

**Preliminary Evidence on the Appointment of Institutional
Solutions to Franchisor Moral Hazard**

The Case of Franchisee Councils

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Abstract

Besides franchisee opportunistic behavior, franchisor moral hazard is a central concern in franchise chains. Economic literature thus far focused on the sharing of franchisee revenues as an incentive for curbing franchisor malfeasance. In this paper, we ask whether and how the obligations of chains may be enforced through institutional arrangements like franchisee councils. Consistent with expectations, the appointment of a council empirically turned out to be more likely as decision rights – a proxy for the scope of moral hazard – were increasingly allocated to companies' management. We found this relationship to be negatively moderated by the contractual share parameter. (98 words)

JEL classification: L14, L22, M21

Keywords: franchising, double-sided moral hazard, institutions, decision rights

1. Introduction

Franchising is a contractual distribution channel in which an upstream parent corporation, the franchisor, sells the right to market a product or service to downstream firms, the franchisees.¹ Since franchisees' success depends importantly on the network's brand name, franchisors must be given incentives to meet their obligations to uphold brand value once the agreement is signed. The agency-theoretic literature has been exclusively concerned with contractual mechanisms as solutions to problems of franchisor moral hazard, especially revenue sharing between the vertical exchange parties (e.g., Sen, 1993; see, for a review, Dnes, 1996).

More recently, some authors (e.g., Arruñada *et al.*, 2005) have pointed out that chains also use institutional solutions such as franchisee councils to induce proper behavior of the franchisor. In addition, the best practice literature has devoted considerable attention to these institutional arrangements (e.g., Ostman, 1995; Seideman, 1997; Grueneberg, 2004). Yet, both a theoretical rationale concerning the precise mechanisms by which institutional bodies may induce franchisors to follow through with obligations as well as empirical evidence on their appointment are lacking.

In this paper, we seek to fill these gaps. We draw from the political economy literature on institutional design (Greif *et al.*, 1994) to submit that franchisee councils chiefly provide channel members with a means to collectively sanction the franchisor for malfeasance. Empirically, we expected the appointment of councils to be more likely the higher the franchisor's decision rights, hence his control over the operations

¹ As opposed to product franchising, business-format franchising involves the transfer of an entire business model to franchisees – including a marketing strategy, operating manuals, quality control, etc. Since the potential for trading hazards is particularly severe in the latter form of distribution, franchising literature deals primarily with this category. In our study, too, franchising pertains to business-format franchising.

of the chain, and therefore agents' exposure to principal moral hazard (Rubin, 1978; Arruñada *et al.*, 2001). We also supposed the set-up of councils to be less probable when business-format providers have strong incentives not to abuse their decision rights as conditioned by a high share in franchisees' sales and a high proportion of outlets company-owned. The empirical results in part support our propositions.

We proceed as follows. In the next section (2.), we briefly review the literature on franchisor moral hazard. Then (3.), we develop the theoretical framework and the hypotheses. The fourth section (4.) presents the data, the operationalizations of variables, as well as the empirical results. In the fifth section (5.), we discuss the results, provide implications for practitioners, and derive limitations of our work. The paper ends with a conclusion (6.).

2. Related literature

Rubin (1978) was the first to advance franchisor incentive constraints as an explanation for the sharing of revenues found in most franchise contracts. His arguments were later formalized by Lal (1990), who used a game-theoretic approach to show that royalty payments provide franchisors with incentives to invest in the chain's brand name (see, also, Mathewson and Winter, 1985). Lafontaine (1992) and Sen (1993) empirically tested and found strong support for Rubin's proposition that franchisor moral hazard influences the fee structure. Additional evidence on the potential of franchise principals acting opportunistically 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 empirically found that company-owned units served as a bond to guarantee continuing franchisor performance to outlet-owners. Bhattacharyya

and Lafontaine (1995) developed a formal model based on double-sided moral hazard which helps 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 franchisor moral hazard affects non-monetary contract provisions. They studied 25 contracts and reported that the property rights to add a new outlet to an existing territory were allocated to either the franchisee or the franchisor, depending on the relative importance of each party's effort. The literature cited above has focused solely on contractual elements, either monetary or non-monetary, as mechanisms to reduce the risk of opportunistic behavior on the principal's side. We advance the field by studying non-contractual, but institutional solutions to franchisor moral hazard. Given the widespread diffusion of franchisee councils in practice, the analysis of institutions within the organizational form of franchising seems to be equally important to understand the governance of trading risks between the dyadic partners.

