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Franchise Agreements: The Distribution of Economic Rents and Agency Costs

Robert Mittelstaedt
Manferd Peterson

University of Nebraska

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CHAPTER 1
INTRODUCTION

Everyone is aware of the rapid growth of franchising in the United States. Most historical accounts (e.g., Haskett, 1977) begin with the development of the automobile distribution system in the early part of this century and go on to describe the petroleum industry's acceptance of the so-called Iowa Plan in the 1930's under which formerly company-owned service stations were licensed to those who operated them. Automobile dealerships and gasoline service stations continue to dominate the franchising data reported each year by the Federal Government (U.S. Department of Commerce, 1972-1981) although, during the past decade, these sectors declined in importance while the newer "business format" types of franchising continued to expand.

This study focuses on this newer type of franchising, typified for many by the fast food restaurant, for two reasons. First, its recent growth has made franchising a significant, and in some cases dominant, way of doing business in sectors that have been traditionally populated by small firms. Second, this growth has occurred since the enactment of the legislation establishing the Small Business Administration which was predicated on the idea that small business needs and deserves government assistance.

Although franchising has grown to be an important factor in the U.S. economy, it has inspired only a relatively small body of analytical literature which has addressed only a few of the many questions which franchising raises. This literature may be described as following one of two conceptualizations, both of which will be examined in this study.

In approaching any phenomenon, the analyst begins by conceptualizing the research question(s) in a two-phased effort. First, one must choose those elements of the phenomenon which typify its essence thereby forming an
abstraction which dictates those elements which are to be observed. Eventually, it is this abstraction of the phenomenon (and not the phenomenon itself in the full range of its complexity) which must be explained. In the second phase of conceptualization, an analytical model is chosen to explain the observations derived from the abstracted view of the phenomenon. In short, the nature of the model chosen depends on how the questions are asked which, in turn, depends on how the analyst views the nature of the phenomenon to be explained.

Chapter 2 discusses what we have chosen to call the traditional conceptualization of franchising. In essence, this approach sees franchising as an institutional arrangement in which the trademark-owning franchisor controls the retailer-franchisee's operation and, through fees and royalties, extracts any economic surplus earned by the franchisee's establishment.

If franchising is a relatively new phenomenon and lacks an extensive analytical literature, it may seem peculiar to give the name "traditional" to any part of that literature. Of course, the designation is arbitrary but refers to the literature which grows out of a more general and long standing concern with vertical integration and applies analytical models which assume away transaction costs. Five hypotheses which follow from this conceptualization are presented at the end of the Chapter.

Chapter 3 presents an alternative conceptualization which explicitly recognizes transaction costs, information asymmetries and incentive problems. This view begins with the realization that the franchisee is the licensee of the franchisor's trademark more than the distributor of its goods. Although the franchisee has a potent incentive to make sales and costs, some market conditions create disincentives to quality maintenance with the potential result of damaging the entire system.
Franchising is seen as a contractual relationship between two parties, each of whom has an interest in the success of the entire system, which creates incentives to assure performance which furthers that mutual interest.

These two conceptualizations are based on different presumed purposes for franchising. Each sees the contract as having a different role in the relationship between the two parties with certain consequences for the nature of the contracts themselves. Further, the traditional view suggests a strong incentive for franchisors to integrate their systems while the alternative view suggests a continued viability for a substantial proportion of franchisees.

Testing the hypotheses suggested by each conceptualization involves looking at various contract provisions plus data about system integration. The methods of collecting and treating this information are described in Chapter 4.

Chapter 5 operationalizes the variables of the various hypotheses in terms of the data collected. Partly because of the inherent difficulty of operationalizing some concepts and partly because the data collection effort was designed only as a pilot for a more extensive project, not all the hypotheses are truly testable with the available data. Such testing as is possible is presented in Chapter 6.

The conclusions which emerge are more consistent with the alternative conceptualization. However, the nature of the data require caution in interpretation and the limitations of the study are also presented in Chapter 7. Finally, to the extent the conclusions are tenable, the public policy implications of rejecting the traditional conceptualization are discussed.
CHAPTER 2

TRADITIONAL CONCEPTUALIZATION

The first section of this chapter lays out the traditional abstraction of franchising. This is followed by a section which discusses the questions to which this abstraction does - and does not - lead. The third section briefly describes the micro-economic model generally employed in answering the questions as posed and presents five (partially) testable hypotheses which result.

The Traditional Abstraction

Although most aspects of this abstraction are not articulated in the literature, the traditional conceptualization appears to be based on five salient features. This subsection describes those features; questions about their accuracy or completeness are left until the hypotheses to which they lead are presented.

First, franchising is seen as a single phenomenon, i.e., a "hybrid" form of organizing a channel of distribution which combines the franchisor control of a vertically integrated channel while maintaining many of the features of the usual buyer-seller relationship between legally separate producers and distributors. While some recognition is often given to the difference between (to use the U.S. Department of Commerce's terminology) "product and trademark franchising" (e.g., automobile and truck dealers, gasoline service stations and soft-drink bottlers) and "business format franchising" (e.g., restaurants, real estate services, motels, barbershops), little if any conceptualizing derives from the differences between the distribution of goods and, in effect, the licencing of production processes. The franchise agreement is viewed as a mechanism for routinizing the transactions between the franchisor as seller and the franchisee as buyer. Almost all contracts address a set of basic
issues and, while there are differences in the terms set by various contracts, analytical attention has been focused exclusively on those parts of the agreements which involve the payments by the buyer/franchisee to the seller/franchisor, i.e., purchases of goods and services, initial fees and royalties.

Second, the franchisor's major contributions to the relationship are seen to be a trademark and, to a much lesser degree, a specified method of operation for the outlets to follow. Presumably the trademark derives its value from a combination of the franchisor's past and current advertising and the reputation built by other franchisee-owned establishments following the prescribed operational format. It serves as a symbol by which the franchise system's product is identified and, therefore, the franchisee's establishment is seen as being differentiated from its competitors only by its use of the franchisor's trademark and adherence to the operational format.

Third, the franchisee's contributions to the relationship are seen as consisting of labor and capital. The franchisee is presumed to be a person who would otherwise be a small entrepreneur or a hired manager of a chain outlet similar to the franchised establishment, and in possession of at least potential managerial skills sufficient to operate an establishment within the confines of the franchisor's prescribed mode of operation. The capital required of potential franchisee, while important to the franchisor's expansion, is relatively modest for any one establishment. Thus, neither the skills or capital required are viewed as especially restrictive and there is presumed to be a substantial pool of prospective franchisees.

Fourth, both franchisees and franchisors are viewed as being rational, desiring to maximize their respective profits and not differing from each other in their risk preferences. Presumably the franchisor's drive to
maximize profits manifests itself in a desire to expand the scope of operations to some saturation point by adding more and more outlets. On the other hand, the scope of the franchisee's operation is tightly circumscribed by the contract and largely dependent on the strength of the franchisor's trademark (and, therefore, on the actions of the other franchisees within the system) and can only be made more profitable by the franchisee closely following the prescribed format and giving careful scrutiny to the day-to-day expenses in his/her operation.

