obligations are usually not specified in the written agreement and are therefore non-verifiable and hence unenforceable by courts. Empirically, I expected the appointment of councils to be more likely, the more extensive the franchisor's decision rights, hence his control over the operations of the chain, and therefore agents' exposure to opportunistic behavior by the principal (i.e., inter-chain level of analysis). I also supposed the set-up of councils to be less probable when business-format providers have strong incentives not to abuse their discretion as conditioned by a high share in franchisees' sales and a high proportion of outlets company-owned. Based on a sample of 131 German business-format franchisors, the empirical results in part supported the propositions. They show that monetary incentives specified by the contract are not the only instruments amenable to enforce franchisor obligations but that institutional arrangements equally deserve attention.

Summing up the cross-sectional approaches of the first three chapters, self-enforcement, relational governance, and collective punishment constitute private enforcement mechanisms which do not rely on third-parties such as courts (but may nevertheless be affected by the law as stressed in chapter B-I.). They are based on repeated interactions within a relationship and make use of the future value arising within the exchange to secure cooperation without loosing the advantages of decentralized decision rights.

Chapter B-IV.

In the chapters introduced above, I employ quantitative statistical techniques to test hypotheses about the interplay between the allocation of decision rights and private enforcement on a cross-section of observations. Put differently, I observe common and thus efficient practice as regards the mechanisms employed by firms at a single point in time to secure cooperative uses of decision rights. These cross-sectional approaches raise one important question: What do the processes leading up to the observation of efficient practice look like? Existing literature on franchise contracting assumes that people anticipate and address major hazards from the outset. Suboptimal arrangements are then not set up in the first place or, if accidentally so, quickly become selected out by market pressures. In chapter B-IV., I challenge this view and provide longitudinal case study evidence on learning processes both as regards contractual rights assignment and private enforcement. The evolution of formal contracts used by three chains from the restaurant, hotel, and retailing industry were explored. Additional data were drawn from interviews conducted with representatives of each franchising company, thereby permitting insights on the motivations for specific contractual adjustments. The results show that major modifications were not triggered in anticipation of changes in the magnitude of exchange risks (e.g., horizontal externalities) or the business-format. Consistent with evolutionary theories, the observed modifications rather emanated as incremental responses to actual misbehavior in the day-to-day business. These findings suggest that common contracting practice corresponding to theoretical predictions may be observed not because inefficient firms are immediately driven out of the market, but because those who initially designed flawed policies adjust to more efficient solutions over time. As opposed to the previous chapters, I consider the evolution of private ordering and rights assignment separately because validity concerns about cause-effect relationships are severe in case studies.

In the remainder of PART A (II.), I will review the relevant literature and motivate the fundamental issues of this dissertation in more depth. First (1.), prior literature on the allocation of decision rights in franchising is summarized. This exercise shows that there are both major benefits yet also costs associated with different decision structures both for the franchisor and franchisees. Then (2.), I will derive the limitations of formal contracts and the promise of private enforcement to induce non-exploitative uses of decision rights.

II. THEORETICAL FOUNDATIONS

1. Allocation of decision rights in franchising

The assignment of rights requires cost-benefit analyses from the franchisor's and franchisees' viewpoints, respectively. Below, I first discuss the franchisor's perspective on the issues involved in allocating discretion to outlet-owners (1.1). Then, I adopt franchisees' standpoint towards franchisor control over important elements of the system (1.2).

1.1 Franchisor perspective

1.1.1 Incentive effects of franchising vs. company ownership

Franchising substitutes outlet-owners for hired employee-managers who generally receive a fixed salary with no or little claims on the store's profits (see, for evidence in the U.S. fast food industry, Krueger, 1991: p. 78; see, also, Lutz, 1995: p. 108). Reaping the residual profits of their business (after payment of fees), franchisee-entrepreneurs have strong interests to constantly seek out, at times innovative, ways to match offer and demand. Comments from practitioners support the notion that employed managers have weaker incentives to put forth effort: "Corporate side store managers are less motivated, even though all corporate people have bonus programs" (statement by a senior franchise consultant of a large U.S. pizza chain, cited in Yin and Zajac, 2004: p. 368). Responsiveness to local market conditions is particularly important for business-format chains. In these systems, stores are not simply distribution outlets; rather, the unit in its entirety is the product seeking fit with the environment (Bradach, 1997: p. 277). Therefore, franchisees responsive to market pressures also enhance a network's ability to adapt the whole business concept to emerging threats and opportunities.

Consistent with these theoretical arguments, Sorenson and Sørensen (2001) found empirical support that the mean performance benefit of franchising (company ownership), in terms of total chain revenue, increased (decreased) with demand heterogeneity. This finding suggests that franchisees engage to a relatively larger extent in the discovery of untapped resources and technologies. In this sense, they act as Knightian (1921) entrepreneurs seeking new employment of existing resources based on personal, non-quantifiable judgment (see Foss and Klein, 2004: p. 8). Further, Pilling *et al.* (1995) applied a population ecology perspective and uncovered the propensity of franchised versus non-franchised

units to react to changes in the environment. These authors reported that the franchise population was more responsive to external stimuli than their company-owned counterparts. Equally, Yin and Zajac's (2004) study in the restaurant industry revealed that franchised stores were more effective in pursuing complex strategies requiring local decision-making than were corporate outlets. Evidence also suggests that franchisors engage in disseminating the best practices that arise from specific stores such that responsive local units eventually benefit the whole network (Bradach, 1998: p. 129; Argote, 1999: chapter 5).

1.1.2 The benefits from decentralized decision rights

The evidence presented above substantiates the view that franchising bears tremendous advantages over hierarchical coordination in terms of local entrepreneurial effort (Minkler, 1992).[16] Since the provision of incentives alleviates the need for monitoring and control (Yin and Zajac, 2004: p. 368), benefits can be derived from allocating discretion over business decisions downstream to franchised-entrepreneurs (Bradach, 1998: p. 127).[17] Franchisees are not only motivated to put forth effort, but they also accumulate superior knowledge, relative to the franchisor, about their geographic area's demand conditions and nearby competitors. To otherwise use that expertise, franchisees' knowledge would have to be moved to the franchise company. This is, however, costly: First, "if we (…) agree that the economic problem (…) is mainly one of rapid adaptation", quick reaction is important in taking advantage of "changes in the particular circumstances of time and place" (Hayek, 1945: p. 524). Were knowledge (e.g., appropriate responses to local competitors' actions) first to travel up the company's hierarchy before being used, organizational failures due to information transmission leaks and time delays would be likely (see, generally, Colombo and Delmastro, 2004). This argument was stressed by a Pizza Hut franchisee: "Franchisees have a faster reaction time. With all the layers in the company, it takes a long time to get things done" (Bradach, 1998: p. 127).[18] Second, outlet-owners' local market intelligence

[16] See Combs and Ketchen (2003) for a meta-analytic review of evidence on the relationship between the importance of dispersed managerial expertise and the incidence of franchising.

[17] The importance of appropriate incentives as a prerequisite to efficient decision-making was emphasized by Bradach (1998). The author explained that decentralized decision-making in company-owned stores was often not found in the chains he studied since "salaried company managers were not viewed as sufficiently motivated to make efficient local responses or for that matter to even attend to the external market environment" (p. 118).

[18] An illustrative example of slow corporate decision processes was reported from an interview with a franchisor representative in Yin and Zajac (2004: p. 370): "There is a store manager, for instance, who says that we should buy the parking lot next door because we have a parking problem. Now by the time that decision goes through the area manager, goes through the director of operations, to asset development, to the regional VP, you know, two years have gone by. The parking lot could be gone. While in a franchise environment, he

(e.g., service depending on customer, time of day, product) cannot be easily transferred to the franchisor since it is generally of tacit and intangible nature, implying that it cannot be codified for transmission (Windsperger, 2003, 2004; generally, Nelson and Winter, 1982: p. 73). From case study research of five large restaurant chains, Bradach (1998: pp. 118-119) highlighted the relevance of specific knowledge for efficient adaptation. The author pointed out that the centralized decision-making by headquarters observed for company units led to local responsiveness for these outlets which was relatively crude compared to the decentralized adaptation processes in franchised stores.[19] In this vein, Shane (2005: p. 3), in his guide to practitioners, recommends franchising for industries in which local market knowledge and management discretion are important to performance.[20]

Though adaptation to idiosyncratic demand is pivotal, the success of chain operations also rests heavily on standardization. Standardization is a prerequisite to consumer perceptions of uniform product offerings across outlets. Because of uniformity, customers know what to expect when making purchases with a chain, hence reducing search costs relative to standalone-stores. Therefore, franchisee decision rights need to be restricted to "tactical" (Bradach, 1998: p. 24) operational aspects. Elements indispensable for buyers to identify each store as belonging to the network, such as logos, trademarks, basic products, as well as quality levels, should be shared by all outlets (Kaufmann and Eroglu, 1999). Tactical decisions requiring dispersed specific knowledge, however, should be made at the store level and include areas such as hiring, hours of operations, local advertisement, inventory management, pricing, and selection of suppliers. Clearly, the benefits from delegating decision rights increase at a decreasing rate with the number of system identifiers affected. The normative claim, here, is therefore not an allocation of decision rights to the extent found in standalone-stores where the owner is free, if not obliged, to decide on every aspect of his business.

Besides the gains from leveraging specific knowledge, further arguments favor a decentralization of tactical decisions. First, downstream decision-making on these elements con-

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[the franchisee] is visiting his store on a regular basis. He is a decision-maker. He is much closer to his operations. He sees an opportunity, snap, he picks up the phone, and that might work well for his business."

[19] But centralization of decisions concerning company outlets also brought about benefits, the author argued, which presumably compensated for the loss in local responsiveness. These gains were realized in terms of economies of scale and an accumulation of experience at headquarters. This suggests that company-owned stores and franchised units serve different and complementary functions within any franchise network (see, also, Ehrmann and Spranger, 2005).

[20] An example of foregone country-specific knowledge in marketing was recently provided by the fast food chain McDonald's. Chinese state-owned media censored a McDonald's television advertising spot after consumers complained about its content. The spot showed a man on his knees begging for a price reduction. In Chinese culture, this expresses humiliation (Spiegel Online b, 06/23/2005).

serves precious time of chains' management teams; time which is better allocated to tackle "strategic" (Bradach, 1998: p. 24) issues regarding the uniform business concept. Second, severely restricting franchisees' operational realm negatively impacts their satisfaction within the relationship (Schul *et al.*, 1985) and fosters intentions to leave the system (Dormann and Ehrmann, 2005). Conversely, Dant and Gundlach (1999: p. 36) pointed out that increasing amounts of independence in decision-making are likely to produce higher levels of motivation (see, also, Maas, 1990; Bradach, 1998: p. 211; and Stanworth and Curran, 1999: p. 335).[21] Note that lacking effort at the outlet (i.e., shirking) is precisely the problem franchising seeks to solve in the first place.

The discussion above provided rationales to understand why the success of the world's most popular franchise chain, McDonald's, is inexplicable, as Love (1986) remarked, without taking into account the entrepreneurship of independent business people. In Love's words, the logic can be summarized as follows: "Without the freedom of franchisees (…) to exercise their entrepreneurial instincts, to test their own ideas on new products and procedures, and even to challenge the corporation head-on, McDonald's might still have attained its celebrated uniformity, but at a terrible price. It would lose the grass-roots creativity that diverse franchisees (…) provide. It would, in short, lose touch with the marketplace." (p. 150). However, precisely this freedom to engage in the pursuit of dispersed entrepreneurial behavior also brings about costs which need to be contained. I now turn attention to the cost side.

1.1.3 Inconsistent objectives and the costs from decentralized decision rights

While organizing transactions based on the price system (i.e., by making use of residual claims) overcomes key shortcomings of hierarchies (i.e., shirking), it brings about costs from cheating (Hennart, 1993). In a franchising setting, cheating refers to the risk of franchisees reducing the quality of their output. This behavior is potentially profitable for the common brand under which the stores of a chain operate allows each outlet to free-ride on investments in the trade name undertaken by peers. Those cheating on investments in the brand reduce their costs and thereby augment profits since they are unlikely to loose (short-term) sales if other units follow through with obligations. The reason is that mobile customers credit the goodwill they attach to the business-format to each store (see Klein and Saft, 1985: pp. 349-351). Brand value and the reputation of the chain will ultimately suffer given that none of the franchisee-entrepreneurs will want to undertake the necessary ex-

[21] See, on the notion of motivation crowding-out more generally, e.g., Osterloh *et al.* (2001).

penditures. Empirical evidence suggests that the horizontal externality related to a shared trademark combined with residual claims have a negative impact on system quality as experienced by customers (Michael, 2000a). These externalities apply to all investments that increase brand value, not only quality in a narrow sense of the term (e.g., cleanliness of franchisee's premises). For instance, Michael (1999) reported that horizontal spillover effects in franchised chains lead to underinvestment in advertising, relative to networks owned by a single firm.[22]

The horizontal externality problem related to a shared brand name in franchising was illustrated by Blair and Kaserman (1994) with a simple model. Assume that there are *n* franchisees operating under the trade name of a single franchisor. Franchisees control the quality of goods through decisions made at the outlet. The quality of products q_i offered by each of the *n* outlets is described by the following vector:

$$q = [q_1, q_2, ..., q_n]. \tag{1}$$

In case all franchisees choose an identical quality level, then $q_i = q_j$ for all i and j. Due to the shared business concept, each store's profits are presumed to depend on the quality levels offered in the entire network:

$$\Pi_i = \Pi_i(q) \quad i = 1,2,...,n. \tag{2}$$

The model posits that offering quality is costly for the franchisee delivering it. In addition, a unit's sales increase at a decreasing rate with quality. There exists therefore a quality level q^o which maximizes each franchised outlet's profits:

$$\left.\frac{\partial \Pi_j}{\partial q_j}\right|_{q_j = q^o} = 0. \tag{3}$$

The chain-wide externality problem is captured by the partial derivate of a franchisee's profit function with respect to the quality levels offered by each of the other owners:

$$\frac{\partial \Pi_i}{\partial q_j} > 0, \; with \; i \neq j. \tag{4}$$

That is, if any outlet *j* disappoints with respect to quality, consumers won't be willing to patronize other units *i* at which they expect similar (low) quality levels and profits of these

[22] For further evidence on free-riding in franchising, see Michael (2002). Note that underinvestment in marketing efforts from the principal's perspective must not only be a result of horizontal externalities. It may also follow from vertical externalities when the franchisor sells its products (or the entire business-format) with a mark-up over marginal costs to franchisees while these, in turn, also charge prices greater than marginal costs when selling to end customers. Franchisees, then, do not take into account the profit-margin of the company when choosing the supply of marketing or promotional services (see Klein 1995: p. 14; Tirole, 2000: pp. 177-179).

stores decline. Now, the franchisor receives a fraction *k* of each outlet's profits within the chain.[23] The franchise company's total profits from franchising then are:

$$\prod = \sum_{i=1}^{n} k[\Pi_i(q)]. \tag{5}$$

Optimization of the franchisor's profits will show that his desired level of quality for each store lies above the quality level maximizing the profits of franchisees. Maximization requires the quality levels for each store *j* be set as to satisfy:

$$\frac{\partial \prod}{\partial q_j} = \sum_{i=1}^{n} k \frac{\partial \Pi_i}{\partial q_j} = 0, \quad j = 1,2,...,n. \tag{6}$$

Equation (6) can be rewritten as:

$$k \frac{\partial \Pi_j}{\partial q_j} = -k \sum_{\substack{i=1 \\ i \neq j}}^{n} \frac{\partial \Pi_i}{\partial q_j}. \tag{7}$$

Simplifying (7) yields the franchisor's profit-maximizing level of quality q^F:

$$\left. \frac{\partial \Pi_j}{\partial q_j} \right|_{q_j = q^F} = -\sum_{\substack{i=1 \\ i \neq j}}^{n} \frac{\partial \Pi_i}{\partial q_j}. \tag{8}$$

Because $\partial\Pi_i/\partial q_j > 0$ (see equation (4) above), $\partial\Pi_j/\partial q_j < 0$. This implies that at the franchisor's profit-maximizing level of quality q^F (as given per (8)), franchisees do not maximize their own profits. With the slope of franchisees' profit function at point q^F being negative, franchisees offer too much quality. This is because the relationship between quality and franchisee profits is inverse U-shaped, with profits initially increasing with quality, then reaching a maximum, and eventually declining at high levels of delivered quality. Hence, the profit-maximizing quality level for each outlet q^o such that $\partial\Pi_j/\partial q_j = 0$ (see (3)) lies below the level q^F.

Based upon these results of Blair and Kaserman's model, I propose that the distribution of decision rights between the franchisor and franchisees determines the level of quality experienced by customers. In the first polar case, the parent company solely determines the quality of the products sold by the outlets. No decision rights will then be allocated to franchisees. The franchisor, instead, issues very detailed operating procedures to make product descriptions, prescriptions as to which inputs to use, how many employees to hire, where and when to advertise, etc. Assuming that court-enforcement of these guidelines were cost-

[23] As mentioned before, royalty fees are usually based on franchisees' sales, not profits. The model is based on profits, however, to simplify the exposition and notation. The qualitative implications do not differ if revenue-based fees are modeled.

less, the resulting quality level q^F would maximize the franchisor's profits. The second polar case describes a situation where the chain sets up no guidelines at all with franchisees deciding on every aspect of the business affecting quality. Then, we would observe a quality level q^o maximizing franchisees' profits. Formally, the continuum of realized qualities q^R associated with different decision structures can be described by the following convex combination:

$$q^R = DR * q^o + (1 - DR) * q^F \tag{9}$$

with the index for decision rights, DR, lying between 0 and 1 depending on whether decision rights are completely allocated to the franchisor or fully residing with franchisees, respectively.[24] Assuming that no private enforcement mechanisms are in place, greater assignment of authority to stores (DR = 0 → DR = 1) leads to lower quality levels in the chain ($q^R = q^F \rightarrow q^R = q^o$). The cost side of decentralized discretion from the franchisor's perspective is then determined by the difference $q^F - q^R$. These costs increase with decentralization since, for instance, in selecting suppliers, franchisees may choose low-price and qualitatively inferior inputs than desired by the parent corporation (Shane, 2001: p. 141). Free-riding may also occur on labor quality by substituting qualified with little-skilled employees demanding lower wages (Michael, 2000a: p. 299 fn. 6). As a result, the reputation of the chain can even be affected by tactical decisions, such as hiring policies, which do not necessarily compromise the uniform business-format. As Hadfield (1990: p. 965 fn. 160) explained: "It becomes essential to have (…) control over those activities delegated to the dealers as well. Without this, the dealers, by virtue of their independent status, are likely to exert their individual prerogatives to the detriment of the joint effort."

The problem of incentive incompatibility is, however, broader than the quality problem described above. For instance, since royalty fees are usually based on sales, the franchise company desires to maximize a store's revenues whereas outlet-owners maximize profits. The vertical partners will then likely disagree about the appropriate price level for sales are generally maximized at lower prices than are profits (Phan *et al.*, 1996; Lafontaine, 1999). Similarly, promptness of service may play a key role in generating revenue. Promptness of service, or the delivery speed of products, varies positively with inventory levels retained by the outlet. However, franchisees incurring costs for holding stock will likely choose, if entitled, inventory below the level which is optimal for the franchisor (Steiff, 2004: p. 36). The franchisor and franchisees may also disagree about the product mix of the business.

[24] See, for different approaches to measure the degree of (de-)centralization, Beuermann (1992: pp. 2620-2621) and Drumm (2004: pp. 182-183).

The principal may favor a low-margin yet high-volume product while franchisee-entrepreneurs would prefer the reverse. Other examples of incentive incompatibility concern the location of new outlets, underinvestment by often undiversified and therefore risk averse agents, and the adoption of new product innovations (Shane, 2005: pp. 53-61). Hence, granting franchisees authority over decisions potentially increases the costs resulting from goal conflicts (see, generally, Jensen and Meckling, 1992).

1.1.4 Containing the downside of decentralized decision rights

In review, assigning decision rights to franchisees is subject to a trade-off between the various gains, especially resulting from the use of specific knowledge, and the costs accruing to the parent company from inconsistent objectives. Though the above section revealed that the cost side cannot be completely contained (i.e., there is empirical evidence for franchisees cheating on quality), the fact that chains nevertheless rely on franchising implies that they find ways to extract net benefits. As a general rule, the more effectively chains safeguard against potential conflicts by achieving goal congruence between the dyadic partners, the higher is the value they can extract from decentralization (and franchised operations more generally).[25] Indeed, as the opening quotation to this introductory part suggests, the most successful chains are precisely so as a result of realizing the benefits from entrepreneurship while effectively containing the downside. This dissertation seeks to shed light on the devices used by franchisors to achieve net gains from decentralized operations.

In the prior portion, I argued that the allocation of decision rights to franchisees is associated with a management challenge for the franchisor. I now discuss franchisees' perspective on control exercised by the company.

1.2 Franchisee perspective

Franchisor control over important parts of the business concept, those he is more knowledgeable about relative to franchisees, represents a risk for the latter in terms of exposure to opportunistic behavior. One instance of such behavior is when the company fails to provide the promised assistance to outlets in an effort to limit own costs. This incentive problem is alleviated by granting the franchisor a sufficiently large stake in the outlets' success by choosing high royalty rates (e.g., Lafontaine, 1992; Sen, 1993). Yet, franchisor oppor-

[25] This reasoning mirrors the principle that the provision of incentives and the delegation of rights are complements as each increases the value of the other (Milgrom and Roberts, 1992: p. 17).

tunism comprises not only passive shirking on, often implicit, responsibilities.[26] An active form of misbehavior relates to chains potentially seeking to redistribute rents from the outlets to the company once the contract is signed (i.e., hold-up). This reallocation of rents is possible since franchisees make investments which are to a large degree sunk and therefore specific to the system (see, generally, Klein *et al.*, 1978).[27] Knowing that outlet-owners will stay in business though not recovering their (sunk) fixed costs (but as long as the revenue covers variable costs), the franchisor can, in principle, engage in hold-up by raising the prices of goods sold to stores, increasing fees, and placing new outlets in proximity of existing stores (see, for other ways to extract value from stores, Hadfield, 1990: pp. 967-969; Altmann, 1996: pp. 86-93). The expected costs from being held-up increase with company control over important aspects of the business. For instance, centralization of inputs implies that franchisees are contractually restricted to purchase from third-party suppliers. They then cannot switch to alternative suppliers in case the franchisor raises prices (Shane, 2001: p. 141). Ex post opportunistic appropriation of quasi-rents directly undermines the local entrepreneurs' motivation for system adherence. As a result, Hadfield (1990: p. 952) remarked that "where franchisors seek to expand their control, franchisees seek to erect boundaries".

Past research showed that among individuals aspiring for self-employment, those highly valuing the benefits of a proven business concept choose the franchising option (Kaufmann, 1999). These benefits, however, directly result from franchisor control over a centralized system infrastructure enabling support of, and assistance to, outlets. This suggests that though extensive authority residing with the chain imposes an expected cost on stores in terms of specific investments being subject to hold-up, there are also major potential benefits involved. Hence, the more effectively franchisees shield against the risks associated with an *unrestricted* exercise of control, the higher is the net value resulting from franchising relative to operating an independent business. This dissertation analyzes means by which franchisees may realize this positive value from centralized control by enforcing proper conduct of the franchising firm.

[26] The discussion of the franchisor's costs from delegated decision rights was largely constrained to horizontal externalities making free-riding on the brand name profitable. Cheating on investments in the chain's reputation is generally considered a passive form of opportunism. Evidence suggests that opportunism by franchisees can also manifest more actively by extracting quasi-rents from the franchisor (see, for an example involving lease holds, Brickley and Dark, 1987: p. 407). However, since the parent corporation controls larger parts of the exchange relationship relative to franchisees, the problem of hold-up (Williamson, 1985), or post agreement jockeying (Goldberg, 1985), is more importantly seen to be emanating from the principal.

[27] See Bercovitz (2000: p. 20) for an estimate of the sunk portion of franchisees' initial expenditures.

2. Enforcement mechanisms

The review of the literature on rights assignment revealed that decisions to be made by either party necessitate safeguards by the other in order to balance the interests of the vertical exchange partners. In franchising, two principal safeguards, or means of enforcement, can be distinguished (Klein, 1995: p. 17). The first is public in nature and relies on formal contracts regulated by the courts of law, as discussed in the next section (2.1). The second, reviewed in the subsequent section (2.2), is private and basically relies on the value of future interactions within the relationship to secure cooperative conduct informally stipulated by relational contracts.

2.1 (Incomplete) formal contracts

The franchise contract and documents referenced therein such as operating manuals are formal institutions governing the relationship between the franchisor and the outlet-owners. Generally, a formal written contract is characterized by the agreement of its signers to structure a business relationship as specified while relying on legal sanctions imposed by the courts to enforce obligations (Macaulay, 1963: p. 56; Macneil, 1974: p. 693). The structure of franchise relationships is, however, described only incompletely by the contract. Incompleteness means that it is not feasible to define in a legally enforceable document the parties' desired behavior in all future circumstances (Klein, 1995: p. 17). The costs associated with accounting for all eventualities associated with uncertainties in the business environment (Hart and Moore, 1988: p. 755) as well as peoples' fundamental inability to foresee the future, i.e., bounded rationality (Williamson, 1985: pp. 45-46), preclude state-contingent comprehensive contracting. More specifically, these factors imply that a mapping of *actions* to all future states of the world is infeasible. Against the backdrop of this incompleteness, franchise contracts are considered to merely set a framework in which the relationship evolves over time by assigning basic roles and responsibilities (Martinek, 1987: p. 258).

Yet, incompleteness is not only an unavoidable evil but a necessary condition to leverage the actors' specific knowledge. A long-term contract regulating the exchange in every detail based on the limited information on future contingencies available at the initial contracting date would constrain the parties' flexibility in adjusting to the circumstances of time and place (Foss and Foss, 2002: p. 112). If behavior were explicitly prescribed by the chain, franchisees would have no incentives to respond to local market conditions and to

engage in explorative search. Their actions would be solely determined by the rewards linked to following the chain's directives, thus minimizing against the penalties from breaching contractual duties (see, relatedly, Raith, 2004: p. 2). Conversely, if behavior is left unspecified, residual-claim franchisees will employ their specific knowledge to maximize against market pressures. Similarly, franchisor obligations vis-à-vis stores as to the future development of the system may also be specified in vague terms only to allow flexibility in further developing the system depending on circumstances (Richter, 1991: p. 419). Hence, contractual incompleteness allows efficiently implementing bilateral adjustments to changing conditions without incurring costly renegotiations of detailed agreements (Klein, 1985: p. 598).[28] Each party can assume its responsibilities by making decisions quickly and efficaciously.

Because a precise definition of desired behavior taking into account the actors' specific knowledge is not feasible, an important function of franchise agreements is to allocate decision rights in the chain to take advantage of the actors' idiosyncratic skills. Decision rights are basically assigned to franchisees by not regulating certain issues specifically in the contract or the operating manuals (e.g., Arruñada *et al.*, 2001: p. 264). As a result of such blanks, franchisees are empowered to deploy their productive resources in the management of the outlet as they see fit. That is, as owners of the stores' assets, franchisees' decision authority is unrestricted unless otherwise stated by the contract (Lutz, 1995: p. 113; Jensen and Meckling, 1999: p. 82). Hence, in an effort to leverage the actors' specific knowledge, the contract can be considered intentionally incomplete in the sense of not imposing complete constraints on behavior (Hadfield, 1990: p. 927; Foss and Foss, 2002: p. 123). However, decision rights may also be assigned by specifying control in certain functional areas, say local advertising, to one of the parties explicitly. In many contracts, these specified control rights especially accrue to the franchisor (see, for evidence, e.g., Arruñada *et al.*, 2001).

Though contractual incompleteness bears advantages in terms of flexibility, it also creates risks for the continuity of the exchange relationship. More precisely, leaving blanks in the contract exposes the franchisor (franchisees) to franchisee (franchisor) opportunism since courts, obviously, cannot compare (mis-)behavior against unambiguously and explic-

[28] Another potential cost from complete contractual specification results from courts enforcing literal terms even in light of changed external conditions (see the General Motors-Fisher Body case for an illustrative example, e.g., Klein, 2000).

itly stated prescriptions in the case of conflict (Foss and Foss, 2002: pp. 112-113).[29] Or, equivalently, it may then be difficult for the plaintiff to supply, at acceptable cost, verifiable evidence to courts that his business objectives were seriously harmed (see, on non-verifiability, Tirole 2000: p. 38). Also, contractually specified incentives cannot fully assure cooperative uses of decision leeway. In light of outlet heterogeneity, incentive clauses in contracts (restrictions on outside ownership, exclusive territories, etc.) would require customization to the particular circumstances of each franchisee (e.g., Bhattacharyya and Lafontaine, 1995) and high degrees of complexity (e.g., Bai and Tao, 2000). Both customization and complexity are, however, costly and difficult to achieve in practice (and thus not observed). In sum, contracts per se can set the necessary conditions for leveraging the advantages of decentralized, state-contingent decision-making but "typically provide the chain", as well as franchisees, "with only limited authority and few practical sanctions" (Yin and Zajac, 2004: p. 369) to assure full cooperation.

Besides public court-ordering of contracts, courts of arbitration may be used (Tietz, 1991: pp. 611-613). Yet, since courts of arbitration function similarly to the courts of law in their emphasis on the principles of jurisdiction, arbitration is exposed to equal limitations (see, for details, Lionett, 1987). Overt conflicts may also be dealt with by way of mediation through independent third-parties. But there, too, problems of non-verifiability of the complex transaction between franchise partners arise (Altmann, 1996: p. 75). In addition, conflict *resolution* mechanisms such as mediation imply that enforcement had been ineffective and that conflict has already grown into a serious issue. Ultimately, however, enforcement mechanisms need to assure that frictions do not arise in the first place. The promise of private ordering in achieving this aim in light of decentralized decision rights is discussed in the next section.

2.2 Private enforcement mechanisms

Private enforcement mechanisms are means to make unwritten agreements and informal expectations about a cooperative exercise of decision rights – in turn stipulated by relational contracts – binding. The literature on private enforcement holds that the relationship between the contracting parties may be worth enough to induce cooperation and to curb

[29] As an alternative to enforcing literal terms, courts could complete incomplete contracts with judges interpreting the parties' behavior and obligations (e.g., Schwartz, 1992). Among other problems, this strategy is, however, complicated by courts' ignorance about the interactive nature of each specific franchise relationship such that "it is difficult to know whether one party's refusal to adjust cooperatively in a particular case represents exploitative behavior, or a measured, retaliatory response to an earlier non-cooperative action by the other" (Scott, 1987: p. 96).

opportunistic behavior without resorting to the law (Hviid, 2000: p. 53). Each of the three specific forms of private ordering discussed in this dissertation (i.e., the self-enforcement mechanism, relational governance, and collective punishment) functions on these grounds. Cooperation arises endogenously if having the reputation to act in good faith, thereby avoiding punishment by the other, is sufficiently valuable. A cooperative outcome is achieved if, at any time, the expected discounted gains from violating (informally) agreed upon obligations are smaller than the expected discounted value from punishment. The Folk theorem for repeated games is useful to frame this reasoning more formally (e.g., Dutta, 1999: chapter 15). It states that with players being sufficiently patient (or, equivalently, the probability of playing the game over a large number of periods being high), they can achieve a Pareto-improving outcome by cooperating compared to a non-cooperative Nash-strategy in a one-period game.[30]

Similar to the functioning of the law (Shavell, 2003), future punishment upon non-cooperation is what keeps opportunism in check.[31] However, private enforcement devices overcome the problem of non-verifiability related to using the legal system for "no third party intervenes to determine whether a violation has taken place or to estimate the damages that result from such violation" (Telser, 1980: p. 27). Rather, the parties subjectively judge whether or not a violation of obligations has occurred. Judgment about the other's uses of discretion can be based on either behavior or outcome (Eisenhardt, 1985). Whenever specific knowledge is vertically dispersed between the franchisor and franchisees, punishment is likely to be based on outcomes. Evaluation of a franchisee (the franchisor) based on behavior is unlikely to be useful in these cases since the agent (the principal) has private information about how his actions contribute to the principal's (the agent's) objective (Arrow, 1985: p. 38). Yet, the franchisor can still decide whether the outcomes of agents' behavior correspond to his interests; conversely, franchisees can judge the franchi-

[30] In franchising, the last period problem associated with finitely repeated games is attenuated when the franchisee has the right to sell his franchise (see Klein, 1995: pp. 26-27; see, also, Milgrom and Roberts, 1992: p. 266). The last period problem denotes the phenomenon that, within finitely repeated games, players do not have an incentive to perform in the last period because there is no future punishment to worry about. Since the players know that by the end of the game cooperative behavior will not be sustained, it cannot be triggered in the middle and therefore in the initial stages of a game. If entitled to sell the store, however, franchisees will have an incentive to cooperate even in the last period of interaction in order to be able to reap the discounted value of future outlet profits on the market.

[31] The most widely recognized form of punishment employed in relational contracts is termination of the relationship (see chapter B-II.). However, as will be seen explicitly in chapter B-III., other forms of punishment can be devised by the exchange parties.

sor after observing the outcomes of headquarters' actions (see, generally, Raith, 2004).[32] This suggests that using private enforcement mechanisms, the downside from allocating authority in an effort to leverage specific knowledge can be contained. For instance, franchisors may choose quality as a relevant proxy for the outcome of franchisees' behavior. The fact that it is difficult to find proxies for quality which are verifiable for courts (Michael, 2000a: p. 316) does not preclude the franchisor to know whether performance conformed to his economic objectives (Klein, 1995: p. 17).[33] Even if courts could verify the outcome of agents' actions, private ordering may still offer important efficiency advantages over legal enforcement for it avoids the noise associated with contract interpretation by judges as well as the time lag involved in public sanctioning (Scott, 2003: p. 1652). In addition, private ordering economizes on the costs of formally specifying constraints on agents' actions. The higher agents' specific knowledge, the more difficult it becomes for the chain to ex ante draw the line between appropriate and disallowed behavior (see, generally, Jensen and Meckling, 1999: p. 83). As a result, franchisees may adapt too extensively to local markets in the absence of relational steering mechanisms.

Recent evidence from experimental economics makes a further case for the positive value of relational contracts. This strand of the literature shows that cooperative outcomes may be sustained even in situations where the theory of repeated games between selfish and opportunistic agents would predict non-cooperative behavior. Basically, experimental economics has provided robust results which directly contradict rational choice theory's assumption of individuals being solely motivated by their material self-interest. A substantial fraction of the population rather seems to be determined by social preferences such as reciprocity and fairness. These people attribute, at least in experimental settings, a value to matching the behavior of others independently of the material implications for themselves (see, for a review of this literature, Kirst and Ehrmann, 2005). Not surprisingly, cooperative behavior among non-selfish strangers can then arise even if interacting only once. The theory of repeated games would predict non-cooperative action in such a situation. Given that the fraction of reciprocal agents is fairly high (between 40% and 60%) in any population (Fehr and Gächter, 1998), the payoff function of self-interested individuals can also be

[32] This result is well known from studies testing the impact of task programmability on the choice of compensation strategies within firms (Eisenhardt, 1985; Stroh *et al.*, 1996; Foss and Laursen, 2005). A programmable task is clearly defined and requisite behaviors can easily be monitored. Behavior related to tasks which are more complex cannot be evaluated at low cost and therefore necessitate outcome-based compensation (which comes at the cost of shifting risk to agents).