3. Theoretical foundations and hypotheses

3.1 Franchisee councils as an institutional solution to franchisor moral hazard

3.1.1 Direct monitoring and participation

Franchisee councils are composed of both franchisee and franchisor representatives. They serve as communication platforms where (a) channel members can verify that the system's head office applies control mechanisms in a fair and non-discriminating way, (b) new ideas concerning the network's value proposition can be discussed, (c) compromises on precarious issues can possibly be negotiated in mutually beneficial ways, and (d) otherwise dispersed franchisee interests are grouped. Through direct and

personal interactions, these councils reduce information asymmetries between up- and downstream firms. Hence, they constitute an interface for franchisees to monitor the franchisor, and thereby potentially attenuate the risk of moral hazard (Arruñada *et al.*, 2005).²

Moreover, councils not only enable franchisees to better observe franchisor 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: *'We actually had the chairperson of the advisory council help us interview and select our director of sales and marketing'* (statement by Gerry Bergler, an executive of American Speedy Printing, cited in Seideman, 1997: p. 14; see, also, Grueneberg, 2004 on this issue). Hence, where franchisees' input is perceived as valuable by the franchisor, the chain's management may seek franchisee participation.

3.1.2 Enforcement through collective sanction

Yet, franchisees' ability to observe franchisor behavior does not automatically imply that the franchisor has an incentive to forego misbehavior. Franchisee participation may be allowed only when franchisors perceive benefits from involving the outlet-owners in their decision-structures. If the company's obligations are ill-specified by the contract or are non-verifiable (Hadfield, 1990), court-enforcement is difficult. In addition, franchisee councils generally have no formal rights making their decisions legally binding for chains (Nebel and Gajewski, 2003). Franchisor obligations must therefore be self-enforced within the exchange relationship.

² Note that it would hardly be profitable for outlet-owners to monitor the franchisor individually.

We submit that franchisee councils may strengthen enforcement through the threat of collective punishment (Greif *et al.*, 1994) of deviant franchisors by franchisees. Councils offer an institutional arrangement to diminish not only vertical information asymmetries but also those between franchisees horizontally and thereby permit coordination of individual outlet-owners' actions. Specifically, they provide the framework to agree on common interpretation of the franchisor's obligations and to gather information on conflicts occurring in the channel. Council leadership can decide when to impose what kind of sanctions and it can communicate actions to franchisees. Hence, we argue that institutional interest groups like franchisee councils reduce the power disadvantage of individual franchisees vis-à-vis the parent corporation (Picot *et al.*, 1995).

Several conditions have to be met if enforcement through collective sanctions is to be successful. First, 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, 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 gains from deviation. But what kind of sanctions do councils dispose of? As aforementioned, literature generally attributes little power (or, equivalently, no threat potential) to franchisees and emphasizes their dependence on the principal instead. Notwithstanding, collective sanctions can be initiated by councils in a variety of ways. For instance, Dant and Nasr (1998) stressed franchisors' dependence on upward information flows from dispersed stores. These are valuable to the franchisor for control purposes since hiding information might enable franchisees 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 since they are chosen in part due to their superior knowledge of local markets (Dant *et al.*, 1992; Jacobsen, 2004). Conversely, detained information represents an opportunity cost to franchisors for this negatively affects their ability to monitor franchisee behavior³ and to successfully open new units by providing downward information flows (Kalnins and Mayer, 2004). 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; 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 allowing to credibly divulging in the franchising community details about franchisor abusive behavior. National franchisee associations like the *Deutscher Franchise-Nehmer Verband* (DFNV)⁴ in Germany, which grant quality labels to fair-dealing chains, may play an important transmitter role in this regard. This would threaten chains’ ability to sell new franchises (assuming a

