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# INSTITUTIONAL SOLUTIONS TO FRANCHISOR OPPORTUNISM: COLLECTIVE PUNISHMENT THROUGH FRANCHISEE COUNCILS

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## 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).<sup>1</sup> 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

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<sup>1</sup> 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.

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 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 existing 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).<sup>2</sup> 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 Seideman, 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:

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<sup>2</sup> 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.

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<sup>3</sup> and to successfully open new 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.

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<sup>3</sup> 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 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.

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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.

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<sup>4</sup>, 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 collocate 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).

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<sup>4</sup> 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.



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 franchisees’ 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).<sup>5</sup>

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

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<sup>5</sup> See, on unfulfilled promises made by franchisors, Hunt (1977).

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 the company. The larger the share parameter, the higher the revenues foregone by the chain when store performance weakens.<sup>6</sup> 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

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<sup>6</sup> 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.

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 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 1.** 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.<sup>7</sup>

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.

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<sup>7</sup> 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 2.** Pearson correlations and descriptive statistics (n = 131)

Model	Dependent variable: Franchisee council (0 = no; 1 = yes)		
	1	2	3
	Exp(b)	Exp(b)	Exp(b)
Constant	0.153* (1.723)	2.570* (0.468)	1.461* (0.583)
System size	1.002 (0.001)	1.002 (0.001)	1.002 (0.001)
Age of the chain	0.998 (0.016)	0.995 (0.017)	0.998 (0.016)
% time not franchising	2.750 (0.958)	2.759 (0.952)	2.747 (0.959)
No. of franchise consultants	0.067* (1.356)	0.049* (1.455)	0.067* (1.358)
Share parameter	0.940 (0.064)	0.942 (0.065)	0.940 (0.065)
Proportion company-owned	0.024** (1.270)	0.024** (1.269)	0.024** (1.273)
Decision index I	2.042† (0.403)	1.948† (0.408)	2.035† (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 <sup>2</sup>	37.78***	38.91***	37.79***
-2 Log likelihood	143.81	142.69	143.81
Nagelkerke's R <sup>2</sup>	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 3.** Logit regression results (decision index I)

Model	Dependent variable: Franchisee council (0 = no; 1 = yes)		
	4	5	6
	Exp(b)	Exp(b)	Exp(b)
Constant	0.889* (0.789)	0.110* (1.491)	1.121* (0.506)
System size	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)
% 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)
Decision index II	1.175* (0.083)	1.178* (0.085)	1.173† (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 <sup>2</sup>	38.47***	41.42***	38.48***
-2 Log likelihood	143.12	140.18	143.12
Nagelkerke's R <sup>2</sup>	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 4.** 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.<sup>8</sup> Equally, none of the brand name variables displayed a significant influence on the probability of a council being appointed.

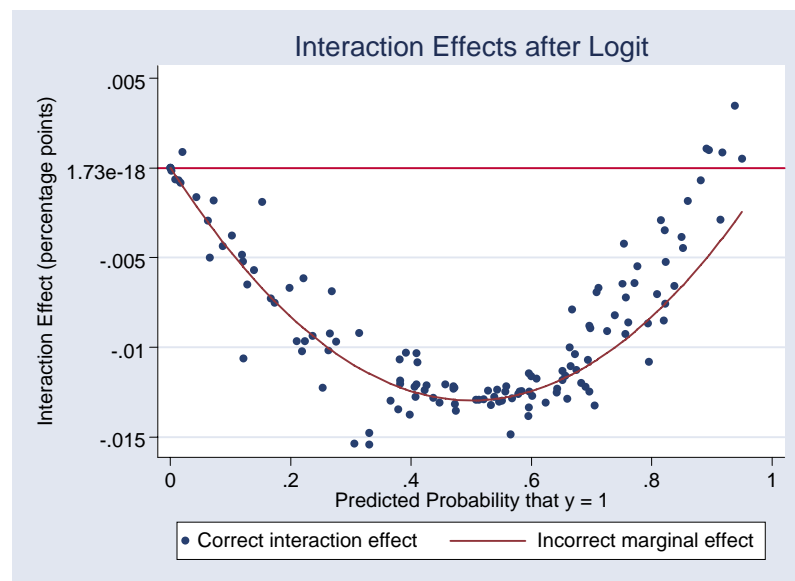
Turning attention to the independent variables, both scales capturing franchisor decision rights emerged as significant determinants of the existence of a franchisee council. In Model 1 (decision index I), the odds of a system having a franchisee council in place were 2.042 times higher with a one-unit 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 derivatives, 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

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<sup>8</sup> Vázquez (2005: pp. 455-456) also found a negative and non-significant relationship between these two variables.

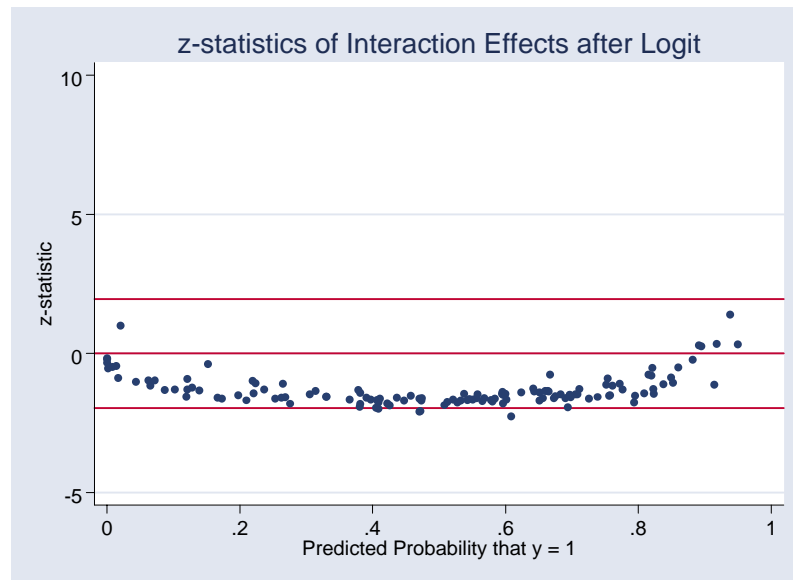
account for these concerns, the *inteff* command in Stata 8.0 was used after running the logit model (Norton *et al.*, 2004). The mean interaction effect across predicted probabilities was still negative but somewhat smaller in magnitude ( $b = -0.009$ ) compared to the unconditional interaction coefficient ( $b = -0.050$ , corresponding to  $\text{Exp}(b) = 0.949$  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  $\Pi \times$  share parameter) across the range of predicted probabilities of a franchisee council being in place.

**Figure 1.** 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  $\times$  share parameter) across the range of predicted probabilities of a franchisee council being in place.

**Figure 2.** 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.

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## **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 importantly, 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

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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 several 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.

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### 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

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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.