[33] See Baker *et al.* (2002) on this two-part assumption of non-observable action but observable, though not verifiable, outcomes in relational contracting.

modified in a way such that cooperative behavior, for instance in franchising (Ehrmann, 2002), becomes more likely. Drafting legally binding obligations, by contrast, may crowd out the self-enforcing properties of the franchise relationship (see, generally, Fehr and Gächter, 2002).

Yet, private enforcement mechanisms are not perfect either. For instance, using the self-enforcement mechanism, the franchisor pays a premium stream to franchisees in order to induce cooperation. The future amount which can credibly be promised in exchange for current performance is limited however (Klein, 2002: p. 59). This amount is, along with the gains from deviation, moreover subject to changes in technology and market conditions (Klein, 1996). Imperfect private enforcement is evidenced by the observation that theoretically derived predictions about insufficient quality provision through franchisees translate into empirical facts (Michael, 2000a), franchisors engage in hold-up (Hadfield, 1990), and litigations between the vertical partners occur in practice (Michael, 2000b). Therefore, rather than claiming private enforcement mechanisms to perfectly align the incentives of the vertical partners, I follow Schanze (1987: p. 468) and argue that they only do so "by tendency". It is also noteworthy that private ordering is not necessarily independent of the written agreement. Formal contracts often build a basis on which private enforcement operates. Particular court-enforced terms can be used to sustain private ordering by both limiting the gains from opportunistic behavior and increasing the gains from cooperation (see, for details, Klein, 1995; Lafontaine and Raynaud, 2002; Poppo and Zenger, 2002).

To sum it up, franchising offers important advantages over company ownership of outlets in terms of responsiveness to local markets. In order to leverage the specific knowledge of residual claim franchisees, decision authority needs to be delegated. The delegation of decision rights, however, also increases the franchisor's costs from agent misbehavior. While formal contracts can set the necessary conditions to leverage dispersed decision capabilities, they may not simultaneously provide for effective safeguards. Private enforcement mechanisms can fill this gap and contain the downside from assigning decision leeway to stores. Evidence suggests that successful chains (e.g., McDonald's) effectively control behavior while allowing for flexibility in decision-making. Similarly, franchisees can use these private mechanisms to take advantage of centralized franchisor assistance and brand development while containing the costs from opportunism emanating from the principal. The analyses in the following chapters will focus on this interplay between rights assignment and private enforcement mechanisms in franchising firms.

PART B

I. THE EFFECTIVENESS OF CONTRACTUAL SELF-ENFORCEMENT AND THE GOVERNANCE STRUCTURE OF FRANCHISING FIRMS

1. Introduction

Transaction costs economics provides a received framework for understanding contractual choices in inter-organizational relationships (e.g., Saussier, 2000). One such choice is the duration of contracts. It specifies the time period over which renegotiation is excluded, thereby protecting relationship-specific investments from flagrant opportunistic expropriation. In order to minimize transaction costs, increasing levels of asset specificity require agreements of longer durations (Joskow, 1987). Empirically, the validity of this general proposition is well-documented for the franchising context (Bercovitz, 2000; Brickley *et al.*, 2003). For attracting buyers in a competitive market for franchises, franchisors must necessarily offer a contract which provides a time horizon sufficiently long to allow for amortization of initial investments. But whereas long-term contracts protect franchisees from hold-up and allow for cost-recovery, the franchisor's subsequent ability to impede misbehavior by stores might be negatively affected. Specifically, the effectiveness of the so called self-enforcement mechanism may suffer. This incentive mechanism operates – inside a range of market conditions (Klein, 1996) – by granting franchisees a compensation which exceeds what they could earn with their productive inputs outside of the relationship (i.e., economic rents). The threat of ending the collaboration should then ensure behavior in line with the parent corporation's business objectives since the premium stream would be lost upon termination (e.g., Klein, 1980; Klein and Leffler, 1981).

Long-term agreements undermine the self-enforcement nature of the contract precisely where termination is legally constrained (Lafontaine and Raynaud, 2002: p. 21). This is the case in Germany, the institutional context of this study, where termination is subject to good cause requirements. Given that termination is difficult, threatening rents by immediately ending the relationship upon detection of non-performance is not credible. As non-renewal of franchise contracts is less severely constrained by German law (Stein-Wigger, 1999), deviant behavior is more easily sanctioned through non-renewal upon expiration of the initial term. Clearly, then, the longer the time horizon to expiration (i.e., contract duration), the less immediate are sanctions and the less effective is the self-enforcement incen-

tive mechanism. Contractually specified renewal options equally harm its functioning since they raise the difficulty to non-renew agreements at expiration.

In this chapter, I argue that franchisors deal with long-term contracts and renewal options by choosing a governance structure which limits their exposure to franchisee misbehavior. Put more simply, it is claimed that firms which cannot punish cheating reduce the scope for cheating. One important governance means to reduce malfeasance is the restriction of franchisees' decision rights (e.g., Arruñada *et al.*, 2001). Decentralization of these rights in chains with long-term agreements and those providing a renewal option is thus expected to be lower as compared to those offering short-term contracts and those providing no renewal option. This claim, which is tested empirically, is based on the assumption that the effectiveness of incentive devices and the incidence of decentralization are complementary (e.g., Nagar, 2002). A franchisor's marginal benefits from delegating rights increase in the extent to which downstream moral hazard can be controlled, and vice versa.

A second core element of the governance structure potentially affected by the duration of contracts and the presence of renewal options is the mix of franchised and company-owned outlets in any one chain.[34] I advance that, and test whether, long-term contracts and those including a renewal option render enforcement of proper behavior among franchised stores more costly such that the cost disadvantage of employee versus franchised operations declines and the company chooses to own more of the chain's units on average. Moreover, by vertically integrating a larger fraction of the network's stores, headquarters can more effectively exert indirect managerial control over the remaining franchisees (e.g., Michael, 2000b). Strong empirical support was found for part of the hypotheses. The data were more supportive of the hypothesized influence of contract duration and renewal options on the degree of (de-)centralization than on the incidence of vertical integration.

The chapter is structured as follows. In the next section (2.), related literature is briefly reviewed. The subsequent section (3.) describes the self-enforcement mechanism, legal constraints on its use, and implications for the governance structure of franchising firms.

[34] The findings of an extensive literature suggest that dual distribution – a mix of company-owned and franchised outlets within the same chain – serves specific governance functions. Empirical support for the relevance of dual distribution to franchisors was provided by longitudinal studies which reported a stable proportion of company-owned outlets significantly above zero and below 100 percent, differing across sectors and individual firms within a same sector (Lafontaine and Shaw, 2001). The example of the fast-food chain McDonald's further illustrates the importance of finding an appropriate ownership mix (see Kaufmann and Lafontaine, 1994: p. 447): McDonald's set a sealing of 25 percent company ownership after experiencing declining efficiency with a rise of this rate to 33 percent between 1967 and 1976. The proportion of stores company-owned thus seems to be a "decision variable" (Scott, 1995) and does not result as a passive outcome of outlet heterogeneity as suggested by agency models (e.g., Brickley and Dark, 1987; Norton, 1988).

Then (4.), the sample on which the hypotheses are tested, the variables and methods employed, as well as the results obtained are presented. Section (5.) discusses the findings of the study and derives implications. The last section (6.) concludes and provides suggestions for further enquiry.

2. Related literature

This study joins two streams of literature on franchising. The first of these analyzes the allocation of contractual rights. The second deals with antecedents of the simultaneous operation of franchised and company-owned outlets within one chain. The central tenant of these literatures is that the governance structure serves to mitigate exchange hazards resulting from a shared brand. Where the risk of free-riding is high as a result of a valuable trade name, more rights are assigned to the principal (Arruñada *et al.*, 2001). Equally, evidence shows that the extent of vertical integration (i.e., the proportion of total outlets owned by the franchise company) in any one chain is positively determined by brand value, suggesting that managerial control is leveraged by company ownership (e.g., Lafontaine and Shaw, 2001; Pénard *et al.*, 2003). Conceiving of the governance structure as a safeguard against exchange risks also implies that the equilibrium proportion of outlets company-owned and the degree of centralization should be higher, the more difficult it becomes to align franchisees' interests with the firm. In this vein, Brickley *et al.* (1991) reported that the fraction of company stores maintained by the chains in their sample was affected by legal provisions surrounding termination of franchise contracts. The authors found that in U.S. states restricting termination, franchising was less common within any network in nonrepeat customer industries (i.e., where the risk of free-riding is high). Their study suggests that constraints on ending the relationship affect chains to different degrees depending on the jurisdiction they confront. The present study complements Brickley *et al.*'s approach. By contrast, however, this chapter investigates how restrictions on termination and non-renewal affect systems operating *within the same* legal environment to various degrees, depending on contract duration and the existence of renewal options. By focusing on the German as opposed to the well-studied U.S. context, this study responds to a recently pronounced call that "still, much more work needs to be done if we are to truly understand how and why franchising works in various jurisdictions" (Blair and Lafontaine, 2005: p. 297).

3. Theoretical foundations and hypotheses

3.1 The self-enforcement mechanism

In light of an incomplete formal specification of desired performance, firms cannot exclusively rely on court-enforcement to ensure proper franchisee behavior (see A-II.). Instead, they rely on an informal contract which creates a self-enforcement mechanism. This mechanism requires (a) the provision of an ongoing rent to franchisees, (b) active monitoring of their actions, and (c) the threat of termination upon detection of misbehavior (see, for the following arguments, Klein, 1995). The company must subjectively decide whether observed performance conformed to the desired level. In order for the agreement to be self-enforcing, franchisees' discounted extra gains from cheating (before being terminated and/or non-renewed) must be smaller at every point in time than the discounted rent stream that accrues from compliance in the long run. Since a formal contract can never fully define desired behavior and because monitoring is costly, gains from cheating are always greater than zero and so must be the rent to satisfy the above incentive constraint. The parent corporation can credibly promise payment of the rent only if it is smaller than the cost disadvantage of using employee-managers instead of franchisees to run an outlet at a particular location. This cost disadvantage comes about for employee-managers have less an incentive to put forth effort (see A-II.).

Direct empirical evidence indicates that franchising firms indeed leave economic rents downstream. Kaufmann and Lafontaine (1994) found substantial premiums for McDonald's franchisees both expected prior to signing the contract and once stores are operational.[35] Michael and Moore (1995) calculated positive rents for members of a number of other channels.[36] Although Dnes (1996: p. 321) called for caution in generalizing results from single-firm case studies, indirect evidence hints to rent streams in the larger population of franchise chains. For instance, Mathewson and Winter (1985: p. 511) interpreted the existence of queues for the purchase of a franchise in many chains as evidence that rents are expected by applicants. Moreover, Lafontaine (1992: p. 276) found no statistically significant negative correlation between upfront fees and royalty rates in a cross-

[35] The authors estimated an ex ante expected value of rents over a 20-year contract period, i.e., after taxes and payment of fees and investments, ranging from $300.000 to $455.000 (in 1982 dollars). Ex post, these amounts additionally include the upfront fees and initial investments.

[36] They investigated franchisee earnings in 70 systems from four different sectors (i.e., auto services, business services, restaurants, and retailing). They found both ex post and ex ante rents for the average franchisee in 49 of these systems. The average capital value of rents before taxes and after payment of fees (ex ante) amounted to $111.000-$160.000 over the contracting period.

section of systems. If franchisees' participation constraints were binding, the fee would extract all future premiums given the royalty rate. For any level of sales, the higher the franchise fee, the lower must be the royalty rate in order to exactly meet franchisees' reservation profits. Were franchisors fully extracting downstream rents, a significant negative relationship would be observed. Finally, the results of Brickley *et al.* (1991), who found that franchising was less common in U.S. states restricting the termination of contracts compared to other states, can be interpreted as evidence for firms relying on a combination of rents and the threat of termination as a motivation device.[37]

3.2 Legal constraints on self-enforcement: The case of Germany

3.2.1 Termination vs. non-renewal: Implications for the role of contract duration

The effectiveness of the self-enforcement mechanism in assuring franchisee performance rests on the franchisor's ability to terminate store-owners upon detection of opportunistic behavior. Termination should optimally be at will, "that is, whenever the franchisor independently judges that a franchisee has failed to comply with quality standards" (Hadfield, 1990: p. 953 fn. 98). The reason is that termination subject to court litigation is costly and uncertain in outcome, hence reducing the credibility of the threat.

The German legal framework relevant for the enforcement of franchise contracts imposes severe constraints on the use of the termination-at-will sanction (see, for a detailed analysis, Stein-Wigger, 1999). Specifically, reasons for terminating (but not for non-renewing) an agreement must meet the good cause criterion (wichtiger Grund)[38] comparable to the provisions specified by the Franchise Relationship Laws in several U.S. states. A good cause requires that the continuation of the dyadic relationship until the expiration of the contract cannot be reasonably expected from the franchising firm.[39] The ex ante long-

[37] If franchisors were not relying on termination to induce performance, the proportion company-owned would be unaffected by the ease of termination.

[38] §89a par. 1 HGB [Commercial Code] applies by analogical reasoning to franchise contracts (Stein-Wigger, 1999: p. 149). Analogical reasoning is necessary since statutory law has not so far developed any specific answers to legal questions raised by franchising. Similar to some statutes in U.S. state level franchise laws, termination must be preceded by the franchisor giving a notice of default to the franchisee and providing an opportunity to cure the defect.

[39] The paraphrasing of a good cause according to German law differs from the Franchise Relationship Laws. According to the latter, a good cause implies a material breach of contractual duties. In practice, however, the catalogue of good causes in each of the legal frameworks is similar (non-allowed use of the brand, deviation from standards and operating procedures, etc.). Also, court decisions concerning the suitability of franchisor termination of franchisees have been based on resembling arguments across the two legal systems. See, for instance, the reasoning of the German Bundesgerichtshof [Federal Court of Justice] concerning the *McDonald's Decision* (BGH NJW, 1985: p. 1894) and the decision of a U.S. court in the case *Amerada Hess vs. Quinn.* In both cases, the courts emphasized that the substantiality of franchisee non-compliance must be

term character of franchising collaborations also implies a strong mutual fiduciary duty (Treuepflicht) in German law (Martinek, 1992: p. 135). This fiduciary duty increases the requirements for a good cause. The importance of the fiduciary duty, in turn, increases with contract duration and decreases with the degree to which franchisee investments have been amortized (Stein-Wigger, 1999: p. 151). These legal provisions surrounding the good cause criterion deflate the franchisor's ability to terminate a contract upon misbehavior. As Müller-Graff (1988: p. 127) remarked: "German courts (…) regularly reject the idea of an implied unilateral right to terminate a long-term contract at any time except in totally intolerable situations."[40]

In light of these constraints on the termination-at-will sanction, the threat of contract non-renewal serves as a substitute to mid-agreement termination in effecting the self-enforcement mechanism. Although several legal provisions also constrain non-renewal[41], these are much less severe – especially for fixed-term contracts (see below) – than the restrictions on termination outlined above. In consequence, then, short-term contracts are favored in terms of their self-enforcing properties since punishment through non-renewal is more immediate than for long-term agreements.

3.2.2 Renewal options: Fixed-term vs. permanent contracts

Franchise agreements containing a renewal option are, by law, classified as permanent contracts whereas in the absence of such a clause they are referred to as fixed-term contracts. Fixed-term contracts automatically expire at the end of the initial term. A notice of cancellation of either party is not required. Permanent agreements specify an initial term during which termination (without good cause) is excluded. Thereafter, a renewal option provides that the contract is renewed with identical conditions, or those the franchise company is using for new franchisees, for another specific term if none of the parties resigns prior to expiration. Contract non-renewal is therefore subject to a notice of cancellation.

The consequences of contracts being qualified as fixed-term versus permanent are important with respect to the franchisor's leeway not to renew an agreement.[42] In case of

gauged in light of the effect upon the franchisor's ability to realize his business objectives (Stein-Wigger, 1999: p. 286).

[40] Bradach's (1997: p. 289) citation of one executive of a large U.S. restaurant chain illustrates this point from a practitioner's point of view: "You need a dead rat in the kitchen, and preferably three or four, if you want a chance of winning [a court case against a franchisee]."

[41] Provisions by the civil- (§242, §307 BGB [Civil Law Code]) and antitrust laws (§26 par. 2 GWB [Act against Restraints of Competition]) dealing with the protection of franchisees' investments apply to non-renewal.

[42] Legal provisions with respect to termination equally apply to either type of contract.

fixed-term contracts, freedom to contract applies after the initial term. Franchisees have no legal guarantee on renewal or severance in the event of non-renewal. In case of permanent contracts, however, the good faith obligation[43] (Gebot von Treu und Glauben) applies. This obligation severely constrains the franchisor's leeway not to renew the contract (Stein-Wigger, 1999: p. 253). Franchisees' chances for renewal are therefore higher in the presence of a renewal option. Equivalently, punishing delinquent outlet-owners through non-renewal is more difficult in the presence of a renewal option. As a result, contracts containing no option are favored in terms of their self-enforcing properties.

3.3 Implications for the governance structure of franchising firms

3.3.1 The costs of long-term contracts and renewal options

How do the legal constraints on (mid-agreement) termination-at-will affect the costs of relying on the self-enforcement mechanism for contracts of different durations? As outlined further above, cooperation is achieved when the present value of the short-term gains from cheating is offset by the present value of the premium stream at every time over the life of the relationship. Given that termination is heavily regulated (or, equivalently, documentation of good cause to courts is expensive), long-term contracts extend the period over which store-owners can achieve returns from misbehavior. In order to fulfill the incentive constraint, the premium has to adjust upwards as well, relative to a short-term contract. In addition, even if a good cause can be proved to courts, franchising firms might be required to compensate franchisees more upon early termination of long-term compared to short-term contracts. Severance payments render self-enforcement more costly since the incentive compatible rent then also has to contain this amount in addition to the extra gains from moral hazard. In summary, the self-enforcement mechanism becomes more costly, the longer is the duration of agreements.

By the same token, since renewal options make non-renewal more difficult compared to a contract which has to be renegotiated after the initial term, franchisees can realize extra profits over a longer period of time before being punished. In order to achieve incentive compatibility, i.e., such that the gains from deviation are more than offset by the rent, the

[43] As specified by §242 BGB [Civil Law Code]. The distinction between the good cause criterion and the good faith obligation is in contrast to the Franchise Relationship Laws where a good cause standard applies to both termination and non-renewal. Franchisees are only protected by the good faith obligation stipulated by the Uniform Commercial Act (§1-203) if the contract contains no provisions concerning termination rights by the franchisor.

premium has to increase as well, relative to a fixed-term contract. Hence, reliance on the self-enforcement mechanism becomes more costly in the presence of a renewal option.

The following implications for the governance structure of franchising firms emerge.

3.3.2 Allocation of decision rights

One means by which franchising firms can account for the costs associated with long-term contracts and renewal options is via restriction of franchisees' decision rights. Figure 2 illustrates that the effectiveness in solving incentive problems using self-enforcement influences the optimal degree of decentralization. The trade-off associated with allocating rights is framed in terms of agency and information costs (see Jensen and Meckling, 1992). Store-owners generally have specific knowledge about their local markets allowing them to make more profitable operating decisions than the franchisor. Thus, centralizing decision rights, despite that franchisees have better knowledge, creates information costs. These costs are referred to as the sum of the franchisor's costs of acquiring information from the stores plus the costs of poor decisions given that it would be prohibitively expensive (and time-consuming) to obtain all the relevant knowledge (see, for the benefits of decentralization or, equivalently, the costs from centralization, A-II.). Information costs therefore fall with the degree of decentralization. Agency costs are here defined as the costs of making the self-enforcement mechanism work; that is, the monitoring costs plus the payment of the incentive compatible rent at least equaling franchisees' short-term gains from cheating. These costs rise with decentralization (for a given level of contract duration and in the absence of a renewal option, SE_1) since franchisees have increasingly room to pursue their economic interests at the expense of the whole chain (see A-II.). Conversely, the franchisor's costs from franchisee cheating can be contained by limiting outlets' decision rights through contractual clauses.[44] Specific clauses include input purchase requirements, minimum advertising levels, as well as education and training standards. Moreover, contracts may reference detailed norms and policies in the operating manual. Explicit provisions limit the scope of downstream misbehavior as non-compliance with these stipulations is easily verified by the courts (Lafontaine and Raynaud, 2002: p. 23).

The franchisor will choose a degree of decentralization, D_1, at which the marginal information costs equal the marginal agency costs, SE_1. Now, a decrease in the effectiveness of the self-enforcement mechanism (i.e., longer contract duration and the existence of a

[44] As legally independent businesses and owners of the assets employed for production at the outlet, franchisees' decision rights are unconstrained unless otherwise specified by the contract. Rights which are not explicitly restricted by the contract represent residual rights which make up franchisees' decision space.

renewal option) shifts the agency cost curve upwards (SE_2) for every given level of decentralization.[45] This is because franchisees' gains from cheating and hence the incentive compatible rent surge, as discussed in the prior section.

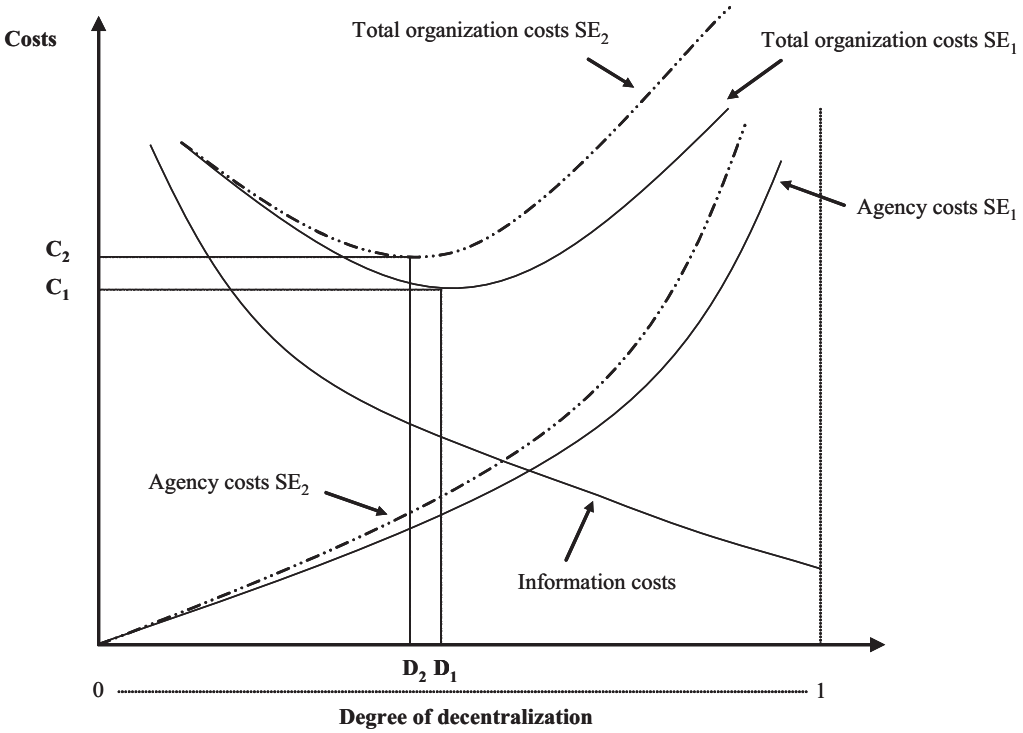

Figure 2. Costs of organization as agency and information costs

It is assumed that the information cost curve is independent of contract duration and renewal options as the characteristics of knowledge are exogenous to the effectiveness in solving the incentive problem. The figure shows that the minimum total organization costs for the ineffective (i.e., long-term, renewable) contract are reached at a lower level of decentralization, D_2, than for the high-incentive contract (i.e., short-term, non-renewable), D_1.[46] In sum, franchisors are expected to attenuate the costs from long-term contracts and renewal options by restricting franchisees' decision rights. The testable hypotheses from this analysis are:

[45] Agency costs for the case of complete centralization remain identical. In case of complete centralization, franchisees have no rights assigned and hence no potential for making decisions which are inconsistent with the interests of the franchisor. It should be noted, however, that complete centralization is difficult to achieve given that contracts are incomplete. Some residual decision leeway and hence potential for misbehavior will then remain.

[46] Note that the total organization costs are higher for long-term contracts and those providing a renewal option, C_2, than for short-term contracts and those providing no renewal option, C_1. The implications from this observation are discussed further below.

H1: Contract duration is positively associated with centralization of decision rights.

H2: The provision of a renewal option is positively associated with centralization of decision rights.

3.3.3 Vertical integration

Another means by which long-term contracts and renewal options can be factored back into the governance structure is by vertical integration. Franchisors will vertically integrate any particular unit when the gains from employee-management are higher than the gains from franchising, net of the payment of the incentive compatible rent to the independent entrepreneurs (Klein, 1995: p. 31). As asserted above, the incentive compatible rent increases with franchisees' expected extra-profits from cheating. These, in turn, vary positively with contract duration and the existence of a renewal option. Hence, franchising becomes more costly relative to company ownership with an increase in contract duration and in the presence of a renewal option, all else equal. Franchising firms should then own more of the network's units in consequence. In sum, any unit for which the payment of rents is too costly will be vertically integrated, and incentive compatibility should hold for the remaining franchisees within the chain. Termination and non-renewal should then not occur.

In practice, however, termination and non-renewal of franchisees occurs.[47] A high proportion of company-owned units may then additionally serve to better control operations at the remaining franchised units indirectly. The argument suggests a synergetic effect of owning and franchising units in parallel. By running own stores, franchisors gain information about demand levels, costs of quality, and customer preferences. Data from company-owned units also allow benchmarking of franchisees' performance and thereby reduce agency risks due to hidden information. Bradach (1997: p. 290) remarked that it is easier for franchisors to take a franchisee to court for poor performance when favorable performance comparisons with company outlets are possible. Outlet-owners are likely to anticipate these costs from court-enforcement. In this vein, Michael (2000b) found empirical support that the reliance on company ownership increased franchisor bargaining power vis-à-vis

[47] For instance, Dnes (1993: p. 373) reported that the franchisors he studied had terminated approximately half a percent of their franchisees over a ten-year period. Non-renewal seems to be a relatively more frequent phenomenon. The U.S. Department of Commerce reported a nine percent non-renewal rate for franchise agreements in the U.S. (cited in Dnes, 1993: p. 373 fn. 16). See also Beales and Muris (1995) for further evidence.

franchisees, thereby deterring quality degradation eventually reducing the need for litigation and termination.

The arguments above interpreted company ownership as a device to curb franchisee opportunistic behavior, either directly or indirectly. Company ownership can also be framed in a two-sided moral hazard model in which the incentive constraints of franchisors are considered. Scott (1995) as well as Windsperger and Yurdakul (2004) argued that company-owned outlets may compensate for the diluted residual income rights brought about by the share contract. This suggests that in order to induce effort of the parent corporation where this is important for the chain as a whole, company ownership should increase. In a recent paper, Brickley (2002) studied the impact of U.S. franchise termination laws on the fee structure of franchise systems. He found that the royalty rate was higher in U.S. termination states requiring good cause for termination compared to non-termination states for franchisor effort would be more important in the former. Specifically, he argued that "franchisors must keep better records to justify franchise terminations, expend resources in litigation, and exert additional effort working with poorly performing franchisees to correct performance deficiencies" (p. 513). The importance of franchisor effort may also increase with contract duration and the presence of a renewal option. That is, long-term contracts are more difficult to terminate even for good cause and contracts incorporating renewal options make non-renewal more problematic. Enforcing quality through the threat of contract termination (or non-renewal) then requires more franchisor resources being devoted to litigation and working with non-cooperative franchisees, hence increasing the need to compensate headquarters through company outlets.

The three arguments from above support the following hypotheses:

> **H3**: Contract duration is positively associated with the proportion company-owned.

> **H4**: The provision of a renewal option is positively associated with the proportion company-owned.

4. Empirical tests

4.1 Sample

4.1.1 Data sources

The hypotheses were tested on cross-sectional data from German business-format franchisors. The *Jahrbuch Franchising und Kooperation 2005* (Peckert *et al.*, 2005) served as the main data source. Besides information on contractual terms (e.g., royalty rates), it contains measures of the degree of centralization within chains. The *Jahrbuch Franchising und Kooperation* is edited by the Forum Franchise und Systeme (FFS), a private information services company with the objective to independently report on franchising activities in Germany. The directory is primarily addressed to individuals interested in purchasing a franchise. No fee is taken from franchisors for inclusion in the directory. The data were gathered by the FFS through self-administered mailed questionnaires. As the directory is a valuable source of information for potential franchisees, one might raise concerns about response biases. For instance, companies may overstate the degree of decentralization in order to attract productive entrepreneurs with a preference for independent decision-making. Scott (1995: p. 76) partially accommodated such concerns about publicly available franchise data and put forward that companies have an incentive to provide accurate information since candidates certainly verify the details of offers. The sampling approach chosen here is comparable to other studies on franchising in the academic literature which also used publicly available data, such as from the *Sourcebook of Franchise Opportunities* (e.g., Agrawal and Lal, 1995; Scott, 1995; Shane, 2001) and the *Entrepreneurship Magazine* (e.g., Lafontaine, 1992; Shane, 1998).

The mail questionnaires for the *Jahrbuch Franchising und Kooperation 2005* were sent out by FFS to about 940 Germany-based distribution systems in autumn 2004. The mailing yielded a response rate of about 44 percent. Yet, 12.5 percent of the respondents had ceased operations (Peckert *et al.*, 2005: p. 161). Out of the responding and still active firms, 301 used business-format franchising – the organizational form of interest here – while the remaining firms relied on alternative types of distribution, such as licensing. Additional information was gathered from *Forby's Guide 2004* (Kessler, 2004) and *Franchise-Opportunities 2005* (Graf, 2004) to corroborate or complement the data found in the *Jahrbuch Franchising und Kooperation 2005*. Complete and consistent information on the variables in this study was available for 159 business-format franchisors, the final sample

size. In 2003, approximately 830 business-format franchisors operated in the German market (DFV, 2005) and hence this study covered about 19 percent of the population.

4.1.2 Characteristics of the sample

Based on the classification scheme employed by Lafontaine and Shaw (2001: p. 35), franchisors were distributed across specific sectors as shown in Table 1.[48]

Industry sector	% of chains in sample
Automotive	5
Business services	5
Cosmetic products & services	1.3
Eating places	12.6
Education	5.7
Health & fitness	3.1
Maintenance	5
Personal services	11.3
Real estate	1.9
Recreation	4.4
Rental	1.9
Repair	3.8
Retail	37.1
Travel	1.9

Table 1. Distribution of chains across industry sectors (n = 159)

Further, four characteristics are pertinent to describe franchise chains: (1) proportion company-owned, (2) system size, (3) age of the chain, and (4) years franchising (see Table 2 for descriptive statistics). To verify whether this sample differed significantly from others used in the literature, t-tests were computed where the relevant information was published.

The average franchise company operated 20 percent of all outlets itself. This value is comparable to the average proportion company-owned in samples used by earlier authors: Lafontaine (1992: p. 272) (mean = 17.25 percent), Scott (1995: p. 76) (mean = 22.70 percent), Lafontaine and Shaw (2001: p. 6) (mean = 22.20 percent), and Windsperger and Yurdakul (2004: p. 37) (mean = 26.96 percent). The only significant difference was found with Windsperger and Yurdakul's sample (t = -2.24).

[48] Industry-specific effects were controlled for in the multivariate regression analyses.

The average chain in the present sample had a total number of 84.89 outlets (franchised plus company-owned). This mean for system size is significantly smaller than in Lafontaine (1992: p. 272) (mean = 273, t = -12.65) and Lafontaine and Shaw (2001: p. 6) (mean = 207.69, t = -6.68), and significantly larger than in Windsperger and Yurdakul (2004: p. 37) (mean = 30.32, t = 3.43). The differences are attributable to variance in the size of the national markets in which the studies were conducted, with the U.S. being the largest, followed by the German, and last by the Austrian market.

The average age of the chain in years (mean = 20.00) is similar and not significantly different from earlier studies, e.g., Lafontaine (1992: p. 272) (mean = 17.82, t = 1.31), Lafontaine and Shaw (2001: p. 6) (mean = 17.33, t = 1.71).

Finally, franchisors in this sample had on average 10.70 years of experience in franchising. Lafontaine and Shaw (2001: p. 6) reported a similar value of 10.56 years franchising (t = 0.23). Overall, and with exception of system size, the sample is comparable to those used by other franchising researchers in the past.

4.2 Variables

4.2.1 Dependent variables

In order to enhance the robustness of the results, two alternative operationalizations for the degree of (de-)centralization were employed. First, franchisor ratings on the following three questions were summed and averaged – using equal weights on all items – to form decision index I: (a) How intense is your support of franchisees concerning their entrepreneurial decisions?, (b) How important is uniformity among your franchisees?, (c) How strongly do you standardize/organize business operating procedures? Respondents classified the characteristics of their system into one of five ordered categories. Categories for (a) and (c) were minimal to very strong and not important to very important for (b). All three measures approximated franchisees' decision-making independence in the day-to-day business. Support of franchisees concerning their entrepreneurial decisions captured the extent to which franchisors were involved in the decision processes of outlets and, therefore, to which degree they exercised control (see Phan *et al.*, 1996: p. 399). Questions tapping uniformity and standardization were inverse measures of the extent to which local actions were allowed to be customized by stores. Principal components factor analysis revealed all items to load on one factor. All loadings were above 0.675, total variance explained was of 56.949 percent and scale reliability as assessed by Cronbach's alpha was

0.62 (see Appendix A).[49] The higher the index, the more was decision-making centralized and the lower was franchisees' leeway to influence outcomes. Note that decision index I was a holistic measure capturing centralization without regard to specific dimensions (procurement, price, etc.).

Second, precise decision dimensions centralized with the franchisor were added up to build decision index II. Functional areas to be included were selected based on previous work by Windsperger (2003: pp. 309-310) and Shane (2001: p. 146): procurement, accounting system, budgeting and controlling, regional advertising, regional public relations, recruiting and employee training, investment, quality management, site-selection assistance, and inventory control. For each dimension, a dummy variable indicated whether the decision was centralized (1) with the franchisor or decentralized (0). In addition, two dummy indicators, assessing whether standardized operating manuals and marketing manuals within any chain existed, were added (these constrain franchisees' decision leeway). The twelve dummy variables formed a single summated variable. The more tasks were performed by the franchisor, the higher was the degree of centralization. Convergent validity of the measurement instruments decision index I and II was assessed via inspection of their bivariate correlation (Hair *et al.*, 1998: p. 118), which amounted to 0.42 ($p < 0.001$).

The second dependent variable, i.e., the proportion company-owned, was calculated as the number of company-owned over total outlets (franchised plus company outlets) in any sampled network in 2003.

4.2.2 Independent variables

The theoretical variables were operationalized as follows. The number of years over which the initial contract between franchisees and the franchisor was valid served as a measure for contract duration. A dummy variable indicated whether the agreement contained a renewal option (1) or not (0) and hence whether it was classified as permanent or fixed-term, respectively.