³ 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., through councils) agree on lower levels of performance. From a game-theoretic perspective, the threat of collectively agreeing on lower performance to punish non-performance of the franchisor is not credible since franchisees would harm themselves (i.e., free-riding is only profitable to individual franchisees if their peers uphold brand value). However, it could be argued that lower performance of each member can be rationalized by assuming that each outlet bears only a small fraction of the punishment costs – a strategy Coleman (1990) refers to as incremental sanctions. In an interview conducted with the representative of one franchisor active in the retailing of computer hardware, he provided an example of such an incremental sanction. The franchisor might want to boost sales through offering, on a temporal basis, a product package combining different hardware components. Whereas the aggregate gain for the chain would be important, the benefit to the individual franchisees may only amount to a couple of hundreds of euros. In such a situation, though some (opportunity) costs are incurred by franchisees, they may gain more by putting pressure on the franchisor in threatening to blockade the special offer. That is, they may enforce franchisor obligations on other issues which are worth more to them than the foregone sales.

⁴ <http://www.dfny.de>

competitive market for productive franchisees) while strengthening the position of incumbent outlet-owners.

Second, franchisee councils should hold a certain regulatory power over franchisees to make collective punishment credible. For instance, out of fear of contract termination and/or non-renewal, it may be in the economic interest of individual channel members not to participate in the collective action. Though councils have no legal power over individual franchisees that do not comply with propositions of the council, indirect monetary sanctions may nevertheless be inflicted. While franchisors are important for knowledge dissemination in the network, franchisees also share cost and profit data among them and discuss best practices (Darr and Kurtzberg, 2000; Ehrmann, 2002). 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). In addition, franchisee commitment to the decisions made by the council can be gained through democratic elections of the representatives, usually being opinion leaders (Stanworth, 1995), in the council (Nebel and Gajewski, 2003).⁵ Besides, franchisee councils usually report to franchisees on an annual or biannual basis to promote acceptance of their decisions. Optimally, the chains' head offices are not involved in the selection process of franchisee representatives.

Third, commitment to honest behavior by setting-up a franchisee council must be advantageous for franchisors since otherwise they could simply avert their appointment. There is considerable evidence that chains are aware of the important self-commitment

⁵ The representatives should be in good standing and in full compliance with system-wide standards (Anderson, 2002).

function fulfilled by such councils since they are usually deeply involved in initiating and financing these bodies (Arruñada *et al.*, 2005). Franchisees' understanding of the benefits is also well established. Steiff (2004) found that franchised units from 13 networks with a franchisee council in place, on average, ranked this institution among the top ten out of 30 instruments to control headquarters' conduct. From a study including four franchise companies, Stanworth (1995) reported that franchisees saw the council's main role in protecting their interests in the face of unilateral changes to the contract leading at times to more restrictive rights of the outlet-owners: "*Some franchisees believed the effect of the association had been to achieve a more favorable contract than would have otherwise been the case*" (p. 170). The considerable attention paid to franchisee councils by best practice franchising literature further underscores that the advantages of this institutional form are perceived among practitioners (e.g., Bloom, 2003; Howe, 2003; Grueneberg, 2004).

Arguably, it seems that explicit and overt punishment of franchisors through councils is rarely (if ever) implemented. Yet, the effectiveness of institutions for punishing contractual violations is inversely related to the number of enforcement actions (Greif *et al.*, 1994). Thus, the empirical absence of any explicitly stated threat should not be misinterpreted as an indicator of the irrelevance of councils guarding against franchisor moral hazard by threatening collective sanctions.

To test the proposition that franchisee councils serve as a mechanism to prevent the realization of franchisor moral hazard either through direct monitoring, participation and/or collective sanctions⁶, circumstances under which a council should be expected are identified below.

⁶ The proposed arguments are not mutually exclusive and all three might be relevant at the same time. We do not seek to differentiate between these alternative rationales in the empirical tests.

3.2 Franchisor decision rights and moral hazard

Decision rights provide the holder with decision-making authority as far as the practical fulfillment of specific tasks is concerned. From a property rights perspective, it is efficient to co-locate 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. Though franchisors 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 downstream partners (e.g., site-selection leading to territorial encroachment). 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 (see, also, Arruñada *et al.*, 2001). In addition, from franchisees' perspective, having the franchisor make decisions also implies receiving ongoing services which outlets pay for through the royalty rate (e.g., centralized purchasing).⁷ Since franchisors incur costs in providing these services, franchisees risk not receiving the expected assistance in operating affiliated units (Sen, 1993) especially in situations where obligations are not explicitly spelt out (see, for the case of Avis Europe PLC, Jacobsen, 2004: p. 530).

