Allocation of decision rights in international franchise firms:

The case of master and direct franchising

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September, 2009

Abstract

This paper investigates the allocation of decision rights in master and direct/multi-unit franchising by applying the frameworks of property rights, agency and transaction cost theory. The right to make decisions actually implies control over firm’s operations which is a very important issue in international franchising. In international setting the control over the partner's action becomes increasignly difficult and certain decision rights must be allocated to foreign franchisees. It is therefore essential for the success of franchise systems that franchisors choose the appropriate portion of decision rights to be delegated, which will result in maximizing economic gain but simultaneously enable optimal control over the network.

We use the framework of property rights theory because it involves residual decision rights and intangible knowledge assets, which have significant importance in international franchising. This theory assumes that residual decision rights should be delegated to the party which intangible knowledge assets generate the network surplus. Agency theory was already extensively applied for examining franchising issues. This stems from the fact that the relationship between franchisor and franchisee can be seen as an agency relationship. We use it to examine how monitoring costs and agency problems influence the allocation of decision rights. Finally allocation of decision rights can also be determined by the firm's efforts to reduce risk-asssociated transaction costs. We direct our attention to two determinants based on the transaction costs view – environmental and behavioral uncertainty.

Previous literature did not examine the difference in allocation of decision rights between master and direct/multi-unit franchising and we aim to fill that gap with this study. The contribution to the franchising literature is twofold: (1) By combining property rights, agency and transaction cost theory, we grasp the allocation of both residual and non-residual decision rights of franchising relationship, since each firm possesses both tangible (explicit) and intangible knowledge assets. (2) We try to explain the difference in the allocation of decision rights between two particular modes of the international franchise firms – master and direct franchising.

1. Introduction

Franchising is one of the most important organizational forms of international retail and service firms in today's economy. According to the US Department of Commerce business format franchising accounts for over 40% of the retailing industry in the United States and is applied in more than 75 industries (Castrogiovanni et al. 2006). In retailing, franchising is one of the most important foreign market entry modes (Burt, 1993; Quinn and Doherty 2000; Doherty and Alexander 2004). The concept referred to in this study is „business-format franchising"[1] (e.g., Burton et al., 2000; Bercovitz, 1999; Rubin, 1978) defined as a form of contractual relationship where owner of a brand and business concept (franchisor) grants exclusive right to independent entrepreneurs (franchisees) to conduct business in a prescribed manner, within a certain geographical region and over a specified period of time, under a system trade name owned and developed by the franchisor. In return franchisor receives payment of royalties and fees. International franchising refers to the business arrangement with a franchisee that is located outside franchisor's home market (Konigsberg 2008).

Franchising research can be divided into three major streams. The first focuses on the choice between franchising and vertical integration (see Lafontaine and Slade, 1998; Blair and Lafontaine 2005). Second investigates the choice among different franchising modes of foreign market entry and factors which influence that choice (e.g. Chan and Justis, 1992; Zietlow, 1995; Burton et al, 2000; Alon, 2006; Garg and Rasheed, 2006). Third stream deals with design and provisions of franchise contracts, concerning primarily royalties and fees, i.e. incentives and compensations (e.g., Lafontaine 1992; Sen, 1993; Lafontaine and Shaw, 1999). Relatively small body of literature deals with other contractual provisions (e.g., Dnes, 1996;

[1] The definition, which is accepted from the US Department of Commerce, identifies two types of "franchising": (1) „Product and tradename franchising" that represents an independent sales relationship between supplier and dealer in which the dealer acquire[s] some of the identity of the supplier. (2) „Business-format franchising" that is characterized by an ongoing business relationship between franchisor and franchisee and includes not only the product, service and trademark, but the entire business format itself.

Mathewson and Winter, 1994; Brickley, 1999) or allocation of ownership and decision rights between franchise partners (e.g., Windsperger, 2004; 2003; 2002; Arrunada et al., 2001).

Allocation of decision rights is the important issue in franchising since having a decision right implies having control over the particular use of an asset. Hence, the allocation of decision rights determines the allocation of control between business partners. In international franchising this issue raises following research questions: Which decision rights should be delegated to local partners and how to retain maximal control over the network? Due to the difference in contractual design, each franchise mode provides different level of control to franchisor. Franchising forms identified throughout franchising literature are: direct (single and multi-unit) franchising, area development, master franchising, joint venture franchising and franchising via wholly owned subsidiaries on foreign market.