4.2.3 Control variables

To strengthen the empirical tests, variables which might additionally influence the allocation of decision rights and/or the proportion company-owned were controlled for. All con-

[49] The lower Cronbach's alpha-value of acceptability is 0.6 for exploratory scales (Hair *et al.*, 1998: p. 118).

trol variables have previously been employed in franchising research. Further justification for the inclusion of each is provided in the section discussing the regression models.

System size. Following Lafontaine (1992: p. 276) and Shane (1998: p. 726), the total number of outlets (franchised plus company-owned in 2003) captured system size.

Advertising fee. This fee was calculated as the percentage of monthly sales that franchisees paid to the company for advertising purposes.

Years franchising. This variable reflected the number of years since the firm first franchised an outlet.

Franchisee experience. To measure the degree of franchisee experience demanded by the chain, I followed previous studies which used a dummy variable indicating whether a franchisor required applicants to have previous experience in the business (e.g., Lafontaine, 1992: p. 273). For reasons of reliability, this measure was extended to include information on whether further skills, each captured by a dummy variable, were necessary to successfully apply for a franchise. The variable took on the value zero for no skills and no experience required to seven if skills specific to the job, experience in the industry, general management experience, management education, selling skills, organization skills, and specific background knowledge about technology were demanded.

Franchisor knowledge assets. Franchisor knowledge assets were measured as the number of franchisor services which permit the top-down transfer of (non-contractible) knowledge. The variable ranged from zero if no services were delivered by the franchisor to four if experience meetings, outlet visits, compulsory training for franchisees, and general seminars took place in a franchise system. This measurement approach is similar to Windsperger (2003: p. 309) who used three separate continuous measures, namely the number of annual training days, the number of visits, and the number of annual meetings days. It is also related to Lafontaine (1992: p. 274) and Scott (1995: p. 77) who employed the number of initial training weeks.

Percentage time not franchising. The variable percentage time not franchising captured the length of time between the founding of the company and the year it sold the first franchise, divided by age of the chain. This measure was taken from Lafontaine (1992: p. 274), as were the following three.

Age of the franchise system. Age was measured in years since founding of the parent company.

Franchisor financing. A dummy variable indicated whether franchisor financing was available to franchisees (1) or not (0).

Capital required. A franchisor's capital needs were reflected in the average projected amount of capital required (in €1000s) to open an outlet.[50] Where franchisors indicated a range of values which could vary depending on outlet size, the minimum and maximum amounts were averaged.

4.3 Methods and results

4.3.1 Correlations

Table 2 shows bivariate Pearson correlations between the various variables. Three of the four hypothesized relationships were supported in this bivariate setting – the exception being the link between renewal option and proportion company-owned. The correlations between contract duration and decision indices I and II were positive and statistically significant ($r = 0.34$, $p < 0.001$ and $r = 0.33$, $p < 0.001$, respectively). Also, the presence of a renewal option positively influenced centralization of decision rights as indicated by decision indices I and II ($r = 0.20$, $p < 0.05$ and $r = 0.23$, $p < 0.01$, respectively). The correlation between contract duration and proportion company-owned amounted to 0.17 ($p < 0.05$). These unconditional correlations provided only preliminary support for the hypotheses however. That is, inspection of unconditional correlations could not reject that co-movements in the variables under study were due to movements in other variables. Therefore, these correlations were considered conditional on the other observables in the data through multivariate regressions as reported below.

[50] This amount includes, for instance, expenditures for equipment and fixtures, leasehold improvements, signage, uniforms, opening advertising, and several month of working capital. Initial fees were not included in the measure.

Variable	mean	s.d	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
(1) Decision index I	4.21	0.51													
(2) Decision index II	7.30	2.58	0.42***												
(3) Proportion company-owned	0.20	0.23	-0.05	-0.04											
(4) Advertising fee	1.33	1.68	0.05	-0.07	0.06										
(5) System size	84.89	182.74	0.02	0.19	0.19*	0.04									
(6) Years franchising	10.70	7.36	0.12	0.14	-0.08	0.14	0.54***								
(7) Franchisee experience	3.18	1.44	0.19*	0.25**	0.10	0.21**	0.13	0.00							
(8) Franchisor knowledge assets	3.02	0.96	0.32***	0.41***	-0.09	0.05	0.18*	0.14	0.14						
(9) % time not franchising	34.96	29.35	-0.04	-0.04	0.29***	0.01	-0.13	-0.24**	0.06	-0.04					
(10) Age of the franchise system	20.00	19.53	0.10	0.06	0.13	0.12	0.23**	0.48***	0.10	0.03	0.43***				
(11) Franchisor financing	0.57	0.50	0.16*	0.31***	-0.11	-0.08	0.12	0.08	0.07	0.14	-0.02	0.04			
(12) Capital required	117.44	162.82	0.19*	0.25**	0.24**	0.23**	0.27**	0.20*	0.15	0.02	0.08	0.20*	0.05		
(13) Contract duration	7.90	3.27	0.34***	0.33***	0.17*	-0.02	0.32***	0.14	0.04	0.16*	0.08	0.11	0.10	0.47***	
(14) Renewal option	0.77	0.42	0.20*	0.23**	0.01	-0.14	0.02	0.06	-0.04	0.12	0.11	0.13	0.18*	-0.04	0.02

n = 159. Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05.

Table 2. Pearson correlations and descriptive statistics (n = 159)

4.3.2 Cross-sectional variance in the allocation of decision rights

To test H1 and H2 in a multivariate setting, ordinary least squares (OLS) regressions were employed.[51] Industry dummies were included as control variables to capture the influence of various business types on the need to delegate decision rights to franchisees. For instance, service sectors typically require more downstream discretion than capital intensive industries. Furthermore, system size, years franchising, franchisee experience, and franchisor knowledge assets were added as controls. First, larger systems may enjoy economies of scale in centralizing decision structures and therefore experience lower levels of delegation. Another argument suggests that the value of the brand increases with the number of outlets that display it. In an effort to prevent free-riding, larger systems should then restrict outlets' authority more heavily than smaller chains.[52] Both arguments predict a positive relationship between system size and centralization variables. Second, the higher the number of years since the first franchise was sold, the longer the time period over which a centralized infrastructure could have been built up. Thus, a positive regression coefficient was expected for years franchising. Third, Windsperger (2003) suggested that knowledge assets of both franchisees and the franchisor influence the allocation of decision rights in chains. The more knowledgeable franchisors are, the higher the value which can be extracted from centralized authority. Franchisor knowledge assets should thus positively influence centralization. Conversely, franchisee experience should be negatively related to centralization. However, Lafontaine and Shaw (2001: p. 32) found a positive relationship between franchisee experience and the proportion company-owned. The authors argued that more business experience is required in chains in which operations are complicated and franchisors therefore seek to protect their brand names by exerting direct managerial control through company ownership. A similar argument can be advanced to predict a positive relationship between education requirements and centralization of decision-making, i.e., direct managerial control of franchisee behavior is enhanced through centralization.

[51] Formally, the Likert-type items used to operationalize decision index I were ordinal scales which would have required categorical estimation techniques. However, in the literature, it is common to assume equal interval length and to use OLS regression techniques in consequence (Backhaus, 2000: p. XIX). Results from ordered probit and ordered logit models were not qualitatively different from the OLS results.

[52] In the regressions estimating the proportion company-owned, further controls for brand value, namely the percentage time not franchising, age of the chain, and advertising fees were included. These were not considered in the regressions estimating the degree of centralization since their inclusion reduced the adjusted R-square and thus model quality. The results with respect to the variables of interest here, i.e., contract duration and renewal option, did not change when these variables were added to the models.

Obviously, system size, industry, and years franchising are predetermined with respect to centralization (i.e., franchisors have little control over these variables) and are thus exogenous. Also, the knowledge required to run an outlet is likely to follow from the special task requirements of the business activity. Independent variables in OLS regressions need to be exogenous to obtain consistent parameter estimates (technically, they must not be related to the error term). Yet, the degree of centralization may be simultaneously determined along with other, endogenous contract variables such as non-compete covenants (e.g., Brickley, 1999). These could serve the franchisor to increase franchisees' costs from contract termination and therefore reduce the probability of decision rights being abused, hence increasing the incidence of decentralization. Since these data were not available, it was not possible to account for this simultaneity in a structural approach and therefore reduced-form regressions including only the exogenous control variables from above were estimated.

The results from the OLS models are displayed in Table 3. Model 1 regressed decision index I on the independent and control variables. The standardized coefficient for contract duration was positive ($B = 0.343$) and highly significant ($p < 0.001$). Renewal option was also positively and significantly ($B = 0.190$, $p < 0.05$) related to decision index I. The estimated model was highly significant (adj. $R^2 = 0.253$, $p < 0.001$). Compared to the null model (not reported), the independent variables added 13.5 percent to the explanation of variance in decision index I. The results using decision index II as dependent variable were qualitatively identical with respect to contract duration and renewal option (see Model 3). The effect size of contract duration reduced somewhat while the influence of renewal option gained in strength and significance, relative to Model 1.

The OLS models assumed that contract duration and the existence of a renewal option are exogenous to the degree of centralization. However, there is good reason to believe that these variables are simultaneously determined. That is, causality between centralization and contract duration (and the provision of a renewal option) could flow in both directions. For example, Bercovitz (2000: p. 36) found that contract duration is not only determined by the level of franchisees' specific investments as suggested by transaction costs economics but also by the potential for free-riding (as measured by the value of the chain's brand name times spillover potential). The higher franchisees' potential to free-ride on the brand name, the shorter is contract duration. By the same token, centralization might condition contract duration (and the provision of a renewal option):

Model	Dependent variable: Decision index I				Dependent variable: Decision index II			
	1		2		3		4	
	OLS		2SLS		OLS		2SLS	
Industry dummies								
Automotive	0.068	(0.167)	0.068	(0167)	0.116†	(0.820)	0.121†	(0.863)
Business services	0.104	(0.170)	0.104	(0.170)	-0.012	(0.836)	-0.013	(0.879)
Cosmetic products & services	-0.034	(0.322)	-0.032	(0.327)	0.072	(1.581)	0.092	(1.690)
Eating places	0.124	(0.121)	0.118	(0.143)	0.040	(0.595)	-0.039	(0.743)
Education	-0.010	(0.161)	-0.010	(0.161)	-0.132†	(0.791)	-0.134†	(0.831)
Health & fitness	0.033	(0.212)	0.030	(0.224)	-0.041	(1.041)	-0.079	(1.154)
Maintenance	-0.008	(0.169)	-0.008	(0.169)	-0.069	(0.829)	-0.069	(0.872)
Personal services	0.097	(0.119)	0.096	(0.119)	0.084	(0.582)	0.076	(0.613)
Real estate	-0.052	(0.186)	-0.050	(0.189)	0.056	(0.914)	0.076	(0.976)
Recreation	0.185*	(0.269)	0.188*	(0.284)	0.076	(1.320)	0.115	(1.469)
Rental	0.081	(0.263)	0.081	(0.263)	-0.030	(1.293)	-0.026	(1.360)
Repair	0.050	(0.189)	0.050	(0.190)	0.028	(0.927)	0.017	(0.979)
Travel	0.025	(0.270)	0.027	(0.281)	0.053	(1.328)	0.085	(1.453)
Control variables								
System size	-0.279**	(0.000)	-0.287*	(0.000)	0.001	(0.001)	-0.105	(0.002)
Years franchising	0.199*	(0.006)	0.200*	(0.006)	0.024	(0.030)	0.045	(0.032)
Franchisee experience	0.239**	(0.028)	0.238**	(0.027)	0.199*	(0.136)	0.196*	(0.143)
Franchisor knowledge assets	0.246**	(0.039)	0.244**	(0.040)	0.316***	(0.193)	0.289***	(0.109)
Independent variables								
Contract duration	0.343***	(0.012)	0.364†	(0.032)	0.291***	(0.061)	0.587**	(0.165)
Renewal option	0.190*	(0.087)	0.189*	(0.088)	0.219**	(0.430)	0.207**	(0.455)
n	159		159		159		159	
F	3.814***		2.992***		4.427***		3.734***	
Adjusted R^2	0.253		.		0.292		.	

Beta coefficients reported. Standard errors in parentheses. Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05; † p < 0.1.

Table 3. OLS and 2SLS regression results

Decentralized decision-making structures – possibly made attractive through the properties of production technology – may be governed by relatively short contracts (and no renewal option) in order to induce franchisee compliance. The results of Hausman specification tests confirmed the presence (absence) of simultaneity of contract duration (renewal option) with both measures of centralization. Under conditions of simultaneity, OLS regressions provide inconsistent parameter estimates.

Therefore, two stage least squares regressions (2SLS), which produce consistent and efficient estimates, were estimated. In the first stage, contract duration was endogenized using capital required as an instrumental variable (as well as the other exogenous control variables; see Baltagi, 1998: p. 278). Capital required was used as an instrument since Bercovitz (2000: p. 36) as well as Brickley *et al.* (2003: p. 18) reported that contract duration was to a large degree determined by the magnitude of franchisee investments in the outlet. Since a major portion of these investments is specific to the franchise system, franchisees need assurance that they recoup these expenditures.[53] In the second stage, the OLS models were re-estimated replacing the actual values for contract duration with the estimates from the first stage. The results of Models 2 and 4 in Table 3 emerged. The coefficient of contract duration in Model 2 gained slightly in strength (B = 0.364), relative to Model 1, but lost in significance ($p < 0.10$). The coefficient in Model 4 clearly gained in strength (B = 0.587, $p < 0.01$), relative to Model 3. The renewal option coefficients remained stable in both effect size and significance. Overall, the data provided very robust evidence for H1 and H2.

In order to assure reliability of these results, it was tested whether the assumptions of multivariate regression analysis were met. First, variance inflation factors for each of the regression models were investigated to test for multicollinearity among the explanatory variables. All values lay well below the usual threshold of 10 (the maximum observed was 1.845 for Model 1), beyond which problems of multicollinearity can be considered severe (Hair *et al.*, 1998: p. 220). This indicated that the results were not negatively affected by problems of multicollinearity. Second, Kolmogorov-Smirnov tests were run to assess nor-

[53] Brickley *et al.* (2003: p. 19) found that contract duration and capital investments were simultaneously determined in their sample. This may be the case because the amount of cash required to open an outlet can partly be determined by the franchise company. For instance, the franchisor may choose the level of entry fees. Therefore, the models here were run without entry fees included in the total investments. However, there are other factors the franchisor can decide on and which influence capital required, for instance, whether buildings are to be bought or rented by franchisees. In this vein, the authors used the square footage of outlets' premises as an instrument for capital required. Since similar variables which could have served as a priori valid instruments were not available for this study, capital required was assumed to be to a large extent exogenous and determined by the production technology.

mality of the error term distributions of the OLS models. The Kolmogorov-Smirnov test's null hypothesis is that the error term does follow a certain pre-specified distribution, here, the normal distribution. None of the tests across the models revealed an asymptotic significance (two-tailed) of less than 0.974 (for Model 3) and thus failed to reject the null hypothesis of normally distributed error terms. Finally, White's test was used to assess the assumption of homoscedasticity. White's general test sets the null hypothesis of homoscedastic variance (Greene, 2000: p. 508). The type I error of rejecting the null hypothesis of constant variances when actually it is true ranged from 0.860 to 0.978 across the models. Based on these values, the null hypothesis of homoscedasticity could not be rejected.

4.3.3 Cross-sectional variance in the proportion company-owned

H3 and H4, relating contract duration and the presence of a renewal option to the proportion company-owned, were tested using Tobit regressions. Since the dependent variable was left-censored (i.e., 22.01 percent of franchisors operated no company units), OLS regressions would have provided inconsistent parameter estimates biased toward zero. Algebraically, the censored Tobit model takes on the following form:

$$y^*_i = x_i ß + \varepsilon_i$$

with $\varepsilon_i \sim \mathrm{N}(0, \sigma^2)$ as a normally distributed random variable. y^*_i is a latent variable which can be observed for values greater than zero ($y_i = y^*_i$ if $y^*_i > 0$) and which is censored for values below zero ($y_i = 0$). x_i denotes a vector of independent variables, with ß as the estimated coefficients (see Greene, 2000: chapter 20).

The Tobit estimates are displayed in Table 4. Industry dummies, system size, age of the franchise system, percentage time not franchising, advertising fee, franchisee experience, franchisor financing, and capital required were included as control variables. Two basic rationales relate these variables to the proportion company-owned. The first assumes that franchise companies choose to own more of their outlets when brand value is high because they then need to exert more managerial control over downstream operations in order to prevent free-riding. Since the value of the brand should increase with the number of outlets that display it, as already mentioned, system size was introduced as one proxy for brand equity. The trade name is also assumed to be more valuable for established franchisors and so age of the chain was additionally included. A further proxy for brand value is the per-

centage time not franchising, assuming that more valuable business concepts are more time-consuming and expensive to develop. In addition, the amount of advertising fees paid by franchisees to the company served as a direct measure of funds invested in the brand. Finally, the experience and business skills required by franchisees reflected the emphasis of the franchisor on issues of quality and ultimately brand value, as outlined by Lafontaine and Shaw (2001: p. 31).[54] The second argument acknowledges that firms are more dependent on franchising for rapid expansion, the higher the capital needs to set up stores. Franchisor financing provided to franchisees and capital required served as proxies for capital constraints of the company. Firms capable of financing franchisees have access to the capital markets and no need to rely on franchising for reasons of resource scarcity. Equally, franchisors should be facing a less binding capital constraint, the lower the capital necessary to open a store.[55] Model 5 regressed the proportion company-owned on the independent and control variables. The coefficient for contract duration was positive ($b = 0.000$) but not significant. This multivariate finding was in contrast to the significant, though weak, bivariate relationship ($r = 0.17$, $p < 0.05$) between contract duration and the proportion company-owned. Contrary to expectations, the renewal option dummy was negative ($b = -0.005$) and not significant. Overall, the estimated model was significant ($p < 0.01$).

After conducting conditional moment tests[56], the null hypothesis of normally distributed errors for the Tobit model had to be rejected. Maximum likelihood Tobit estimates are highly sensitive to non-normality. The reason why maximum likelihood results are nevertheless presented is that this technique remains widely used in research on contract mixing in franchise channels and thus facilitates comparison of results (e.g., Lafontaine, 1992; Lafontaine and Shaw, 2001). From visual inspection of the residuals and by the fact of non-normality, it was suspected that the Tobit models also suffered from heteroscedasticity chiefly determined by the degree of censoring. Therefore, Huber-White robust standard errors (for Model 5) are reported. These are less likely to mislead about the significance of independent variables in the presence of heteroscedasticity.

[54] Brand value is determined by past investments such that these variables should be exogenous with respect to the proportion company-owned.

[55] These two variables are also assumed to be exogenous. Past research presented evidence, however, suggesting that the percentage company-owned and the royalty rate are simultaneously set by chains in response to incentive issues (Pénard *et al.*, 2003; Windsperger and Yurdakul, 2004). Including the royalty rate in the regression would have implied an endogeneity bias. Therefore reduced-form regressions excluding the royalty rate were estimated.

[56] The *tobcm* command in Stata 8.0 was used.

Model	Dependent variable: Proportion company-owned			
	5		6	
	Tobit		Box Cox Tobit	
Industry dummies				
Automotive	-0.142	(0.081)	-0.607	(0.526)
Business services	0.043	(0.106)	0.419	(0.517)
Cosmetic products & services	0.175	(0.120)	1.164	(0.990)
Eating places	0.018	(0.077)	-0.005	(0.380)
Education	-0.013	(0.112)	-0.208	(0.508)
Health & fitness	-0.198	(0.090)	-0.230	(0.661)
Maintenance	0.023	(0.089)	0.281	(0.529)
Personal services	-0.011	(0.053)	0.393	(0.364)
Real estate	-0.313**	(0.120)	-1.851**	(0.675)
Recreation	-0.122	(0.125)	-0.451	(0.846)
Rental	-0.014	(0.070)	0.764	(0.819)
Repair	-0.032	(0.092)	-0.115	(0.603)
Travel	-0.068	(0.235)	-0.798	(0.918)
Control variables				
System size	0.003†	(0.000)	0.001	(0.001)
Age of the franchise system	-0.001	(0.001)	-0.005	(0.007)
% time not franchising	0.338***	0.089)	1.797***	(0.467)
Advertising fee	-0.003	0.016)	-0.065	(0.074)
Franchisee experience	0.017	(0.018)	-0.008	(0.090)
Franchisor financing	-0.080†	(0.045)	-0.450†	(0.236)
Capital required	0.000†	(0.000)	0.001†	(0.001)
Independent variables				
Contract duration	0.000	(0.008)	0.011	(0.042)
Renewal option	-0.005	(0.051)	-0.204	(0.282)
n	159		159	
Limit observations (PCO = 0)	35		35	
Nonlimit observations	124		124	
Likelihood ratio test	45.68**		43.31***	

In parentheses: Huber-White standard errors for Model 5. Standard errors for Model 6. Significance levels (two-tailed): *** $p < 0.001$; ** $p < 0.01$; † $p < 0.10$.

Table 4. Tobit regression results

To deal with these issues more fundamentally, a Box Cox transformation of the dependent variable was adopted, thereby allowing for a Tobit estimation which, along with the non-normality problem, accommodated problems of heteroscedasticity (Greene, 2000: pp. 444-453). The estimated theta value used for transformation was 0.235 ($p < 0.001$).[57] A Tobit model was re-estimated under the transformed dependent variable (Model 6). Contract duration and renewal option remained insignificant. Therefore, H3 and H4 were not supported by the data.

Several robustness checks were performed. First, Lafontaine and Shaw's (2001) longitudinal analysis of 4842 different chains revealed that after the first seven years of franchising experience, there were no significant changes in the proportion company-owned over time within chains. Their results suggest that firms learn about an optimal proportion of company ownership, and, once reached an equilibrium level, actively manage to keep that level even in periods of system growth. The relationship between contract duration (and renewal option) and the proportion company-owned could be expected to be stronger among older franchise chains which have already learned about the costs of different organizational designs. Therefore, following the approach offered by Lafontaine and Shaw (2001: p. 24), the sample was restricted to those franchisors with eight or more years of franchising experience and 15 or more units in total. The remaining chains in this stable sample ($n = 79$) were likely to be those that have grown enough to have reached their target levels. The regression equations of Table 4 were re-estimated based on the stable sample.[58] However, the results with respect to the variables contract duration and renewal option did not change. Second, robustness of the Tobit regression results was verified by comparing the maximum likelihood estimates to the estimates from a semiparametric censored least absolute deviations (CLAD) estimation method which was performed using the *clad* command in Stata 8.0. The semiparametric CLAD approach offers the advantage of being insensitive to non-normality and heteroscedasticity of the error terms (Greene, 2000: p. 916; see, also, Chay and Powell, 2001). Qualitatively similar results were obtained. Finally, Windsperger and Yurdakul (2004: pp. 21-22) found evidence that increases in residual decision rights of the franchisor relative to franchisees led to a higher fraction of franchisor ownership rights, expressed by the proportion company-owned. Their results, fol-

[57] Before running the Box Cox regression, an arbitrarily small constant of 0.00001 was added to the dependent variable, proportion company-owned, to meet the requirements of strictly positive values for the variable to be transformed.

[58] While the bivariate correlation between contract duration and the percentage company-owned was twice as high ($r = 0.34$, $p < 0.01$) than for the whole sample ($r = 0.17$, $p < 0.05$), the correlation between renewal option and proportion company-owned weakened.

lowing from property rights arguments, suggest that centralization of decision rights and the proportion company-owned are complements. But neither were the decision indices and the proportion company-owned significantly correlated in a bivariate setting (see Table 2), nor were the error term distributions of the Tobit and OLS/2SLS regressions. Thus, complementarities between centralization and company ownership were either not present in the sample or not captured by the specific variables employed.

5. Discussion

5.1 Findings and null findings

The empirical results were strongly supportive for the thesis that long-term contracts and those containing a renewal option negatively influence franchisors' ability to self-enforce franchisee behavior and that in consequence, organizational design has to accommodate the potential costs from malfeasance by limiting the scope for independent franchisee action. However, no evidence was found for the hypotheses relating contract duration and renewal options to the incidence of vertical integration. It appears therefore that the legal constraints on the self-enforcement mechanism are not important enough to offset the attractiveness of franchising relative to company operations. More precisely, the incentive compatible rent of the least effective self-enforcing contracts (i.e., long-term, renewable) seems not to pass the threshold value at which employee-management of stores becomes more profitable than franchising.

5.2 Implications for public policy

The theoretical and empirical analyses in this chapter suggest two regulatory implications. First, the empirical models showed that franchising agreements allocate decision rights based on economic efficiency considerations: Franchisees' rights are more restricted where inconsistencies in objectives cannot be otherwise controlled by headquarters. This implies that viewing contracts as one-sided and unfair agreements which favor the powerful franchisor at the expense of "naïve" franchisees may be overly pessimistic. In particular, the rights of downstream channel members are apparently not constrained simply because franchise companies would have the bargaining power to do so. The findings of this chapter provide further support that contract provisions should rather be perceived to serve the socially useful purpose of economizing on the costs of quality enforcement (e.g., Klein and Saft, 1985; Bonus and Wessels, 1994; OECD, 1994; Brickley *et al.*, 2003; Lafontaine and

Slade, 2005). Public policy, whose role is "fighting unconscionably restricting clauses in franchise agreements" (Müller-Graff, 1988: p. 127), should take account of these efficiency arguments.

The second implication is theoretically motivated. Figure 2 showed that in light of the legal restrictions surrounding termination and non-renewal, long-term as well as renewable contracts are penalized with an extra cost of organization ($C_2 > C_1$). With all else being equal, in particular information costs, long-term and renewable contracts are associated with higher levels of agency costs at every given level of (de-)centralization. This cost disadvantage would not occur if mid-agreement termination and non-renewal were unconstrained. In light of these increased organization costs, legal restraints on termination and non-renewal may be overemphasized; especially when taking into account that franchisors' reputation concerns are considerable (Beales and Muris, 1995). In a competitive franchise market, terminating franchisees opportunistically would decrease the price paid by new applicants and potentially reduce the level of effort of existing store-owners, thereby damaging the brand value of the chain.

5.3 Generalizability across jurisdictions

It is important to note that the results may be highly specific to the German legal framework. Differences across jurisdictions with respect to franchise contract termination and renewal exist. These certainly impact the effectiveness of the self-enforcement mechanism and thereby franchisee incentives to cheat. But more importantly, even where stipulations surrounding termination are comparable, such as between Germany and several U.S. states, the strength of the relationship between the effectiveness of self-enforcement (i.e., contract duration, renewal options) and the propensity to centralize and/or own operations may still differ across legal traditions. It was argued above that centralization is an efficient response in light of constraints on means of private ordering because, by specifying contractual obligations, it increases verifiability of franchisee performance through third-party enforcers (i.e., courts). Verification of behavior by reference to specified duties might be more important in Civil Law compared to Common Law countries. The Common Law tradition (such as in the U.S.) places emphasis on decision-making and contract interpretation by juries. Conversely, the Civil Law tradition (such as in Germany) relies more heavily on procedural codes in written form, rendering explicit contractual provisions more important. A recent work by Pfister *et al.* (2004) demonstrates the relevance of these conjectures. It showed how institutional parameters affect the proportion company-owned in any chain

across countries.[59] The authors reported significant differences in the propensity to franchise between countries following the German legal tradition (e.g., Austria, Germany, and Switzerland) and other countries. In addition, labor regulations and trademark laws significantly affected the incidence of vertical integration in their sample. Given the above points, research on how franchising firms across jurisdictions deal with contracts of weak self-enforcing properties appears to be promising.

6. Conclusion

The objective of this chapter was to investigate whether legal constraints on contract termination and non-renewal affect the governance structure of franchising firms in terms of the allocation of decision rights and the mix of franchised and company-owned outlets. It was argued that because mid-agreement termination of franchise contracts is difficult in the German legal framework, the costs from franchisee malfeasance increase with the duration of agreements. Consistent with expectations, strong evidence was found that franchisors account for these costs by limiting their exposure to moral hazard in the first place by restricting outlets' decision leeway. Following a similar logic, the evidence revealed that the existence of renewal options inversely determined the delegation of rights to stores. Yet, contrary to the hypotheses, the prevalence of vertical integration within any network was unaffected by contract duration and renewal provisions.

From a theoretical vantage point, some interesting implications can be drawn. First, unless alternative explanations for the empirical findings are put forward, these make an additional case for the self-enforcement mechanism being an important incentive device in franchising. This theoretical lens thus seems promising to explain other essential aspects of organization besides the degree of centralization. Second, the data provided support for complementarities to exist between incentives and decentralization in franchise networks, pointing to an issue which needs careful consideration by management. Thus, delegating rights to outlets is worth more when inconsistencies in objectives are effectively curbed. Finally, the theoretical underpinnings of this study imply that the performance of chains may depend on contract duration and renewal options where the law regulates termination and non-renewal. Figure 2 illustrated that total organization costs rise with a fall in the effectiveness to which agency conflicts are resolved, all else equal. Assuming that these costs cannot be compensated through other firm policies, franchising companies offering

[59] See Oxley (1999) for an analysis of how the institutional environment, namely, national differences in intellectual property rights protection, affect governance features of alliances.

long-term contracts and renewal options suffer in relative performance, also because they cannot fully take advantage of franchisees' specific knowledge.

Several areas, which partially result from the limitations of this study, are worth being pursued further. First, this chapter studied the effectiveness of only one dimension of the self-enforcement mechanism, i.e., the threat of termination, while the other important element, i.e., monitoring intensity, was not considered. However, franchisees' short-term gains from cheating are a function of the resources headquarters devote to monitoring. Investigating the interplay between termination conditions and monitoring frequency remains an interesting avenue for future research. Second, though the efficiency implications of aligning the governance structure with the duration of contracts and the provision of renewal options may be compelling from a theoretical perspective, they deserve empirical testing in order to gain a better understanding of the level of costs associated with misalignments of these elements (see, for such an approach, Yvrande-Billon and Saussier, 2005). Third, one might suspect that franchisors increase their investments in relational forms of governance (see B-II.) to substitute for constraints on the ability to punish franchisees through the threat of termination as discussed here. Finally, it was assumed that decision rights of franchisors and the resulting obligations for franchisees were completely enforced by the courts. By contrast, Arruñada *et al.* (2001) found that automobile manufacturers' completion rights in their contracts with franchisees (e.g., right to determine service target) were complemented with explicit termination rights (e.g., repeated breach of service target) acknowledging that "determining obligations without corresponding mechanisms to enforce these obligations is mindless" (p. 280). Analyzing how specific termination rights interact with contract duration (as an inverse proxy of the effectiveness of self-enforcement) in franchise chains also represents an interesting topic for further analysis.

II. LEVERAGING FRANCHISEE AUTONOMY: RELATIONAL GOVERNANCE IN IDIOSYNCRATIC FRANCHISE DYADS

1. Introduction

Franchising is an attractive organizational form to pursue growth strategies (Shane, 1996; Michael, 2003). It does not only permit realizing economies of scale through system-wide standardization in various functional areas such as marketing, purchasing, and product development. Relative to company operations, franchising additionally allows profiting from the expertise and motivation of independent entrepreneurs to continuously adapt to local markets (see A-II.). For their specific knowledge to be leveraged and local market adaptation to occur, franchisees should be granted autonomy in various operational aspects of the business.

Leeway for independent action is furthermore important to the prospect of the whole chain since it upholds franchisees' satisfaction in the relationship and hence their motivation to deliver performance (e.g., Schul *et al.*, 1985). That is, franchisees often choose the franchise option in order to become their own boss and to run a business according to own decisions while profiting from a proven business concept (e.g., Peterson and Dant, 1990; Kaufmann, 1999). Placing too narrow restraints on outlets' operations increases the risk of disappointing hopes for entrepreneurial behavior.

Notwithstanding the above benefits, increasing levels of autonomy equally raise the potential costs from agency problems present in any franchisee-franchisor dyad (see A-II.). In consequence, autonomous decision-making by downstream stores may or may not lead to increased performance *from the franchisor's perspective*. Success eventually hinges on chains' ability to counterbalance the loss in control inherent to autonomy with mechanisms that achieve goal congruence between the exchange partners. Only under conditions of common economic interests between the parties can the full economic potential of decentralized dyadic decision-making be realized.

A growing body of literature analyzes the importance of social interactions in the governance of channel structures. In particular, the functionality of trust and relational norms – or, more generally, the role of relational governance – in coordinating vertical relationships has been subject to scholarly attention (e.g., Palay, 1984; Kaufmann and Stern, 1988; Noordewier *et al.*, 1990; Poppo and Zenger, 2002). In this chapter, I empirically explore

franchisors' reliance on relational governance as a control mode to attenuate the agency problems resulting from franchisee autonomy. Most notably, it is hypothesized that relational governance becomes more important to accompany autonomy, the weaker franchisees' structural incentives are aligned with the franchisor. Hence, individual franchisee-franchisor dyads from different networks are the units of analysis. The moderating roles of five franchisee characteristics which have previously been proposed to affect agency issues in the dyad are considered: (1) multi-unit ownership, (2) age of the franchisee-franchisor relationship, (3) geographic distance between the outlet and the company's head office, (4) franchisees' past economic success, and (5) the level of perceived intra-chain competition.

This study contributes to the literature in the following ways. First, although past work has investigated appropriate functional areas for independent action by franchisees (Kaufmann and Eroglu, 1999), little is known about the governance of behavior within these limits. Relative to Kaufmann and Eroglu's conceptual study and earlier empirical literature which has been concerned with the question of "who makes decisions" in chains (e.g., Windsperger, 2004), this paper shifts the research focus to the question of "how to assure that decision rights are not abused". The aim is therefore to investigate empirically how companies assure that franchisees use their autonomy in Pareto-improving ways such that it leads to better performance at the outlet while having a non-negative impact on the viability of the system.

Second, by incorporating franchisee characteristics such as single- vs. multi-unit ownership in the analysis, this study extends and corroborates earlier research which found incentive effects of these characteristics to be important for channel management (e.g., Dant and Nasr, 1998). From a practical point of view, asking how a chain can achieve cooperation with outlet-owners of differing expectations and orientations is crucial (Grünhagen and Mittelstaedt, 2005). By focusing on the specific characteristics of each outlet, this chapter advances the theoretical understanding of agency issues in franchising. This knowledge might also provide conceptual guidance to managers in the field when structuring decision rights and control mechanisms.

The chapter is organized as follows. In the next section, the theoretical concepts and hypotheses are introduced (2.). Then, an empirical test of the hypotheses is reported (3.). In the subsequent section, the findings and limitations are discussed and implications for practitioners are provided (4.). The last section concludes and provides suggestions for further enquiry (5.).

2. Theoretical foundations and hypotheses

2.1 Franchisee autonomy

2.1.1 Defining autonomy

Autonomy can be conceived of as the extent to which a party, here a franchisee, is unconstrained to independently make decisions (Kappler, 1992: pp. 272-280; Strutton *et al.*, 1995: p. 82; Dant and Gundlach, 1999: p. 37).[60] Independence pertains to the practical fulfillment of a task as far as its content is concerned; more precisely, it relates to the search for different solutions, to the choice of one feasible alternative, and to subsequent actions. Autonomy entails leeway not only on how but also as to which task is performed – e.g., the latitude of franchised outlets to select a new project (Lewin-Salomons, 1998: p. 2). Thus, autonomy is referred to as franchisees' entrepreneurial freedom to operate affiliated units according to own decisions.