Finally, as the name franchising implies, the franchisee is viewed as coming into being and continuing to exist at the sufferance of the franchisor. Combined with the value of the trademark and the differences in the scope of the franchisor's and the franchisee's operation, the traditional view sees the franchisor as always "holding the upper hand." The franchisor is seen as large and the franchisee as small; the franchisor is seen as powerful and the franchisee as weak.

Stated as above, this abstraction of franchising invites evaluation as an accurate representation of reality. However, this is deferred to the last chapter and attention is now turned to the questions raised by this abstraction.

The Traditional Questions

The traditional view of franchising gives rise to a number of questions, at least two of which are widely discussed elsewhere and will not be addressed in this study. First, because the relationship is viewed as a contract between two parties whose interests are not necessarily identical, there seem to be causes for conflict between franchisee and franchisor built into the relationship. Since it would be in the franchisors' interest to have the franchisees full cooperation in the distributing of its products, much of the
marketing literature has focused on the sources and possible resolution of franchisor/franchisee conflict. Second, since a franchisor/franchisee relationship is a form of exclusive dealing, it may be argued that the very nature of franchising is contrary to the underlying philosophy of our public policy as typified by the anti-trust laws. On the other hand, it may be countered that there are substantial social benefits to franchising (e.g., entrepreneurial opportunities afforded to minority persons) and there is a body of literature examining the existence of presumed social harms and benefits accruing to society from the franchising.

The body of literature most germane to this study is concerned, directly or indirectly, with the question "How are the economic profits generated at each establishment distributed between franchisor and franchisee?" Before examining and testing several hypotheses which have been advanced, several general comments are required about the nature of the question itself. To ask the above question presupposes at least four things.

First, and most importantly, the question presumes the existence of franchising. While it might at first seem to be analytically trivial it is not at all irrelevant because a franchisor might always capture the economic surplus generated at the establishment level through ownership, i.e., vertical integration. In other words, an obvious "answer" to the question of the distribution of economic surpluses is an arrangement in which there is no franchising. How then does the traditional view account for franchising's existence?

Early on, most writers postulated that franchising existed because the franchisor needed the franchisee's capital for expansion. The typical franchisor, starting as a small business, would be unable to borrow funds at reasonable rates and/or unwilling to take in partners and would turn to
franchising as a convenient and, presumably, inexpensive source of capital. Indeed, Rubin (1978, p. 225, n. 6) reports that "Every source I have found assumes that capital is the explanation for franchising." However, he goes on to show that "A consideration of this argument in light of modern capital theory quickly indicates that it is fallacious" (p. 225). As he points out, the risk in a franchise system is asymmetrical. Were it to integrate, the franchisor's risk would be diversified over many outlets in many areas while the franchisee's risk is specific to one or a very few outlets in the same area. He goes on to describe the effects of this asymmetry on the franchisor's cost of capital:

This means essentially that the franchisee will require a higher rate of return on his capital if he is required to invest in one outlet rather than a portfolio. Conversely, the franchisor, by forcing a relatively large risk on the franchisee, will himself earn a lower rate of return. This argument (that franchisees are a good source of capital for expansion) thus appears to make sense only if we assume that franchisors are more risk averse than franchisees. But since franchisees commonly invest a large share of their assets in acquiring a franchise, it is unlikely that this will be the case (p. 225).

Without the "capital argument," the traditional view is left with the task of explaining why franchising came into existence in the first place. In general, this question has not been addressed as such. Rather, those of the traditional view have seen the reasons to franchise as the barriers inhibiting the eventual vertical integration of extant franchise systems. These arguments will be discussed and evaluated later in connection with Hypothesis 3.

Second, to ask the question about the distribution of economic surpluses presumes the existence of some level of economic surplus at the establishment level. Besides covering direct production costs a franchisee would require, as a condition of continued participation, a fair rate of compensation for
his/her efforts and a fair rate of return for any contributed capital. Thus what is at issue is some amount of surplus (economic profit or quasi-rent).

Since the product in question (good or service) is trademarked, promoted, and, thereby, "differentiated," it presumably faces a downward sloping demand function which allows it to command a price exceeding its marginal cost of production. However, for an economic surplus to exist, price must exceed the average cost of production which means that the traditional approach must assume a condition of restricted entry. Most writers picture the franchisor as an "upstream monopolist," capable of choosing the buyer/resellers of its "unique" product. Obviously, any one franchisor can and does restrict the number of its own franchisees. Whether or not this results in the sort of restriction of entry capable of producing an economic surplus in equilibrium is a question which has not been addressed except through implicit assumption. Further, scant attention has been paid to those other factors which might affect the elasticity of the franchisee's demand function (e.g., location) and, thereby, to a consideration of inter-establishment differences in demand elasticity within a given franchisor's system. Recognition of such differences, of course, would call into question the existence, even in principle, of an "optimum" contractual arrangement (from the franchisor's perspective) for distributing economic surplusses. Most analysts have been content to assume that an "optimum" is possible.

Third, and in a similar vein, although the question of the distribution of economic surplus raises questions of cost, little attention has been given to the cost functions of franchisees and, especially, franchisors. To the extent franchisors do not supply inputs to franchisees, the franchisor's marginal costs of production are lowered. In the extreme case, when the franchisor furnishes only a trademark and know-how to the franchisee, the
marginal costs are essentially zero. Only one pair of writers (Blair and Kasserman, 1982) has recognized the implication of this condition, namely that the franchisor who is dependent to any degree on a royalty payment would maximize profits by maximizing revenue. Thus, any franchise system with sales-based royalty payments would cause the franchisor to seek a lower, and the franchisee a higher, price to the consumer. This would lead to the analytically "simple answer" to the question posed above that the distribution of any surplus depends on which party holds the right (and power) to set the final price. While there may be de facto methods by which a franchisor can substantially affect prices charged by the franchisee, the general thrust of law is to prohibit franchisors from doing so and the existence and implications of cost differences remain largely unexamined.

Finally, focusing on the issue of the distribution of economic surplus naturally leads to a detailed examination of only those portions of a contract which involve the payment of money from franchisee to franchisor, i.e., purchases of goods and services, initial fees and royalty payments. While one might argue that Inaba's (1980) statement of the question is "loaded", it is certainly in keeping with the traditional abstraction. He poses it thusly:

This paper employs a simple franchising model to examine two common franchising practices and how they enable the franchisor to raise price, restrict output, and capture consumer's surplus to increase monopoly profit with a concommitant deadweight loss to society (Inaba, 1980, p. 65).

The Traditional Models And Their Hypotheses

While it is an oversimplification to suggest that all analysts of the traditional view have employed identical models to investigate the distribution of economic surpluses in franchise systems, most have used standard micro-economic tools of analysis. The abstraction described above is assumed, usually implicitly, but sometimes explicitly, as:
Regarding market structure at the two stages of production, we assume that the franchisor holds a monopoly over a differentiated intangible asset (a trademark) that is employed as an input by the franchisee. And we assume competition among franchisees in the purchase of the franchise (Blair and Kaserman, 1982, p. 495).