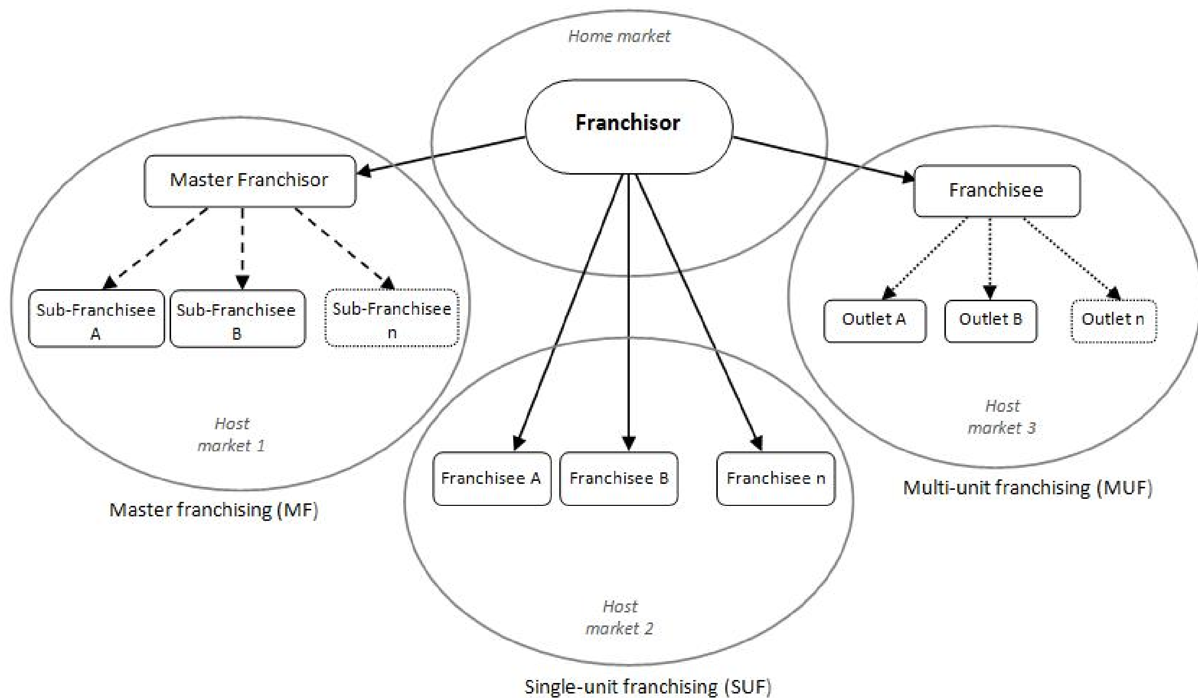
This study focuses on master and direct (single and multi-unit) franchising in particular. We aim to explain the allocation of residual decision rights between these two franchise modes and the choice between these two forms by applying property rights, agency and transaction cost theory. The paper is organized as follows: in the second chapter we analyze the differences between master and single/multi-unit franchising forms, and review the theory on decision rights. In the chapter three we review the literature regarding all three theoretical perspectives. Subsequently hypotheses regarding market entry choice as well as allocation of decision rights are proposed. Chapter four includes the discussion about the model.

2 Organization of international franchise firms

Franchising relationship involves two independent business entities cooperating on the basis of franchising contract. Franchising can in general be divided in two basic forms –direct and indirect franchising. In direct franchising the agreement is concluded with each franchisee on