2.1.2 Structural sources of autonomy

Basically, four structural sources of entrepreneurial autonomy can be identified: (1) allocation of contractual rights, (2) contractual incompleteness, (3) control costs as well as limited monitoring capacities, and (4) direct acceptance of deviant franchisee behavior by the franchisor.[61] First, contractual clauses as well as obligations detailed in handbooks – included in the contract by reference – can restrict franchisees' decision rights. Varying degrees of explicit specifications explain idiosyncrasies in downstream operating independence across chains. Yet, these formal elements in the dyadic channel relationship frequently cannot account for differences in autonomy across individual franchisee-entrepreneurs of a same system, which is the focus of this chapter. The reason is that due to legal costs, concerns for equity, and franchisor moral hazard, contractual requirements are most often standardized within a network (Bhattacharyya and Lafontaine, 1995: p. 765).

[60] Note that in chapter B-I., the extent to which franchisees were (un-)constrained to make decisions independently was circumscribed by the term *allocation of decision rights*. In this chapter, the expression *autonomy* was consciously chosen for two reasons. First, the distinction in terminology intends to highlight that the present chapter is concerned with variance in decision-making independence across franchisees *within* any chain rather than with this variance *across* franchise chains. The implicit assumption in the previous chapter (B-I.) was that decision rights of an average outlet in every chain were measured and that these rights were residual, i.e., those not restricted by the contract remaining with franchisees. For the present context, this definition is insufficient because no variance in decision-making independence within any chain would be observed as all franchisees of one chain are usually governed by the same contract. Second, the use of the term autonomy is consistent with earlier studies on franchisee decision-making independence (e.g., Dant and Gundlach, 1999; Pizanti and Lerner, 2003).

[61] More indirectly, franchisor support services – for instance, in form of advices on operating decisions – also limit outlets' autonomy (see Phan *et al.*, 1996: p. 399).

Second, as a result of bounded rationality, unforeseeable contingencies, writing costs, and difficulties of verification through third-party enforcers such as courts (Milgrom and Roberts, 1992: pp. 129-130), franchise contracts do not completely specify each party's obligations. As legally separate entities and owners of the assets employed for production at the outlets, franchisees' decision rights are unconstrained unless they are restricted by the legal documents. Hence, contractual incompleteness conditions local de facto decision-making authority (Stanworth, 1995: p. 165; Dant and Gundlach, 1999: p. 36).

Third, outlets also possess a substantial amount of de facto autonomy because of limited control capacities of the systems' head offices and prohibitively high costs of monitoring local activities. Since control costs may differ among units (Lafontaine and Slade, 1997: p. 7), differential scopes for decentralized operations can emerge within any chain. Outlets which are more costly to monitor should then experience higher levels of autonomy compared to stores which are less expensive to monitor and which are therefore controlled intensely.

Finally, the degree of autonomy across a focal network's franchisees can as well fall apart for the company could accept deviations from contractually regulated business procedures if beneficial outcomes for the whole channel are expected. Lewin-Salomons (1998) argued and provided some anecdotal evidence that this kind of informal allocation of decision rights is a central source of franchisees' operational realm. Also, one representative of a computer retailing franchisor explained in an interview that the average outlet is visited four times a year. Franchisees which are expected to behave appropriately, by contrast, are visited only once a year and are accorded more operating autonomy. This demonstrates that "in a single franchising chain the level of control and autonomy exercised may differ from one franchisee to the next" (Pizanti and Lerner, 2003: p. 138) and that franchisors are aware of the specific level of autonomy which is granted to each individual outlet.

2.1.3 Agency issues related to autonomy

Agency theory is concerned with the resolution of exchange hazards inherent to "a contract under which one or more persons (principals) engage another person (the agent) to perform some service on their behalf" (Jensen and Meckling, 1976: p. 308). In distribution, the organizational form of franchising circumvents an important agency problem which would arise between a system's head office and an employee managing an outlet (Rubin, 1978). In particular, franchisees' residual claim on the profits of their unit (net of royalty payments) induces greater effort than is provided by a company employee who receives

mainly a fixed salary and who therefore seeks to minimize costs of effort. Notwithstanding, residual claims create another goal conflict, namely incentives to free-ride on the chain's brand name (Lafontaine and Raynaud, 2002). Examples of free-riding include underinvestment in advertising, failure to comply with production standards, and insufficient supervision of staff. Franchisees cheating on investments in the brand name reduce their costs and thereby augment profits since they are unlikely to loose (short-term) sales if other units follow through with obligations. The reason is that consumers credit the goodwill they attach to the trade name even to stores which fail to deliver promised quality. The extent of autonomy allocated to franchised dealers positively determines the potential costs resulting from these goal conflicts (see A-II.).

2.2 Controlling franchisees: Relational forms of governance

2.2.1 Defining relational governance

Relational forms of governance, also referred to as informal institutions (North, 1990: p. 36), are defined as norms of behavior and unwritten codes of conduct which safeguard exchanges against potential conflicts. Norms, in turn, are defined as expectations of behavior shared by dyadic partners (Heide and John, 1992: p. 34). They emerge from the social embeddedness of a contractual relationship (Macneil, 1980: p. 1; Granovetter, 1985: p. 490; Ring and Van de Ven, 1994: pp. 102-106; Jones *et al.*, 1997: pp. 924-925) and/or are conditioned by the prospect of realizing a higher transaction value in the future than would be possible without such norms (Baker *et al.*, 2002). The existence of (cooperative) norms is thus not necessarily inconsistent with economic theory's assumption of individuals being rational, self-interested utility maximizers.[62] Rather, in the framework of relational contracts self-enforced within the relationship, norms determine which kinds of behavior are to be expected – or, conversely, which type of behavior triggers punishment by others (Hviid, 2000: p. 56). Though not restricting the behavior of economic actors, norms increase the degree of confidence of an actor that one type of action within the choice set available is chosen by the other actor, making cooperative (equilibrium) outcomes in a repeated interaction more likely (Voss, 2001).[63] In this vein, norms are patterns of actual

[62] For a review of the literature on social preferences (e.g., Fehr and Gächter, 2002), which acknowledges that people sometimes value reciprocal behavior independently of their own utility maximization, see Kirst and Ehrmann (2005).

[63] It does not follow, however, that norms automatically reduce opportunism for opportunism may be an established norm as well. The behavior of people ultimately depends on the specific norms sustained in a

behavior which are enforced by mechanisms of reward and punishment within repeated interactions. While formal governance arrangements such as explicit contract terms are in general discrete (i.e., they either exist or are absent), relational forms of governance are continuous since they differ in degree rather than in kind (Zenger *et al.*, 2001: pp. 8-9). An intensification of the specific norms considered in the next section conforms to more pronounced relational content in a business liaison (see Macneil, 1980: p. 65).

Relational governance does not categorize exchanges by their institutional structure (e.g., markets or hierarchies), but describes actual behavior within modes of organization. Also, the institutional structure within which the economic transaction occurs does not determine prevailing norms (Ivens and Blois, 2004: pp. 242-263). Hence, relational governance can be found in markets, hierarchies, and hybrids and to different degrees in each of these frameworks (Bradach and Eccles, 1989: p. 98). For instance, one can potentially identify high-trust hybrids and low-trust hybrids (Adler, 2001: p. 219). Furthermore, some hybrid organizational forms such as franchise systems are characterized by more than one dyad. In principle, one can then identify high- and low-trust franchisee-franchisor dyads within the same chain.

The major reason why relational governance is suitable to control the behavior of dispersed franchisees is that control in the day-to-day operations is often guaranteed by means of persuasion – not authority (i.e., contracts). Bradach (1997: p. 288) cited one franchise consultant – franchisor personnel charged with managing the contact to outlets – who described that "relationships are crucial and when they deteriorate it becomes extremely frustrating to try to get the company's goals across". Good dealings may be essential because formal contractual control is associated with legal and administrative costs as well as with motivational crowding out (e.g., Macaulay, 1963; Osterloh *et al.*, 2001).

2.2.2 Specific norms and autonomy

In order to describe how relational governance functions as a protective device against opportunistic abuses of autonomy, concrete exchange norms have to be specified. Most studies on relational governance in distribution channels have drawn from the atmospheric dimensions initially proposed by Macneil (1980), though none considered all of the elements simultaneously (see, for a review, Ivens and Blois, 2004). Concerns about the consequences of incompleteness in the consideration of codes of conduct can be partially ac-

relationship. Only those norms which conform to the criterion that they potentially safeguard exchanges against conflict are considered here.

commodated. Noordewier *et al.* (1990: p. 84) noted that individual norms tend to be highly related to one another and might thus be part of a single higher order "relational syndrome". Therefore, no attempt was made here to be exhaustive in the enumeration of shared behavioral expectations as they are discussed in the literature. Attention was paid to (1) the harmonization of conflict, (2) the intensity of cooperation, and (3) the prevalence of trust in any dyad. The construct of relational governance encompasses these three aspects. As explained below, these dimensions are considered to be relevant in the context of franchisee-franchisor dyads.

The *harmonization of conflict norm* defines the extent to which a franchisee and a franchisor find mutually satisfying solutions to conflicts (Macneil, 1980: pp. 67-68; Mohr and Spekman, 1994: pp. 139-140; Gundlach *et al.*, 1995: p. 81; Brown *et al.*, 2000: pp. 53-54). A dyad can be classified as being more relational, the better it achieves to settle conflicts such that the benefits of the exchange remain ex post for both the up- and the downstream firms.[64] Because the long-term character of franchise agreements inevitably imposes needs for flexible change over the life cycle of the relationship, harmonization of conflict also presumes an intensification of the flexibility norm (Ivens and Blois, 2004: p. 247). The flexibility norm refers to the parties' willingness to continuously negotiate and agree on mutual obligations. Flexibility is especially needed when franchisees gain in autonomy for decision rights are accorded to them precisely in order to engage in explorative and adaptive activities. Whereas the need for change may be obvious to both parties, there may be intense bargaining over the distribution of outcomes. Dyadic partners who share the harmonization of conflict norm attempt, by definition, "to resolve their disagreements in mutually satisfying ways, including refraining from opportunism" (Brown *et al.*, 2000: p. 54).

Cooperation is a second element capturing the relational nature in any franchisee-franchisor dyad. It refers to the extent to which exchange parties carry out their respective tasks in a coordinated and cooperative way (Anderson and Narus, 1990: p. 45; Heide and John, 1990: p. 25; Lambe *et al.*, 2000: p. 214). A dyad becomes increasingly relational, the more the operations and planning procedures of both parties are intertwined; namely, exceeding the minimum requirements of the contract. Anderson and Narus (1990: p. 45) stated that cooperation is effectuated in order to realize "*mutual outcomes* or singular outcomes with expected *reciprocation* over time" (emphases added). The concept of cooperation is thus related to Macneil's norm of mutuality – which he later referred to as reciproc-

[64] Note that every transaction, whether discrete or relational, necessarily needs an ex ante minimum level of harmonization within the social matrix for the transaction to take place.

ity (Boyle *et al.* 1992: p. 464). Mutuality, although not requiring equality in the distribution of outcomes, does presume an even distribution of surpluses (Macneil, 1980: p. 44; Kaufmann and Stern, 1988: p. 536; Spinelli and Birley, 1996: p. 336). Cooperation and mutuality establish when franchisors and franchisees learn that outcomes from joint effort exceed those achievable through self-interest seeking and opportunism.

Third, *trust* is a necessary condition for relational governance to emerge (Zaheer and Venkatraman, 1995: p. 378). Drawing from past research on inter-organizational linkages, trust is referred to as the expectation of an actor that another actor can be relied on to fulfill promises and to act fairly where the possibility for opportunism is present (Zaheer *et al.*, 1998: p. 143); including situations where his or her own decisions are affected and monitoring of the others' actions is impossible (Gambetta, 1988: p. 217; Adler, 2001: p. 217).[65] Trust between franchisees and the franchisor conditions a multitude of other exchange norms. Most importantly, trusting parties are expected to have a clear understanding of each others' roles and associated promises and a mutual expectation of their respective enactments. This is what Macneil (1980: p. 40) refers to as the role integrity norm (see also Kaufmann and Stern, 1988: p. 536). Channel members who fulfill their roles do, by definition, not behave opportunistically (Brown *et al.*, 2000: p. 54). Therefore, in trusting dyads, where the role integrity norm is intense, less opportunistic action is expected compared to dyads in which trust and role integrity are weak. The view of trust as a mechanism against the risk of opportunistic action is in line with previous research on the effects of trust on economic organization (e.g., Bradach and Eccles, 1989; Granovetter, 1985; Ring and Van de Ven, 1992; Bromiley and Cummings, 1995).

As a common feature of norms, they define acceptable limits to behavior, taking the preservation of the relationship as a constraint. Elaborating on their binding character for the behavior of exchange parties, Heide and John (1992: p. 35) noted that relational norms inherently constitute a safeguard against the exploitive abuse of decision rights. The analysis of the relationship between Avis Europe PLC (AVE) and its franchisees provided by Jacobsen (2004: p. 530) illustrates this argument: "AVE fully expects the franchisees to operate vehicles that meet Avis quality standards. This 'no lemons' principle refers to the

[65] In the vast literature on trust, there is considerable debate over an appropriate conceptualization. Bigley and Pearce (1998: p. 408) put forward that a universal conceptualization of trust (and distrust) is unlikely to be successfully devised and that the definition should be tailored to the research question at hand. Therefore, I followed a definition employed earlier in the study of inter-organizational exchanges. I felt that the definition adopted here, which conceives of trust as a decision to cooperate under asymmetric information, conforms to the circumstances found in principal-agent relationships such as between franchisees and franchisors.

exclusion of cheap, low-quality, high mileage cars. Whilst the maintenance of standards is emphasized in the contract, the particulars are not articulated. Hence, reliance is placed on an informal understanding as a means of preventing shirking or quality-shading on the part of the franchisee." Since franchisees are expected to behave appropriately on the grounds of these informal understandings, they are given autonomy to independently decide on the car fleet. Other empirical results support this logic. In a laboratory experiment, Gundlach *et al.* (1995), for instance, found that the existence of shared expectations was negatively related to opportunism on both sides of an exchange. The parties use self-control based on internalized values (Heide, 1994: p. 74) and/or the value of future transactions in the relationship (Voss, 2001; Baker *et al.*, 2002) to prevent opportunism. In light of the reasoning presented above, the relationship between autonomy and relational governance is formalized in the following way:

> **H1**: The extent of franchisee entrepreneurial autonomy is positively related to the intensity of relational governance in any dyad.

2.2.3 The moderating role of franchisee incentive characteristics

Thus far, it was implicitly assumed that franchise networks accompany autonomous decision-making at the outlets with equal relational governance intensity irrespectively of franchisees' incentives to engage in opportunistic behavior. However, past research revealed idiosyncratic incentive characteristics across stores of a same chain (e.g., Gal-Or, 1995; Lafontaine and Slade, 1997). In addition, any costs being brought about by relational control were ignored. Yet, the setup of dense ties with focal partners consumes time and resources (Larson, 1992: p. 91; Heide, 1994: p. 76; Ring and Van de Ven, 1994: p. 100; Poppo and Zenger, 2002: p. 710). It is a planned activity and may not only include costs of trust building but also those of failing to reach minimal levels of trust (Das and Teng, 1998: p. 496). Thus, investments necessary to shape exchange norms constitute sunk certification costs (Mills and Ungson, 2003: p. 148) to be borne primarily by the systems' headquarters. As a consequence, franchisors should commit resources to the development of intense linkages only in the presence of significant incentives of franchisees to deviate from the company's interests. In sum, franchisees with incentive structures more closely aligned to those of the company should be awarded entrepreneurial autonomy with less counterbalancing through relational forms of governance.[66] Formally:

[66] Incentive characteristics are also expected to directly affect the need for relational governance. Therefore, the variables which describe these incentive characteristics were included as controls in the regression mod-

> **H2**: The degree of structural incentive congruence in a dyad will moderate the relationship between the extent of franchisee autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger, the weaker franchisees' incentives are aligned with the franchisor.

In the following, five incentive characteristics are considered with regard to their impact on the link between autonomy and relational governance: multi-unit ownership (2.2.3.1), age of the franchisee-franchisor relationship (2.2.3.2), geographic distance between a franchisee's outlet and the chain's head office (2.2.3.3), past franchisee success (2.2.3.4), and the level of intra-brand competition faced by a unit (2.2.3.5).

2.2.3.1 Multi-unit ownership

Multi-unit ownership describes a situation where one franchisee owns more than one outlet (Kaufmann and Dant, 1996: p. 346). While some multi-unit franchisees start a single unit in the beginning and acquire the rights to operate additional outlets over time, referred to as sequential expansion, others are entitled to run multiple units from the outset, referred to as master franchising (Kaufmann and Kim, 1995; see, also, Garg *et al.*, 2005).

Empirical evidence suggests that franchise companies must be little concerned about opportunistic abuses of autonomy by multi-unit agents (Dant and Gundlach, 1999: p. 55). This is because the interests of multi-unit owners are closely aligned with those of the entire network. Most notably, incentives to free-ride on the common brand name are weak, even in nonrepeat customer industries (Dant and Nasr, 1998: p. 14). By cheating on quality, multi-unit partners would jeopardize their own sales to a greater extent than would their single-unit counterparts. In other words, multi-unit ownership internalizes a large fraction of specific investments in the trade name. Furthermore, due to higher stakes in question, head offices are less likely to terminate or non-renew contracts of multi-unit than those of single-unit franchisees. Therefore, the former should project their channel membership farther into the future than the latter. Consequently, foregoing investments in quality would impair future sales of franchisees owning multiple units to a relatively large degree (Dant and Nasr, 1998: p. 14). Dant and Gundlach (1999: p. 45) summarized the argument as follows: when allocated decision-making authority, multi-unit franchisees "are not likely to exploit such opportunities to deviate from the prescribed procedures because they

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els. No hypotheses about their main effects were built since the purpose of this chapter is to highlight the agency problems resulting from autonomy and how these are attenuated or exacerbated by incentive characteristics of individual franchisees.

can directly appreciate the rationale for discipline and standardization within a franchising context from the franchisor's perspective". Anticipating this incentive structure, the marginal benefits from investments in relational quality with multi-unit owners should be smaller for every given level of autonomy compared to the benefits derived from investments in good dealings with single-unit operators.

> **H2a**: The number of outlets owned by a franchisee will moderate the relationship between the extent of autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger among single-unit than among multi-unit franchisees.

2.2.3.2 Age of the franchisee-franchisor relationship

Age of the relationship defines the time period since a franchisee started operating his first outlet. Relationship length has been argued to positively influence the expectations on both sides of the dyad about the continuity of the exchange in the future (Dant and Nasr, 1998: p. 12). Franchisees' incentives to invest in system-specific assets, thereby refraining from free-riding, increase as the future time horizon over which such investments can be amortized extends. Also, potential pecuniary advantages from opportunistic deviation that would accrue in the short-run are more likely to be evened out by the gains from cooperation, the longer the discounting period.

From the perspective of the chain, the age of a relationship can also be interpreted as an indicator for past agent behavior, namely whether autonomy has been utilized constructively (see, generally, Eisenhardt, 1989a: p. 62). Franchisors' unilateral discretion about periodical contractual renewal provides a bond to punish opportunism. Thus, the track record of franchised partners which have been part of the system over two or more contractual periods should certify their quality (Dant and Nasr, 1998: pp. 12-13).

Besides the risk of opportunism, downstream decision-making independence can also damage a system's reputation due to a lack of knowledge about routines and procedures on behalf of inexperienced franchisee-entrepreneurs. In this sense, relational governance can be understood as a communication and cooperation mechanism amenable to assist the outlets as they gain in control over decisions. With the passage of time, the dispersed units acquire proficiency and specific knowledge about operations and assistance should become less important.

The preceding arguments support a negative relationship between relationship length and the need for shared behavioral norms. From the knowledge-based rationale above, however, one can also derive a positive relationship between age of the relationship and the severity of agency issues. Since, over time, franchisees gain in experience regarding specificities of local demand and efficient operating processes, they develop own beliefs about quality and behavioral standards and increasingly challenge the franchisor's authority (Knight, 1986: p. 13; Baucus *et al.*, 1996: p. 373). Their willingness to comply with imposed standards may decrease as a result, augmenting agency conflicts.

In sum, however, the motivation for franchisors investing less in relational governance at every level of autonomy when relationship length increases is more compelling and therefore the following hypothesis should hold.

> **H2b**: Age of the franchisee-franchisor relationship will moderate the relationship between the extent of autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger among younger than among older dyads.

2.2.3.3 Geographic distance

Geographic distance denotes how far an outlet is physically remote from the franchisor's monitoring head office. Distance raises the level of behavioral uncertainty about the agent and widens the information gap in the dyad (Fladmoe-Lindquist, 1996: p. 424). This is because monitoring is costly. More precisely, the costs of sending a company representative to inspect a unit's operations (e.g., cleanliness, product quality) increase in the number of kilometers between the system's head office and the outlet.

Monitoring costs are central to agency theory's prediction about the choice of vertical integration versus franchising. The argument assumes that managers of owned units have weak incentives to perform efficiently since a large fraction of their salary is fixed. Although financial performance of a store can be gauged by the company in each period, performance may not be attributable to either the outlet's manager or to other factors beyond his control, such as the general economic environment. Where behavior-based monitoring is difficult, the franchisor may, in consequence, franchise an outlet. Franchisees have higher incentives to perform since they claim the unit's residual profits. Brickley and Dark (1987) as well as Fladmoe-Lindquist and Jacque (1995) provided empirical evidence in line with the agency-theoretic argument that physically removed outlets tend to be fran-

chised whereas those in proximity to headquarters are company-owned. Monitoring costs thus have an important bearing on the organization of distribution channels.

The behavioral uncertainty associated with increased distance should amplify agency problems associated with a shift of decision rights from the franchisor to the outlets. Agrawal and Lal (1995) showed that monitoring costs negatively affect the frequency of inspections by the franchisor and the level of service provided by franchisees. Since behavior-based monitoring is costly, outcome-based controls may be a valuable substitute. However, electronic data transmission is often inadequate to communicate information that accurately reflects the outlet's operations (Fladmoe-Lindquist and Jacque, 1995: p. 1239). In addition, franchisees seldom integrate their information systems with the head office (Bradach, 1997: p. 288). If relational governance is a mechanism to reduce behavioral uncertainties, the relationship between autonomy and relational governance would be expected to be stronger for distant franchisees than for those partners located close to the network's head office.

> **H2c**: Geographic distance between a franchised outlet and the franchisor's monitoring head office will moderate the relationship between the extent of autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger among distant franchisees than among those located closer to the monitoring head office.

2.2.3.4 Success

Success pertains to franchisees' satisfaction with past economic performance relative to comparison levels (Anderson and Narus, 1990: p. 44). Drawing from power-dependence theory, Dwyer and Oh (1987: p. 349) noted that because of their criticality for systems' access to growing markets, franchisee-entrepreneurs operating in munificent environments (i.e., those who are generally successful) have power over the extent of control exercised by the principal. Conversely, poor performing outlets are more likely to actively seek centralized franchisor support (Peterson and Dant, 1990: p. 49). Indeed, empirical evidence indicates that munificence in local markets decreases bureaucratization (i.e., formalization and centralization) thereby favoring downstream independent decision-making (Dwyer and Oh, 1987: p. 355). In a similar vein, it could be argued that networks' dependence on successful franchised stores also increases these agents' bargaining power in case of conflict; bargaining power which franchisees can exploit to their advantage and at the expense of

the chain. This line of reasoning would suggest relatively strong requirements for relational exchange norms to accompany autonomy of successful franchisees.

Based on self-enforcement theory (see B-I.), I alternatively submit that high levels of satisfaction with past performance reduce the risk of opportunism. Self-enforcement operates by leaving sufficient rents downstream such that the threat of termination of the relationship ensures franchisee compliance. Chains must observe performance at stores through monitoring and subjectively decide whether it conforms to the desired level. Specifically, in order for the implicit contract to be self-enforcing, franchisees' discounted extra gains from opportunistic behavior (before being terminated) must be smaller than the discounted rent stream that accrues from cooperation in the long run. The higher a franchised outlet's economic potential, the more important the returns foregone upon termination. At every given level of autonomy, opportunism should then be better controlled, the higher a franchisee's performance. Therefore:

> **H2d**: Franchisee success will moderate the relationship between the extent of autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger among franchisees which are less successful than among those which are more successful.

2.2.3.5 Competition

Intra-chain competitive intensity soars with the number and geographic proximity of affiliated outlets (Posselt, 1999: p. 358). The extent of rivalry a franchisee confronts with peers (and company outlets) of the same chain determines his incentives to free-ride. In this vein, Arruñada *et al.* (2001: p. 262) pointed out that the larger the network size (and thus likely the degree of intra-chain competition), as given by the number of dealers, the more important the extent of horizontal externalities. Horizontal externalities emerge as a result of an individual franchisee's inability to realize the full benefits accruing to his investments in improving the quality of products and the reputation of the chain. While the whole chain capitalizes on enhanced reputation in terms of rising sales volumes, the individual outlet will only extract a small fraction of these increases. Franchisee-entrepreneurs have an incentive to wait for other stores to commit the necessary resources, thereby keeping costs down and profits up. Now, competition has the effect of reducing a franchisee's market size and thereby the fraction of returns from investments in reputation which can be internalized. Furthermore, market size affects the functioning of the self-enforcement mecha-

nism. This mechanism, as outlined above, relies on the provision of an ongoing rent to franchisees. Market size positively determines the level of these rents and thereby the amount foregone by franchisees when the contract is terminated (Klein and Murphy, 1988: p. 207). The lower the level of rents lost upon termination, the higher the attractiveness of realizing short-term gains from moral hazard. Therefore, competition should amplify the need for relational safeguards. As a result, for every given level of autonomy, franchisors should invest more heavily in the quality of relationships to franchisees facing intense competition than to those facing low competition.

> **H2e**: The level of intra-chain competition perceived by a franchisee will moderate the relationship between the extent of autonomy and relational governance intensity: specifically, the positive relationship between autonomy and relational governance will be stronger among franchisees which perceive higher levels of competition than among those which perceive lower levels of competition.

3. Empirical tests

3.1 Sample

The hypotheses were tested on cross-sectional data collected from a sample of franchisees operating in Germany. The data were gathered through mail surveys and for purposes of a broader research project on franchisee satisfaction (see Schlüter, 2001) during the years 1999 to 2003. A self-administered questionnaire was sent to the whole population of franchised outlets within each of 11 different business-format franchise chains participating in the study.[67] Franchisors provided the postal addresses of their partners to the researchers. Each mailing included the questionnaire, a cover letter describing the purposes of the study and guaranteeing anonymity to participants, as well as a postage-paid reply envelope.

The specific formulation of the Likert-type questionnaire items emerged from a qualitative-explorative pre-study involving franchisors, consultants, and franchisee focus groups. A total of four moderated focus groups gathered 15 franchisees from eight different chains. In the framework of these meetings, probands were given the opportunity to express important facets of the relationship to their franchisors. Balance and trust in the partnership were named central criteria regarding relationship quality.

[67] The average chain was 13.87 years old, had 104.12 franchised outlets, and an entry fee of about 19.000 €.

In collaboration with the participating chains' management teams, channel members had been informed about the study in advance of the mailings to assure that, following the key informant approach, the owners of the outlets personally answered the questionnaire. Despite collaboration with the systems' head offices in conducting the survey, participation in the study remained voluntary. In order to enhance response rates, subjects were offered a copy of the survey results; no other incentives to participate in the study were provided.

In total, questionnaires were sent to 1050 franchisees. After reminder notices, the survey yielded an overall average (weighted) response rate of 21 percent (system specific response rates lay between 13.68 and 42.85 percent). The final sample consisted of 208 observations. Table 5 provides a breakdown of the number of sampled units across chains. Based on the detailed classification scheme used by Lafontaine and Shaw (2001: p. 35), each of the networks operated in a different industry sector. The population the sample draws from is defined as the entirety of franchisees from these sectors in Germany.

System	Sector	Number of franchisees in sample	System-specific response rates (in %)	% of total number of franchisees across systems in sample
1	Retail: Food	17	24	8.17
2	Business services	5	20	2.40
3	Retail: Home furnishings	3	43	1.44
4	Retail: Pet food	21	32	10.10
5	Retail: Building materials	34	18	16.35
6	Retail: Computer equipment	18	30	8.65
7	Repair	10	19	4.81
8	Retail: Other	13	14	6.25
9	Eating places: Full service	5	19	2.40
10	Retail: Tobacco	13	16	6.25
11	Travel	69	18	33.18

Table 5. Breakdown of franchisees across chains and industries

Tests for nonresponse biases were conducted by comparing the average sampled observation in each system with the average outlet-owner computed from the population of each chain along the dimensions age, gender, number of years in business, and multi-unit ownership. To obtain information on the characteristics of the populations, officials in the chains were contacted. For system 4 (10 percent of cases in the sample, see Table 5), it was not possible to discuss the data with the chain's management because the network has dissolved since the survey was conducted. No evidence of obvious nonresponse biases emerged for the remaining systems.

3.2 Variables

3.2.1 Dependent variable

Relational governance was operationalized using items alluding to the exchange dimensions identified in the theoretical section: harmonization of conflict, intensity of cooperation, and prevalence of trust (see Appendix B for the exact wording).

The questions relating to the harmonization of conflict norm (5a-5c) evaluated to which degree dyadic partners engaged in problem solving as opposed to cultivating disputes (see Dant and Schul, 1992: p. 39). Items 5d to 5f assessed the most important element of cooperative behavior, namely, the extent to which mutual interdependence was appreciated by the channel members in their respective business processes (see Anderson and Narus, 1990: p. 45). The trust specific items (5g-5i) tapped whether vulnerabilities on both sides were mutually exploited by the other, a central theme of trust research (see Bigley and Pearce, 1998: p. 406).

The "syndrome" of relational governance was expected to encompass these partially overlapping norms. Results of a principal component factor analysis (see Appendix C) revealed that the three dimensions were indeed part of a higher order construct. All of the items loaded highly on one factor (all factor loadings $\geq$ 0.577), suggesting that they were strongly associated with each other. A composite measure was built by summing and averaging – using equal weights – the scores of the individual items. Reliability of the summated scale was assessed by Cronbach's alpha. The alpha value of 0.87 was well above the lower limit of acceptability, set at 0.60 for newly developed scales (Hair *et al.*, 1998: p. 118). Also, item-to-total as well as inter-item correlations were investigated. The results confirmed sufficient reliability of the relational governance construct. Furthermore, convergent scale validity was assessed by inspecting the correlation between the summated scale and a single item capturing franchisees' overall satisfaction with the quality of the relationship to the provider of the business-format (exact wording: How satisfied are you overall with your relationship to the franchisor? 1-7; very unsatisfied-very satisfied). The strength of the bivariate correlation was substantial ($r = 0.773$, $p < 0.001$). Concerning validity, it must be cautioned that a single source key informant approach was followed. John and Reve (1982) noted that sentiments variables, such as exchange norms, may fail to converge across respondents from the opposite sides of a dyadic relationship. However, it is claimed that relational governance was measured on the "right" side of the dyad (with franchisees) for relational governance only safeguards against conflict when the party

which has room for opportunism (brought about by franchisee autonomy) perceives the above norms to be relevant for his behavior.

3.2.2 Independent variables

Autonomy. Respondents assessed their perceived level of autonomy on four separate questionnaire items (see Appendix B). These intended to capture two notions of autonomy frequently reappearing in the literature: (1) the leeway to make independent decisions, and (2) quasi as a result, the extent to which a franchisee feels to be his own boss (e.g., Schul *et al.*, 1985: pp. 16-17; Feldstead, 1991: p. 83). Questions 6a and 6b grasped to what extent franchisees perceived to be unconstrained when making decisions, referring to the first notion above. Items 6c and 6d measured, corresponding to the second notion, whether the franchised partners considered themselves as primarily executing directives, being employees, or rather managing their outlet according to own decisions, being entrepreneurs.[68] Results of a principal component factor analysis (see Appendix D) indicated the four items to load highly on one common factor (all factor loadings $\geq$ 0.645). The scores on the four items were summed and averaged – using equal weights. Cronbach's alpha of reliability for the composite autonomy measure was 0.64. Reliability was further assured through item-to-total and inter-item correlations. With all inter-item correlations except one (being $r = 0.29$) exceeding the threshold of 0.30 and all item-to-total correlations above 0.50 (the smallest correlation being 0.55), I felt confident about the reliability of the scale.

One caveat regarding this measurement approach must be highlighted. It is assumed that franchisors are aware of the level of autonomy each franchisee disposes of. It could be argued that measuring *franchisors*' perceived levels of autonomy with regard to each individual outlet would have been more accurate. However, John and Reve's (1982) results accommodate this concern. The authors showed that perceptions on structural variables such as the degree of centralization of channel dyad decision-making converge across key informants from the different sides of a dyad.

Multi-unit ownership. Consistent with earlier literature (e.g., Dant and Gundlach, 1999: p. 48), a nominal no/yes question, coded as a dummy variable (0 = no; 1 = yes), was used to ascertain whether a franchisee operated one or more outlets (see Appendix B).

[68] These latter two questions position franchisees on an independence continuum as proposed by Knight (1984).

Age of the franchisee-franchisor relationship. Franchisees were asked to indicate the year in which they opened their outlet, from which the relationship length to the company was calculated. This measure is consistent with Dant and Nasr (1998: p. 17).

Distance. Following Brickley and Dark (1987: p. 412) as well as Minkler (1990: p. 79), geographic distance was calculated as the number of kilometers (instead of miles) that lie in between a franchised outlet and the chain's head office. In the questionnaire, respondents specified the first two digits of their postal code. Although information about the full postal code, comprising five digits, would have added precision to the calculations, only two digits were requested in order to guarantee anonymity. To calculate distance, a standard route planning software was used; introducing franchisees' two-digit postal code as the destination and the five-digit postal code of chains' headquarters as the starting point.[69]

Success. Franchisee success, or the extent of satisfaction with past performance, was measured by four separate questionnaire items (see Appendix B). The questions asked respondents to evaluate their recent performance relative to different comparison levels. Comparison levels included (1) alternative activities, (2) average industry sales growth, (3) own income expectations, and (4) own sales objectives. Anchoring success by reference to comparison levels is in line with Anderson and Narus (1990: p. 44). The results of a principal component factor analysis (see Appendix D) revealed the four items to load highly on one factor (all factor loadings $\geq$ 0.633). A scale was built which averaged – using equal weights – the sum of the scores on the four items. Cronbach's alpha of reliability was 0.83. Inspection of item-to-total and inter-item correlations provided further support for the reliability of the scale. Convergent scale validity was verified via the correlation between the summated scale and a single item assessing franchisees' overall satisfaction with performance (exact wording: How satisfied are you overall with your performance? 1-7; very unsatisfied-very satisfied). The correlation could be classified as substantial ($r = 0.713$, $p < 0.001$).