Employing the usual assumptions of profit maximization and no transaction costs, analysts began by looking at franchising as one of the several alternatives to vertical integration. A sizeable literature existed which explored and explained the conditions which lead to vertical integration; thus, one early explanation of the existence of franchising was that it flourished when those conditions were absent. Some of the original literature on franchising explored the effects of certainty or uncertainty or the effects of fixed or variable proportion production functions in the downstream firms. However, no testable hypotheses about franchising emerged from this early work.

Meanwhile attention was turning to the terms of the franchise agreement and their implications for the distribution between franchisor and franchisee of any economic surplus. Caves and Murphy (1976) described franchise fees, royalties and full-line forcing and found some advantages and disadvantages to the franchisor in each. They came to no conclusion about any one being more advantageous to the franchisor, but concluded that each was inferior to vertical integration as a rent extraction device, concluding:

Thus, to the extent the franchisor cannot perfect the process of rent extraction by means of the devices listed, he has an incentive to offer contracts that restrict the franchisee's tenure and his opportunities to capture location-specific goodwill....These contract terms assure that the franchisor can recapture a franchise at renewal time without any capitalized goodwill value accruing to the franchisee and provide him with a pretext for recapturing unexpired franchises should he find that strategy profitable (Caves and Murphy, 1976, p. 580).

All of this results in a motivation to the franchisor to integrate vertically. Caves and Murphy's accept the "financing" reason for franchising.
existence (discussed above), go on to argue that the barriers to integration recede as franchise systems mature and end by predicting, "Direct ownership increases as franchise systems mature, probably testimony to the franchisor's declining cost of capital" (Caves and Murphy, 1976, p. 584). Of course, the proposition that vertical integration increases as systems mature is a testable hypothesis but, since these authors' rationalization depends on an argument that Rubin (1978) has shown to be fallacious, it will be re-introduced later in this section when rationalized from a different perspective.

Gradually attention shifted to an analysis of the conditions which would favor the use of one payment form over another as a rent extraction mechanism. An early paper by Blair and Kaserman (1978) concluded that "...vertical integration and tying arrangements are alternative means of obtaining precisely the same results for an input monopolist facing variable proportions at the downstream stage" (p. 401). Inaba's (1980) analysis appeared to take the profit maximizing franchisor's preference for full-line forcing a step further when he concluded:

Therefore, a single fixed royalty rate fails to achieve the full monopoly profit under conditions of changing demand. On the other hand, under full-line forcing, input prices can be adjusted in response to changes in demand. Thus, a mere duplication of the analysis in the previous section for each period's demand curve shows that the franchisor's profit potential can be achieved by full-line forcing (Inanba, 1980, p. 71).

In a later comment, Blair and Kaserman (1981) responded to Inaba's analysis and showed that the use of a royalty, full-line forcing or a combination of the two would produce economically equivalent results, a conclusion with which Inanba (1981) agreed. According to Blair and Kaserman (1981):

Due to this exact equivalence, there is no mechanism in the model to determine an optimal combination of these strategies in franchise contracts. Consequently, in the context of Inaba's model, we can offer no explanation of why these strategies are, in fact, combined in such contracts (Blair and Kaserman, 1981, p. 1074).
At this point, it appeared that the traditional micro-economic models were incapable of generating any testable hypotheses about the use of the various payment mechanisms, including combinations, in franchise agreements. Since reaching this apparent conceptual dead end, Blair and Kaserman (1982) have proposed a revised model which, while retaining the usual features of the traditional models, introduced the relationship between the franchisor's implicit discount rate \( (r_u) \) and the franchisee's implicit discount rate \( (r_d) \) as the central explanatory device in the model.

Since the franchisee's risk is specific to a given location while the franchisor's is, at least geographically, diversified, it might be argued that \( r_u < r_d \) was always true. This, it will be recalled, was the basis of Rubin's criticism of the standard "financing argument" for the existence of franchising. However, Blair and Kaserman choose to ground their argument in Williamson's (1971) concept of "the strategic misrepresentation of risk" in which "the franchisor has an obvious incentive to overestimate the future demand for the franchised product, and the franchisee will have an equally obvious incentive to underestimate it" (Blair and Kaserman, 1982, 496). According to them, this implies that \( r_u < r_d \). While this introduces what we have called a nontraditional element into their model, their analysis is quite traditional in all other respects. The use of perception (or, more accurately, misperception) as the basis of the inequality allows the possibility that \( r_u = r_d \) in the situation of perfect certainty and leads them to their first three propositions:

Proposition 1: With future levels of final demand certain (i.e., with \( r_u = r_d \)), the franchisor will not make use of the output royalty but will, instead, extract all monopoly rent through the fixed fee.
Proposition 2: Under broadly defined conditions of uncertainty concerning future levels of final product demand (i.e., with \( r_u < r_D \)), the franchisor will employ both a fixed fee and an output royalty.

Proposition 3: The existence of uncertainty and the mixed strategy that it entails reduces the franchisor's potential profit below that attainable under perfect information (Blair and Kaserman, 1982, pp. 498-499).

Taken together, these propositions suggest that the often observed combination of entry fee and royalty is the franchisor's way of coping with the differences in implicit discount rates arising out of uncertainty. This leads to the following:

As might be expected, the optimal level of the fixed fee increases and the output royalty decreases as the franchisor's discount rate rises or as the franchisee's discount rate falls. In other words, when \( r_D - r_u \) is large, more reliance is placed on the output royalty \( R \). In contrast, when \( r_D - r_u \) is small, more reliance is placed on the entry fee \( E \) (Blair and Kaserman, 1982, p. 500).

After formalizing this argument into two more propositions, Blair and Kaserman present two hypotheses which, although borrowed from Rubin (1978), are derivable from their model. Described as "testable" by their authors, these two hypotheses are stated and rationalized by them as follows:

First, ... that franchised businesses that require a relatively large degree of managerial discretion in the sale (and service) of the final product will tend to make relatively heavy use of the fixed fee. In terms of our model, this simply means that the future period demand is relatively dependent upon the behavior of the franchisee as opposed to the franchisor. Such a case would imply relatively low franchisee discount rates and relatively high franchisor discount rates since the burden of uncertainty regarding future demand will be borne primarily by the latter.

Second ... increases in the relative value to the business of the trademark itself should lead to a relatively heavy reliance on the output royalty. In our model, the greater the value of the trademark means that future demand will be more dependent upon the post-contractual behavior of the franchisor in policing the performance of other franchisees to avoid devaluation of the trademark. This, in turn, implies a relatively low discount rate for the franchisor and a relatively high
discount rate for the franchisee, both of which lead to
decreases in the optimal level of the fixed fee and
increases in the level of output royalty (Blair and

Finally, Blair and Kaserman argue, that, since the use of a combination
royalty and entry fee results from the condition \( r_u < r_D \), the present value of
the same stream of future economic profits to the franchisor will always
exceed their present value to the franchisee. Put another way, the franchisor
will perceive the existence of uncaptured positive profits at the downstream
stage after the contract is negotiated thus providing a powerful incentive to
the franchisor to integrate vertically. This leads them to another
hypothesis:

(Third:) Consequently, there is some reason to believe
that \( r_u \) may fall over time leading the mature franchisor
to pursue an integrated structure more vigorously than a
new franchisor (Blair and Kaserman, 1982, p. 502).