⁷ Note that in the franchising literature, centralized services (or support services) and decision rights are sometimes treated as two separate constructs. In this study, decision rights are meant to encompass these elements which can be framed as the two sides of the same coin. For instance, centralized purchasing is both a *service* delivered to franchisees and a *right* of the franchisor to *decide* on the inputs used in the production process (thereby constraining franchisees' leeway to decide on this issue).

Fundamentally, franchisor non-performance is problematic since franchisees' relationship-specific investments in franchisor inputs render outlet-owners vulnerable if companies opportunistically seek to change the terms of the contract (Scott, 1995; Shane, 2001). In sum, in chains where a large fraction of decision rights is allocated to the franchisor and hence his ongoing performance is required, franchisees should be concerned about moral hazard 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, chains 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 less as their interests in the ongoing success of franchised outlets increase. 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 the company. The larger the share parameter the higher the revenues foregone by the chain when brand-name strength weakens. 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. We expect

that high royalty rates 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

As discussed above, the chain can take a positive share in franchisees' sales to give itself an incentive to put forth effort. Yet, sharing of sales dilutes franchised outlets' property rights. This lowers the incentive effects of franchising and increases the total costs of operating the network. To avoid these costs, Scott (1995) as well as Windsperger and Yurdakul (2004) argued that franchisors can substitute sales sharing through company ownership to simultaneously satisfy 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 lowering profits at company outlets. Thus, the alignment of franchisor decision rights with property rights, as expressed through 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.

4. Empirical test

4.1 Sample

We tested the hypotheses 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. We chose this data source since it contains – besides information on contractual terms (e.g., royalty rates) – measures for the allocation of decision rights within chains. The *Jahrbuch Franchising und Kooperation* is edited by the Forum Franchise und Systeme (FFS), a private information platform that publishes independent reports on franchising activities in Germany. The annually published directory is sold to individuals interested in purchasing a franchise, but also to lawyers, consultants, and franchisors. Inclusion in the directory is free of charge. The data are gathered by the FFS through self-administered mailed questionnaires. As the directory is publicly addressed to potential franchisees, this might raise concerns about response biases – e.g., chains overstating the degree of decentralization to attract productive applicants. Scott (1995) partially accommodated such concerns about publicly available franchise data and put forward that franchisors have a strong incentive to provide

accurate information since prospective franchisees certainly verify the details of offers. Our sampling approach is comparable to other studies on franchising in the academic literature which also used public data sources including the *Sourcebook of Franchise Opportunities* (e.g., Agrawal and Lal, 1995) and the *Entrepreneurship Magazine* (e.g., Lafontaine, 1992).

The questionnaires for the *Jahrbuch Franchising und Kooperation 2005* were mailed by FFS to about 940 Germany-based distribution systems in autumn 2004. The response rate reached about 44 percent, yet 12.5 percent of respondents had ceased operations (Peckert *et al.*, 2005). Out of the responding and still active firms, 301 used business-format franchising – the organizational form we were interested in – while the remaining firms used alternative forms of distribution such as licensing. In order to corroborate and complement the information found in the *Jahrbuch Franchising und Kooperation*, we also gathered information from *Forby's Guide 2004* and from *Franchise Chancen für Deutschland, Österreich und die Schweiz 2005* (Graf, 2004). Complete and consistent information for the variables used in this study was available for 131 systems, our final sample size. In 2003, approximately 830 business-format franchisors operated in the German market and hence our study covered approximately 15.8 percent of the population.⁸

Based on the detailed classification scheme employed by Lafontaine and Shaw (2001), we arrived at the following distribution of franchisors across specific sectors: Automotive 6.1%, Business services 5.3%, Cosmetic products & services 1.5%, Eating places – full service 2.3%, Eating places – limited service 9.9%, Education 6.9%, Health & Fitness 3.1%, Maintenance 4.6%, Personal services 10.7%, Real estate 3.8%,

⁸ http://www.dfv-franchise.de/index_d.htm [Category: Presse / Statistiken], last access 02/19/2005.