Competition. The measure evaluated the intensity of competition between franchisees of the same chain, i.e., intra-chain competition (see Appendix B). Outlet-owners were called upon to report whether the number of franchised outlets in the chain exceeded a reasonable size. In the present context, a perceptual measure seemed more appropriate than an objective count of the number of outlets in the chain – as previously used by other researchers (e.g., Arruñada *et al.*, 2001: p. 268). First, a simple count does not capture the geographic

[69] A two-digit postal code covers a surface of approximately 6000 square kilometres. There are 99 different two-digit postal codes in Germany.

dispersion of outlets and thus the level of intra-brand competition faced by each individual unit. Although the measure here did not ask respondents to state whether the number of franchised outlets in *their geographic area* had exceeded a reasonable size, it is sensible to assume that answers were provided with this fact in mind. Second, actual free-riding behavior generally needs to be preceded by the perception of the potential to improve one's own performance at the expense of peer franchisees and/or company-outlets. Validity of this measure was checked by correlating it with the number of sampled franchised outlets within each geographic area, as defined by the two-digit postal codes. This is a measure similar to Minkler's (1990: p. 80) outlet density, calculated as the number of stores within a five mile radius. The correlation between the two measures amounted to only 0.19, but was significant at the 0.01 percent level. Given that I could only count franchisees which were included in the sample, I felt that the correlation with the perceptual measure indicated sufficient convergent validity.

3.2.3 Control variables

In the empirical models, there was no need to control for contractual variables (e.g., royalty rates) usually considered by agency theorists in the study of franchising (e.g., Lafontaine, 1992). This is because the study focused on variance in autonomy across outlets of a same chain. As an empirical fact, franchisees within any system usually face homogenous contractual conditions. Variance in contractual terms across the 11 different chains in the sample was captured by 10 system dummy variables.[70] The variables which describe franchisees' incentive characteristics were also included as controls since these were expected to affect the need for relational governance.

3.3 Methods and results

3.3.1 Descriptive statistics

Table 6 shows descriptive statistics on the variables used in this study (only arithmetic means and standard deviations are reported).

Inspection of descriptive statistics on the dependent variable revealed that the average franchisee perceived high relational governance intensity in the past (mean = 5.35). Positive responses to questions tapping relational elements in franchising are not unusual. In

[70] The system dummy variables may also capture the general or average level of franchisee autonomy within a chain and therefore be related significantly to relational governance. This average level of autonomy, in turn, is determined by the business the franchise system operates in, the level of competition the franchise system faces, environmental uncertainty, etc.

part, they may reflect structural characteristics of franchise chains; that is, franchising, by definition, implies an ongoing relationship and cooperative effort between dyadic partners (Dant and Schul, 1992: p. 49). However, with a minimum of 2.56 and a maximum of 7 (s.d. = 1.06), the data also showed a high range of scores. The observed variance across franchisees assured that the measure captured "true" relational facets. This observation is not trivial since, for instance, Dant and Schul (1992: p. 50) found – reflecting structural conditions – virtually no variance on other atmospheric variables such as the degree of solidarity within any dyad.

Descriptive figures for the independent variables are as follows. First, about one fourth of the franchisees in the sample owned more than one outlet (mean = 0.23). Second, the distribution of scores on the autonomy scale occurred around a mean of 5.45. This suggests that the average franchisee in the sample perceived relatively high degrees of autonomy in decision-making. Third, the mean age of franchisee-franchisor relationships in the sample was 7.5 years. Fourth, the average outlet was placed at a distance of 310 kilometeres from the chain's head office (s.d. = 206.77). For an outlet which was situated within the same two-digit postal code as the system's head office, I attributed a distance of zero kilometers separating the two sites – the minimum on this variable. The maximum distance recorded in the sample was 793 kilometers. Fifth, the observed scores on the success variable ranged from 1 to 7 (mean = 4.41). Hence, very successful franchisees were included in the sample but also some which were unsatisfied with performance given various comparison levels. Finally, the average franchisee-entrepreneur in the sample perceived rather low levels of intra-chain competition (mean = 2.98).

Variable	mean	s.d.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
(1) System Dummy 1	0.08	0.27																
(2) System Dummy 2	0.02	0.15	-0.05															
(3) System Dummy 3	0.01	0.12	-0.04	-0.02														
(4) System Dummy 4	0.10	0.30	-0.10	-0.05	-0.04													
(5) System Dummy 5	0.16	0.37	-0.13	-0.07	-0.05	-0.15												
(6) System Dummy 6	0.09	0.28	-0.09	-0.05	-0.04	-0.10	-0.14*											
(7) System Dummy 7	0.05	0.21	-0.07	-0.04	-0.03	-0.08	-0.10	-0.07										
(8) System Dummy 8	0.06	0.24	-0.08	-0.04	-0.03	-0.09	-0.11	-0.08	-0.06									
(9) System Dummy 9	0.02	0.15	-0.05	-0.03	-0.02	-0.05	-0.07	-0.05	-0.04	-0.04								
(10) System Dummy 10	0.06	0.24	-0.08	-0.04	-0.03	-0.09	-0.11	-0.08	-0.06	-0.07	-0.04							
(11) Relational governance	5.35	1.06	0.29***	-0.02	0.08	0.36***	-0.04	-0.07	0.07	-0.02	-0.18*	0.09						
(12) Multi-unit ownership	0.23	0.42	0.01	-0.01	-0.07	-0.18**	0.38***	-0.09	-0.12	-0.09	-0.09	0.05	0.00					
(13) Age of relationship	7.50	5.76	-0.11	-0.05	-0.02	-0.17*	0.66**	-0.06	0.01	-0.06	-0.01	-0.09	-0.03	0.36***				
(14) Distance	309.74	206.77	-0.12	0.21**	-0.17*	-0.18*	0.06	0.11	-0.09	-0.07	0.08	-0.23**	-0.32***	0.02	0.05			
(15) Success	4.41	1.35	0.26***	-0.03	-0.04	0.31***	0.12	0.07	0.04	0.04	-0.14	0.01	0.51***	0.13	0.09	-0.12		
(16) Competition	2.98	2.06	-0.14*	-0.08	-0.04	-0.18*	0.12	-0.06	-0.11	-0.08	0.03	0.11	-0.33***	0.08	0.09	0.04	-0.19**	
(17) Autonomy	5.45	0.70	0.23**	-0.04	0.04	0.28***	-0.04	0.01	0.05	-0.25***	-0.38***	0.10	0.55***	0.03	-0.08	-0.20**	0.37***	-0.25***

n = 208. Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05.

Table 6. Pearson correlations and descriptive statistics

3.3.2 Regression results

Table 6 shows bivariate Pearson correlations between the variables. A positive and highly significant correlation ($r = 0.55$, $p < 0.001$) between autonomy and relational governance was found, providing preliminary evidence for H1. But significant correlations among the independent variables suggested using multivariate regression techniques to examine the variance in the endogenous variable uniquely explained by the theoretical constructs of interest to the hypotheses.

As a multivariate dependence technique, hierarchical ordinary least squares regressions were employed (OLS). For testing the implications of franchisee incentive characteristics on the relationship postulated in the first hypothesis (H2a through H2e), moderated OLS regressions were estimated (Aiken and West, 1991). These are appropriate to reveal whether a certain variable, the moderator, has an influence on the strength and/or form of the relationship between an independent and a dependent variable.

To assure that the results are reliable, tests for the assumptions of multivariate regression techniques were performed. Variance inflation factors, Kolmogorov-Smirnov, as well as Breusch-Pagan tests gave no indications for any of the assumptions being violated.

First, relational governance was regressed on the system dummies and the independent variables except for autonomy (Model 1 in Table 7). This estimation was found to be highly significant (adj. $R^2 = 0.418$, $p < 0.001$). Distance ($b = -0.001$, $p < 0.01$), success ($b = 0.255$, $p < 0.001$), and competition ($b = -0.103$, $p < 0.01$) came out significant.

In a second step, autonomy was added to the regression equation (Model 2). The coefficient for this variable was positive ($b = 0.489$) and highly significant ($p < 0.001$). H1 was therefore strongly supported. With an adjusted R^2 of 0.48, explanatory power of Model 2 was high. Compared to the null model, Model 2 added 6.2 percentage points to the explanation of variance in the data. Significance of the overall model lay at the 0.1 percent level.

	Dependent variable: Relational governance						
Model	1	2	3	4	5	6	7
Constant	5.183***	5.158***	5.153***	5.152***	5.168***	5.204***	5.184***
	(0.114)	(0.108)	(0.107)	(0.109)	(0.109)	(0.108)	(0.108)
System Dummy 1	0.749**	0.630**	0.648**	0.627*	0.633**	0.628**	0.652**
	(0.253)	(0.240)	(0.239)	(0.240)	(0.240)	(0.237)	(0.238)
System Dummy 2	0.228	0.318	0.308	0.321	0.316	0.300	0.266
	(0.385)	(0.364)	(0.362)	(0.365)	(0.365)	(0.361)	(0.363)
System Dummy 3	0.658	0.620	0.618	0.633	0.635	0.521	0.649
	(0.496)	(0.469)	(0.466)	(0.470)	(0.470)	(0.466)	(0.465)
System Dummy 4	0.818**	0.685**	0.652**	0.674**	0.690**	0.778**	0.728**
	(0.247)	(0.235)	(0.234)	(0.237)	(0.235)	(0.236)	(0.234)
System Dummy 5	-0.016	0.022	0.033	0.038	-0.022	-0.012	0.018
	(0.228)	(0.216)	(0.215)	(0.219)	(0.220)	(0.214)	(0.214)
System Dummy 6	-0.135	-0.100	-0.072	-0.094	-0.106	-0.126	-0.071
	(0.227)	(0.215)	(0.214)	(0.216)	(0.215)	(0.213)	(0.214)
System Dummy 7	0.265	0.263	0.262	0.270	0.271	0.186	0.295
	(0.294)	(0.277)	(0.276)	(0.278)	(0.278)	(0.276)	(0.276)
System Dummy 8	-0.087	0.317	0.353	0.328	0.304	0.240	0.263
	(0.260)	(0.259)	(0.258)	(0.260)	(0.260)	(0.258)	(0.258)
System Dummy 9	-0.593	0.160	0.305	0.158	0.204	0.434	0.175
	(0.378)	(0.389)	(0.395)	(0.390)	(0.395)	(0.403)	(0.387)
System Dummy 10	0.466†	0.380	0.396	0.378	0.384	0.405	0.361
	(0.263)	(0.249)	(0.247)	(0.249)	(0.249)	(0.246)	(0.247)
Multi-unit ownership	0.013	0.004	0.020	0.012	-0.001	-0.005	0.003
	(0.155)	(0.146)	(0.146)	(0.148)	(0.147)	(0.145)	(0.145)
Age of relationship	0.007	0.009	0.009	0.007	0.010	0.010	0.008
	(0.013)	(0.013)	(0.013)	(0.014)	(0.013)	(0.013)	(0.013)
Distance	-0.001**	-0.001*	-0.001*	-0.001*	-0.001*	-0.001**	-0.001*
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
Success	0.255***	0.196***	0.191***	0.194***	0.205***	0.205***	0.207***
	(0.052)	(0.051)	(0.050)	(0.051)	(0.052)	(0.050)	(0.051)
Competition	-0.103**	-0.073*	-0.072*	-0.072*	-0.072*	-0.078**	-0.073**
	(0.028)	(0.028)	(0.028)	(0.028)	(0.028)	(0.028)	(0.028)
Autonomy		0.489***	0.485***	0.490***	0.479***	0.498***	0.477***
		(0.100)	(0.099)	(0.100)	(0.101)	(0.099)	(0.099)
Autonomy x Multi-unit ownership			-0.397†				
			(0.214)				
Autonomy x Age of relationship				-0.009			
				(0.018)			
Autonomy x Distance					0.000		
					(0.000)		
Autonomy x Success						-0.142*	
						(0.062)	
Autonomy x Competition							0.083*
							(0.042)
n	208	208	208	208	208	208	208
F	10.894***	12.937***	12.533***	12.141***	12.715***	12.750***	12.588***
Adjusted R^2	0.418	0.480	0.486	0.478	0.479	0.491	0.488
Δ in adj. R^2		0.062	0.006	-0.002	-0.001	0.011	0.008
F Δ in adj. R^2		24.000***	3.433†	0.293	0.501	5.206*	3.881*

Standard errors in parentheses. Significance levels (two-tailed): *** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$; † $p < 0.1$. Independent variables have been mean centered (all models) in order to circumvent problems of multicollinearity associated with interaction terms.

Table 7. Regression results of direct and moderated effects

The results of the moderated regression models are presented in columns 3 to 7 of Table 7. H2a stated that franchisors would invest less in shared exchange norms for every level of decision-making authority of multi-unit compared to single-unit franchisees since incentives of the former are more closely aligned with the network. The coefficient of the interaction term was expected to be negative, attenuating the strength of the positive relationship of H1. Model 3 displayed a negative ($b = -0.397$) and marginally significant coefficient ($p < 0.10$) of the interaction term between autonomy and multi-unit ownership. Hence, H2a was weakly supported by the data. The unique variance explained by the interaction term amounted to 0.6 percentage points.

H2b supposed that the older the franchisee-franchisor relationship, the weaker would be the need for relational safeguards. Although the coefficient of the interaction term was negative ($b = -0.009$), as expected, it was not statistically significant (see Model 4). The data therefore did not support H2b.

H2c suspected geographic distance between an outlet and the chain's head office to positively moderate the strength of the relationship between autonomy and relational governance. While the sign of the coefficient was in the direction expected (see Model 5), the influence was not different from zero on statistical grounds. H2c was therefore not supported.

The data however lent support for H2d which presumed that it would become less important to accompany decision-making independence with relational control mechanisms, the more successful the franchisee (see Model 6). The coefficient of the interaction term was negative ($b = -0.142$) and statistically significant ($p < 0.05$). The amount of unique variance explained amounted to 1.1 percent.

H2e suggested a positive coefficient of the interaction between the level of intra-chain competition perceived by a franchisee and autonomy. Indeed, Model 7 revealed a positive ($b = 0.083$) and statistically significant ($p < 0.05$) coefficient. H2e was therefore supported. The interaction term explained 0.8 percent of unique variance in the dependent variable.

3.3.3 Post hoc analyses

For Models 3, 6, and 7, which revealed significant coefficients of the interactions between autonomy and multi-unit ownership, success, and competition, respectively, post hoc analyses were conducted. I followed the approach prescribed by Aiken and West (1991) which suggests testing for the significance of the simple slopes of the regression line between the independent and the dependent variables at low, medium, and high values of the

continuous moderators. Multi-unit ownership, success, and competition influenced, as proposed by the hypotheses, the strength but not the form of the relationship between the autonomy and the dependent variable. It is especially noteworthy that autonomy was, consistent with the predictions, not related at all to relational governance for the group of multi-units owners. In addition, while the simple slope at low levels of competition was insignificant, it was statistically different from zero at mean and high levels of rivalry.

4. Discussion

4.1 Findings and null findings

The empirical results were fully supportive of the main thesis that franchisors would confront agency problems triggered by franchisee autonomy with relational forms of governance. However, mixed evidence was found for franchisee incentive characteristics to affect the severity of these problems at every given level of local decision-making independence such that the intensity of observed exchange norms would differ accordingly. While multi-unit ownership and success attenuated, and competition exacerbated the need for relational control as expected, age of the relationship and geographic distance did not emerge as significant moderator variables.

Concerning age of the relationship, one important shortcoming of the measurement instrument may provide an explanation for the null finding. Measuring age of the relationship as the number of years elapsed since the first outlet was opened by every single franchisee does not capture the full length of the relationship for every sampled dyad. It is a frequent phenomenon that the career path of franchisees involves employment by the company prior to starting an outlet (Bradach, 1997: p. 292). In addition, even if the full relationship length had been grasped, the measure would not plainly reflect the severity of agency issues at hand. For equal relationship lengths, the goal discrepancies are more severe for a franchisee not previously working at the chain's head office compared to a former employee. In this regard, prior socialization into an organization can be an effective way of aligning interests (Ouchi, 1980).[71] From a theoretical perspective, the insignificant interaction term may stem from the two conflicting incentive effects possibly resulting

[71] A statement of the COO of one chain studied by Bradach (1997) illustrates this point: "The company people know the system. They are proven operators and they appreciate the importance of maintaining standards and running the business right" (p. 292). Hence, former company managers understand the requirements to operate an outlet and their experience as company managers allows them to appreciate the importance of maintaining standards.

from an increase in relationship length as outlined in the argument leading up to H2b. On the one hand, age of the relationship positively influences the expectations about the continuity of the liaison in the future and thus the time horizon over which system-specific investments can be amortized. On the other hand, franchisees gain in experience over time and may therefore be increasingly reluctant to comply with imposed standards.

As regards distance, a methodological problem related to its operationalization was already acknowledged for I relied only on the first two out of five digits of franchisees' postal codes to determine the geographical position of each outlet. Put into perspective, however, the inaccuracy of the measure did not appear to be a serious concern as plausible and significant correlations of distance with other variables emerged from the data; for instance with autonomy (see Table 6). One theoretical account for the insignificant interaction term is that information asymmetries may have become more independent of physical distance with the rise in information technology over the past decade. As a result, the severity of agency issues for remote and nearby outlets and the subsequent need for relational safeguards are likely to have converged to some degree.

4.2 Implications for managers

The present study bears clear implications for the management of franchised distribution channels. First, since the results revealed that multi-unit franchisees necessitate less governance intensity in light of decision-making independence, limiting the number of single-unit partners could lead to efficiency gains.[72] As a consequence, the extent of intra-chain competition faced by each outlet would also be reduced. Benefits may be derived from lower intra-chain competition as the regressions indicated that those franchisees facing few competing outlets require less control. Furthermore, the data made a case for the presumption that high performance relative to comparison levels fosters incentive alignment with the company. Hence, it may potentially pay-off to leave rents downstream to induce efficient decentralized operations.

Second, against the backdrop that the incentive characteristics of franchisees are not easily modifiable in the short-run, franchisors should carefully pay attention to selectively grant decision rights to those partners which are expected to behave appropriately. This could increase returns from local adaptation as smaller control costs should be incurred to

[72] Note, however, that multi-unit ownership also reintroduces some of the problems franchising seeks to solve in the first place, namely shirking on effort on behalf of employed outlet managers. These agency problems then occur between the (non-managing) multi-unit owner and his employee-managers at the stores under his control.

achieve Pareto-improving results. More generally, managers should be aware of the linkage between structural (i.e., autonomy) and behavioral (i.e., relational governance) processes in the management of channel members.

Finally, the research draws attention to the value of relationships in governing dispersed outlets. Though no empirical evidence on the performance effects of relying on relational governance to control decentralized decision-making structures was provided, the findings suggest that norms of behavior provide a powerful safeguard against opportunistic abuses of decision rights. Companies which invest in the relationships to their dyadic partners in the presence of exchange hazards brought about by downstream autonomy should outperform those chains foregoing close ties, all else equal.

4.3 Limitations

This study is subject to several limitations. First, standard criticisms of data from perceptual survey-type measures such as ambiguity of questions, nonresponse biases, and common methods variance apply. The ambiguity of questionnaire items was sought to be minimized by means of extensive pre-tests with franchisees and experts. Comparison of average sampled franchisees in each chain with the average computed from the systems' populations revealed no evidence for obvious response biases. To deal with common method variance from social desirability, guarantees of anonymity were provided to respondents. Normally distributed summated scales were indicative of social desirability effects being negligible.

Second, it has to be noted that this study relied on newly developed items to operationalize the constructs. However, care was taken in the construction of the scales. The formulation of the questionnaire items arose from a qualitative-explorative pre-study with franchisee focus groups. In addition, the results from principal component factor analyses as well as inspection of Cronbach's alpha, item-to-total and inter-item correlations, all reported earlier, accommodated concerns about reliability issues.

Finally, the implications presented herein should only carefully be generalized to an international setting since they are likely to be dependent on the German institutional framework. The costs as well as the effectiveness of formal and informal control mechanisms may significantly vary across countries with different institutional parameters such as legal traditions, levels of procedural formalism, and trademark protection laws (see Pfister *et al.*, 2004).

5. Conclusion

Relying on franchised outlets for decision-making in various functional can bring about important efficiency gains and enhance system-wide adaptability. These positive effects from entrepreneurial autonomy are threatened to be offset by agency costs which arise from imperfect alignment of interests among the vertical channel partners. Here, it was inferred from theory that franchise companies would use relational forms of governance to counterbalance their loss in control associated with allocating decision-making independence to individual outlets. The results from an empirical analysis based on German franchisees strongly supported this presumption. Furthermore, the data partly confirmed the claim that franchisee incentive characteristics alleviate or intensify the need for relational safeguards in light of downstream decision control.

Though this study was conducted within the context of franchising, its implications may be extended to other inter- as well as intra-organizational relationships between principals and agents (e.g., venture capital firm-portfolio company, employer-empowered employee). While organizations make extensive use of formal control mechanisms such as contracts, monitoring, and certification, some degree of residual vulnerability to individual self-interest seeking and organizational goal conflicts often remains. As a consequence, realizing the full economic value of agents' specific knowledge is put into peril. Relational forms of governance can play a prominent role in reducing the costs from exchange hazards thereby paving the way for successful decentralized decision structures.

There are at least two promising areas for further research. First, Table 7 displays two system dummies (1 and 4) which were positively and significantly related to relational governance. This raises an interesting question: Is relational governance a dyadic phenomenon or does it affect the chain as a whole? Furthermore, what is curious about the positive coefficient of System Dummy 4 is that the chain has gone bankrupt three years after the survey had been conducted. One would expect channel climate to be rather adverse than benign. Second, it was not possible to empirically distinguish between economic and sociological explanations for the emergence and functioning of exchange norms. Separating economists' rational view from sociologists' understanding based on familiarity would help to clarify how relational sentiments can be built to confront trading hazards.

III. INSTITUTIONAL SOLUTIONS TO FRANCHISOR OPPORTUNISM: COLLECTIVE PUNISHMENT THROUGH FRANCHISEE COUNCILS

1. Introduction

Franchising relationships involve an upstream parent corporation, the franchisor, selling the right to market a product and/or service using a proven business-format to local downstream firms, the franchisees. The local entrepreneurs' success within these relationships crucially depends on the business decisions made by the franchising firm as regards the management of the overall system and its brand name as well as the vertical distribution of surpluses. Solutions to incentive and hold-up hazards emanating from the principal (see A-II.) therefore need to be devised. Agency-theoretic literature has thus far been exclusively concerned with contractual mechanisms as solutions to problems of franchisor opportunism, namely revenue sharing (e.g., Rubin, 1978; Lafontaine, 1992; Sen, 1993).

More recently, scholars have pointed out that chains also use franchisee councils as institutional solutions to improper franchisor conduct (e.g., Arruñada *et al.*, 2005: pp. 162-163).[73] In addition, the best practice literature has devoted considerable attention to these arrangements (e.g., Seideman, 1997; Anderson, 2002; Grueneberg, 2004). Yet, both a theoretical rationale concerning the precise mechanism by which such institutional bodies may curb malfeasance as well as empirical evidence on antecedents of their appointment are lacking.

This chapter seeks to fill these gaps. Advancing upon the theoretical understanding, I draw from the political economy literature on institutional design (Greif *et al.*, 1994) to submit that franchisee councils chiefly provide channel members a means to collectively sanction the franchisor for misbehavior, thereby triggering cooperation in the first place. This private enforcement rationale stresses that traditional arguments pointing to franchisee councils as vehicles for monitoring and participation in headquarters' decision processes are insufficient. The main reason is that the company's obligations are usually not specified in the written agreement and are therefore non-verifiable and hence unenforceable by courts (Hadfield, 1990). Empirically, the appointment of councils was expected to be more

[73] As a working definition, a franchisee council denotes "an elected or selected group of franchisees who meet with representatives of the franchise headquarters to discuss and provide advice on issues of importance to all franchisees" (Dandridge and Falbe, 1994: p. 43). Franchisee councils are also referred to as franchisee advisory councils (or FACs), franchisee advisory boards, and franchisee-franchisor advisory councils.

likely, the more extensive the franchisor's decision rights, hence his control over the operations of the chain, and therefore agents' exposure to opportunistic behavior (e.g., Arruñada *et al.*, 2001). The set-up of councils was also supposed to be less probable when business-format providers have strong incentives to use their discretion in line with the partners' interests as conditioned by a high share in franchisees' sales and a large proportion of outlets company-owned. The data provided partial support for these propositions.

The structure of this chapter is as follows. In the next section (2.), related literature is briefly reviewed. Then (3.), the theoretical framework and the hypotheses are developed. The fourth section (4.) presents the data, operationalizations of variables, as well as the empirical results. The fifth section (5.) discusses the findings, provides implications for practitioners, and derives limitations of this work. The chapter is concluded in (6.).

2. Related literature

Rubin (1978) was the first to advance franchisor incentive constraints as an explanation for the sharing of store revenues between franchisees and the company. Upstream firms are thereby granted incentives to continuously put forth the necessary effort to assure the viability of networks, such as monitoring outlets and maintaining brand strength. His arguments were later formalized by Lal (1990), who used a game-theoretic approach to show that royalty payments set appropriate incentives to uphold brand value (see, also, Mathewson and Winter, 1985). Lafontaine (1992), Sen (1993), and Vázquez (2005), in turn, empirically tested Rubin's proposition and found that the importance of franchisor input in the production process positively influenced the fraction of franchisees' sales claimed by headquarters. Additional evidence on the need to provide incentives to the principal came from Scott (1995). He argued that franchisors can also use company ownership – instead of royalties on sales – to internalize investments in the brand name. Accordingly, Scott reported from his sample that company-owned units served as a bond to guarantee continuing performance to outlet-owners. On the theoretical side, Bhattacharyya and Lafontaine (1995) developed a model based on moral hazard by both up- and downstream firms to explain a number of stylized facts concerning absent contract customization, such as the stability of linear sharing rules over time (see, for empirical evidence, Lafontaine and Shaw, 1999). Mathewson and Winter (1994) showed how incentive requirements of the vertical partners affect non-monetary contract provisions. These authors studied 25 franchise agreements and reported that the property rights to add a new outlet to an exist-

ing territory were allocated to either the franchisee or the franchisor, depending on the relative importance of each party's effort. In sum, literature has focused on contractual elements, either monetary or non-monetary, as mechanisms to reduce the risk of opportunistic behavior of chain headquarters. This study advances the field by focusing on a non-contractual, but institutional solution to these problems. Given the widespread diffusion of franchisee councils in practice (see, for evidence, McCosker *et al.*, 1995), the analysis of such institutions within the organizational form of franchising seems to be equally important to understand the governance of exchange risks between the dyadic partners.

3. Theoretical foundations and hypotheses

3.1 Franchisee councils: A solution to franchisor opportunism

3.1.1 Direct monitoring and participation

Franchisee councils are composed of both franchisee and franchisor representatives. As is often specified in councils' statutes (Hartmann, 1997: pp. 129-132), these bodies serve as communication platforms where (1) channel members can verify that the system's head office applies control mechanisms in a fair and non-discriminating way, (2) new ideas concerning the network's value proposition can be discussed, (3) compromises on precarious issues can possibly be negotiated in mutually beneficial ways, and (4) otherwise dispersed franchisee interests are grouped. Through direct and personal interactions, councils reduce information asymmetries between up- and downstream firms. Hence, they provide an interface for store-owners to monitor the company and thereby potentially attenuate risks from hidden actions (Arruñada *et al.*, 2005: pp. 162-163; Vázquez, 2005: p. 454).[74] In consequence, franchisors have less room to deviate from contractual obligations where these are specified ex ante.

Moreover, councils not only enable franchisees to better observe the principal's behavior but also to participate in the company's decision-making processes and to provide – on an informal basis – input into different operational aspects. For instance, franchisee councils may influence the franchisor's recruitment outcomes. As an executive of American Speedy Printing, a U.S. franchisor, recalls: "We actually had the chairperson of the advisory council help us interview and select our director of sales and marketing" (cited in Sei-

[74] Given that the returns from monitoring the company accrue to all outlets independently of their contribution to monitoring efforts, horizontal externalities exist. As a result, it would hardly be in the economic interest of outlet-owners to monitor the franchisor individually.

deman, 1997: p. 14; see, also, Grueneberg, 2004 on this issue). Hence, where franchisees' input is perceived as valuable by the company, management may seek participation. Through participation, councils may thus influence chains' business decisions to better represent franchisees' interests.

Yet, franchisees' ability to observe franchisor behavior through councils does not necessarily imply that the company has an incentive to forego misbehavior. Equally, participation of council representatives may be allowed only when firms perceive benefits to themselves from involving the outlet-owners in their decision processes. Two fundamental reasons suggest that monitoring and participation cannot fully explain how councils enforce cooperative behavior when serious conflicts between the company and the local entrepreneurs emerge. First, franchisors' obligations are regularly ill-specified by the formal contract and are therefore non-verifiable for outsiders (Hadfield, 1990: pp. 946-948). Court-enforcement of proper behavior is then difficult even if opportunistic action is made observable for store-owners through councils. Second, franchisee councils generally have no formal rights making their decisions legally binding for chains (Nebel and Gajewski, 2003: pp. 445-446). The absence of formal rights follows from German antitrust law, according to which councils are not allowed to determine business decisions of either the franchise company or the franchisees (see Hartmann, 1997: pp. 100-109).

Councils may therefore be successful in preventing franchisor opportunism not primarily because they allow for monitoring and/or participation but because they provide a device to self-enforce franchisor obligations by collectively confronting the franchisor. The claim that institutional interest groups reduce the power disadvantage of individual franchisees vis-à-vis the parent corporation is not new to the literature (e.g., Knight, 1986: pp. 14-15; Picot and Wolff, 1995: p. 233). However, precise mechanisms by which this shift in bargaining power comes about have not previously been explicated. I attempt to describe one plausible mechanism in the following.

3.1.2 Enforcement through collective punishment

Franchisee councils may strengthen enforcement through the threat of collective punishment of deviant franchisors by all or at least a majority of franchisees within the chain. In this regard, councils offer a platform to diminish not only vertical information asymmetries but also those between franchisees horizontally. Specifically, councils provide the framework to agree on common interpretation of the company's obligations and to gather information on conflicts occurring in the channel. Coordination of individual outlet-owners is

facilitated as a result. Council leadership can then decide when to impose what kind of sanctions and can communicate actions to individual franchisees.

Within this line of reasoning developed by Greif *et al.* (1994) to explain the function of merchant guilds in the medieval period, several conditions have to be met for councils to emerge and to successfully enforce proper behavior of franchisors through the threat of collective sanctions: (1) collective punishment must be more effective than bilateral sanctioning, (2) collective punishment must be severe in its consequences for franchisors, (3) franchisee councils must hold regulatory power over franchisees to make collective punishment credible, and (4) franchisors must be aware of the self-commitment function of councils since otherwise they could avert their appointment. These conditions are discussed in the following.

First, for councils to emerge, collective punishment must be more effective than bilateral punishment by single units or by a betrayed franchisee potentially acting in concert with a few peers. Indeed, literature generally attributes little power (or, equivalently, no threat potential) to individual franchisees and emphasizes their dependence on the principal instead (e.g., Hunt, 1972: pp. 36-37). Thus, in the face of franchisees' weak bargaining position, to the company the costs resulting from punishment by only a fraction of outlets are likely to be marginal compared to the potential gains from defection.

Notwithstanding the fact that individual franchisees have little impact, collective sanctions coordinated through councils may render the adverse effects of punishment severe for franchising firms. This severity of sanctions is a second condition for effective enforcement through councils. A variety of costly sanctions can, in principle, be imposed by franchisee councils. For instance, Dant and Nasr (1998: pp. 10-11) stressed the franchisor's dependence on upward information flows from dispersed stores. These are valuable to the firm for control purposes since hiding information might enable stores to opportunistically shirk their responsibilities. Furthermore, information from local units reveals details about consumer needs and consumption patterns. By withholding this proprietary data, franchisees stand to gain from reducing the probability (real or subjectively perceived) of ownership redirections (see, for evidence, Dant and Kaufmann, 2003) since they are chosen in part due to their superior knowledge about local markets (see A-II.). Conversely, detained information represents an opportunity cost to franchisors because this negatively affects their ability to monitor the local entrepreneurs' behavior[75] and to successfully open new

[75] Even if information were fully delivered to the head office, it may not usefully serve the intended control purposes by allowing benchmarking the outlets. This is for example the case when agents collectively (e.g.,

units by providing downward information flows. That is, franchisors play a crucial role in codifying and disseminating among the population of stores the knowledge that arose from specific units (Argote, 1999: chapter 5; Knott, 2003). Whereas the threat of keeping back specific knowledge by one or a few franchisees is relatively inconsequential for the franchisor, the impact would be more serious if the council were to organize a "systematic blockade". Another example by which councils can put pressure on the corporate parent is by credibly divulging in the franchising community details about franchisor abusive behavior. National franchisee associations such as the Deutscher Franchise-Nehmer Verband in Germany, which grants quality labels to fair-dealing chains, may play an important transmitter role in this regard. More directly, since applicants for the purchase of a franchise usually gather information from existing stores, franchisees could negatively influence their willingness to join the chain. In consequence, chains' ability to sell new franchises (assuming a competitive market for productive franchisees) would be threatened while strengthening the position of incumbent outlet-owners.

Note that actions undertaken for punishment must be profitable of themselves to franchisees. Otherwise, the threat of punishment would not be credible. Knowing that sanctions will not be effectuated, franchisors would have nothing to fear and no reason to forego misbehavior. Council leadership will constantly compare the costs from not imposing these sanctions with the resulting benefits. Franchisees will then choose, for instance, not to withhold information though this would bring about short-term gains (see above), if store-owners can enforce cooperative behavior of the franchisor in return. The benefits from proper franchisor conduct may then outweigh the costs from transmitting valuable intelligence about local markets. Once the franchisor defects, however, the net benefits from cooperative franchisee action evade and non-cooperative behavior in form of collective punishment will be triggered.

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through councils) agree on lower levels of performance. From a strict game-theoretic perspective, the threat of collectively agreeing on lower performance to punish misbehavior of the franchisor is not credible since franchisees would harm themselves (i.e., free-riding is only profitable to individual franchisees if others uphold brand value). However, lower performance of all channel members can be rationalized by assuming that each outlet bears only a small fraction of the punishment costs – a strategy Coleman (1990: chapter 11) refers to as incremental sanctions. In an interview conducted with a representative of a computer hardware franchisor, an example of such incremental sanctions was provided. The franchisor might want to boost sales by offering, on a temporal basis, a product package combining different hardware components. Whereas the aggregate gain for the franchising firm would be important, the benefits to the individual franchisees may be marginal if they are to bear the costs from changing product lines. In such a situation, though some opportunity costs are incurred by franchisees, they may gain more by putting pressure on the franchisor by threatening to blockade the special offer. That is, they may enforce franchisor obligations on other issues which are worth more to them in the long-run than the foregone sales.

A third necessary condition for effective collective punishment is that franchisee councils hold regulatory power over franchisees to make threats credible. For instance, out of fear of contract termination and/or non-renewal (see B-I.), it may be in the economic interest of individual channel members not to participate in the collective action. Though a council has generally no legal power over individual franchisees who do not comply with its propositions, indirect monetary sanctions may be inflicted. For instance, while franchisors are important for knowledge dissemination in the network, franchisees also share cost and profit data among them and discuss best practices, ultimately enhancing stores' efficiency (Darr and Kurtzberg, 2000: p. 37). Units which are excluded from the community incur an opportunity cost in terms of foregone improvements in their own operating efficiency since regular communication, personal acquaintances, and meetings are particularly relevant for effective knowledge transfers (see, for a practical example, Darr *et al.*, 1995: pp. 1751-1752). In addition, franchisee commitment to the decisions made by the council can be gained through democratic elections of representatives, usually being opinion leaders, in the council (Nebel and Gajewski, 2003: p. 446). Besides, councils usually report to franchisees on an annual or biannual basis to promote acceptance of their decisions. Optimally, chains' head offices are not involved in the selection process of franchisee representatives. Empirically, franchisees' understanding of councils' benefits is well established. Steiff (2004: p. 232) found that franchised units from 13 networks with a council in place, on average, ranked this institution among the top ten out of 30 instruments to control headquarters' conduct. Also, from a study including four franchise companies, Stanworth (1995: p. 170) reported that franchisees saw the council's main role in protecting their interests: "Some franchisees believed the effect of the association had been to achieve a more favorable contract than would have otherwise been the case."