individual basis (e.g., Burton et al., 2000; Fladmoe-Lindquist and Jacque, 1995; Julian and Castrogiovanni, 1995; Konigsberg, 2008) and franchisees are served *directly* from the franchisors home market. Indirect franchising, in contrast, refers to the agreement with an intermediary located in the host market which develops and coordinates whole network in the foreign market (or some other geographic area) and franchisees are served *indirectly* by the franchisor. Basic direct forms, single (SUF) and multi-unit franchising (MUF), both involve direct interaction with local franchisee. The difference is that MUF implies the possibility that local franchisee owns and operates several outlets (Kaufmann and Dant, 1996; Konigsberg 2008). Single-unit franchisees often gain the right to open additional outlet when having successful results, which is in the literature known as incremental or sequential MUF (Kaufmann and Dant, 1996). Master franchising is an indirect franchising form in which local partner has a role of franchisor on the local market. Master franchise agreement, therefore, grants the right to the local partner to "sell" franchises to other independent entrepreneurs within the exclusive territory. Master franchisee is frequently referred to as sub-franchisor (e.g. Konigsberg, 2008; Garg and Rasheed, 2006; Welsh et al., 2006; Alon, 2000, 2006; Burton et al., 2000; Zietlow, 1995; Chan and Justis, 1992). The Figure 1 illustrates the structures of described franchise modes.

Figure 1: Structure of direct (SUF/MUF) and master franchising



Decision rights

Franchisors transfer decision rights across firm's boundaries through franchise contracts (Baker et al., 2005; Lerner and Merges, 1998) without transferring ownership. Allocation of decision rights is of substantial importance because it affects the capability and motivation of the franchisor and franchisees to undertake investments in system-specific and local market assets, thereby influencing the creation of the residual income stream of the network (Aghion and Tirole, 1997). In organizational economics the concept of *decision rights* refers to the rights and authority regarding deployment and use of the firm’s assets (Hansmann, 1996). Decision rights refer to strategic decisions, e.g. decisions concerning international expansion, product line, organization design, investment, etc.; and to operational decisions such as marketing decisions (pricing, product, promotion, and service), human resource decisions and procurement decisions (Windsperger, 2004). Franchisors usually retain strategic decisions in their hands, whereas certain operative decisions are transferred to franchisees. By transferring decision rights to franchisees, franchisors transfer the authority to decide regarding the use of

local assets in the future activities. Organizational economics differentiates between non-residual (specific) and residual decision rights. Non-residual decision rights are explicitly defined by the contract (Demsetz, 1998) and they refer to the use of tangible knowledge (explicit knowledge) which is easier to codify and less costly to transfer. Residual decision rights concern the use of system-specific and local market assets which are "intangible", i.e. have substantial tacit component and are difficult to communicate, codify or transfer due to the high transaction costs (Contractor and Ra, 2002; Contractor 2000; Kogut and Zander 1993). Intangible knowledge assets are referred to as the "knowledge of particular circumstances in time and place" (Hayek, 1945; p.524). Franchisee's intangible assets refer to the know-how specific to the local market, such as marketing, customer service, quality control, human resource management and product innovation (Windsperger, 2004; Sorenson and Sorensen, 2001; Caves and Murphy, 1976), whereas franchisor's intangible assets refer to the system-specific know-how and brand name assets.

What is the difference in the distribution of decision rights between master and multi-unit franchisees, and how do franchisors allocate them when they choose the international governance mode? Master and single/multi-unit franchising provide different levels of control. Compared to multi-unit franchisees, master franchisors can hold certain strategic decision rights regarding their local market, such as location decisions, marketing and procurement decisions and franchisor cannot directly control the local network. Multi-unit franchising, however, provides the franchisor direct control over local partners and strategic decision rights regarding the local market are held by the franchisor.

3 Theoretical views on allocation of decision rights

This paper uses three major theories of organizational economics: transaction costs, agency and property rights theory to explain the allocation of decision rights of the international franchise firm and the choice of the franchising mode for the foreign market entry.

Property rights theory and allocation of decision rights

Property rights theory explains the allocation of residual decision rights in firms and networks (e.g., Kim and Mahoney, 2005; Brynjolfsson 1994; Jensen and Meckling 1976). It suggests that in the absence of comprehensive contracting the ownership of residual decision rights depends on the distribution of intangible knowledge assets that are not explicitly determined by contract[2] (Windsperger, 2004; Hart, 1995). Intangible knowledge assets are such essential assets. High intangibility of local knowledge assets implies that the costs of transferring the knowledge to the network headquarters (i.e. acquisition of the local knowledge) are high. Therefore, if franchisor cannot acquire the knowledge or it would be very costly, he will be motivated to relinquish higher portion of residual decision rights to the better informed party (franchisee) to maximize the network residual income. The higher the impact of the local partner's intangible knowledge on the generation of residual income, the larger should be its proportion of allocated residual decision rights.