The authors qualify this hypothesis with two "practical" considerations
(i.e., factors not part of their model). One is the potential for antitrust
action and the other is a recognition that there are costs to vertical
integration which may exceed the potential gains. It is important to note
that while this latter point is external to the traditional model, it is the
very heart of the non-traditional model(s) to be discussed in the next
chapter.

Two variant's of Blair and Kaserman's third hypothesis may be obtained by
considering the rationalizations of the first two hypotheses. Since the
motivation to integrate arises from the magnitude of \( r_D - r_u \), those factors
which affect the relative magnitudes of \( r_D \) and \( r_u \) should have an observable
effect on the structure of franchise systems.

The first hypothesis above was based on the argument that when the future
demand for a franchised good is relatively dependent on the behavior of the
franchisee as opposed to the franchisor, the franchisee's implicit discount rate will be relatively low while the franchisor's implicit discount rate will be relatively high. With \( r_D - r_u \) being relatively small, there would be a reduced impetus to integrate. Stated as an hypothesis:

**Fourth:** Franchised businesses that require a relatively large degree of managerial discretion in the sale and service of the final product will provide relatively less incentive to the franchisor to vertically integrate.

In an analogous fashion, the second hypothesis above was based on the argument that when the future demand for the product is relatively more dependent on the post contractual behavior of the franchisor in policing the performance of the other franchisees to avoid the devaluation of the trademark, the franchisor's implicit discount rate will be relatively low while the franchisee's will be relatively high. With \( r_D - r_u \) being relatively large, there would be a relatively large impetus to integrate. Stated as an hypothesis:

**Fifth:** Franchised businesses that depend to a relatively high degree on the value of the trademark will provide relatively more incentive to the franchisor to vertically integrate.

**Summary**

The traditional conceptualization of franchising views the relationship as one in which the large franchisor controls the small franchisee through a contract which, in addition, extracts all, or nearly all, of the economic surplus generated by the sale of the differentiated product. Ultimately, outlet ownership incurs both control and profits to the franchisor and, as a franchise system matures, franchising itself is predicted to wither away to be replaced by vertical integration.

Viewing the contract as a rent-extraction device, two hypotheses were
advanced which predicted the circumstances in which one would expect to find relative reliance on either the initial fee or the output royalty. A general hypothesis predicting increasing vertical integration was presented. Finally, it was argued that the circumstances which lead to a reliance on a franchisee fee would result in less motivation to integrate when compared to the circumstances which lead to a reliance on a royalty.
CHAPTER 3

AN ALTERNATIVE CONCEPTUALIZATION

A Different Abstraction and Question:

The traditional model of franchising is seen to be incomplete or misdirected when examined in light of extensions of neoclassical theory and when confronted with observations on recent developments in franchising. The following five observations suggest that an extension of the traditional model is needed:

First, franchising is more productively viewed as a licensing of production rather than as a channel of distribution. This is most apparent with "business format" franchising, where the trademark or the business process is franchised and the sale of goods is not important. This implies that the only realistic alternative to franchising is vertical integration.

Second, market power or "the licensing of monopoly" cannot explain why firms start franchising. While there are large and powerful franchisors with well-known brand names, none began that way.

Third, the argument that franchises provide low cost capital for expansion is unsound or at best questionable, and so is not a good explanation for the existence of franchising.

Fourth, since the franchisor's alternative is vertical integration, (with hired managers) they must perceive benefits in franchising, presumably in increased work incentive for franchisees.

Finally, franchisees have other alternatives, including operating an independent business or working for wages. Individuals considering a particular franchise of course have the option of rejecting it in favor of a franchise of another system. Franchisees must have some knowledge of the various franchise "honor stores" and be aware that in addition to ordinary
business risk there is a risk of franchisor failure or exploitive behavior. Yet, given these risks and given alternatives, franchisees continue to sign up.

These observations lead to different questions than those posed in the traditional model. Rather than concentrating on the division of economic rents, these observations suggest that a more general exploration of the reasons for the existence of franchising is needed. Specifically, what are the mutual benefits to franchisees, franchisors and customers of franchise systems?

Developments in Neoclassical Theory

In the theory of the firm, the departure from the traditional neoclassical model has taken two paths.* One is characterized by abandonment of individual's maximizing behavior as the key assumption and driving force in the model. Satisfying, bounded rationality or multiple objectives are postulated. Following this is the development by Leibenstein of X-efficiency, the idea that firms fail to minimize costs.

While this line of thought served to highlight shortcomings in the traditional theory, as a collection of ad hoc statements about behavior it did not displace traditional neoclassical theory. Rather it stimulated generalization of the existing neoclassical theory to include explicitly, property rights, transaction and adjustment costs, and information asymmetries.*

Applications to Franchising

A development that has important implications for franchising is the theory of principal-agent relationships articulated by Jensen and Meckling (1976):

*De Alessi (1983) identifies three paths - in addition to the two outlined here, the retention of maximizing behavior but with respect to arguments other than profit, e.g. growth, size or sales.
*For a summary see DeAlessi (1983)
We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will take certain actions which will not harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or agent at zero cost to ensure that the agent will make optimum decisions from the principal's viewpoint (p. 308).

Agency costs are the sum of: (1) monitoring expenditures by the principal, (2) bonding expenditures by the agent, and (3) the residual loss—the dollar value of departures from optimum that will (may) occur despite monitoring or bonding activity.

Jensen and Meckling continue:

The problem of inducing an "agent" to behave as if he were maximizing the "principals" welfare is quite general. It exists in all organizations and in all cooperative efforts—at every level of management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, and in relationships normally classified as agency relationships such as are common in the performing arts and the market for real estate. The development of theories to explain the form which agency costs take in each of these situations (where the contractual relations differ significantly), and how and why they are born will lead to a risk theory of organizations which is now lacking in economics and the social sciences generally (p. 309).

In a channel of distribution, the trademark owner is the "principal" and the outlet operator, whether an employee of the trademark owner or franchisee, is the "agent." Jensen and Meckling tell us that in either arrangement there will be incentive problems and associated agency costs. While its persistence suggests that franchising is an institution that minimizes these costs, the way in which this is done deserves further exploration. At first glance, it might be presumed that the agency costs would always be less in the owner-
employee relationship, because monitoring would be easier. However, there are limits to the ability to "manage" the behavior of employees, particularly those at remote locations, and to the extent that incentive problems are less serious in franchising, less monitoring may be required.