Recreation 2.3%, Rental 1.5%, Repair 3.8%, Retail – clothing 6.1%, Retail – food 8.4%, Retail – furnishings 5.3%, Retail – home improvements 3.1%, Retail – other 14.5%, Travel 0.8%.

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 franchisor decision rights, we built a summated variable which measured the number of decisions made by the franchisor. We selected the decision dimensions to be included based on previous work done by Windsperger (2003) and Shane (2001): procurement, accounting, budgeting and controlling, regional advertising, regional public relations, recruiting and employee training, investment, quality management, site-selection and inventory control. For each dimension, a dummy variable indicated whether related decision rights were centralized (1) with the franchisor or decentralized (0) with franchised outlets. In addition, we considered whether a chain provided standardized operating and marketing manuals. All of these dimensions reflect the degree of control the franchisor exercises over the operations of the chain either through recurrent decisions on issues such as regional advertising or through the determination of long-term operating norms including those

specified in marketing manuals.⁹ We summed the dummy variables on the twelve possible decision dimensions to form a single continuous variable.

Share parameter. The share parameter measured the percentage of monthly sales that franchisees paid to the franchisor. Following Lafontaine (1992), Sen (1993), Agrawal and Lal (1995), and Shane (2001), the share parameter included the royalty rate plus the advertising fee. Where franchisors indicated a range of values, we used the average. Flat figures were divided by the monthly sales level of an average outlet of the system to obtain percentage values. The share parameter should be negatively related to the incidence of a franchisee council being set-up since it provides franchisors monetary incentives to ongoing performance.

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 should be negatively related to the existence of a council.

4.2.3 Control variables

In order to strengthen the empirical analysis, we controlled for variables derived from agency theory which may, in addition to the independent variables, influence the scope

⁹ Note that guidelines such as standard operating manuals and marketing handbooks may also need adaptation to changing environments in the long-run. Since the provisions of the operating manuals can be changed at the prerogative of the franchisor, potential conflicts could arise over issues such as the timing of adaptation, the bearing of adjustment costs and the content of the changes. In addition, standardized operating manuals prepare the grounds for contract terminations and non-renewals since violations of standards are more easily verified by courts. The drawback from franchisees' perspective is that these manuals may serve as vehicles for franchisors to push individual franchisees opportunistically out of business (Hunt, 1972; see, for the case of Avis Europe PLC, Jacobsen, 2004: p. 530).

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 name the higher the fraction of franchisees' sales which it generates and the more should outlets be keen on controlling the chain through councils, all else being equal. Following Lafontaine (1992), we employed three proxies for the value of the brand name. First, the trade name is assumed to be more valuable for established franchisors and so we included the *age of the chain* in years. Second, as the value of the brand increases with the number of outlets that display it, we used the *total number of outlets* (franchised plus company-owned in 2003) as another control variable. Third, 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 the age of the chain.¹⁰

Another essential role of franchisors, which they are indirectly paid for by franchisees, is to monitor the quality delivered at individual outlets. Franchisors can signal not to cheat on the provision of such services the higher the resources devoted to monitoring franchisees. Franchisee behavior is typically monitored by having franchisor personnel visit franchisee-owned outlets to verify that they are adhering to operational norms. Thus, the span of control is meaningfully proxied by the number of headquarters' *franchise consultants per franchised outlet* (Shane, 2001). The more consultants per outlet the higher is the monitoring capacity and the less likely should be the existence of a council.

¹⁰ We did not employ the number of weeks of initial training as a further proxy for franchisor opportunism such as in Lafontaine (1992) since franchisor knowledge assets are an antecedent to franchisor decision rights (see Windsperger, 2003).

4.3 Methods and results

Table 1 shows descriptive statistics and Pearson correlations for the variables used in this study.

[Insert Table 1 about here]

About 51 percent of all sampled chains had a franchisee council in place (this number is comparable to earlier surveys, see McCosker *et al.*, 1995). Cross-sectional variance in the existence of a council across observations set the necessary condition to test our hypotheses. The significant bivariate correlation ($r = 0.19$, $p < 0.05$) between the extent of franchisor decision rights and the council dummy variable provided preliminary support for H1. Because of bivariate correlations between the control and independent variables (e.g., with system size), multivariate regression techniques were necessary.