A fourth condition to make collective punishment work is the franchising firm's awareness that commitment to honest behavior by setting up a franchisee council is advantageous. Otherwise, franchisors could simply avert their appointment. There is considerable evidence that chains are indeed aware of the important self-commitment function fulfilled by such councils since they are usually deeply involved in initiating and financing these bodies (McCosker *et al.*, 1995: p. 23; Arruñada *et al.*, 2005: p. 163). At PC-Spezialist, a German computer retailing franchise firm, the council is even termed "honesty committee", reflecting its main function to assure fair dealings (Ostmann, 1995: p. 27). The considerable attention paid to franchisee councils by best practice franchising literature further

underscores that the governance advantages of this institutional form are perceived among practitioners (e.g., Bloom, 2003; Howe, 2003; Grueneberg, 2004).

Arguably, it would seem that explicit and overt punishment of franchisors through councils is rarely (if ever) implemented. Yet, the effectiveness of institutions in enforcing behavior is inversely related to the number of applied sanctions (Greif *et al.*, 1994: p. 746). Thus, infrequently effectuated sanctions should not be misinterpreted as an indicator for the irrelevance of councils guarding against franchisor misbehavior by threatening collective punishment.

To test the proposition that franchisee councils serve to prevent the realization of franchisor opportunism either through direct monitoring, participation, and/or collective sanctions[76], circumstances under which a council should be expected are identified below.

3.2 Decision rights and the risk of franchisor opportunism

From a property rights perspective, it is efficient to colocate decision rights with intangible (non-contractible) knowledge assets for this is a condition to maximize the residual surplus. Windsperger (2003) found that in franchise chains, decision rights are allocated according to the distribution of these assets between the vertical exchange parties. The higher the intangible knowledge of the franchisor, and therefore the more important his input in the production process, the higher his share of residual decision rights. This system-specific knowledge of the business-format franchisor is an important motivational factor for individuals aspiring for self-employment to join a network (Kaufmann, 1999).

Though franchisors may have knowledge advantages over franchisees in some key aspects, centralized decision-making authority may come at a cost for the outlets. That is, it potentially pays-off for companies to exploit their rights in ways which are in their own best interest but which are detrimental for the downstream partners. More discretion being assigned to the parent corporation especially exacerbates hold-up hazards (Arruñada *et al.*, 2001: p. 258). For instance, site-selection decisions made by the company may lead to territorial encroachment of existing stores. Also, centralized system infrastructures increase the degree of asset-specificity and thus facilitate opportunistic action. As Shane (2001: p. 141) explained: “Centralization makes it easier for the franchisor to hold up franchisees because centralization requires franchisees to make relationship-specific investments in franchisor inputs.” Fundamentally, franchisor opportunism is problematic since franchi-

[76] The proposed arguments are not mutually exclusive and all three might be relevant at the same time. The empirical tests do not seek to differentiate between these rationales.

sees' investments are to a large degree specific to the relationship and would display little value in alternative uses. Quasi-rents resulting from these assets may then be redistributed ex post by the franchising firm.

Having the franchisor make decisions also implies an incentive problem. The franchising firm may shirk its responsibilities by hiring little qualified personal, forego product development, and so forth. Franchisees then risk not receiving the expected assistance in operating affiliated units, especially in situations where obligations are not explicitly spelt out in detail (see, for the case of Avis Europe PLC, Jacobsen, 2004: p. 530). In this vein, Rubin (1978: pp. 228-229) identified control over specific operational aspects of the chain as an essential source of franchisor moral hazard. Revenue sharing alleviates problems of insufficient effort by the principal. As mentioned above, empirical evidence suggests that franchisors claim a larger fraction of the stores' sales where headquarters' effort becomes more important (e.g., Lafontaine, 1992; Sen, 1993; Vázquez, 2005). The company then participates in the success of outlets and has incentives to perform. However, the royalty rate simultaneously needs to assure franchisees' incentives to put forth effort and thus provides only a partial remedy (Scott, 1995: p. 71).[77]

In sum, in chains where the franchisor makes important decisions and hence his ongoing performance is required, franchisees should be concerned about misbehavior and are expected to adopt, possibly in collaboration with the chain's management, a franchisee council. Conversely, where the potential for franchisor malfeasance is low, channel members should avoid the commitment of valuable time and financial resources to these institutional bodies. Formally:

> **H1**: The more decision rights are allocated to the franchisor, the more likely is the appointment of a franchisee council in any chain.

3.3 The moderating role of ownership

3.3.1 Sales sharing

Agency theory posits that franchisors' incentives to shirk their responsibilities become attenuated as their interests in the ongoing success of franchised outlets increase. As already pointed out, one important incentive mechanism in this regard is the sharing of franchisee revenues between the dyadic firms, as expressed by the share parameter (Rubin, 1978). The share parameter indicates the fraction of monthly sales that franchisees pay to

[77] See, on unfulfilled promises made by franchisors, Hunt (1977).

the company. The larger the share parameter, the higher the revenues foregone by the chain when store performance weakens.[78] A high sharing rate should therefore provide assurance to franchisees that the franchisor will, given a level of decision rights, follow through with obligations.

> **H2**: The level of the share parameter will moderate the relationship between the extent of franchisor decision rights and the probability of a franchisee council being appointed: specifically, in chains with a high share parameter, the allocation of decision rights to the franchisor is less likely to lead to the set-up of a franchisee council than in chains with a low share parameter.

3.3.2 Company ownership

Taking a positive share in franchisees' sales dilutes franchised outlets' property rights. This lowers the incentive effects of store-owners and increases the costs of franchised operations. To avoid these costs, Scott (1995) as well as Windsperger and Yurdakul (2004) argued that franchisors can substitute sales sharing through company ownership to more accurately meet their own as well as franchisees' incentive constraints. Foregoing the provision of input to franchisees would diminish the value of the brand and reduce demand at all outlets, thereby also lowering profits at company outlets. Thus, the alignment of franchisor decision rights with property rights, as expressed by a high proportion of company-owned outlets, should make shirking more costly for the chain and therefore the appointment of a council less likely.

> **H3**: The proportion of outlets company-owned will moderate the relationship between the extent of franchisor decision rights and the probability of a franchisee council being appointed: specifically, in chains with a high proportion of outlets company-owned, the allocation of decision rights to the franchisor is less likely to lead to the set-up of a franchisee council than in chains with a low proportion of company ownership.

[78] The specification of initial fees is not sufficient to motivate the franchisor to live up to the outlet-owners' expectations for a deterioration in the network's reputation would have no immediate effect on his income.

4. Empirical tests

4.1 Sample

The hypotheses were tested on cross-sectional data from German business-format franchisors using the same data source as in chapter B-I. (see above for details). Complete and consistent information on the variables employed here was available for 131 systems. In 2003, approximately 830 business-format franchisors operated in the German market and hence the study covered about 15.8 percent of the population.

Franchisors in the sample came from a variety of industries. Table 8 shows the distribution of chains across specific sectors:

Industry sector	% of chains in sample
Automotive	6.1
Business services	5.3
Cosmetic products & services	15
Eating places	12.2
Education	6.9
Health & fitness	3.1
Maintenance	4.6
Personal services	10.7
Real estate	3.8
Recreation	2.3
Rental	1.5
Repair	3.8
Retail	37.4
Travel	0.8

Table 8. Distribution of chains across industry sectors (n = 131)

4.2 Variables

4.2.1 Dependent variable

A dummy variable indicated for each chain whether a franchisee council was institutionalized (1) or not (0).

4.2.2 Independent variables

Franchisor decision rights. To capture the degree of centralization in any network, the same two measures were employed as in chapter B-I.: decision indices I and II. Recall that

decision index I is a perceptual measure of the degree to which decisions were made by the company centrally. Decision index II is a summated variable which counted the number of decisions made by the franchisor (see above for details).

Share parameter. The share parameter measured the percentage of monthly sales that franchisees paid to the franchisor. Following previous work (Lafontaine, 1992: p. 269; Sen, 1993: p. 176; Agrawal and Lal, 1995: p. 218), the share parameter included the royalty rate plus the advertising fee. Where franchisors indicated a range of values, the average was used. Flat figures were divided by the monthly sales level of an average outlet of the system to obtain percentage values (see Shane, 2001: p. 146). Since it provides incentives to franchisors, the share parameter was expected to be negatively related to the incidence of a franchisee council being in place.

Proportion company-owned. The proportion company-owned was calculated as the number of company-owned outlets over total outlets (franchised plus company-owned outlets) in any sampled system in the year 2003. Since company-owned outlets provide a performance bond to franchisees, the proportion company-owned was expected to be negatively related to the existence of a council.

4.2.3 Control variables

In order to strengthen the empirical analyses, variables were controlled which may, in addition to the independent variables, influence the scope for franchisor opportunism and hence the incidence of a franchisee council being adopted.

An important role of the franchisor is to continuously preserve the value of the network's brand name. The more valuable the brand, the higher the fraction of franchisees' sales it generates and the more important it becomes to involve the company in maintaining the brand (Sen, 1993: p. 180). Outlets should therefore be keen on controlling the franchisor through councils in the presence of stronger brands. Following Lafontaine (1992: p. 273), three proxies for the value of the brand name were employed.

Age of the chain. The trade name is assumed to be more valuable for established franchisors and so the age of the chain in years was included in the regression models.

System size. As the value of the brand increases with the number of outlets that display it, the total number of outlets (franchised plus company-owned in 2003) was used as another control variable.

Percentage time not franchising. The franchisor's role in keeping the value of the brand name up should be positively related to the percentage time not franchising, calculated as

the difference between the year the first franchise was sold and the founding year of the parent company, divided by age of the chain. Accordingly, it is assumed that more valuable business concepts are more time-consuming and expensive to develop.

Another essential role of the franchisor is to monitor the quality delivered at individual outlets and to provide assistance in the day-to-day business. These functions are more effectively carried out, the more staff the company payrolls. The following proxy for the franchisor's diligence in carrying out these tasks was used.[79]

Number of franchise consultants. The span of control and intensity of support was proxied by the number of headquarters' franchise consultants per franchised outlet (see, relatedly, Shane, 2001: p. 147). Since a high ratio of consultants per unit may signal that the firm is following through with obligations, this variable was expected to be negatively related to the existence of a council.

4.3 Methods and results

Table 9 shows descriptive statistics and Pearson correlations for the variables of this study. About 50 percent of all sampled chains had a franchisee council in place (for similar findings, see McCosker *et al.*, 1995: p. 4). Cross-sectional variance in the existence of a council across observations set the necessary condition to test the hypotheses. Significant and positive bivariate correlations between the measures of centralization and the council dummy provided preliminary support for H1. Because of correlations between the control and independent variables, multivariate regression techniques were however necessary.

[79] Evidence suggests that insufficient staff at headquarters is a common source of franchisor shirking (see Altmann, 1996: p. 85).

Variable	mean	s.d.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(1) Franchisee council	0.50	0.50								
(2) System size	77.40	175.78	0.13							
(3) Age of the chain	19.54	15.81	0.10	0.32***						
(4) % time not franchising	35.88	28.44	-0.14	-0.07	0.40***					
(5) No. of franchise consultants	0.30	0.55	-0.29**	-0.15	-0.01	0.36***				
(6) Share parameter	5.80	3.20	-0.13	0.08	0.09	0.07	0.14			
(7) Proportion company-owned	0.20	0.23	-0.34***	0.23**	0.09	0.37***	0.33***	0.17		
(8) Decision index I	4.21	0.52	0.18*	0.04	0.12	-0.09	0.00	0.15	-0.09	
(9) Decision index II	7.32	2.59	0.18*	0.14	0.11	-0.01	-0.01	-0.07	-0.06	0.46***

n = 131. Significance levels (two-tailed): *** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$.

Table 9. Pearson correlations and descriptive statistics (n = 131)

	Dependent variable: Franchisee council (0 = no; 1 = yes)		
Model	1	2	3
	Exp(b)	Exp(b)	Exp(b)
Constant	0.153*	2.570*	1.461*
	(1.723)	(0.468)	(0.583)
System size	1.002	1.002	1.002
	(0.001)	(0.001)	(0.001)
Age of the chain	0.998	0.995	0.998
	(0.016)	(0.017)	(0.016)
% time not franchising	2.750	2.759	2.747
	(0.958)	(0.952)	(0.959)
No. of franchise consultants	0.067*	0.049*	0.067*
	(1.356)	(1.455)	(1.358)
Share parameter	0.940	0.942	0.940
	(0.064)	(0.065)	(0.065)
Proportion company-owned	0.024**	0.024**	0.024**
	(1.270)	(1.269)	(1.273)
Decision index I	2.042†	1.948†	2.035†
	(0.403)	(0.408)	(0.419)
Decision index I × Share parameter		0.864	
		(0.031)	
Decision index I × Proportion company-owned			0.936
			(2.105)
n	131	131	131
Chi^2	37.78***	38.91***	37.79***
-2 Log likelihood	143.81	142.69	143.81
Nagelkerke's R^2	0.33	0.34	0.34
Correct classification	69.50%	69.50%	69.50%

Significance levels (two-tailed): *** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$; † $p < 0.10$. Interaction variables have been mean centered in order to circumvent problems of multicollinearity.

Table 10. Logit regression results (decision index I)

	Dependent variable: Franchisee council (0 = no; 1 = yes)		
Model	4	5	6
	Exp(b)	Exp(b)	Exp(b)
Constant	0.889*	0.110*	1.121*
	(0.789)	(1.491)	(0.506)
System size	1.002	1.002	1.002
	(0.002)	(0.002)	(0.002)
Age of the chain	1.000	0.994	1.000
	(0.016)	(0.017)	(0.016)
% time not franchising	2.432	3.044	2.445
	(0.945)	(0.959)	(0.949)
No. of franchise consultants	0.048*	0.033*	0.048*
	(1.403)	(1.489)	(1.406)
Share parameter	0.968	0.969	0.967
	(0.064)	(0.064)	(0.065)
Proportion company-owned	0.022**	0.015**	0.022**
	(1.289)	(1.345)	(1.288)
Decision index II	1.175*	1.178*	1.173†
	(0.083)	(0.085)	(0.086)
Decision index II × Share parameter		0.949†	
		(0.031)	
Decision index II × Proportion company-owned			0.971
			(0.472)
n	131	131	131
Chi^2	38.47***	41.42***	38.48***
-2 Log likelihood	143.12	140.18	143.12
Nagelkerke's R^2	0.34	0.36	0.339
Correct classification	68.70%	68.70%	68.70%

Significance levels (two-tailed): *** $p < 0.001$; ** $p < 0.01$; * $p < 0.05$; † $p < 0.10$. Interaction variables have been mean centered in order to circumvent problems of multicollinearity.

Table 11. Logit regression results (decision index II)

Binary logistic regressions were used as a multivariate technique. The results using decision index I and II are displayed in Table 10 and 11, respectively. The tables show the transformed logit estimates reflecting the marginal effects on the odds of a franchise chain being classified in the higher category of the dependent variable (i.e., franchisee council in place) at the exclusion of the lower category (i.e., no council in place) corresponding to a unit change in the independent variable (Liao, 1994).

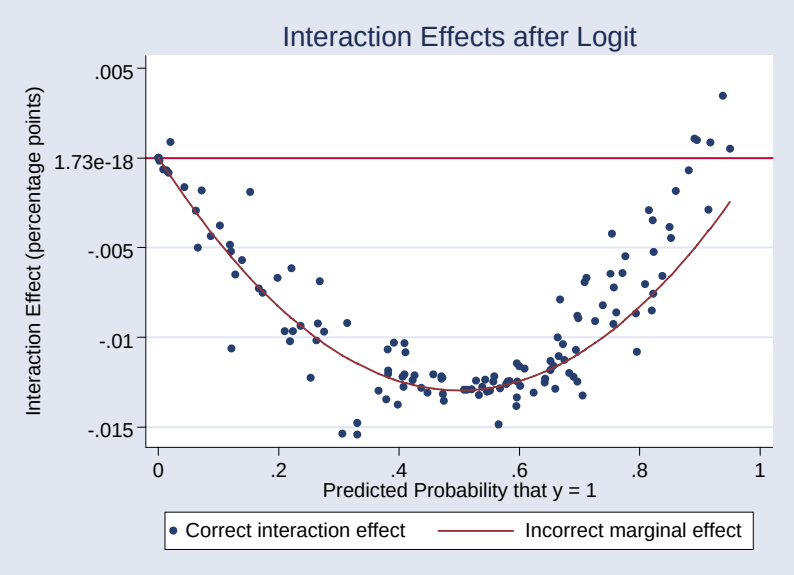
Of the control variables, the number of consultants per franchised outlet ($p < 0.05$) and the proportion company-owned ($p < 0.01$) came out significant across all models. The higher the franchisor's span of control for monitoring franchisees, the lower was the probability of a council to exist. Equally, the higher the proportion of outlets company-owned – and therefore the franchisor's incentives to perform –, the lower was the probability of a council being in place. Though the directional influence of the share parameter was as expected, it did not emerge as a significant predictor of the existence of franchisee councils.[80] Equally, none of the brand name variables displayed a significant influence on the probability of a council being appointed.

Turning attention to the independent variables, both scales capturing franchisor decision rights emerged as significant determinants of the existence of a franchisee council. In Model 1 (decision index I), the odds of a system having a franchisee council in place were 2.042 times higher with a one-unit increase in franchisor decision rights ($p < 0.10$). In Model 4, using decision index II, the odds were 1.175 ($p < 0.05$). Likelihood ratio tests indicated that the estimated models were highly significant ($p < 0.001$). In sum, H1 was supported by the data.

Whereas Model 2 showed no support for H2, the coefficient of the interaction between decision index II and the share parameter was marginally significant ($p < 0.10$) in Model 5, with a negative directional influence as expected. Among chains with a relatively high share parameter, the allocation of decision rights to the franchisor was less likely to be associated with a council than among channels with a low share parameter. However, Ai and Norton (2003) suggested that for nonlinear models, tests for the statistical significance of interaction effects must be based on the estimated cross partial derivates, not on the coefficient of the interaction term. The reason is that the interaction effect in nonlinear models depends on other covariates and may therefore vary in magnitude and significance across the range of predicted values (i.e., probabilities of a franchisee council in place). To ac-

[80] Vázquez (2005: pp. 455-456) also found a negative and non-significant relationship between these two variables.

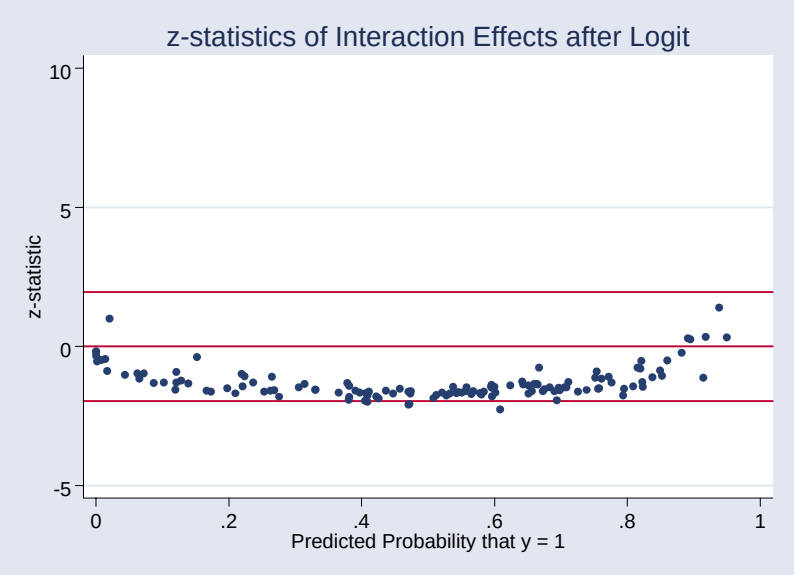
count for these concerns, the *inteff* command in Stata 8.0 was used after running the logit model (Norton *et al.*, 2004). The mean interaction effect across predicted probabilities was still negative but somewhat smaller in magnitude (b = -0.009) compared to the unconditional interaction coefficient (b = -0.050, corresponding to Exp(b) = 0.949 in Model 5). Figure 3 shows that the interaction coefficient was negative across almost all predicted probability values.



Note: Magnitude of interaction coefficient (decision index II × share parameter) across the range of predicted probabilities of a franchisee council being in place.

Figure 3. Interaction effects after Logit

In terms of the significance of the interaction effect, Figure 4 shows that for the left- and right-hand groups of franchise chains, i.e., whose predicted probabilities are smaller than 0.20 and higher than 0.80, significance of the interaction term did not reach acceptable thresholds.



Note: Significance of interaction coefficient (decision index II × share parameter) across the range of predicted probabilities of a franchisee council being in place.

Figure 4. z-statistics of interaction effects after Logit

In sum, since the interaction coefficient across observations was negative but only marginally significant (though over a large range of values of the predicted probability), H2 was weakly supported, using decision index II as a proxy for the degree of franchisor control.

Models 3 and 6 estimated the coefficients for the interaction between franchisor decision rights and the proportion company-owned. The influence of these interaction terms was not significantly different from zero. Again, the magnitude and significance of the interaction effects across predicted probabilities were verified. All of these investigations confirmed that H3 was not supported.

5. Discussion

5.1 Findings and null findings

One of the two purposes of this chapter was to clarify the theoretical grounds on which to infer that franchisee councils reduce opportunism on the principal's side. It was argued that councils potentially achieve this aim by enabling direct monitoring of franchisors, by fostering channel members' participation in chains' decision processes, and, most impor-

tantly, by setting incentives through the threat of collective punishment. The second objective was to empirically test whether the existence of franchisee councils was – consistent with these three rationales – systematically related to the risk of franchisor misbehavior. The empirical results confirmed this presumption and showed that a cross-sectional increase in the scope for malfeasance, as expressed by the extent of companies' decision rights, increased the probability of a council to exist.

This chapter also submitted that the incidence of a franchisee council would be less likely when property rights create strong monetary incentives for franchising firms not to abuse their discretion. The empirical results were only in partial agreement with this claim. Weak support was found that the existence of franchisee councils was less likely for chains in which franchisor decision rights were accompanied by high shares in franchisee sales. However, the appointment of a council was no less likely at every given level of franchisor authority among systems with a high proportion of outlets company-owned than among those with a low proportion. One plausible explanation for this null finding might be that demand is imperfectly correlated across outlets – possibly due to repeat customers – such that franchisors can selectively cheat on franchisees without simultaneously damaging revenues and therefore the profit potential in company outlets. Company ownership cannot then serve as a collateral bond for store-owners that franchisors will behave properly.

5.2 Implications for managers

This research has important implications for practitioners. First, contract design decisions could usefully incorporate the ideas presented in this chapter. Basically, the results provide some support for the claim that institutional (i.e., franchisee councils) and monetary contractual (i.e., sharing of franchisee revenues) elements can be substituted to provide franchisors incentives not to abuse their discretion. The same implication does not hold, however, for the relationship between institutional arrangements and company ownership. In consequence, it does not seem that "the franchisor can accomplish the same thing as it would through raising the royalty rate by owning and operating outlets itself" (Scott, 1995: p. 80). Shares in sales and company operations should therefore not be considered completely equivalent incentive devices.

Second, this chapter introduced a new perspective on the mechanisms by which franchisee councils may privately enforce – through collective punishment – franchisor obligations given that decisions made by these bodies are legally non-binding and chains' obligations are only incompletely specified in the written agreements. The analysis outlined sev-

eral elements which should be considered by practitioners for collective punishment to be successful. Most importantly, franchisees should accept the leadership of their council representatives and follow issued recommendations. In addition, outlet-owners are advised to conceive of effective communication structures with peers, thereby allowing for information exchange and coordination of actions.

Third, the study provides new insights into the trade-off between the risk of franchisor and franchisee opportunism involved in assigning decision rights. It has been pointed out that in most franchise chains the business-format provider owns more decision rights than the downstream parties (e.g., Hadfield, 1990). This uneven contractual allocation has been attributed to the risk of opportunistic franchisee action while the scope for franchisor moral hazard would be constrained by his reputation capital (Arruñada *et al.*, 2001). The results of this chapter imply that in franchising networks, reputation itself may not suffice to assure franchisees of the company's ongoing performance. Instead, institutionalized interest groups seem to be necessary for effective enforcement of chains' obligations. Therefore, this study should encourage chains which are reluctant to appoint franchisee councils to consider these institutions rather as means of self-commitment to the long-term viability of the system than as vehicles by which power is unnecessarily shifted to the periphery (see, on such concerns by some chains, Mendelsohn, 1992: p. 155). Also, ex ante signaling of cooperative intent through franchisee councils may aid in attracting productive franchisees.

Finally, though the nature of the analysis performed here was positive rather than normative, chains which setup franchisee councils in the face of extensive franchisor discretion should perform better, especially when franchisor property rights are diluted, than those networks foregoing institutional arrangements.

5.3 Limitations

This study is subject to several limitations. First, but one of many institutional arrangements typically found in franchised channels of distribution was considered (see Hartmann, 1997). Experience and specialized working groups as well as mediation boards are other means to group franchisee interests and to confront the franchisor in a collective manner. These alternative institutions may offer mechanisms to reduce franchisor opportunism similar to those described herein. Yet, the mere existence of these different forms suggests that there might be differences – besides those with respect to the task performed by each group – concerning the particular interests represented, the mechanisms and the effectiveness of enforcement.

Second, the empirical analyses focused only on the probability of a franchisee council to exist in each chain. While this approach is a useful first step to test the empirical relevance of institutional arrangements in the presence of franchisor malincentives, it did not allow shedding light on the extent of formal and/or informal rights of these councils to govern the behavior of channel members.

Third, the empirical tests were confined to German franchise chains. A recent study by Pfister *et al.* (2004) demonstrated the implications of variance in legal traditions, labor regulations, and trademark protection across countries for the organization of franchise channels. It may thus well be that across countries, the need for institutional solutions to protect franchisees may fall apart and/or that differences in the legal status of such arrangements makes them more powerful in some jurisdictions than in others. Therefore, implications of this paper should only carefully be generalized to an international setting.

Finally, the regressions included only ownership rights set up as residual income rights as moderator variables. However, ownership rights in franchised channels of distribution may also take the form of ownership surrogates such as lease controls and exclusive dealing clauses (Windsperger, 2003).

6. Conclusion

In this chapter, I have attempted to theoretically explore how councils protect franchisees against opportunistic action emanating from the franchisor. Also, empirical tests on antecedents of the appointment of franchisee councils were reported. The results show that monetary incentives specified by the contract are not the only instruments amenable to induce franchisor obligations but that institutions within the franchising organizational form equally deserve attention. However, the precise mechanisms by which these arrangements function to guard against misconduct are little understood. Though the arguments based on ease of monitoring, participation, and enforcement by collective punishment are intuitive, I do not claim them to be complete. While economic rationales may be appropriate to explain the incidence of such institutions in light of exchange hazards, insights derived from research in organizational behavior, for instance concerning collective identity and action (e.g., Hardy *et al.*, 2005), might be equally useful to understand the underlying mechanisms at work once a council is in place.

IV. A LEARNING PERSPECTIVE ON FRANCHISE CONTRACTING

1. Introduction

Franchising relationships are a form of collaboration in which an upstream firm, the franchisor, sells the right to market its products and/or services using a proven business concept to legally independent entrepreneurs, the franchisees. Economists have since long emphasized that formal contracts play an essential role in safeguarding these exchanges against disturbances emanating from inconsistent objectives between the vertical partners (e.g., Rubin, 1978). Direct evidence on contract design affecting the survival of franchise chains substantiates this view (Azoulay and Shane, 2001; Shane, 2001). Despite the documented relevance of appropriate contract structure, research has neglected to address whether and how franchising firms learn about the governance of their relationships to franchisees using legally-binding agreements.

This lack of research effort may partially result from the dominant theoretical perspectives applied to the analysis of franchising. Incentives-based theories relying on agency reasoning, in particular, fully capture the notion (often implicitly) of franchisors correctly anticipating and adjusting to exchange hazards ex ante – with the future holding no surprises. Suboptimal agreements are then not drafted in the first place or, if accidentally so (Alchian, 1950), quickly become selected out by the environment. This equilibrium approach allows testing hypotheses about the functionality of specific provisions and other policy variables, such as the mix of franchised and company-owned outlets within any chain (e.g., Lafontaine, 1992). Moreover, it helps to explicate the conditions under which efficiency can be improved through the assignment of pecuniary incentives and decision rights (e.g., Arruñada *et al.*, 2001). As a drawback, however, this framework obstructs the view on potentially underlying learning processes associated with contracting (MacLeod, 1995; Mayer and Argyres, 2004). Gaining knowledge of these processes is not only a prerequisite to better understand observed contract structures at any point in time, but also to derive normative implications for applied contracting.

As an entry to issues of learning in franchise contracting, this chapter explores the evolution of formal contracts used by three chains from the restaurant, hotel, and retailing industry. Instead of focusing solely on the monetary aspects (Lafontaine and Shaw, 1999), the analysis considers the entirety of clauses in the written agreements. The minimum time

series investigated across the sample firms was eight, the maximum 18 years. Additional data were drawn from interviews conducted with representatives of each franchising company, thereby permitting insights on the motivations for specific changes. The results show that the contracts altered frequently in material ways over a wide range of dimensions, including termination and monitoring rights. The interviews revealed that major modifications were not triggered in anticipation of changes in the magnitude of exchange risks (e.g., horizontal externalities) or as a result of changes in the business-format. They rather emanated as incremental responses to actual franchisee misbehavior in the day-to-day business.[81] Though the observed modifications can be rationalized ex post using agency-theoretic reasoning as steps to address obvious incentive misalignments, the backward looking nature of solving these problems was more consistent with theories of organizational learning, especially those emphasizing local experimentation (Cyert and March, 1963; Nelson and Winter, 1982). That is, franchisors continuously updated their contracting routines to incorporate the results of local search efforts triggered by actual problems encountered. Also, some evidence for vicarious learning from second-hand experience (e.g., Huber, 1991) was found, suggesting that embeddedness within a web of industry participants may be critical. Over time, then, contract structure in each chain increasingly reflected outcomes from past learning rather than anticipated design-outcome linkages as efficient contracting theories would imply.

In addition to offering a description of the nature of learning in the sampled chains, this chapter makes the following contributions. First, focusing on the franchising setting, this study contributes to the understanding of the reasons for agreements not being set up once-and-for-all. Since drafting contracts with independent entrepreneurs is the very task the franchisor is rewarded for (Shane, 2005: p. 189), the findings presented here corroborate the claim that boundedly rational actors cannot fully address exchange hazards ex ante, even if they expanded considerable search effort (Azoulay and Shane, 2001: p. 339). This explanation concurs with arguments based on excessive opportunity costs in allocating extensive attention to thinking about potential hazards and addressing these through contracts (Mayer and Argyres, 2004: p. 403). Second, this chapter identifies factors which determined the pace of contractual evolution. The role of new management and the influ-

[81] Note that there was also evidence in the data that franchisees learned how to better assure fair dealings of the franchisor. Hence, both principal and agents in franchising relationships may gain better knowledge over time how to safeguard their interests. However, in this entry to issues of learning to contract in franchising, interviews were only conducted with the franchise companies and not with representatives of the local stores. Therefore, the analysis is conducted primarily from the franchisor's perspective.

ence of franchisee councils are discussed in this regard. These factors may serve as starting points for future deductive analyses of learning processes in structuring franchising relationships. Third, implications for contracting theories are derived. The data indicate that bounded rationality and adjustment costs may hold explanatory power for the stickiness of different contractual variables. Also, the data imply that firms may learn about the effectiveness of private and public enforcement and ultimately choose between them. It also emerged from the case studies that parties not only care about the wording of provisions in terms of their enforceability in the courts. Rather, the terms of the agreement need to prevent opportunistic behavior by signaling severe punishment while at the same time guarding against a loss of credibility when it is not in the interest of the company to apply threatened sanctions ex post.

The chapter is structured as follows. First, efficiency-based perspectives on contracting are briefly sketched out (2.). Then, prior evidence on learning effects in drafting agreements is reviewed (3.). In the subsequent section (4.), the evolution of contracts in three chains is discussed. Next, I interpret the data using learning perspectives in particular (5.). After discussing the determinants of change (6.), implications for contracting are derived (7.). The last section concludes and draws attention to issues for future research (8.).

2. Efficient contracting theories

Transaction costs, property rights, and agency theory offer rationales to understand contractual design. These theoretical lenses situated within the efficiency branch of organizational economics unanimously maintain that the structure of legal documents reflects economizing purposes (see Kim and Mahoney, 2005). That is, contracts are drafted in such a way as to address specific exchange risks following from self-interest seeking, if not opportunism, including a failure to supply effort (shirking), misrepresentation of quality (adverse selection), insufficient contribution to the quality of outputs (cheating) and expropriation of rents from a partner's relationship-specific investments (hold-up).

Central to these positive, efficiency-based theories is the assumption that most people are farsighted in the sense that hazards are foreseen and factored back into the design of inter-organizational agreements. This assumption is thus also underlying analyses of incentives in franchise contracting, which are often framed in agency-theoretic terms (e.g., Brickley, 1999; Arruñada *et al.*, 2001). In essence, rational principals are assumed to be aware of individual contract terms' specific governance functions and to correctly antici-

pate the costs and benefits from their adoption. Since trading risks are solved in the best possible (i.e., efficient) way upfront, agreements never need to be revised given that exchange attributes do not change.

Though the emphasis is clearly placed on farsighted anticipation of malincentives, efficiency frameworks also acknowledge that not all contracts emerge in optimal forms, i.e., as theory would predict. Individuals and/or organizations may not be equally able to structure complex agreements, thereby creating variance even in the presence of identical exchange conditions (Williamson, 1991: p. 78). From the perspective of efficiency theories, suboptimal arrangements are then presumed to be quickly selected out by the environment (e.g., Jensen, 1983: p. 331). In equilibrium, only firms with appropriately designed contracts are observed in the marketplace (see, for evidence, Shelanski and Klein, 1995; Lafontaine and Slade, 1997) since those unfortunate enough to have selected bad practices do not survive for long. As a result of this strong emphasis on competitive pressures fostering efficacious selection, little room is provided for the analysis of adjustment processes triggered by learning.

Yet, slack financial resources may be one reason why firms are able to sustain inefficient structures for some time without being forced out of the market. Also, since feedback by the environment often relates to an aggregate performance measure rather than to the appropriateness of individual elements of the system (Winter, 1988: p. 177), such as single contract clauses, firms have leeway to adjust to past mistakes in future periods.[82] Efficient designs may then not only be observed because suboptimal agreements are selected out by market pressures, as claimed by efficient contracting theories, but also because initially flawed agreements can be readjusted over time. This does not mean, however, that allowing for adjustment categorically excludes failure. Path-dependencies may prevent a fraction of the population starting from unattractive initial conditions to reach an optimum (Cohen and Levinthal, 1990). Selectively, firms will also not be able to detect the sources of poor performance (Meyer, 1982). But what is important to note is that adjustment, regardless of the final outcome, may be observed where selection is not immediate.