If franchisees view themselves as independent businesspersons with an equity interest at stake, they may be self-monitoring in ways which would ultimately benefit the principal. As Ridgeway concludes, "in short, the initiative, ambition, and hard work of the dealer who is in business for himself is perhaps the most valuable marketing asset the manufacturer can obtain" (Ridgeway, 1957, p. 469). A study by Shelton (1967) would seem to confirm this expectation by showing that, within a particular fast food franchise system and "despite detailed supervision which would seem to minimize opportunities for managerial initiative, restaurants operated by independent franchisee-owners outperformed those supervised by company managers, even though the company managers are paid on a basis that involves some incentive compensation for achieving profits" (p. 1258). The greater work effort put forth by a franchisee over an employee-manager is perhaps the most often cited advantage of franchising over vertical integration.

Problems of Quality Assurance

This, however, is not the end of the story and cannot by itself explain the success of franchising nor the particular contractual arrangements observed. While franchising may diminish the incentive for shirking, in at least some situations, it creates incentives for the franchisee to lower the quality of output, thereby decreasing costs and increasing profits at the expense of other franchisees and the franchisor. If it pays each individual franchisee in the system to cheat in this way, a competitive lowering of quality will occur, leading to an inevitable depreciation in the value of the
trademark. This predicts that quality control is paramount for a successful franchise system, even to the extent that contract provisions and franchisor supervision "would seem to minimize opportunities for managerial initiative" (Shelton 1967, p. 1258).

Franchising continues to exist and grow. This suggests that ways have been found to reduce the costs of cheating such that these and other costs are exceeded by the benefits of franchising.* While the survival of franchising can be explained by this framework, the "survivor technique" is weak in that it may be unable to distinguish between this and competing models, and in that it does not reveal the richness of the model. Franchise agreements are complex and incentive problems are not constant across franchise systems. So, the theory should do more than simply explain the existence of franchising. It should provide an understanding of the institutions that have evolved and yield testable hypotheses about important aspects of franchising.**

Williamson (1982) states:

Franchised products and services are generally ones for which demand externalities are important. The franchisor develops a product or service with distinctive quality, price and other attributes and makes it available to what is often a mobile population. Responsible franchisees are ones that supply the good or service in a manner that maintains the basic image. There is always a hazard, however, that individual franchisees will shade quality—since they alone realize the cost savings while franchise debase.ment. effects are spread among others. Franchisors will recognize these incentive hazards and attempt to devise correctives (p. 16a).

The correctives generally involve bonding or monitoring or both. Enforcement can be either by third party guarantees (court enforcement, arbitration), by market enforcement mechanisms or by some combination of the two.

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*We present evidence on the viability of franchising elsewhere.

**Important aspects are, of course, defined by the researcher and influence the choice of the model.
Monitoring activities are well known and are the quality assurance activity that first comes to mind. Franchisors inspect franchisees premises, sample their product, invite customer comments, inspect the books and in some cases meter inputs and outputs.

Monitoring activity and the threat of it, coupled with contract specifications of quality standards and remedies, reduces the franchisees incentive to diminish quality. However, monitoring activities are expensive and remedies enforced by courts are uncertain and expensive. In some instances remedies under contract provisions are limited by "consumer protection" laws designed to protect the franchisee who is generally presumed to be at a bargaining disadvantage relative to franchisors. For these and other reasons, monitoring and court enforcement remedies will be supplemented by less obvious quality control mechanisms.

The initial franchise fee and the investment in specific assets can be viewed as a bond posted by the franchisee. Should the franchisee be found in violation of the contract and the agreement terminated, he would obviously lose the initial franchise fee. Also, much of the initial investment, particularly signs, special building features and specific equipment, would be non-salvagable or partially salvagable if the agreement were terminated. A collateral bond is thus created that will deter cheating by the franchisee. See Klein (1980).

The enforcement mechanism above involves detection of violations of the contract and subsequent action to terminate the contract. This is not the only mechanism that can work towards assuring quality. Buyer reactions where repeat purchases are important will also discipline the seller (whether the product is franchised or not). In particular, one could conceive of a situation in which buyers could not judge quality before purchase, but could
unambiguously judge quality after purchase. If repeat purchases are common for each customer or if customers could communicate their evaluation to other customers, the market may provide an incentive for producers to maintain quality. However, the threat of lost business alone will not be sufficient to insure quality in all cases. It will generally be necessary that producers invest in some specific non-salvageable capital and that they price their product such that they receive rents on their specific capital and that the expected gain from maintaining quality exceeds the expected gain from cheating. (Klein and Leffler, 1981). Moreover, in this setting both the investment in specific capital and the higher price charged are signals to the customer that the seller will maintain quality. Note that a high price by itself is not sufficient to signal quality, since all sellers, whether selling quality goods or not, would attempt to signal quality with a high price. Neither is investment in specific capital sufficient, since if the seller were not earning rents on the specific capital he would have no incentive to maintain its value.* This implies that to maintain quality the franchisor will require the franchisee to invest in specific nonsalvageable capital, including the initial fee, and will allow the franchisee to earn rents on this investment.

There exist, however, some interesting questions when this analysis is applied to franchising. First, if repeat purchases are important in the system but not at each outlet, cheating will impose externalities on other franchisees and the franchisor. Second, franchisees must be concerned with reverse cheating by the franchisor. Third, why would franchisees sign contracts that seem on their face to be unfair?

*See Klein and Leffler (1981) for a formal development of the conditions necessary for an equilibrium with no cheating.
The problem of cheating by franchisees will be handled by a combination of market enforcement and third party enforcement mechanisms. Klein (1980) states:

The franchisor knows, given his direct policing and monitoring expenditures, the expected profit that a franchisee can obtain by cheating. For example, given the number of inspectors hired, he knows the expected time to detect a cheater; given the costs of low-quality inputs he knows the expected extra short-run cheating profit that can be earned. Therefore the franchisor may require an initial lump sum payment from the franchisee equal to this estimated short-run gain from cheating. This is equivalent to a collateral bond forfeitable at the will of the franchisor. The franchisee will earn a normal rate of return on that bond if he does not cheat, but it will be forfeited if he does cheat and is terminated (p. 359).

It should be noted that this mechanism does not eliminate information costs. Real resources are expended in monitoring and are invested in the hostage capital that would not be necessary in the absence of information costs. It is presumed, however, that monitoring and penalty costs will be balanced in an optimal manner. To deter cheating the franchisor will require a bond greater than the franchisee's expected gain from cheating (motels and car rentals).

As stated by Klein (1980):

It is important to recognize that franchise termination, if it is to assure quality compliance on the part of franchisees, must be unfair in the sense that the capital cost imposed on the franchisee that will optimally prevent cheating must be larger than the gain to the franchisee from cheating. Given that less than infinite resources are spent by the franchisor to monitor quality, there is some probability that franchisee cheating will go undetected. Therefore termination must become equivalent to a criminal-type sanction. Rather than the usually analyzed case of costlessly detected and policed contract breach, where the remedy of making the breaching party pay the cost of the damages of his specific breach makes economic sense, the sanction here must be large enough to make the expected net gain from cheating equal to zero (p. 359).