How do franchisors allocate residual decision rights between the headquarters and the local partners? If the system-specific assets of the franchisor are more intangible (less contractible) and have higher importance for the generation of income in relation to the local partner's, franchisors are expected to hold more residual decision rights. Consequently, by applying property rights reasoning we can formulate the following propositions. (1) If franchisors

[2] Incomplete contractibility is a key assumption in the GHM model (Grossman and Hart 1986; Hart and Moore 1990), also accepted by the property rights view, which determines which ex post bargaining positions will prevail in the absence of complete contractibility (Brynjolfsson, 1994)

system-specific assets are intangible and more important for the generation of network surplus in relation to the local partners (master and multi-unit franchisees), his proportion of residual decision rights is relatively high. (2) If the local partners' knowledge assets are more intangible and have a higher impact on the residual income of the network compared to the franchisor, their proportion of residual decision rights is relatively high. We can derive the following hypotheses:

> ***Hypothesis 1a:*** *The more important the franchisor´s intangible knowledge compared to the local partners' intangible assets for the generation of the residual surplus of the network, the more residual decision rights are allocated to the headquarters.*

How does the intangibility of franchisees' knowledge assets influence the choice between direct franchising and master franchising? As argued above, due to the master franchisor strategic decision-making power, he has more residual decision rights than the multi-unit franchisee. The greater residual income-generating effect of the master franchisor compared to the multi-unit franchisee depends on the intangibility (non-contractibility) of the local market assets. Therefore, the residual income-generating effect of the master franchisor is higher, the less contractible and more important local market assets are for the generation of the residual surplus. Consequently, according to the property rights theory we derive the following hypothesis:

> ***Hypothesis 1b:*** *Given the franchisor's intangible system-specific assets, the lower the contractibility of local market assets, the higher is the residual income-generation effect of the master franchisee compared to the single/multi-unit franchisee, and the larger is its proportion of residual decision rights compared to the single/multi-unit franchisee.*

Agency theory and allocation of decision rights

Agency theory is based on the following assumptions: (1) the principal and the agent have conflicting interests, and (2) it is difficult and costly for the principal to monitor agent's behavior (e.g., Kaufmann and Dant, 1996; Eisenhardt, 1989; Jensen and Meckling, 1976). The costs of monitoring of manager's performance have attracted much of the attention in the literature (e.g. Norton, 1988a,b; Mathewson and Winter, 1985; Brickley and Dark 1987). Franchising largely alleviates principal's monitoring costs by providing to franchisee powerful economic incentives in a form of claim on residual profits (Norton, 1988; Rubin, 1978), which represents the main reason to choose expansion via franchising over company-owned units (Brickley and Dark, 1987; Mathewson and Winter, 1985).

How do agency costs influence the allocation of decision rights? Agency costs represent the costs of aligning incentives of the principal and the agents (Jensen and Meckling, 1976:308). The principal has the choice either to increase monitoring in order to reduce residual loss and prevent agency problems, or to allocate more decision rights to increase the local partner's incentive. Findings confirm that monitoring costs influence the allocation of decision rights and that decentralization of decision rights is higher, the higher the monitoring costs (e.g., Brickley et al., 2003). Monitoring costs result from information asymmetry that is particularly high in the international settings where both geographical and cultural distances cause higher environmental and behavioral uncertainty, thus precluding effective monitoring and raising monitoring costs (Fladmoe-Lindquist and Jacque, 1995; Carney and Gedajlovic, 1991). Despite the technological progress it is still very difficult to completely monitor foreign operations especially when the outlets are geographically far from the headquarters. Large geographic distance induces high travelling costs of the franchisor's representatives who conduct direct observations, thus increasing information gap and uncertainty. Without having relevant knowledge about the local environment in the foreign market, franchisor's decision-

making can be significantly lingered. Brickley et al. (2003: 353) suggest that higher decision-making authority should be allocated to the local partner when the costs of monitoring due to the greater distance are high, as well as when the local market knowledge is essential for the effective operation of the local outlet. When the costs of monitoring are high principals have to delegate higher portion of decision rights to agents to achieve the optimal decisions-making and decrease the need of monitoring. In this aspect franchising serves as the mechanism of creating incentives for self-monitoring of local partners because they bear the costs of shirking and underperforming due to the reduction of the residual income. Based on the agency-theoretical view we can derive the following proposition: The higher the monitoring costs of the franchisor, the more residual decision rights should be transferred to the local partners. Monitoring costs vary with (1) geographic distance and (2) cultural distance.