We used binary logistic regressions as a multivariate technique. The results are displayed in Table 2 and show the transformed logit estimates giving the marginal effects on the odds of being classified in the higher category of the dependent variable at the exclusion of the lower category corresponding to a unit change in the independent variable (Liao, 1994).

[Insert Table 2 about here]

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 (Model 1). The

higher the franchisor's span of control for monitoring franchisees the lower the probability of a council being in place. Equally, the higher the proportion of outlets company-owned – and therefore the franchisor's incentives to perform – the lower is the probability of a council being set-up. Though the directional influence of the variable capturing the share parameter was as expected, it did not come out as a significant predictor of the existence of franchisee councils. Equally, none of the brand name variables displayed a significant influence on the probability of a council being appointed.

Turning attention to the independent variable, the scale capturing franchisor decision rights emerged as a significant ($p < 0.05$) determinant of the existence of a franchisee council. The odds of a system having a franchisee council are 1.175 times higher with a one-unit increase in franchisor decision rights. The likelihood ratio test indicated that the estimated model was highly significant ($p < 0.001$). Therefore, H1 was supported.

Model 2 indicates that the coefficient of the interaction between franchisor decision rights and the share parameter was marginally significant ($p < 0.10$) with a negative directional influence as expected. Among chains with a relatively 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 among channels with a low share parameter. However, Ai and Norton (2003) suggested that, for nonlinear models, tests for the statistical significance of the interaction effect must be based on the estimated cross partial derivatives, not on the coefficient of the interaction term. The reason is that the interaction effect in nonlinear models, as opposed to linear 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 set-up). To account for these concerns, we used the

inteff command in Stata, 8.0 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 ($b = -0.050$). Figure 1 shows that the interaction coefficient was negative across almost all predicted probability values.

[Insert Figure 1 about here]

In terms of the significance of the interaction effect, Figure 2 shows that for the left and right groups of franchise chains whose predicted probabilities are smaller than 0.2 and higher than 0.8, significance of the interaction terms did not reach acceptable thresholds.

[Insert Figure 2 about here]

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.

Model 3 estimated the coefficient for the interaction between franchisor decision rights and the proportion company-owned. The influence of this interaction term was not significantly different from zero. Again, we verified the magnitude and significance of the interaction effect across predicted probabilities. All of these investigations confirmed that H3 was not supported.

5. Discussion

5.1 Findings and null findings

One of the two main purposes of this paper was to clarify the theoretical grounds on which to infer that franchisee councils reduce opportunism on the principal's side. We argued that councils potentially achieve this aim by fostering channel members' participation in chains' decision processes, enable direct monitoring of franchisors and/or set incentives by threatening collective punishment of those franchisors that deviate from their obligations. Our other objective was to empirically test whether the existence of franchisee councils was – consistent with the three rationales above – systematically related to the risk of franchisor moral hazard. The empirical results confirmed this presumption and showed that a cross-sectional increase in the scope for franchisor moral hazard, as expressed by the extent of chains' decision rights, increased the probability of a council set-up.

We also submitted that the existence of a franchisee council would be less likely when property rights create strong monetary incentives for franchisors not to abuse their decision rights. The empirical results were only in partial agreement with this claim. The existence of franchisee councils was indeed less likely for chains in which franchisor decision rights were accompanied by high shares in franchisee sales. However, it was no less likely at every given level of franchisor decision rights among systems with a high proportion of outlets company-owned than among those with a low proportion. One explanation for this null finding is that demand might be imperfectly correlated across outlets – possibly due to repeat customers (see Brickley, 1999) – such that franchisors can selectively cheat on franchisees without simultaneously damaging revenues and therefore the profit potential in company outlets.

5.2 Implications for managers

Our research has important implications for practitioners. First, contract design decisions could usefully incorporate the idea of our paper. Basically, our results indicate that institutional (i.e., franchisee councils) and monetary contractual (i.e., sharing of franchisee revenues) elements can be substituted to provide franchisors incentives to perform. 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-operation should therefore not be considered completely equivalent incentives.