In the next section, prior evidence on contractual adjustments which point to learning effects will be reviewed.

[82] This leeway is likely to be greatest during pre-shakeout periods of the industry life cycle (Argyres and Bigelow, 2004).

3. Prior evidence on learning to contract

Along with the persistent surge of inter-firm collaborations as a way to organize economic activity (e.g., Teece, 1992), organizational learning literature has been increasingly concerned with how partnering firms make progress in managing their exchange relationships over time. These efforts have been especially directed towards strategic alliances (e.g., Doz, 1996). Several studies have accumulated empirical support for prior alliance experiences with the same and/or other firms to increase returns to collaboration (Anand and Khanna, 2000; Zollo *et al.*, 2002; Sampson, 2005). The findings suggest that repeated participation in alliances enhances the allying firms' skill sets to effectively coordinate activities and to govern potentially conflicting business objectives. It thus appears from this literature that own past experiences made in the governance of between-firm relationships are an important source of organizational learning potentially translating into increased performance.

Contract design may be one mediating factor between acquired experience of how to work together and improved collaborative gains. Learning perspectives emphasize that contracts evolve over time not in response to changes in the underlying exchange risks per se (asset specificity, risks of free-riding on brand name, etc.), but rather in the course of observing behavior and perceiving effective incentive misalignments. Though the universality of this phenomenon across various settings, especially in franchising, remains to be systematically explored, some studies hint to the existence of learning effects in contracting. For instance, in the railroad industry, Pittman (1991) studied the evolution of several hundreds of agreements for the construction of sidetracks between the main line, owned by a railroad company, and the plant of shippers in the late nineteenth and early twentieth century. The author reported substantial changes in these contracts over time and pointed out that they occurred in response to opportunistic behavior and recurring litigations among the parties. Gompers and Lerner (1996) provided further evidence for contracting parties to learn about agency costs. In a work on the use of covenants in venture partnership agreements, they found that more severe restrictions on the deployment of investors' funds by venture capitalists were included as the market became more mature and experienced.[83] Reuer and Ariño (2002) studied the incidence of contractual change in an alliance context and reported that the likelihood of modifications was positively determined by governance misfit. Mistakes in the alignment of transactions with discrete structural governance alter-

[83] For recent evidence on learning in venture capital contracting, see Cumming (2005).

natives (i.e., equity vs. non-equity) were corrected once frictions became manifest. Similarly, Ryall and Sampson's (2003) analysis of technology alliance contracts revealed that these became more detailed with firms' alliance experience, reflecting learning to draft more complete contracts.[84] The most conclusive evidence on the nature of such learning processes was delivered by Mayer and Argyres (2004). Tracing a time series of 11 contracts between two partner firms from the personal computer industry, they observed incremental learning effects with respect to communication between the firms, codification of past experiences, and governance of opportunistic behavior. Instead of anticipating many problems, management had to experience adverse outcomes before addressing them in a new contract version; with the new clauses bringing about unanticipated side effects in turn. This gradual and slow learning on contractual design is consistent with evolutionary accounts stressing an incremental updating of routines (Nelson and Winter, 1982) as well as with concepts of problemistic search (Cyert and March, 1963). Actual problems experienced thus explained a great deal of contractual design at every given time. It is not clear, however, whether these contracting patterns generalize to franchising – the setting of this study – since franchising firms are usually considered experts at structuring their relationships to independent entrepreneurs.

Though the nature of learning processes in franchise contracting is unexplored, some evidence on the evolution of franchise agreements exists, especially with respect to monetary terms. Lafontaine and Shaw (1999) found in a large sample of franchise chains that the most important elements of the fee structure, namely the royalty rate, are basically invariant over time. Seaton (2003) corroborated these findings with data from the U.K. and additionally reported little changes in contract duration over the years. Finally, Azoulay and Shane (2001) documented from interviews with 16 founders of new franchise systems that some which had initially ignored the provision of exclusive territories adopted them later on. These authors also noted that while the stability of monetary contract terms has been subject to careful examination, "unfortunately, there is no evidence on the stickiness of other policies" (p. 341).[85] However, besides monetary terms, various other provisions such as those surrounding monitoring and termination are important governance instruments in franchising relationships (e.g., Arruñada *et al.*, 2001). With the detailed data presented in

[84] See, for the influence of repeated interaction between the same trading partners on contract structure, Corts and Singh (2004) and Kalnins and Mayer (2004b).

[85] Some evidence on changes in non-monetary provisions can be found in Dnes (1992: pp. 284-286). Detailed case study data from 19 networks showed that some implicit aspects of the dyadic relationships were later formalized. Yet, since the author's main objective was to explain the functioning of franchise contracts from a static perspective, no systematic analysis of the entirety of changes was provided.

the next section, I seek to further the understanding of dynamic aspects in franchise contracting.

4. Longitudinal evidence on franchise contracting

4.1 Methodology and research design

In order to gain insights of rich detail into the evolution of franchise contracts, a multiple case study approach was adopted (Eisenhardt, 1989b). As is well known, there are important drawbacks to case research. Problems include limited generalizability of findings and questionable validity of cause-effect relationships. Large sample questionnaire-based techniques would overcome these shortcomings. Conversely, however, they do not permit to gather information on theoretical constructs which are not well understood, as is the case with learning to contract in franchising. In the past, case studies have thus provided much of the data on contracting generally (e.g., Masten, 1996) and franchising specifically (Dnes, 1992; Bradach, 1997; Jacobsen, 2004). In this vein, Dnes (1996: p. 320) called for further case study research on franchise contracting.

Three Germany-based franchise chains were selected as the units of analysis. To enhance the generalizability of results, chains from different industries were sampled. PizzaBox (fictitious name) is a chain active in the home delivery of pizzas. SleepWell (fictitious name) is a chain of middle-class hotels. The third chain, HardTail (fictitious name), is a computer hardware retailer. These industries are theoretically interesting since problems of free-riding on the brand name are generally accepted to be severe as a result of a large fraction of nonrepeat customers (e.g., Brickley and Dark, 1987). A high emphasis should therefore be placed on issues of vertical coordination and formal safeguards.

Within these industries, PizzaBox, SleepWell, and HardTail were chosen specifically since they met the following two criteria. First, the three chains started franchising more than 10 years ago (as of 2005). A decade of experience laid the foundation to track the evolution of sequentially issued contracts over a relatively long time period such that adjustments at various points in the life cycle could potentially be observed.[86] Second, and relatedly, these chains displayed steady growth in the number of franchised outlets. This crite-

[86] Franchising involves sequential contracting on nearly identical exchanges with the chain's multiple entrepreneurs, with the latter differing mainly by location and marginally by size of the outlets. The contract versions studied do not mirror repeated contracting between any pair of dyadic partners.

rion assured that new contracts potentially varying in their design were continuously issued.

Table 12 provides descriptive information on the sampled firms. PizzaBox operates exclusively in Germany and is privately held. It sold the first franchise in 1987, just two years after it had been founded. By 2005, it operates 63 franchised outlets and no company-stores. SleepWell is the German master-franchisor of a U.S.-based hotel chain. By 1986, the first license was granted to a hotel in Germany. No company-owned hotels are operated while 70 franchised hotels exist by 2005. HardTail gained its first franchisee in the same year (1991) as the company was founded. By 2005, it operates 104 franchised stores in Germany (and some abroad) and is publicly quoted at the national stock exchange since 1999. No company outlets are operated. All three chains survive as of 2005.

Company	Activity	# of franchised units (in 2005)	Year of founding	Year first franchising
PizzaBox	Pizza home delivery	63	1985	1987
SleepWell	Hospitality services	70	1986	1986
HardTail	Retailing of PC hardware components	104	1991	1991

Source: Company interviews

Table 12. Descriptive information on sampled franchising firms

The different contract versions employed by each franchisor at least once over the years were the primary sources of data. A time series of 12 versions since the first contract in 1987 up to the most recent in 2005 was made available by PizzaBox.[87] Five different issues covering the years 1994 through 2003 built the basis for the analysis at SleepWell.[88] SleepWell had no access to earlier versions itself since ownership of the master-franchise for Germany changed in 1994. The first contract from HardTail dates back to the year 1997 while the last was used in 2005, reaching four in total.[89] HardTail was not willing to provide the early agreements for reasons of ongoing litigation with franchisees. Though the

[87] The different contract version are referred to in the following as: PB#1987; PB#1989; PB#1990; PB#1991.1; PB#1991.2; PB#1998; PB#2000; PB#2002.1; PB#2002.2; PB#2003; PB#2004; PB#2005. One contract, issued to a multi-unit franchisee, was excluded. Since the incentive structure of franchisees owning more than one outlet is different from those of single-unit owners (e.g., Garg *et al.*, 2005), contracts could differ between these groups and bias the analysis.
[88] These are denoted SW#1994; SW#1998; SW#1999; SW#2002; SW#2003.
[89] HT#1997; HT#1998; HT#2000; HT#2005

focus was on the formal contracts per se, the standard operating manuals were also considered as additional sources of information.

Furthermore, data were obtained from interviews conducted with chains' representatives during the summer and fall of 2005. At PizzaBox, I interviewed the CEO of the company who declared to be the sole responsible for any issues concerning the written contracts. The CEO started his career as one of the first franchisees of the chain. He later became a regional store checker (quality control, management advice, etc.) for account of the company. By the end of 2001, he bought out the former owner of the system. With his track record, the CEO was fully aware of any issues regarding the network's evolution, including contracting. At SleepWell, the person responsible for contractual changes in the German office was interviewed. In addition, I interviewed two employees responsible for contract design with the U.K. master-franchisor. The U.K. office channeled communication of European offices with the U.S. parent company whose legal department had the final approval rights for all contracts worldwide. At HardTail, interviews with several people were necessary for knowledge about specific changes was dispersed throughout the company. In total, four (non-owner) employees of the chain were interviewed. Though no interviews were conducted with franchisees, the data should paint a large part of the franchise contracting picture. This is because agreements are seldom subject to bargaining but are offered on a take-it-or-leave-it basis.

The interviews were semi-structured. A standardized case study protocol (Yin, 2003) for all three chains was employed (see Appendix E). It covered the background of the company, reasons for franchising, means of contract enforcement, as well as sources of, and solutions to, conflicts. Specific questions were tailored to the contract changes in each chain and solicited descriptions of events leading up to each modification. Combining interviews with written documents helped to ensure the validity of findings (Jick, 1979).

4.2 Contractual evolution at PizzaBox, SleepWell, and HardTail

Analyses of the contracts revealed significant changes from one version to another for all three chains in the sample. Major modifications fell into the categories termination and non-renewal (4.2.1), monitoring (4.2.2), payment of fees (4.2.3), exclusive dealing (4.2.4), sources of supply (4.2.5), vertical price controls (4.2.6), other vertical restrictions (4.2.7), as well as training (4.2.8). The evolution of the fee structure (4.2.9) and of contractual complexity more generally are also discussed (4.2.10). Table 13 displays selected changes in each category.

Contract clause	Company	Adopted in version
Termination		
Contract duration of five years	PizzaBox	PB#2002.1
Missing official registration of business	PizzaBox	PB#2005
Non-compete covenant	PizzaBox	PB#1998
Provision of severance payments to harmed party	SleepWell	SW#1998
Monitoring		
Deadline for transmission of franchisees' monthly sales reports	PizzaBox	PB#2002.1
Deadline for transmission of franchisees' monthly sales reports	HardTail	HT#2005
External auditing of yearly income statement required	HardTail	HT#1998
External auditing of yearly income statement required	SleepWell	SW#1999
Franchisor right to approve regional advertising	SleepWell	SW#2003
Payment of fees		
Non-payment defined as two monthly fees being due	PizzaBox	PB#2002.2
First royalty payment due for opening month	HardTail	HT#1998
Stipulation of average expected franchisee sales	SleepWell	SW#2003
Exclusive dealing		
Explicit prohibition to sell other than listed products	PizzaBox	PB#2002.1
Sources of supply		
Period of three weeks to match non-listed suppliers' offer	PizzaBox	PB#2002.1
Prohibition to purchase from black-listed suppliers	HardTail	Standards and Guidelines 1994, 1998, 2001, 2005
Vertical price controls		
Right to set maximum resale price	PizzaBox	PB#2002.2
Other vertical restrictions		
Cooperation preamble	PizzaBox	PB#1989
Affirmation about validity of rooms indicated	SleepWell	SW#2003
Restriction to transfer Internet domain	SleepWell	SW#2003
Duty to exercise brand rights personally with full effort	SleepWell	SW#2003
Maintenance of software at own costs	SleepWell	SW#2003
Installation of luminous advertising at own costs	SleepWell	SW1998
Training		
Duty to attend national gatherings	PizzaBox	PB2002.1
Duty to attend management trainings	SleepWell	SW#1998
Duty to attend meetings	SleepWell	SW#2003
Duty to participate in yearly written exam	HardTail	HT#2005

Source: Franchisors' contracts

Table 13. Selected contract modifications

4.2.1 Termination and non-renewal

Termination rights serve to enforce franchisees' obligations without relying on the courts of law for interpretation of behavior (e.g., Arruñada *et al.*, 2001: p. 261). Contract duration is also important in this regard since mid-agreement termination is severely constrained by German law (see B-I.). Franchisors therefore have to rely on the threat of non-renewal – which is more immediate the shorter is contract duration – to punish and therefore deter opportunistic behavior (e.g., free-riding on the brand-name). Contracts issued by PizzaBox displayed major modifications concerning termination over time. The observed changes reflected efforts to enhance enforceability of appropriate downstream operations. For instance, after realizing that the threat potential of a 10 year contract was relatively low, PizzaBox reduced the duration to five years (PB#2002.1). As the CEO explained: "With a 10 year contract, I have no means to put someone in his place".[90] More recently, PizzaBox reserved the right to terminate the agreement if franchisees fail to officially register their business with state authorities (PB#2005). This clause was triggered by a court case involving another chain. Since no statutory franchise law exists in Germany, a missing official registration of the business allowed a franchisee to be classified as an employee. In consequence, he was granted severance from the company upon bankruptcy of his own outlet.

PizzaBox also changed the conditions prevailing after the contract had expired or been terminated. In particular, a non-compete covenant was put in place (PB#1998) after two former franchisees left the chain to compete in the same product market. Each of these former channel members founded their own network with either ultimately growing bigger than PizzaBox in terms of the number of outlets. At SleepWell, adverse litigation experiences led not only to the stipulation that the contract can be unilaterally terminated in case of misconduct, but that franchisees also have to compensate the company for any harm caused (SW#1998). Ultimately, this clause increases the costs from being terminated and thus makes deviations less attractive.

[90] This observation lends further support to the notion of self-enforcement in franchising (Klein, 1995; Lafontaine and Raynaud, 2002). It is in contrast, however, with Bradach (1998: p. 218) who found that termination – or the threat thereof – was rarely used in franchising (see Blair and Lafontaine, 2005: p. 269 fn. 309 for a reconciling view).

4.2.2 Monitoring

Monitoring rights are essential for franchisors to control whether, as well as to assure that, outlets follow through with obligations (e.g., Arruñada *et al.*, 2001: p. 261). Management at the three sampled firms modified a number of these rights over time. Specifically, it emerged as a cross-case pattern that the firms were continuously improving the effectiveness of existing monitoring processes. At PizzaBox, a clause asking for monthly transfer of sales data from franchisees to the company was complemented (PB#2002.1) to then include the precise deadlines at which the transfer had to take place. Fixing precise deadlines in the contract allowed management to exert more pressure on those running chronically late with transmission. A similar observation was made for HardTail. As of HT#2005, stores had to report sales for the previous month until the third day of the following month. No exact deadline had been fixed in earlier contract versions, providing leeway to postpone transmission and thus payment of fees. To assure that the transmitted information was accurate, HardTail (HT#1998) and SleepWell (SW#1999) also included requirements for franchisees to let approve their yearly income statements by an external auditor.

Franchisors were also expanding the scope of their monitoring rights over downstream operations. For instance, SleepWell claimed the right to approve regional advertising and promotion as of SW#2003 after experiencing that control over these downstream activities had been too low. At one instance, the master-franchisor changed the appearance of logos. This modification brought about costs for franchisees. Some hotels were thus reluctant to adhere to the new policy. As a response, the contractual right to enforce such requests via approval of advertising (which includes logos) was designed.

4.2.3 Payment of fees

Franchisors earn most of their revenues from royalties on outlets' gross sales. It is therefore crucial to design mechanisms which assure accurate and timely payment of fees (Shane, 2005: p. 88). The data shows that chains were making steady progress as to the effectiveness of these mechanisms. PizzaBox experienced over time that "some people think that other issues [besides payment of royalties] are more important" (Interview 07/26/2005). The fraction of people repeatedly delaying payment was considerable and amounted to nearly a quarter of the chain's franchisees. As a result, the company had to devote considerable resources to writing reminder notices and negotiating. Even though refusal to pay was a cause for termination since the first contract version in 1987, it was only as of 2002 that contracts addressed the issue more specifically. As of PB#2002.2,

non-payment was defined as two monthly fees being due. Since non-payment was lacking a proper definition prior to that, franchisees could always negate a case of non-payment by promising payment for the near future. Similarly, only as of 1998 did HardTail explicitly state that royalty payments are due as of the very first month after store opening (HT#1998). SleepWell was equally exposed to difficulties in collecting fees. One hotel, for instance, refused to supply monthly sales reports which build the basis for calculating royalties. The case was eventually disputed in court. As a result of this experience, contracts henceforth (SW#2003) stipulated an average expected sales level. This figure serves as the basis for calculation in case the hotel refuses to supply sales figures.

4.2.4 Exclusive dealing

Exclusive dealing of products and services of the franchisor by the outlets ensures chains' incentives to invest in the trade name for returns do not additionally accrue to other brands (Shane, 2005: p. 87). PizzaBox demanded exclusive dealing as of the first contract (PB#1987). It specified that the right to use the brand name was tied to the products listed by the company in the addendum, which figured the restaurants' menu. However, the prohibition to sell other goods was not explicit enough from the outset and "people started to sell (…) ice cream and other things" (Interview 07/26/2005). To clarify this issue, the company added a clause to one of the recently issued contracts (PB#2002.1) stating that "other than the listed products must not be sold by the franchisee".

4.2.5 Sources of supply

Controlling sources of supply is a key policy variable to guarantee quality standards at the outlets (Shane, 2005: p. 86). Though PizzaBox was aware of the importance to limit the choice of franchisees' inputs, it had not always been particularly successful in enforcing these limits. In the contract, a list of approved suppliers was mentioned. To accommodate legal requirements, restaurants had the possibility to purchase with other suppliers if these were to offer a better priced product of comparable quality. PizzaBox had a two-week period to match the non-listed supplier's offer. This, management thought, would provide leeway to effectively control every input used. Yet, the company recognized that two weeks were too short a time period to match offers. Eventually, the period was extended to three weeks (PB#2002.1).

HardTail equally experienced problems in effectively controlling sources of supply and repeatedly changed the prohibition to purchase resources from black-listed suppliers enu-

merated in the standards and guidelines section of the agreement. For instance, Standards and Guidelines (1994) specified that "partners attracting attention through purchases of such kind cannot expect to get the full support of HardTail." The next version (Standards and Guidelines, 1998) was more explicit with respect to the consequences of such purchases: "No business must be done with these [suppliers]. Violation of this stipulation will trigger a contractual penalty." In the Standards and Guidelines (2001), then, reference to a contractual penalty was omitted again and replaced by: "In no case, do make purchases with these suppliers, regardless of the attractiveness of their offers." This formulation was kept in the Standards and Guidelines (2005) but was complemented with the warning that "you risk a contractual penalty". These contractual changes are further explored below.

4.2.6 Vertical price controls

Vertical price controls allow franchisors to solve disagreements with franchisees about price levels to their advantage and to limit the price dispersion within the chain (Blair and Lafontaine, 2005: chapter 7). Generally, franchisees (maximizing the profits of their outlet) seek to set prices which lie above the level desired by the franchisor (interested in maximizing outlets' sales). This was precisely the case at PizzaBox as outlets in one region of Germany continuously raised price levels over an extended period of time. To deal with the high price levels and to limit the dispersion in prices across stores, PizzaBox management modified the contract (PB#2002.2) thereof reserving the right to set a maximum resale price on specific products.

4.2.7 Other vertical restrictions

The analysis of contracts provided by PizzaBox and SleepWell also revealed changes regarding terms not falling in either of the categories above. For instance, very early on in the life cycle of PizzaBox, litigation between the company and a franchisee triggered the adoption of a preamble stating the following: "Despite a dynamic relationship subject to tensions, the parties always seek to balance their interests" (PB#1989). Preambles can be used by courts as starting points to judge about the nature of the relationship between the parties (Schanze, 1991: p. 94). A similar clause requiring honest dealings was introduced by SleepWell in SW#2003. This version of the agreement explicitly asks franchisees to affirm that the number of rooms indicated in the contract corresponds to the facts. The company added this provision since some hotels under-reported the number of rooms operating under the brand.

Concerning protection of this brand, SleepWell lately included a restriction on the transfer of brand elements to other uses. Specifically, the transfer of system-specific Internet domain names was restricted as of SW#2003 after a franchisee was unwilling to abandon a site containing the trade name of the chain upon contract expiration. Also, a duty for the franchisee to exercise brand rights personally and with full effort was added (SW#2003). This latter stipulation is an important device to reduce franchisees' opportunity costs of effort investments in the business (Brickley, 1999: pp. 750-751).

The company also intended to clarify the distribution of costs between hotel-owners and the company more clearly by requiring that the reservation system software be maintained and updated at the expense of the franchisees (SW#2003). Furthermore, some hotels were reluctant to install luminous advertising at the exterior of the building. In response, SleepWell specified in the contract (SW#1998) that these ads had to be installed at own costs by franchisees.

4.2.8 Training

Trainings, seminars, and meetings are vehicles to transmit the franchisor's tacit knowledge about operations to franchisees and/or to foster socialization within the network (Shane, 2005: pp. 106-111). A common skill set across channel members is also necessary for uniformity in production. Since the associated costs are often charged to the downstream partners, these may, however, be unwilling to attend seminars and meetings to the extent demanded by the company. There are not only direct (e.g., travel expenses) but also opportunity costs (e.g., lost business) involved. At PizzaBox, a majority of franchisees repeatedly failed to attend national gatherings organized by the company. In response to high rates of absenteeism, management specified participation in meetings as a contractual duty as of PB#2002.1. In a similar vein, obligations to participate in management trainings (SW#1998) and meetings (SW#2002) have been introduced by SleepWell. After conflict about the allocation of costs, the chain later included a specific clause specifying franchisees to bear the costs from seminars (SW#2003). HardTail recently added a provision requiring franchisees to participate in a yearly written exam (HT#2005). Outlet-owners should thus have a higher incentive to invest in education (foregoing adverse effects from failed exams) thereby contributing to the reputation of the chain.

4.2.9 Fee structure

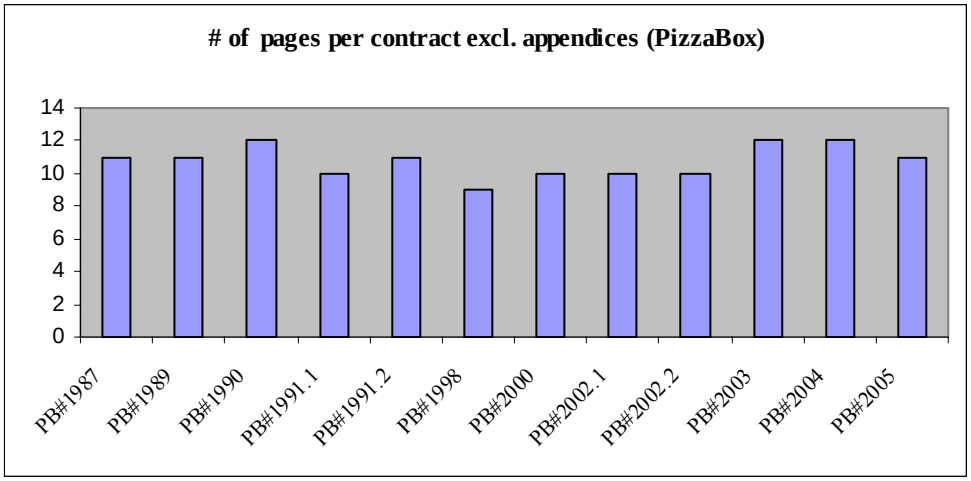
There were also changes with regard to the fee structure. PizzaBox, for instance, started with a royalty rate based on a percentage of sales. In the mid-nineties, all of the chain's outlets were experiencing declining sales and the CEO decided to fix a flat monthly payment. After the new CEO came in, he reverted to a percentage-based sales royalty again. Thus, these modifications were triggered by changing economic conditions rather than by experience of how to work together.

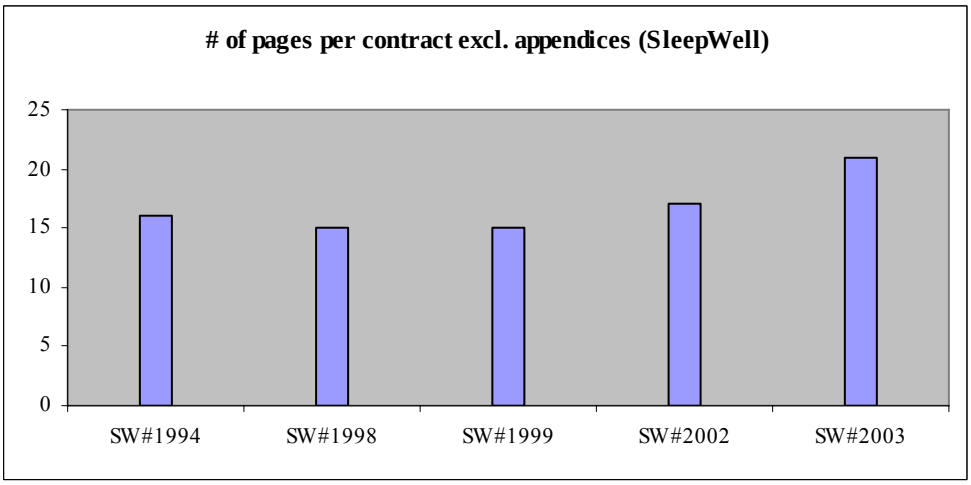
PizzaBox experimented with its income structure more generally. Initially, the chain leased the buildings and sub-leased to franchisees. Restaurant-owners were paying more than the company did to the landlord. The franchisor considered income from the lease an important building block of the business model until a court decided that the sub-lease must be in a fair proportion relative to the lease. It basically meant for PizzaBox that it could not earn enough from the sub-lease to make up for the risk of continued lease payments in case the franchisee abandoned the business.[91] These learning processes were not obviously related to the governance of exchange hazards but rather concerned the way PizzaBox earned money.

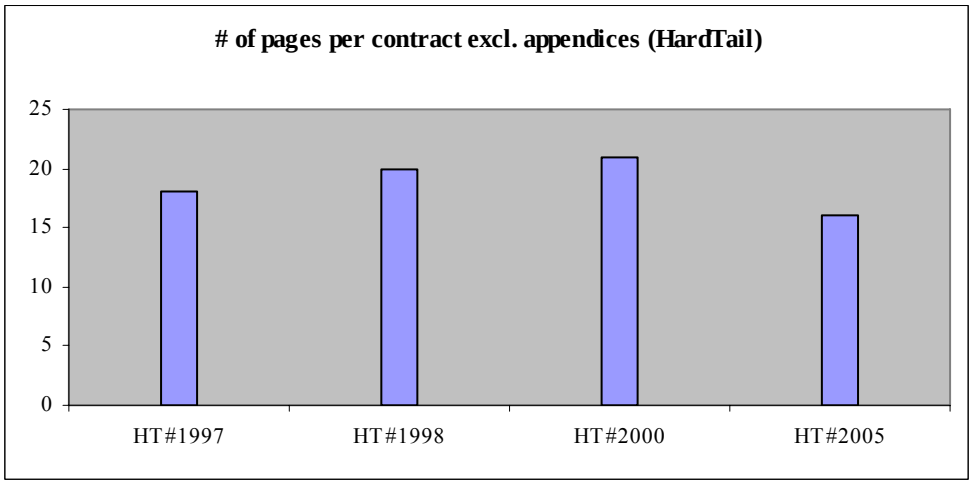
4.2.10 Contractual complexity

Though the extensive changes documented above suggest that the legal documents became more complex over time, the data does not support this claim when using conventional measures of complexity, such as the number of contract pages (e.g., Poppo and Zenger, 2002: p. 717). Figure 5 shows that the length of the contracts remained fairly stable over time. The figure excludes addendums since the modifications discussed above did show up in the main body of the agreements. While important for incentive alignment, the changes were thus marginal in terms of contractual complexity. However, it should be noted that the number of appendices at all three chains increased with new contracts. For instance, while SW#1994 contained two appendices, SW#2003 had eight. These were supplementary agreements surrounding, for instance, the central reservation system.

[91] The interviews suggested an additional rationale for abandoning sub-leases. If the franchisor controls too many aspects of franchisees' business, courts are generally reluctant to consider franchisees as independent entrepreneurs. This is because, then, outlets do not have much leeway to influence their fait by own decisions. As a result, the franchise company must assume responsibilities for the stores and franchisees are treated similar to employees with all accompanying rights (e.g., severance in case of bankruptcy). This example illustrates how the existence or absence (as in Germany) of statutory franchise laws shapes franchisors' business models and the structure of contracts – a promising area for future research (see, also, Pfister *et al.*, 2004).







Source: Franchisors' contracts

Figure 5. Evolution of contractual complexity

5. Interpretations of the data

5.1 Learning about efficient contracting

The prior section revealed that the sample firms modified the structure of the written agreements over a wide range of different contracting dimensions. The elements which were redesigned, added, or removed clearly served the aim of reducing the costs, mainly for the principals, from inconsistent objectives. Modifications to monitoring and termination rights, but also to sources of supply and modes of fee payment followed from this rationale, as were the precise specifications on the allocation of costs for training, seminars, maintenance of software, etc.[92] Any version of the legal documents reflected the focal franchisor's knowledge about efficient contracting at that time. As viewed from an evolutionary economics perspective (Nelson and Winter, 1982: pp. 17-18), franchisors continuously embodied the fruits from prior experiences into the routines used in contracting. Contracting routines were retained or adapted based on their actual success. As incentive misalignments became apparent, the companies addressed these issues in later versions of the agreement.[93] The objective of change then was clearly to more effectively govern franchisee behavior in the future. Because uniform selection criteria (e.g., Jambulingam and Nevin, 1999) assure that downstream channel members within any network are quite similar in terms of management skills, business objectives, incentive responsiveness, and so forth, knowledge from contracting practices with prior outlet-owners could easily spill over to prospective candidates.

The speed at which experiences changed contract structure was fairly incremental. Problems within present relationships were addressed one-by-one in the agreements concluded with subsequent franchisees. Reflecting a pattern of problemistic search (Cyert and March, 1963: pp. 120-121), encountered frictions triggered a local search for specific solutions which then resulted in learning about these solutions. As a result of searching locally

[92] The companies also made progress how to coordinate business activities with the outlets more generally (communication via intranet, etc.). But the contracts did not come to embody, e.g., for repository purposes (Mayer and Argyres, 2004: pp. 405-407), this knowledge. The function of contracts as knowledge repositories of how to work together may be less important in franchising than in other inter-organizational relationships, such as in learning alliances set up in an ad hoc-fashion (e.g., Lane and Lubatkin, 1998). Generally, basic roles and responsibilities of the upstream and the downstream firms follow closely from the standardized nature of the franchising organizational form. The main purpose of franchise contracts therefore seems to be their governance function.

[93] It is not obvious from the data that chains perceived franchising in the course of these experiences to become less attractive compared to company ownership of outlets since they continued to rely exclusively on franchised stores.

in areas highly related to existing practices, the parties did not always find immediate solutions to some of the incentive problems.[94] For example, though HardTail realized the need to restrict purchasing from black-listed suppliers, management searched quite unsuccessfully for the right wording in the standards and guidelines (see below). In fact, none of the chains reached stable provisions even after a decade of franchising practice. Thus, as franchisors issued new versions of the agreement, contract structure could increasingly be understood as a result of trials and errors and decreasingly reflected cognitive foresight about design-outcome linkages. Contracting at these chains sharply contrasts, therefore, with predictions derived from efficiency-based theories about ex ante once-and-for-all contracting. Corroborating earlier evidence (Mayer and Argyres, 2004), these findings, I suggest, hint to processes of experiential learning associated with contracting.

Previous research has pointed at excessive opportunity costs involved in allocating time to thinking about potential contingencies to explain the gradual nature of contractual adaptation processes (Mayer and Argyres, 2004: p. 403). In franchising, however, the opportunity costs of searching for efficient contract design should be relatively low. First, contracting with local entrepreneurs is the very task of the franchisor for which he is ultimately rewarded.[95] Second, exchange hazards in distribution channels are well known (e.g., free-riding) and discrete contract clauses which address these problems at least partially are easily drafted (exclusive territories, restrictions on sources of supply, etc.). The data rather suggest that "entrepreneurs (…) do not necessarily know what they are ignorant about" and what information they would need to search for to draft better contracts (Azoulay and Shane, 2001: p. 355). For instance, it is likely that obvious practices such as stores selling ice cream were detected by PizzaBox management prior to effectively requiring exclusive dealings in PB#2002.1 (see above). But the brand diluting effect of stores selling third-party products was apparently not perceived for a relatively long time. Hence, the data make a strong case for bounded rationality to be a main reason for the incremental learning processes observed. That is, managers seem to only slowly acquire information necessary to assess the variety of adverse outcomes with observed behavior.

Although the vast majority of modifications resulted from own experiences, managers also profited from those made by others – a form of knowledge acquisition referred to as vicarious learning (e.g., Huber, 1991: p. 96). PizzaBox requiring franchisees to officially

[94] This observation is in line with empirical evidence on the local nature of search efforts found in other contexts (e.g., Podolony and Stuart, 1996).
[95] As a franchisor, Shane (2005: p. 189) argued, "you are in the business of franchising, not in the business of serving customers in the industry in which your franchisees provide a product or service".

register their businesses as of PB#2005 resulted from this type of learning (see above). The CEO of PizzaBox learned about the court case which motivated this clause through personal acquaintances in the industry. This suggests that the diversity of contacts within a web of industry participants (competitors, consultants, etc.) may play an important role to gain fine-grained information relevant for efficient contracting. Substantiating this proposition, McEvily and Zaheer (1999) documented that the embededdness in a network of external ties is a critical source of firms' competitive capabilities. SleepWell, in turn, profited strongly from the experiences of the group's other master-franchisors across Europe and the U.S. The company incorporated elements of the contracts from the U.K. and made adjustments for specificities of German law. Though chains acquired some information through second-hand experiences, modifications did *not* follow from blind imitation of successful competitors or common practice in the industry (see Haunschild and Miner, 1997).[96] As opposed to the U.S., where the Federal Trade Commission has demanded disclosure of franchise contracts since 1979, agreements are not publicly available in Germany and are therefore difficult to copy.[97]

5.2 Alternative theoretical explanations

At first sight, orthodox theories applied to contracting might offer an explanation unrelated to learning for the observed evolution of the agreements: Contractual modifications were only implemented when a new unit was added to the existing network (i.e., the data do not reflect repeated contracting between any pair of dyadic partners). Enlarging the network increases the importance of horizontal externalities rendering free-riding on the brand more profitable for franchisees. As a result, franchise companies would be expected to impose more severe restrictions on the dealers' behavior – as actually displayed in the data – by claiming more monitoring and termination rights, specifying constraints on sources of supply, and so forth. Empirical studies have found strong cross-sectional support for this positive relationship between system-size and vertical restrictions (e.g., Bercovitz, 2000; Arruñada *et al.*, 2001). Yet, this incentives-based theory would imply that franchisors add further restrictions to each new contract without experiencing problems with existing outlets because externalities increase only after the new outlet has gone operational. Basically,

[96] Interviews revealed that the companies also did not use experiences acquired in contracting with third-parties (e.g., suppliers) in the design of the franchise agreements. For an analysis of how the structure of franchise contracts may be affected by transactions undertaken by the franchisor with other firms, see Azevedo and Silva (2005).