(1) Geographic distance: The costs of monitoring regarding the geographic distance can additionally be increased with the number of partners at the foreign market. A franchisor which has a higher number of franchisees at the foreign market will bear higher monitoring costs than the one that interacts with only one partner on the foreign market. Hence, we can expect that the geographic distance is positively related with the allocation of decision rights to local partners and the tendency to choose master compared to single/multi-unit franchising. We can formulate following hypotheses:

> ***Hypothesis 2a:*** *The portion of decision rights that franchisor allocates to the local partners on the foreign market (master and single/multi-unit franchisees) is positively related with geographic distance.*
>
> ***Hypothesis 2b:*** *The higher the geographic distance between the domestic and host market, the higher is tendency of choosing master franchising over direct franchising.*

(2) Cultural distance: When a foreign market is culturally different from the franchisor's domestic market the monitoring of agent's behavior is additionally impeded. Cultural

difference requires various aspects of a business format to be translated and adopted to the local culture. These costly requirements force companies to use lower-cost governance structures (Fladmoe-Lindquist and Jacque, 1995). Franchising allows company to shift responsibility for cultural adaptation to its foreign franchisees which share the financial risk if the service is not adequately adapted to the cultural context. To successfully monitor and effectively evaluate franchisees in the culturally different market, franchisors must acquire the knowledge about local market (Minkler, 1990). However, the adaptation of the local knowledge is also costly and difficult. This forces franchisors to allocate more decision rights to the local partners since their knowledge of the local culture allows them to make better decisions.

How is the choice between master franchising and multi-unit franchising influenced by cultural distance? As argued above, cultural distance increases the information asymmetry between the franchisor and the franchisees and requires more intensive communication and adaptation. Master franchising enables transfer of a substantial part of tasks to the master franchisor, e.g. negotiation with local entrepreneurs, adaptation of strategies to local market, monitoring activities, etc.; thus reducing monitoring costs. In the situation of the high cultural difference local partner can even be more competent to make such decisions. Based on these assumptions, the following hypotheses can be formulated:

> ***Hypothesis 2c:*** *The portion of residual decision rights that franchisor allocates to the local partners (master and single/multi-unit franchisees) on the foreign market is positively related with cultural distance.*
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> ***Hypothesis 2d:*** *The higher the cultural distance between domestic and host market, the higher is tendency of choosing master franchising over direct franchising.*

Transaction costs view on allocation of decision rights

TC theory was widely used in the entry mode literature to explain firm's choice of a foreign market entry mode[3]. This literature differentiates entry modes by the equity stake level and respectively the control level. It involves three key factors that influence the choice of governance form: asset specificity, environmental uncertainty and behavioral uncertainty (Groenewegen, 1996:18).

Asset specificity, that primarily influences the choice between equity and non-equity mode, was widely investigated as an entry mode determinant in the TC literature (e.g. Erramilli and Rao 1993; Gatingon and Anderon 1988; Palenzuela and Bobillo 1999). Given that we investigate master and direct franchising as non-equity modes, asset specificity will not be included as a determinant of the entry mode choice. However, the other two TC determinants –environmental and behavioral uncertainty, are relevant for the franchisor's decision between master and direct franchising.

(1) Environmental uncertainty represents risks associated with the economic, political and legal unpredictability of a foreign market (Williamson, 1985; Erramilli and Rao, 1993) and "the extent to which a country's political, legal cultural and economic environment threatens to the stability of business operations" (Gatignon and Anderson, 1988:315). Economic uncertainty concerns changes in a country's business or economic environment. Political and legal uncertainty are closely related and refer to uncertainty at transferring property ownership and funds, as well as to inadequate protection of foreign businesses in the form of property rights. Market entrant will seek to identify all the characteristics and risks of the target market, in order to choose the governance mode which minimizes transaction costs. Franchisors economize with transaction costs of searching, monitoring or servicing costs of local franchisees. When environmental instability is high, master franchising can enable lower

[3] See e.g. Gatignon & Anderson, 1988; Anderson & Gatignon, 1986; Klein, 1989; Klein et al. 1990; Brouthers and Brouthers, 2003; Delios & Beamish, 1999; Erramilli & Rao, 1993; Hennart, 1991

resource commitment by reducing costs of searching servicing and monitoring. Burton et al. (2000:381) described master franchising as a *"hands-off" strategy* where the control of a sub-system is relinquished to a local intermediary to a much greater degree than in direct franchising.