Second, we offered 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 for its members. The analysis outlined several elements which should be considered by practitioners for collective punishment to be successful. Most importantly, franchisees have to accept the leadership of their council representatives and should follow the recommendations issued by them. In addition, outlet-owners are advised to conceive of effective communication structures with peers allowing them to exchange information and to coordinate their actions.

Third, our 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 franchising contracts 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). Our results 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 reputation-based enforcement of chains' obligations (see, generally, Greif, 1994). Therefore, we 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 shifted to the periphery. Also, *ex ante* signalling 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, we conjecture that chains which setup franchisee councils in the face of extensive franchisor decision rights perform better, especially when franchisor property rights are diluted, than those networks foregoing institutional arrangements. In a similar vein, Shane (2001) found that as exchange hazards increase with system size, membership of the franchisor in the International Franchise Association reduced the probability of system failure.

5.3 Limitations

This study is subject to several limitations. First, we considered but one of many institutional arrangements typically found in franchised channels of distribution (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 moral hazard similar to those described herein. Yet, the mere existence of these alternative institutional forms suggests that there are differences – besides those with respect to the task performed by each group – concerning the particular interests represented, the mechanisms and the effectiveness of their enforcement.

Second, our empirical analysis focused on the probability of a franchisee council to exist in each chain. While this approach is a useful first step to test the empirical relevancy of institutional arrangements in the presence of franchisor moral hazard, it did not allow us to shed light on the extent of formal and/or informal rights of these councils to govern the behavior of the channel members. Detailed case studies would be an appropriate methodology to explore these issues in further detail.

Third, our empirical test was 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 countries 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 control variables (and moderator variables). Ownership rights in franchised channels of distribution may also take the form of ownership surrogates such as tying arrangements, lease controls, and exclusive dealing clauses (Windsperger, 2003).

Robustness of our empirical results would have been corroborated by including these ownership surrogates as control variables. These data were not available to us.

6. Conclusion

In this paper, we have attempted to theoretically explore how, and to empirically confirm that, institutional arrangements protect franchisees against moral hazard emanating from the franchisor. The results clearly show that monetary incentives specified by the contract are not the only instruments amenable to induce franchisor obligations but that institutional arrangements equally deserve attention in the analysis of franchisor opportunism. However, the precise mechanisms by which institutional arrangements function to guard against moral hazard are little understood. Though we feel that our arguments based on ease of monitoring, participation and enforcement by collective punishment are intuitive, we do not claim them to be complete. It may actually be that while economic rationales are appropriate to explain the incidence of such institutions in light of trading hazards, insights derived from research in organizational behavior, for instance concerning collective identity and action (e.g., Hardy *et al.*, 2005), may be equally useful to understand the underlying mechanisms at work once an institutional arrangement is in place.

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Appendix

Variable	mean	s.d.	(1)	(2)	(3)	(4)	(5)	(6)	(7)
(1) Total no. of outlets	84.89	182.74	1						
(2) Age of the chain	20.00	19.53	0.23**	1					
(3) Percentage time not franchising	0.35	0.29	-0.13	0.43***	1				
(4) No. of franchise consultants	0.32	0.56	-0.16	-0.05	0.29**	1			
(5) Share parameter	5.78	3.12	-0.02	0.04	0.10	0.13	1		
(6) Proportion company-owned	0.20	0.23	0.19*	0.13	0.29***	0.33***	0.10	1	
(7) Franchisor decision rights	7.30	2.58	0.19*	0.06	-0.04	-0.03	-0.13	-0.04	1
(8) Franchisee council	0.51	0.50	0.18*	0.00	-0.13	-0.29**	-0.11	-0.34***	0.19*

Table 1. Descriptive statistics and Pearson correlations. n = 131. Significance levels (two-tailed): *** p < 0.001; ** p < 0.01; * p < 0.05.