The Problem of Franchisor Cheating

Given that significant capital losses can be imposed on the franchisee, what, if anything, prevents the franchisor from acting opportunistically,
arbitrarily terminating the franchise agreement, capturing the initial fee and expropriating the franchisee's investment? Simple reciprocal bonding will not work. If A gives B a $100 bond and B gives A a $100 bond, each forfeitable upon the occurrence of some event, no bonding has taken place. However, if exploitation of franchisees imposes costs on the franchisor, such action will be discouraged. Klein (1980) suggests the following:

Such behavior may be prevented by the depreciation of the franchisor's brand name and therefore decreased future demand by potential franchisees to join the arrangement. However, this protective mechanism is limited by the relative importance of new franchise sales compared to the continuing franchising operation, that is, by the "maturity" of the franchise chain (p. 359-60).

Another important deterrent to franchisor cheating is the "threat" that the franchisor would have to integrate vertically and operate the system with employee managers. In much of the traditional neoclassical and popular literature this is viewed as no threat. Indeed, it is often proposed as the ultimate goal of franchising, ignoring the incentive benefits of franchising. The work incentive is effective because the franchisee can capture the rewards of his efforts, either through future profits or sale of the franchise asset. Any increase in the probability that the franchisor may arbitrarily terminate the agreement will reduce the incentive for franchisees to build up the business.

If it is assumed that the opportunistic expropriation of any franchise is communicated among the remaining franchisees, and, "as long as the implicit collateral bond put up by the franchisee is less than the present discounted value of this cost difference (between cost of vertical integration and franchising), franchisor cheating will be deterred." Klein (1980). Klein goes on to state that although simultaneous explicit bonding will not work:

...the discounted value of the cost difference has the effect of a collateral bond put up by the franchisor to assure his noncheating behavior. This explains why the franchisor does not increase the
initial franchise fee to an arbitrarily high level and correspondingly decrease its direct policing expenditures and the probability of detecting franchisee cheating. While such offsetting changes could continue to optimally deter franchisee cheating, and save the real resource cost of direct policing the profit from and hence the incentive for reverse franchisor cheating would become too great for the arrangement to be stable (p. 360).

We would thus not expect to see franchisors attempting to extract all "profits" from the system through initial fees. Also, some monitoring costs will be expended.

The Issue of "Unfair Contracts"

Why would franchisees sign contracts that are seemingly unfair to them?

The obvious and trivial answer is that they perceive it in their best interest to do so. A number of explanations of how or why franchisees believe this to be so have been advanced: the chance to be one's own boss, the lower risks (better success rates) of franchises versus independent businesses, unwarranted optimism, ignorance. The view presented here is, of course, that franchisees sign because they indeed perceive it to be in their interest. It is also that they realize there are positive probabilities that the franchisor will not comply with all contract provisions and that enforcement through the courts is expensive, time consuming, and uncertain. Rather, the franchisee relies on market enforcement mechanisms to prevent franchisor cheating. If a business relationship is mutually beneficial in a way described above, the threat of termination of the business may be a more effective deterrent than court action.

The signing of a contract that appears one-sided may also be viewed as a signal. Assume there are two types of potential franchisees - low quality franchisees who will diminish quality and high quality franchisees who will not.* Both types will represent themselves as high quality candidates, the high quality candidate signalling correctly and the low quality candidate...
signalling falsely. To achieve a signalling equilibrium, it must in some sense be cheaper for high quality individuals to signal quality than for low quality individuals to do so. The substantial initial investment required, together with the apparent ease with which the franchisor can terminate, makes a false signal of high quality expensive. So in addition to affecting incentives after the contract is signed, certain seemingly unfair contract provisions provide a screening mechanism for the franchisor and signalling mechanism for the franchisee.

Some will still argue that such contracts arise because franchisors have superior information and bargaining power. Klein (1980) states:

An argument made against contract provisions such as termination-at-will clauses is that they appear to favor one party at the expense of another. Hence it is alleged that the terms of the agreement must have been reached under conditions of "unequal bargaining power" and therefore should be invalid. However, a further implication of the above analysis is that when both parties can cheat, explicit contractual restraints are often placed on the smaller, less well-established party (the franchisee), while an implicit brand name contract-enforcement mechanism is relied on to prevent cheating by the larger, more well-established party (the franchisor).

If information regarding quality of a product supplied by a large firm is communicated among many small buyers who do not all purchase simultaneously, the potential holdup relative to, say, annual sales is reduced substantially compared to the case where each buyer purchased from a separate independent small firm. There are likely to be economies of scale in the supply of a business brand name, because in effect the large firm's total brand name capital is put on the line with each individual sale. This implies a lower cost of using the implicit contract mechanism, that is, a lower-price premium necessary to assure non-breach, for a large firm compared to a small firm. Therefore one side of the contract will be relatively more incomplete (p. 360-1).

If seemingly unfair contract provisions result from unequal bargaining power, then greater unfairness should result from greater discrepancies in

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*This dichotomy is obviously artificial since cheating depends upon the incentives to cheat. However, we could think of it as reflecting other endowments (such as management ability) that bear upon the success of the venture.
power. This can be tested by comparing contract provisions offered by large and powerful franchisors with those offered by small fledgling franchisors. A finding of no significant difference would support arguments based on quality assurance incentives and signalling presented in this chapter.

Hypotheses

A theory of franchising that explicitly recognizes transactions and information costs yields plausible explanations of many real world practices and is rich with recommendations for government policy toward franchising. However, the yield of directly testable hypotheses is less clear. The theory does predict greater survival properties for franchising than do traditional models. This, is perhaps the most important prediction of the model.

Blair and Kasserman (1982) divided franchises into those for which managerial discretion at the franchisee level is relatively more important and those for which the value of the trademark is more important. They hypothesize that in the first case franchisors will rely more heavily upon the fixed fee and in the second case will rely more heavily on an output royalty. (See above p. 14). They also hypothesize that if the franchisor's cost of capital declines as the system matures, the franchisor will move to integrate the system vertically. The alternative model cuts in a different dimension. The emphasis is on the tradeoff between effort incentives and quality assurance, with the problem of assuring quality dependent upon the pattern of repeat purchases. Since, ceteris paribus the incentive to diminish quality is greater at outlets where repeat purchases are less important, one would hypothesize that greater bonding (e.g., higher initial fees and other investments) would be required at these outlets. If these are also systems for which the trademark is important, the prediction is opposite that of Blair and Kasserman - higher initial fees would be expected in systems where the trade-
mark is relatively important. We do not push this competing hypothesis very far because in the alternative conceptualization it may not make sense to distinguish between franchises on the basis of the relative importance of the trademark versus franchisee discretion. This distinction ignores externalities a franchisee can impose on other franchisees in the system. If the trademark is important, as indeed it is in most franchises, and there is a large potential for franchisee cheating (a form of franchisee discretionary behavior), in what sense can it be said that one is relatively more important than the other? Maintenance of the value of the trademark depends critically upon the behavior of franchisees. The important dimension in which franchisees vary is the degree to which individual franchisees can shift the cost of reduced quality to other franchisees. This is higher when repeat purchases at specific locations are relatively unimportant. Thus, the alternative theory suggests that more resources (monitoring and bonding) will be devoted to assuring quality in these cases.