[97] At the same time, missing requirements for disclosure may foster contractual adaptation processes since no transaction costs in filing new contracts with authorities are incurred.

existing perspectives on contracting would predict that franchisors know about system size as a parameter shifting the risk of downstream opportunism and adjust to these hazards ex ante. The contracting pattern in the data suggests, however, that modifications were introduced *after* insufficient incentive alignment had become apparent. This process is clearly inconsistent with efficient contracting theories as articulated above. This is not to say that incentives-based theories relying on agency reasoning cannot ex post rationalize specific terms added to the agreements. But the notion of learning is still required to explain how the necessity of some specific terms came to the mind of management.

Another rationale which might be invoked to explain the pattern in the data follows from property rights theory (Grossman and Hart, 1986). From this perspective, the observed tendency towards broader franchisor control rights over time (e.g., the right to approve regional advertising introduced by SleepWell in SW#2003) might reflect increases in the importance of the franchisor's effort. Specified control rights restrict franchisees' residual rights from outlet ownership (see, generally, Elfenbein and Lerner, 2003: p. 358). Specific rights thereby protect the franchisor's relationship-specific efforts (expenditures for screening applicants, management assistance to outlets, investments in partner-specific trust, etc.) to be deployed in ways countering the company's business objectives. As a result, firms have an increased incentive to commit these resources in the first place. However, the interview data did not unambiguously support the claim that franchisors' inputs became more important over the sampling period. In any case, the clear association of adverse experiences in prior relationships with the remedies introduced in subsequent versions of the contracts does not conform to the assumptions made in property rights theory, namely that the parties correctly anticipate the downside of different allocations of residual control rights (Hart, 1995: p. 32).

5.3 Modifications of business-formats

Over the study period, there were no significant modifications of the business-formats used by the chains which could have affected the relationship between the companies and their franchisees. Of course, the product line at HardTail was keeping pace with technological innovations. Shifts in technology did not, however, influence the distribution of basic roles and responsibilities in the channel. HardTail was also changing its selection strategy. Whereas the franchisor relied on existing retail outlets in the beginning, it sought franchisees with no experience in hardware retailing later on. These modifications in selection policy did affect contract structure to some degree. For instance, since relying on non-

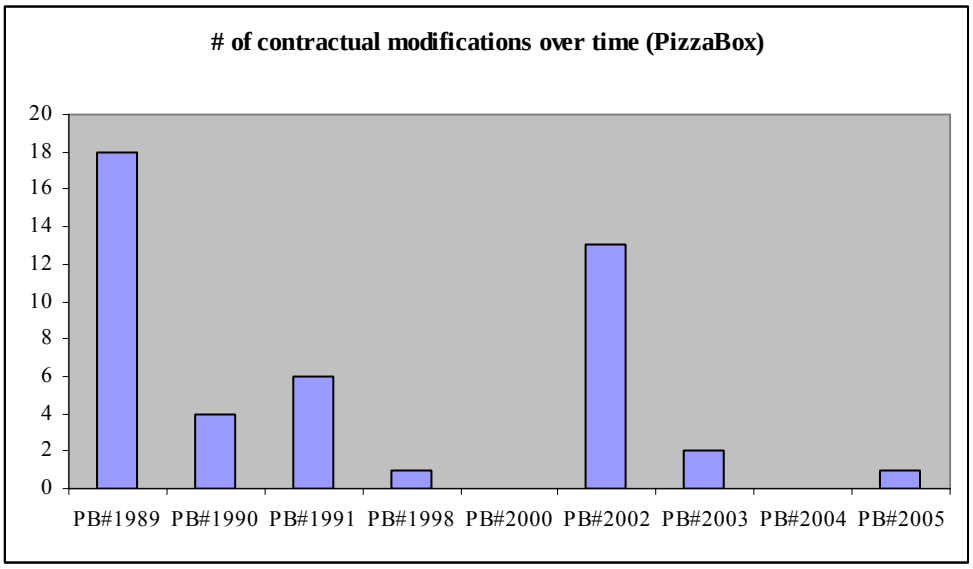
experienced outlet-owners necessitates more training, the required initial training days extended from four (in HT#1997) to 11 as of 2005. It emerged from the interviews that no other contractual elements were impacted. No fundamental changes were occurring at the other two chains.

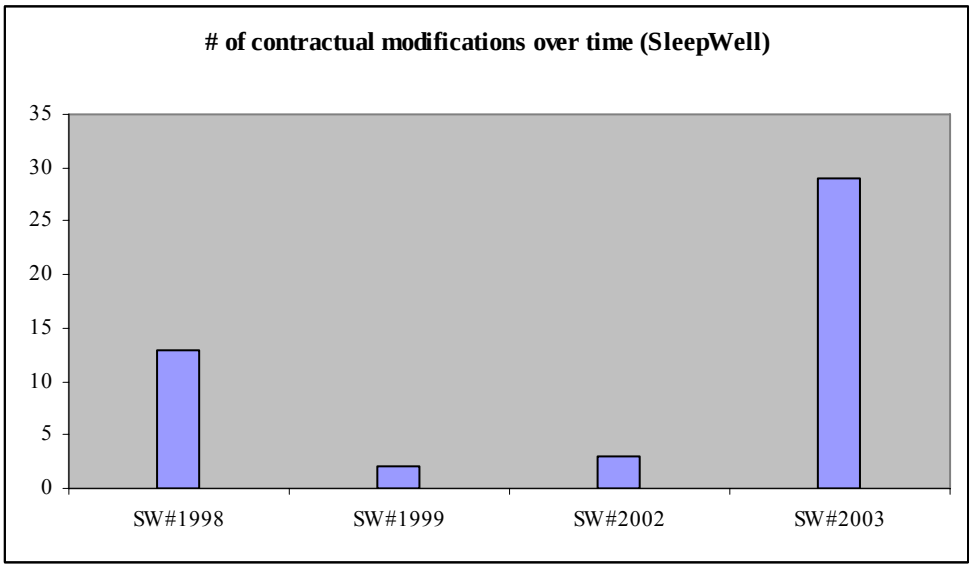
6. Drivers of contractual change

6.1 The role of new management

An interesting finding is that new management was driving contractual change, both at PizzaBox and SleepWell. Figure 6 shows that the highest number of modifications at PizzaBox was observed in PB#1989 (relative to PB#1987). The interview data suggest that management made intense adverse experiences with the first contract (PB#1987) and addressed problematic issues in the next version of the agreement (PB#1989). As of then, however, the number of modifications steadily declined (PB#1991 interrupting this trend) until no changes were eventually made to PB#2000 (relative to PB#1998). By the end of 2001, the new CEO, a long-time franchisee of the chain, bought out the former owner of the brand rights. The figure shows that in the first year following the buyout, the number of changes suddenly surged again. During the interview, the new CEO explained that „as I took it [the business] over in 2002, I made a true cut" (Interview 07/26/2005). After 2002, the figure displays a similar decline in the number of modifications as observed in the years following the first "big wave" of changes in PB#1989.

Figure 6 also shows a sudden increase in the number of changes for SW#2003 (relative to SW#2002). In 2001, responsibility for negotiation with prospective franchisees was delegated to an employee joining the German office at that time. The interviews revealed that the importance of contract design came to the new employee's attention when first engaged in negotiation with a new hotel in 2002. Fundamental questions arose as to different parts of the agreement. In an effort to clarify the issues, the agreement was compared to the contracts used by the master-franchisor in the U.K. While still designed to accommodate the German legal requirements, a host of stipulations was effectively copied into the national agreements (e.g., prohibition to participate in central reservation systems of third-parties). The German master-franchisor thus built on experiential wisdom from other members of the group. In an interview, a representative of the U.K. office explained that most of these provisions copied to SW#2003 were already in use in the U.K. for a long time.





Note: Number of contractual modifications over time per chain. Changes made to PB#1991.1 and PB#1991.2 were added to form PB#1991. Similarly, PB#2002 comprises PB#2002.1 and PB#2002.2. Source: Franchisors' contracts

Figure 6. Contractual modifications over time

Though the legal department at the U.S. headquarters required contracts to be updated and compared to each other regularly, employees in the German office were not following through with this obligation. When interviewed about the reasons for this omission, the new responsible forwarded reasons which are well captured by agency theory's notion of effort-aversion.

Incentives of the new management at PizzaBox to search for better design are obvious. The new CEO bought the chain since he thought it was under-valued under the former management. He made use of his long-time experience as a franchisee of, and store checker for, the chain to redesign, add, or remove a number of clauses. Changes to the contracts were thus part of an effort to increase the value of the whole network. As owner of the brand rights, all surpluses directly accrued to the CEO thus providing motivational incentives. From an agency-theoretic perspective, it is less clear, however, why the new responsible for contract design at SleepWell engaged in the search for solutions to a larger extent than the predecessor. Strictly speaking, agency theory would imply that incentive systems had changed – which they did not. Yet, another factor directly shaping the propensity to act is stressed by organizational learning literature, namely the awareness of alternative solutions (e.g., Miller and Chen, 1994: p. 3). It may thus be argued that new management shifts the cognitive frame – i.e., beliefs about action-outcome linkages – applied to contracting, thereby also enhancing subsequent adaptation because attention is paid to aspects which were neglected under the previous cognitive representation (Gavetti and Levinthal, 2000). The observed effect of such shifts resounds Williamson's (1985: p. 130) description of how inefficiencies are removed where market pressures do not operate quickly: "Where incumbent managements are not pressed to adopt the new procedures by economic events, successor managements, often in conjunction with the appointment of a new chief executive, commonly will".[98] New management may thus play an important role in favoring post-birth adaptation of contracts thereby weakening the effects of initial conditions on organizational survival (e.g., Hannan and Freeman, 1977).

6.2 The influence of franchisee councils

One major reason for the lack of attention given by literature to contractual evolution in franchising might stem from the assumption that companies cannot differentiate between the terms governing the relationship to franchisees joining the system at different points in

[98] See Jensen (1993) on the role of buyouts in driving out inefficiencies.

time. Accordingly, uniform provisions across all outlets accommodate concerns for equity, economize on transaction costs in customization, and reduce the risk of franchisor moral hazard (e.g., Bhattacharyya and Lafontaine, 1995). Indeed, one of the chains studied, namely HardTail, was seeing a need to set up homogeneous agreements with all franchisees of the chain, independently of when they entered the network. As one representative explained, restricting rights of one outlet more than that of others would "create dispute and quarrel within the group" (Interview 07/07/2005). In an effort to prevent governance differentiation (Argyres and Liebeskind, 1999), HardTail updated, subject to renegotiation, existing contracts to then incorporate the conditions agreed upon with new franchisees. This process of renegotiation was intensely mediated by the chain's franchisee council.

Even though contractual modifications at HardTail were not impossible, they were, I conjecture, more difficult to effectuate than without a franchisee council in place. Institutionalized bodies may, through their collective bargaining power (see B-III.), negotiate more favorable terms than would be reached if the parent corporation made a simple take-it-or-leave-it offer to prospective outlet-owners while renegotiating existing contracts bilaterally. Within this logic, Stanworth (1995: p. 170) concluded from his study of four franchise companies that "some franchisees believed the effect of the association had been to achieve a more favorable contract than would have otherwise been the case". Hence, councils might impede the franchisor's ability to unilaterally incorporate learning effects into new agreements.[99]

Given that franchisee councils may prevent firms from effectively carrying out contractual changes they deem necessary, the question arises why councils are allowed by the principal. It could be argued that firms do not anticipate the shifts in bargaining power associated with these bodies. This explanation is unsatisfactory, however. In the interest of the network's long-term viability, franchisors are often deeply involved in the set-up of councils in order to self-commit to honest behavior (see B-III.). Thus, franchisee councils may be initiated and financed by chain headquarters – which they often are –, precisely because of anticipated shifts in bargaining power to favor the downstream partners. If companies are aware of these shifts, it can be speculated that they invest more resources

[99] The above argument assumes that if the company applies uniform versions throughout the chain, then franchisee councils moderate the extent to which the company can incorporate changes in the agreement. This is because by collectively confronting the franchisor, councils increase the bargaining power of the downstream firms. Another perspective suggests that councils are also an antecedent to uniformity requirements in the first place. For instance, the institutionalized information exchange between outlet-owners via councils may promote equity considerations. This rationale does not, however, affect the qualitative conclusion that these bodies make it harder to incorporate learning effects into the agreements over time.

upfront to draft contracts which need less revision in the future. However, the learning perspective outlined above suggests that the need for revision resulted primarily from bounded rationality, not from opportunity costs in initial contracting. Then, franchisee councils may slow the evolution of agreements because contractual changes undergo intense negotiation. But it should be noted that franchisee councils may also filter contractual changes proposed by the company and differentiate between efficiency-enhancing learning and opportunistic action.

7. Implications for contracting

7.1 The stickiness of contracts: Bounded rationality vs. adjustment costs

The observed importance of new management for contractual adjustments, presumably towards greater efficiency, sheds light on the reasons for the stickiness of misaligned agreements – an unresolved issue which has been raised for further research (see Shane, 2001: pp. 156-157). The sudden increase in modifications with the advent of the new CEO at PizzaBox, for instance, suggests that contracts were not fully moving to an optimal design prior to that for reasons of bounded rationality. As mentioned above, the new CEO had considerable experience as a franchisee of the chain. In addition, he had worked as a store checker for the chain. He thus disposed of deep insights about franchisees' incentives and de facto behavior in the daily business. Based on these experiences, he could later effectively assume the principal's position and design appropriate governance mechanisms. Former management certainly did not dispose of this extensive, partly tacit, knowledge base. Hence, it appears that the former CEO's ignorance precluded more comprehensive contracting. This explanation for the stickiness of certain variables contrasts with rationales based on excessive adjustment costs (e.g., Wernerfelt, 2004). These, goes the argument, disallow changing terms while the need for adaptation is perceived by management.

But the interview data also revealed that adjustment costs provided a good explanation for other changes *which did not occur* even though they were intended. For instance, HardTail, which offers a 10 year contract, realized the value of a shorter duration to more effectively enforce proper franchisee behavior by threatening more immediate non-renewal. However, the company was unable to cut duration to five years for the banks financing outlets opposed to it. This result is consistent with transaction costs theory (e.g., Brickley, 2003). Accordingly, contract duration must be long enough to assure a normal return on the sunk investments. Shorter contracts would not permit this rate of return be-

cause franchisees are exposed to a risk of hold-up by the franchise company. This implies that in this case, excessive adjustment, in form of transaction, costs inhibited change.

In summary, it follows that bounded rationality and adjustment costs might hold explanatory power to explain the stickiness of different contractual variables.

7.2 Choosing between public and private enforcement

Literature generally distinguishes between public and private enforcement mechanisms (Klein, 1995: p. 17). Whereas the former relies on the legal system to ensure proper franchisee behavior, the latter enforces obligations through rewards and punishments designed and decided upon within the relationship (see A-II.). The interview data indicated that franchisors may choose between these two modes, an observation which existing theory still fails to consider (Arruñada *et al.*, 2001: p. 281). At PizzaBox, for instance, there has been an unambiguous shift towards greater reliance on private ordering as of the buyout through the new CEO. Most transparently, the reduction in contract duration was intended to more effectively exert pressure on deviant franchisees without relying on the legal system (see above). The CEO of PizzaBox also explained during an interview that "in former times, much more communication [between the company and the outlets] was channeled through lawyers" (Interview 07/26/2005).

Private enforcement necessitates some degree of impartiality of the franchisor, in turn safeguarded by concerns to attract productive franchisees in the future (see, in a related context, Arruñada, 2000). Otherwise, prospective franchisees would discount the risk from franchisor opportunism and pay a lower price for the rights to use the business-format. While reputation for fair dealings is a necessary condition to private ordering, it cannot fully explain the sudden shift towards extra-legal ordering with the advent of the new owner at PizzaBox. Reputation effects were likely to be present before, but the former CEO continued to rely on the legal system (i.e., lawyers) to threaten franchisees and settle disputes. Thus, at least in this instance, the enforcement mechanism in use seemed to be a decision variable. However, it must be noted that private enforcement was facilitated by the new CEO's background as a franchisee. This background may have added to his decisions being accepted by the outlets. Indeed, at the time, the CEO's store was the most successful in terms of revenue in the chain. Persuasion of the local entrepreneurs in the sense of altering their perspective on focal issues (Dant and Schul, 1992: p. 38) may thus have been supported by the CEO's prior career.

The new CEO's preference for private ordering might have resulted from his long-time experience as a franchisee of the chain and the insight that communication through lawyers makes disputes worse instead of solving them. Supporting this argument, Boyle *et al.* (1992) found that strategies adapted by manufacturers to influence the behavior of automobile dealers based on legalistic pleas reduced the cooperative climate in the channel. In addition, Bies and Taylor (1993) reported that the quality of interpersonal treatment of employees by their employer in case of dispute was inversely related to the probability of employees suing the employer in the courts of law. Hence, relying on lawyers and foregoing interpersonal communication may escalate conflicts.

In sum, franchising firms may learn about the effectiveness of private and public enforcement as they accumulate experience and then choose between them.

7.3 Contract terms and the reputation for credible threats

Existing analyses of contract design are usually based on the assumption that explicit provisions are discrete, i.e., they either exist or are absent (Zenger *et al.*, 2001: pp. 8-9). But the case studies revealed that parties also care about the specific wording of provisions. The wording does not only seem to be important in terms of enforceability in the courts. More importantly, it needs to simultaneously curb deviation from contractual duties by signaling severe sanctions while preventing a loss of credibility when it is not in the interest of the company to carry out these sanctions ex post. The effects of discrepancies in announced and effectuated punishment may be important. Not following through with punishment threatened in the agreement imposes a cost on the franchisor. This cost comes about in form of reduced credibility of future punishments in the face of franchisee misbehavior. Anticipating that the principal will behave similarly in other situations, store-owners may feel encouraged to ignore the behavioral constraints imposed by the formal contract. Conversely, if the franchisor has a reputation for staying true to his word as outlined in the agreement, even very extreme threats, which may be necessary on other occasions, will be taken seriously by the outlets (see, generally, Malhotra, 2005: p. 5).[100]

[100] The rationale according to which a credible reputation for retaliatory action affects the behavior of other players is well known from industrial organization research (e.g., Caves and Porter, 1977) but has not been considered in contracting studies.

The interview data indicated that this logic was underlying the frequent modification of restrictions on sources of supply at HardTail.[101] If stating that "violation of this stipulation [restriction on purchase with black-listed suppliers] *will* trigger a contractual penalty" (Standards and Guidelines, 1998, emphasis added), then the franchisor "has to bite" (Interview 07/07/2005) in case of deviation. However, the company may not always want to severely punish such deviations as announced. For instance, a once non-cooperative franchisee may be one of the most successful outlets, and additionally an opinion leader, with whom it pays to maintain good relations. At the other extreme, HardTail's warning that "partners attracting attention through purchases of such kind cannot expect to get the full support of HardTail" (Standards and Guidelines, 1994) is an example of a threatened punishment which may be credible but not costly enough for franchisees in its consequences – a major reason why the wording had been changed eventually. Against the backdrop of the trade-off described above, the wording adopted by the time of this writing can be rationalized. By stating that "you *risk* a contractual penalty" (Standards and Guidelines, 2005, emphasis added), the franchisor has an option to severely punish any deviation.[102] It provides a clear signal to agents that there might be negative consequences. At the same time, the franchisor does not completely loose credibility if not effectuating sanctions.

8. Conclusion

The case studies presented in this chapter add further evidence on the existence and the nature of learning to contract. The data show that acquiring experience about effective safeguards is also an important phenomenon in a franchising context, where high levels of professionalism in initial design would be expected. The observed processes underlying the design of agreements were by and large inconsistent with efficiency theories and asserted claims that "the features of contracts are not continuously refined in order to obtain an "optimal contract"" (Ménard, 2004: p. 8). Though the content of the modifications can be rationalized ex post with incentives-based theories, the way by which franchising firms came to recognize the need for specific safeguards is more neatly described by theories of local experimentation (e.g., Cyert and March, 1963; Nelson and Winter, 1982). As franchisors matured, contract structure was increasingly a result of trial and error learning and differed

[101] The company changed the wording in the Standards and Guidelines, which is the document referred to in the day-to-day business. But the contracts per se did not change at all with respect to this issue over the sampling period. Enforceability of these restrictions was, therefore, not affected.
[102] Note that the precise penalty was not defined ex ante.

sharply in many respects from the agreements designed in the early days of chains' life cycle.

By studying learning to contract in the franchising setting, further insights on the sources of ex ante imperfect contracting were derived. Basically, the results imply that bounded rationality, i.e., a lack of awareness of the importance of certain safeguards, holds strong explanatory power. Furthermore, this study revealed new management and franchisee councils as factors potentially determining the pace of contractual change. It was also argued that bounded rationality and adjustments costs may hold explanatory power for the stickiness of different contractual variables. In addition, the evidence points to issues in contracting which have been given little attention so far, especially the choice between public and private enforcement, but also the need to maintain a reputation for credible threats.

The observation that the companies in the sample expanded considerable effort to continuously improve the design of contracts, including costly renegotiation of existing agreements, substantiates the importance of legal documents in governing franchising relationships. Following Macaulay's (1963) seminal work, the importance of contracts for the ongoing relationship between legally independent parties has, at times, been downplayed in the literature. It has been argued instead that formal agreements are similar to constitutions, providing merely a frame for the assignment of basic roles and responsibilities and general codes of conduct (e.g., Macneil, 1974). Insufficient attention to formal contracting may be an important source of costly experiences. As a prime example, recall the severe effects for PizzaBox of failing to restrict post contract competition.

This study suggests further research in several directions. First, the locus of contract design capabilities in franchising should be systematically explored. The role of lawyers and specialized consultants deserve further attention within such an analysis (see Argyres and Mayer, 2004). Second, this study points to a principal-agent problem in contracting which has been ignored by theory. It is usually assumed that a principal contracts with an agent. But only at PizzaBox did the principal (i.e., the owner-CEO) *directly* contract with the agents (i.e., franchisees). At SleepWell and HardTail, the task of contracting with franchisees was delegated to non-owner employees, introducing an incentive problem within the company. Future research could shed light on the effects of these principal-agent layers within franchising firms for the evolution of agreements but also for their enforcement (e.g., public vs. private). For instance, non-owner employees may not be willing to put forth costly effort to learn about past mistakes unless they are compensated adequately.

Third, legal requirements to disclose franchise contracts, as in the U.S., might importantly affect the nature of learning. The role of imitation may become more central relative to own past experiences. However, there are also clear limits on successful imitation when complementarities between provisions exist (Shane, 2005: pp. 101-102; see, generally, Rivkin, 2000). Finally, attention should be paid to the factors which determine the speed at which franchise organizations learn to contract. In general terms, the answer may depend on how well the company organizes feedback processes. More specifically, the frequency and intensity of monitoring franchisee behavior should positively relate to the detection of suboptimal structures and therefore to contractual learning, with bounded rationality potentially moderating this relationship.

PART C

I. SYNOPSIS OF MAIN FINDINGS

This thesis opened with a quotation from John Love, a journalist who studied the McDonald's system in depth. To recall:

> "The real secret to McDonald's successful operating system is not in its regimen but in the way it enforces uniform procedures without stifling the entrepreneurship of franchisees." (Love, 1986: p. 150)

This short statement summarizes, I believe, key success factors of the world's most popular franchise chain. First, the company leverages franchisees' unique capabilities. These are specific knowledge about local markets and incentives, induced by residual claims, to capitalize on that knowledge. Second, McDonald's simultaneously secures franchisees' cooperation with the chain. Specifically, the assignment of decision leeway to outlets does not lead to excessive costs from misbehavior (i.e., free-riding on the brand name), an important concern in contractual distribution channels. In short, McDonald's realizes the upside of (partly) decentralized decision structures and effectively contains the downside. Though this suggests that only the parent corporation is concerned about the abuse of decision rights by agents, the reverse is true as well. But franchisees also derive major benefits from centralized franchisor discretion over important parts of the system. Networks which are viable in the long run therefore assure that control by the parent corporation is not abused to the detriment of the local stores. In summary, success demands taking advantage of the parties' capabilities by allocating decision rights accordingly while safeguarding against potential frictions.

In this dissertation, I raised the question of how franchising firms achieve this twin objective. I argued that they provide for decision rights in the written contract while ensuring cooperative behavior, informally defined in relational contracts, through private enforcement mechanisms. The focus on private ordering resulted from the rationale developed in PART A, that formal contracts – the only alternative form of enforcement between legally separate entities – cannot achieve this goal since linking actions to future states of the world is infeasible. According decision rights can then lead to misbehavior which is non-verifiable by the courts. In the first three chapters of PART B, the interplay between the allocation of decision rights and three specific forms of private enforcement was analyzed:

(1) the self-enforcement mechanism, (2) relational governance, and (3) collective punishment. In the fourth chapter, the processes by which franchising firms learn about appropriate contractual rights assignment and effective private enforcement over time were investigated through case studies. Taken together, the empirical insights from these four modular studies can be summarized as follows:

- Franchising firms do, indeed, rely on private enforcement mechanisms to prevent opportunistic abuses of decision rights. This is evidenced by the following empirical relationships:
  - The less effective is private enforcement (i.e., the self-enforcement mechanism) in a cross-section of franchising firms, the more are franchisees' decision rights restricted through the formal contract (see B-I.).
  - The higher is a franchisee's autonomy in a cross-section of outlets within a chain, the more emphasis is placed on private enforcement (i.e., via relational governance) by the corporate parent. And, in the face of downstream autonomy, private enforcement becomes more important, the weaker a franchisee's incentives are aligned with the principal (see B-II.).
  - The more extensive is the franchisor's control over the system in a cross-section of firms, the higher is the likelihood that franchisees rely collectively on private enforcement (i.e., through councils) to assure proper behavior by the principal. In addition, private enforcement becomes more important in light of centralized control, the weaker are the principal's incentives for fair dealings induced by the formal contract (see B-III.).
- Rights assignment and private enforcement are not trivial and subject to learning processes. Thus, at least some economic actors dispose of limited rationality and are not able to set up efficient configurations from the outset (see B-IV.).

Overall, these findings provide empirical corroboration of theoretical conjectures in the literature that "informal aspects, especially relational contracts, are important to the success of (…) nontraditional organizational forms" (Baker *et al.*, 2002: p. 71) such as franchising arrangements. However, the results do not only bear implications for the *management* of chains as emphasized throughout the main chapters, but may also explain, I argue below, the *incidence* of these hybrid organizational forms.

II. IMPLICATION FOR THE THEORY OF THE FIRM

Combining the insights from the cross-sectional and longitudinal data, I finally derive a tentative implication for the core question raised by the theory of the firm (see Garrouste and Saussier, 2005: p. 179): What determines the boundaries of the firm; or, equivalently, which activities are *not* executed within unitary firms? My concern here is specifically with the range of activities organized through hybrid forms. Franchising is but one type of arrangement in this broader class of hybrids. Other varieties include collective trademarks, partnerships, cooperatives, and alliances (see, on regularities among these forms, Ménard, 2004: pp. 6-10).

Transaction costs theory situates these modes on an intermediate position between pure market exchange and coordination through hierarchies (Williamson, 1991). Under hybrid arrangements, resources are pooled through long-term contracts from legally separate entities who remain independent residual claimants. As discussed further above (see A-II.), separate ownership rights create strong incentives which would be considerably weakened under hierarchical coordination.[103] On the other side of the spectrum, markets would not efficiently bundle the parties' relationship-specific resources (e.g., knowledge, production facilities). But still, with the parties remaining legally independent and incomplete formal contracts governing the relationship imperfectly, significant vulnerabilities to trading hazards remain in hybrid forms. The findings of this dissertation show that these hazards can be mitigated through privately enforced relational contracts.

I forward therefore that the effective use of private enforcement mechanisms may act as a shift parameter, making hybrid forms more attractive for some firms than for others. This rationale mirrors a recent proposition in the literature that the ability to structure formal contracts increases the attractiveness of inter-firm collaborations, relative to hierarchies (Mayer and Argyres, 2004: p. 408). Two complementary observations from the different research approaches in this dissertation motivate my argument:

(1) The cross-sectional approaches suggest that relational contracting between legally separate decision-makers with high-powered incentives is efficient. This conclusion is reached by assuming the efficiency principle to hold. Accordingly,

[103] See Baker *et al.* (2001) for limits on incorporating market-like elements in firms.

gains can be realized by economic actors from changing inefficient policies such that efficient business practices – here related to the adoption of private safeguards against exploitative uses of decision rights – should be more frequently observed than suboptimal arrangements. The set-up and enforcement of relational contracts is thus an important function of management (see, on this role of management, Baker *et al.*, 2002: p. 73).

(2) The learning effects documented in the longitudinal case studies revealed that not all firms are equally able to structure the exchange in which they participate, including the use of relational contracts (e.g., recall the shift towards more effective private enforcement at PizzaBox with the advent of the new CEO, see B-IV.).

Hence, firms with strong capabilities to use relational contracts may organize transactions through hybrids over a broader range of asset specificity levels. Put differently, the level of asset specificity at which transaction costs economics predicts firms to be indifferent between hybrid and hierarchical coordination may be higher for firms capable of enforcing cooperative decision-making through private ordering than for firms with weak such capabilities, all else equal. This rationale is similar to the contention that non-integration is favored over integration when reputation effects assuring fair dealings are high (see Garvey, 1995). In the argument advanced here, high reputation effects correspond to strong relational contracting capabilities.

To conclude, though this dissertation is subject to several limitations as outlined throughout the main chapters, I feel that it demonstrated the relevance of private enforcement mechanisms for understanding how inter-firm economic exchange is governed.

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APPENDIX A: FACTOR MATRIX FOR DECISION INDEX I

1 factor extracted (Eigenvalue > 1); Kayser-Meyer-Olkin-criterion: 0.622; Bartlett's test of spherity: $Chi^2 = 122.08$, $df = 3$, $p < 0.001$.

Factor	Eigenvalue	% of var.
1	1.708	56.949

Factor matrix	Decision index I
(a)	0.779
(b)	0.675
(c)	0.803

APPENDIX B: DETAILS OF CONSTRUCTS AND MEASURES

Construct	Description of measures	Cronbach's alpha
1 Multi-unit ownership	Do you own more than one franchise outlet? (no = 0; yes = 1)	
2 Age of the relationship	In which year did you join the franchise system?	
3 Competition	The number of franchised outlets has exceeded a reasonable size. (disagree-agree, 7-point scale)	
4 Success	a Within another activity and with the same level of effort I could realize an income which is … (higher-lower, 7-point scale). b Compared to the average development of sales in my industry I would rate my last period's sales as being… (lower-higher, 7-point scale). c Compared to my expectations my last period's income was… (lower-higher, 7-point scale). d Compared to my last period's sales objectives my last period's sales were… (lower-higher, 7-point scale).	0.83
5 Relational governance	*Harmonization of conflict* a My franchisor understands my problems and concerns. (disagree-agree, 7-point scale) b My franchisor seeks compromises to accommodate conflicts. (disagree-agree, 7-point scale) c Disputes are not typical for the relationship between me and my franchisor. (disagree-agree, 7-point scale) *Cooperation* d When making decisions which concern me, my franchisor takes into account my opinion. (disagree-agree, 7-point scale) e My franchisor asks me for participation in his long-term planning process. (disagree-agree, 7-point scale) f I receive information from my franchisor on time. (disagree-agree, 7-point scale) *Trust* g My franchisor does not exploit my dependency. (disagree-agree, 7-point scale) h My franchisor's trust in me is high. (disagree-agree, 7-point scale) i I can follow the recommendations of my franchisor without any hesitation. (disagree-agree, 7-point scale)	0.87
6 Autonomy	a The franchisor's standard operating procedures do limit my autonomy… (agree-disagree, 7-point scale) b I am free to implement own ideas. (disagree-agree, 7-point scale) c I am my own boss. (disagree-agree, 7-point scale) d As franchisee I feel more like an entrepreneur rather than like an employee. (disagree-agree, 7-point scale)	0.64

Items have been translated from German to English by a bilingual researcher.

APPENDIX C: FACTOR MATRIX FOR RELATIONAL GOVERNANCE

1 factor extracted (Eigenvalue > 1); Kayser-Meyer-Olkin-criterion: 0.885; Bartlett's test of sphericity: $Chi^2 = 826.47$, df = 36, $p < 0.001$.

Factor	Eigenvalue	% of var.
1	4.698	52.205

Factor matrix	Relational governance
5a)	0.652
5b)	0.765
5c)	0.785
5d)	0.804
5e)	0.696
5f)	0.635
5g)	0.808
5h)	0.752
5i)	0.577

Absolute values less than 0.3 were suppressed.

APPENDIX D: FACTOR MATRIX FOR SUCCESS AND AUTONOMY

2 factors extracted (Eigenvalues > 1); Kayser-Meyer-Olkin-criterion: 0.761; Bartlett's test of sphericity: $Chi^2 = 556.42$, df = 28, $p < 0.001$.

Factor	Eigenvalue	% of var.	cum. % of var.
1	3.191	39.893	39.893
2	1.660	20.747	60.640

Factor matrix	Success	Autonomy
4a)	0.633	
4b)	0.855	
4c)	0.880	
4d)	0.850	
6a)		0.645
6b)		0.778
6c)		0.762
6d)		0.664

Absolute values less than 0.3 were suppressed.

APPENDIX E: INTERVIEW PROTOCOL

1. Company & interviewee background
   - Company history
   - Reasons for franchising
   - Career of interviewee at company
2. Governance of relationship to franchisees
   - Instruments (contracts, handbooks, etc.)
   - Implicit agreements
   - Sources of conflict
   - Mechanisms for dispute resolution
   - Communication procedures with franchisees
   - Monitoring (types, frequency, etc.)
3. Contract changes – general
   - Design of first contract
   - Decision-makers on contractual changes in the company
   - Process of a typical contractual change (initiation, approval, etc.)
   - Costs of changing contracts
   - Changes in implicit agreements
   - Changes regarding selection criteria of franchisees
4. Contract changes – specific
   - Which events/experiences led to the adoption/removal/change in wording of clause X in contract version Y?
5. Open questions
6. Further contacts in the company

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