Master franchising also provides higher information processing capacity and local adaptability in an uncertain environment. Most TCE scholars emphasize flexibility as a necessary factor in an unpredictable market (e.g. Erramilli and Rao 1993; Gatignon and Anderson 1988). When having appropriate decision rights, local partners can react to the environmental changes. Therefore, in the situation of higher environmental uncertainty we can expect that the propensity to choose master franchising to enter the foreign market increases.

> ***Hypothesis 3a:*** *The higher the environmental uncertainty, the more residual decision rights are transferred to the local partner, and the higher is the tendency of choosing master franchising over single/multi-unit franchising.*

This hypothesis is also consistent with the search cost hypothesis of Minkler (1992) but inconsistent with the original transaction cost hypothesis that suggests a positive relationship between environmental uncertainty and higher control modes (e.g. Erramilli & Rao, 1993; Hennart, 1991; Gatignon & Anderson, 1988).

(2) Behavioral uncertainty results from opportunistic risk due to adverse selection and moral hazard (Williamson, 1975). The findings regarding the influence of behavioral uncertainty on the governance mode indicate contradictory results depending on whether a firm is service or production firm (see Brouthers and Brouthers 2003). Empirical studies, which examined service firms, found in the case of increased behavioral uncertainty higher propensity of choosing lower control entry modes. On the other hand, studies examining production firms confirmed the tendency to choose wholly owned (i.e. high control) entry modes as behavioral uncertainty rises (e.g. Gatignon and Anderson, 1988). Since franchising is in its nature

people-oriented, franchisors' choice of franchising mode should therefore be strongly influenced by the behavioral uncertainty. When it increases franchisor has to bear higher costs of monitoring and controlling partner's behavior (Hill et al. 1990), but also higher costs of searching and negotiation, due to the increased difficulty of finding a reliable partner (Burton et al. 2000). In this case, franchisors might prefer to transfer more decision rights to local partners to decrease the risk of opportunism (which is higher by having more partners), search, and communication costs. Therefore, franchisor's propensity to choose master over multi-unit franchising will be higher the higher the behavioral uncertainty.

> ***Hypothesis 3b:*** *The higher the behavioral uncertainty, the higher is the tendency toward choosing master franchising over multi-unit franchising, and more decision rights are transferred to the local partner*

This hypothesis is consistent with the discussed agency cost hypothesis and also supported by the empirical evidence from the studies of service firms (Erramilli and Rao 1993; Fladmoe-Lindquist and Jacque 1995). The results of these studies have shown that the propensity of using wholly owned entry mode decreases with the higher behavioral uncertainty. However, this hypothesis is not consistent with the original transaction cost hypothesis that suggests a positive relationship between behavioral uncertainty and higher control modes (e.g. Williamson 1975; Hennart, 1991).

4 Conclusion

The presented concept can be characterized as an *organizational economics approach*[4] on the issue of allocation of residual decision rights in franchising and factors affecting franchisors' modal choice. Each theory was already applied in separate studies of franchising issues, but no study has applied all three perspectives in one model.

Master and single/multi unit franchising are dominating franchise modes in international franchising. In many large international franchise systems both modes are inherent simultaneously. However, to our best knowledge, the existing franchise literature has not explained why systems make different choices in different countries, how the allocation of decision rights differs, and which determinants influence those decisions. Our model combines the determinants from all three theoretical perspectives of the organizational economics, which enables understanding of different perspectives and influences on the entry decision and allocation of decision rights. By taking this approach we aim to add a new dimension to the franchising research and to provide deeper understanding of complex issues of the franchisor-franchisee relationship.

[4] Property rights, agency and transaction cost theory belong to the domain of organizational economics. Kim and Mahoney (2005) derives basic theoretical principles of all three theories to analyze the business case of utilization of an oil field. They used the same expression for combining those theories.

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