This model also predicts a pattern of vertical integration that differs from that of the traditional theory. Blair-Kasserman hypothesize that vertical integration will occur over time as the franchisor's relative cost of capital falls. The alternative theory predicts that vertical integration will occur at specific locations where quality assurance costs are high, specifically high enough to offset the work incentive benefits of franchising. These would generally be the outlets with low repeat purchases - e.g., the fast-food outlet located near the interstate highway. This selective vertical integration is consistent with the observation that franchise systems simultaneously repurchase franchises, open company stores, resell franchises and issue new ones, a pattern that the traditional model has difficulty explaining.
An important tenet of the alternative theory is that contracting is costly. In particular, it is costly (impossible) in a world of imperfect information to write contracts that cover every possible contingency, particularly in long term contracts. This does not imply that no attempt will be made to specify standards of performance, incentives and remedies in a contract. To the contrary, contracting activities will be carried to the point where expected marginal benefits equal marginal costs. Since assuring quality is a complicated business and the potential benefits are great, one would expect that by most criteria, franchise contracts will be complicated. A model that ignores information costs is hard pressed to explain why franchise contracts should be so complicated.

Likewise, the traditional model has difficulty explaining seemingly unfair contract provisions. Ad-hoc analysis or populist economics would attribute them to the disproportionately greater economic power of the franchisor. This would also imply the unfairness of the contract would vary directly with the differential economic power. In contrast, the theory presented in this chapter views seemingly unfair contract provisions as quality assurance mechanisms and predicts that, ceteris paribus, they should not be a function of economic power. We then hypothesize that "unfair" contract provision will not vary with the economic power of the franchisor.

In summary, the alternative theory yields the following hypotheses, numbered sequentially from those in the previous chapter:

6. Franchising will survive to a greater degree (vertical integration will be lower) by the alternative model.

7. Initial investment in specific capital, i.e., the franchise fee and non-refundable capital, will be greater for outlets where repeat purchases are less important.
8. Vertical integration, to the extent it occurs, will be selective, with franchisors reacquiring outlets at which quality assurance problems are most significant, i.e., those outlets where repeat purchases are low.

9. Franchise contracts will be complicated.

10. Seemingly unfair contract provisions will not vary significantly with the economic power of the franchisor.
CHAPTER 4
DATA SOURCES AND RESEARCH METHODS

This study is based on two data sources, those collected annually by the U.S. Department of Commerce and reported as Franchising in the Economy 19XX-19XX, and the franchise agreements filed with the South Dakota Department of Commerce under that State's Franchise Registration Statute. The purpose of this section is to describe the nature of and procedures used to treat each of these data sets and to evaluate the adequacy of each type of data for the purposes of the study.

Commerce Department Data

Beginning in 1969, the U.S. Department of Commerce has conducted an annual survey of franchising organizations and reported the results. The annually published volume, Franchising in the Economy, 19XX-19XX, reports the findings of this survey plus data for automobile and truck dealerships, gasoline service stations and soft drink bottlers which are taken from trade association sources. For these latter three sectors, only the number of outlets and dollar volumes are reported. In 1980, these sectors accounted for 42.9% of the total number of franchised establishments and 75.1% of the total sales of all franchising organizations but, in spite of their relative importance, no other details are available. Therefore, in all that follows, the data used are only those derived from the Commerce Department's annual survey and exclude automobile and truck dealerships, gasoline service stations, and soft-drink bottlers.

Coverage

Unlike many surveys, the Commerce Department's annual study is not a sample but is an attempt at a complete enumeration of all business format franchise organizations. The current volume of Franchising in the Economy describes it this way:
Questionnaires are mailed to all known business format franchisors and individual returns were received from 1,584 franchisors representing an estimated 99 percent of business format franchising sales and establishments in the United States. A complete list of such franchisors is being maintained and updated by the Bureau of Industrial Economics through the use of trade journals, company news releases, trade association data, and the registration lists of those states which require registration of all franchisors (Franchising in the Economy 1980-1982, v.).

Since the Commerce Department's survey is the only published source of franchising data, evaluating the coverage of their survey is complicated by a lack of comparable data. The International Franchise Association has about 350 members, presumably the larger organizations. By contrast, about one-third (31.7%) of all franchisors in the 1980 survey had 10 or fewer outlets and nearly two-thirds (66.5%) had 50 or fewer. Of the 15 states with registration requirements, Illinois has about 450 franchisors registered, presumably the large national organizations plus the regional and local firms that are seeking franchisees in Illinois.

It is also apparent that there is a fairly large turnover in the universe of franchisors included in each year's survey. Table 1 shows the number of franchisors included in each year's survey along with the "failures" and "departures." For example, it appears that the net gain of 125 franchisors during 1980 is the result of 116 firms ceasing franchising and 241 beginning operations during the year.

Putting all of this together suggests that the Commerce Department's survey is very comprehensive, in the sense that it includes not only the large and well-known franchise organizations but many, if not most, of the smaller, regional-local and short-lived organizations as well. What is less clear is exactly the nature of the organizations included. There are many definitions of franchising and the Commerce Department has never published its own. For
example, it is apparent that the distribution systems of the major tire manufacturers are included in the survey but, in the absence of a known operational definition, it is impossible to determine just where the survey's boundaries of "franchising" are.

With respect to time periods covered, each year the survey gathers data for the year past along with estimates for the upcoming two years. For example, the most current volume, *Franchising in the Economy, 1980-1982*, (dated January 1982), contains actual results for calendar-year 1980 in addition to respondent estimates of results for 1981 and 1982. Thus, at best, there are only data for the years 1969 through 1980. Substantial discontinuities appear in the data between 1970 and 1971, especially when they are examined on a sector-by-sector basis. The reasons for these discontinuities are unknown but, for this reason, this study uses only data beginning with the year 1971.

In summary, the Commerce Department data are based on a survey of almost all business format franchisors, including some that might not fit everyone's definition of franchising, and are herein used for the years 1971 through 1980.

**Sectors**

Table 2 shows the sectors of franchising for which data are reported in 1980. These sectors, with two changes, have been used by the survey since 1972. In 1976, the sub-category "Real Estate" was separated from the sub-category "Miscellaneous Business Services" and, in 1980, the category "Campgrounds" was combined with the previously separate category "Hotels and Motels."