Model	Dependent variable: Franchisee council (0 = no; 1 = yes)		
	1 Exp(b)	2 Exp(b)	3 Exp(b)
Constant	0.889* (0.789)	0.110* (1.491)	1.121* (0.506)
Total no. of outlets	1.002 (0.002)	1.002 (0.002)	1.002 (0.002)
Age of the chain	1.000 (0.016)	0.994 (0.017)	1.000 (0.016)
Percentage time not franchising	2.432 (0.945)	3.044 (0.959)	2.445 (0.949)
No. of franchise consultants	0.048* (1.403)	0.033* (1.489)	0.048* (1.406)
Share parameter	0.968 (0.064)	0.969 (0.064)	0.967 (0.065)
Proportion company -owned	0.022** (1.289)	0.015** (1.345)	0.022** (1.288)
Franchisor decision rights	1.175* (0.083)	1.178* (0.085)	1.173† (0.086)
Franchisor decision rights × Share parameter		0.949† (0.031)	
Franchisor decision rights × 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 R ²	0.339	0.361	0.339
Correct classification	68.70%	68.70%	68.70%

Table 2. Logistic regression results. 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.

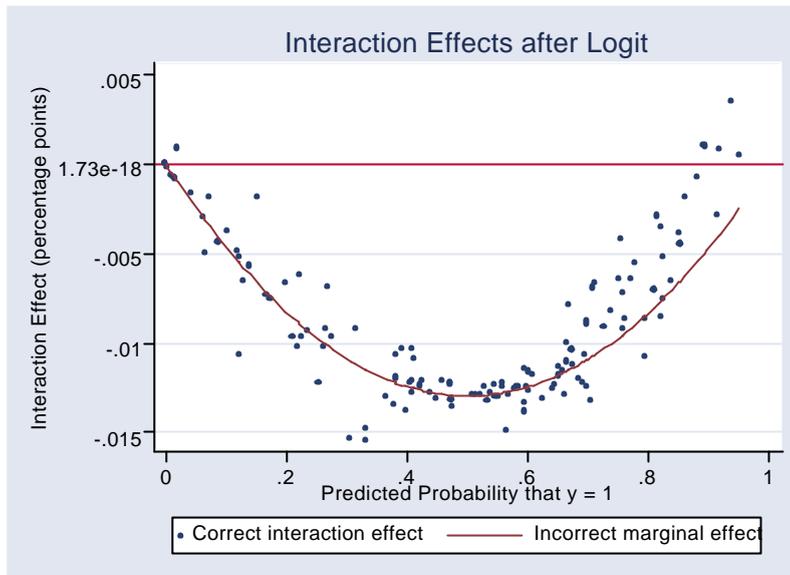


Figure 1. Magnitude of interaction coefficient (franchisor decision rights \times share parameter) across the range of predicted probabilities of a franchisee council being in place.

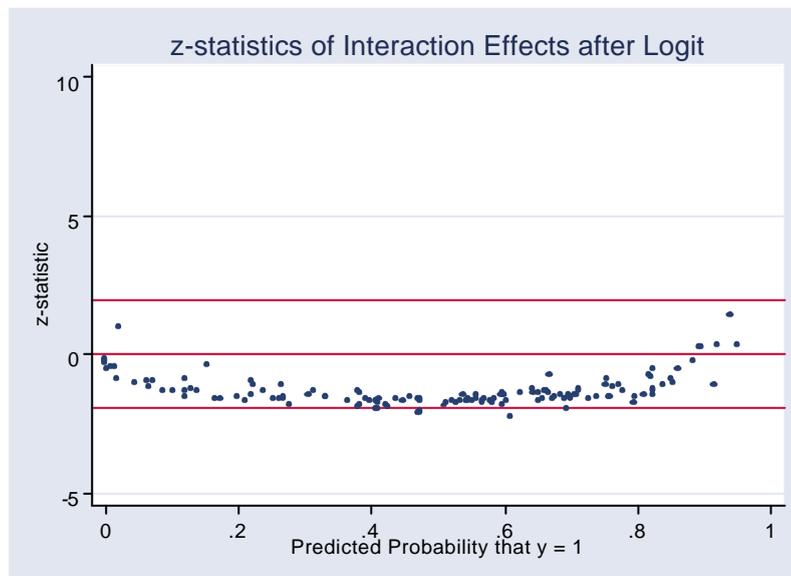


Figure 2. Significance of interaction coefficient (franchisor decision rights \times share parameter) across the range of predicted probabilities of a franchisee council being in place.