Although there are no published operational definitions for each of these sectors in the Commerce Department data, one aspect is clear - they vary
considerably in the degree to which they are homogeneous with respect to the
degree to which they are channels of distribution for the goods produced by
the franchisors. In the traditional sectors of franchising, (i.e., automobile
and truck dealers, gasoline service stations and soft drink bottlers)
franchisees are primarily distributors of or outlets for the franchisor/manufacturer's products. Most of the newer sectors covered by the Commerce
Department survey are not of this type. Table 2 shows total sales of products
and services by franchisors to franchisees as a percentage of total franchisee
sales. Obviously, franchisee sales are at retail while franchisor sales are
at wholesale but, clearly, sectors consisting of systems which produce on-site
services (e.g., Business Aids and Services, Hotels and Motels, Laundry and
Drycleaners, Auto Rentals) involve almost no selling of goods and services by
franchisors to franchisees.

On the other hand some of the other sectors are much less homogeneous
which is reflected in the sort of "mid-range" percentages reported in Table
2. For example, systems in the "Automotive Products and Services" sector
include the retail outlets of tire manufacturers, which are essentially
distribution channels, and other systems which franchise self-service car
washes, lube and oil change centers, and parking services, all of which
involve services produced on-site. Similarly, the category "Construction,
Home Improvement and Cleaning Services" includes systems which provide on-
location cleaning of carpeting and upholstery in homes, offices, etc., and
systems which sell swimming pools, water conditioning equipment, and pre-cut
houses.

Thus, while the general nature of the franchising sectors covered in the
Commerce Department's survey and shown in Table 2 involves systems which are
not channels of distribution in the usual sense of that term, there are some
true product distribution systems included in some sectors. This reduces the usefulness of the survey data to test hypotheses which posit the production of services on-site as an independent variable.

Treatment of Series

A number of data series from the Commerce Department's survey are used to describe the phenomena and test hypotheses in this study. Each will be defined more precisely as they are encountered in the later portions of this report.

Since the data are based on a complete enumeration of the survey's defined universe of franchising systems, the usual sort of inferential statistics are not applicable to test hypotheses. However, one set of hypotheses are stated in terms of trends and do lend themselves to testing for the significance of the "slope" of the apparent trends.

South Dakota Contract Data

A major portion of this study's effort involved obtaining franchise agreements and classifying relevant clauses of each. Chosen for study was the set of contracts on file with the Director of the South Dakota Division of Securities in that state's Department of Commerce.

It should be noted that the Federal Trade Commission promulgated a Trade Regulation Rule on "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures" (16 C.F.R. Part 436, effective October 21, 1979) which requires a disclosure statement, including a copy of the franchise agreement, to be furnished to each prospective franchisee. However, this rule does not require these documents to be filed with the Commission itself; they could be available for research purposes to the extent individual franchisors agreed to furnish them for that purpose.
By contrast, there are 15 States, including South Dakota, which require any franchisor seeking to sell franchises within that State to file a disclosure document with a designated agency. All but Maryland and New York use the "Uniform Franchise Offering Circular" which contains, among other things, a copy of "the franchise agreement and other contracts or agreements proposed for use in this State, including, without limitation, all lease agreements, option agreements and purchase agreements" (UFOC, Item 20). In South Dakota, these disclosure documents are public information and available to anyone willing to use them in accordance with the office policies of the Director of Securities.

Since South Dakota has a relatively small population, only about 200 files are currently maintained. However, because of the pilot nature of this study, this was the set utilized to work out the classification procedures which could be implemented later on a larger set of contracts.

**Coverage**

As with any State law, franchisors who must file disclosure documents are described by statute. South Dakota law (South Dakota Codified Laws, Title 37, Chapters 37-5A 37-5A-1 through 37-5A-57) defines a franchise as a:

...contract or agreement, either express or implied, whether oral or written, for a definite or indefinite period, between two or more persons:

(1) By which a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trade-mark, service mark, logo-type, advertising, or other commercial symbol of related characteristics;

(2) In which the franchisor and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement or otherwise; and

(3) For which the franchisee is required to pay, directly or indirectly, a franchise fee.

Besides exemptions for sales by individual franchisees and transactions of franchises made under court order, two major categories of franchisors or sellers of franchises are exempt from filing disclosures forms:
(1) ...franchises covering farm machinery, motor vehicles or recreational vehicles, including but not limited to snowmobiles, motorcycles, motor homes and mobile homes (37-5A-11)

(2) ...franchisors who have a net worth of ten million dollars or more and have had at least twenty-five franchises in operation in the United States for the last twenty five years. (37-5A-12)

The South Dakota set of franchise agreements contains no oil companies' service station contracts on the list nor are there the agreements for the well-known direct selling organizations. On the other hand, there are a few contracts in the set which have neither explicit franchise fees nor royalty payments. While such agreements do not appear to be "franchises" as defined by the South Dakota statute, they were in the available set and were collected for this study.

Because the disclosure program is ongoing, the total number registered in South Dakota fluctuates from time to time. All contracts on file during May 1982 were collected except for three which were missing from their files and twenty-two which had been filed by franchisors who had never signed an agreement with any franchisee in any state. In addition, a small number of franchisors had made multiple filings with essentially the same contracts. For example, one auto-rental franchisor had made separate filings for an auto-rental franchise with leasing, an auto-rental franchise without leasing, an auto-rental/truck-rental franchise and a truck-only-rental franchise. Since the contracts involved were essentially identical, only one (auto-rental with leasing) was included in the gathered data.

Before describing the nature of the data treatment, several observations about the nature of the contracts available seem appropriate, although some may apply only to those available in South Dakota.

First, there appear to be a few law firms that specialize in drawing up franchise agreements and disclosure documents. In writing contracts, at least
the ones observed in this project, they seem to rely heavily on a bank of "standard clauses." The result is that the contracts from any one law firm, often in widely dissimilar sectors, had identical wording throughout many of their sections.

Second, South Dakota law generally prohibits covenants not to compete. This impinges on those contracts which contain territorial restrictions as well as those which prohibit terminated franchisees from competing with their former franchisors. When contracts containing such clauses are filed with the Franchise Registrar they are returned to the franchisor with the request that they be re-filed with an addendum to the contract calling attention to such clauses and stating that such covenants are generally unenforceable under South Dakota law. The Registrar reports that, when this happens, a substantial proportion of such franchisors choose to redraw their contracts before re-filing, eliminating the clauses in question rather than including an addendum. Thus, the contracts on file in South Dakota may not be the same as those available to franchisees elsewhere.

Third, a more general problem of contract similarity exists. Contracts on file in South Dakota, or any state for that matter, are those currently offered and substantial changes often occur over time. Obviously, many current franchisees are operating under contract terms quite different from those being offered new franchisees.

As for differences that may exist for franchisees in a given system at a given time, it would be presumed that registration under state laws and the F.T.C.'s disclosure rules would force a high degree of uniformity among the contracts offered by a given franchisor at any one time. However, differences exist in the South Dakota contracts. Many agreements, especially for automobile rentals and employment agencies, call for an initial fee whose size
is based on some market potential proxy. With regard to royalties, there are many arrangements other than straight percentage of sales, as shall be seen later. Thus, franchisees within a given system but located in different circumstances may very well be paying differing initial fees and royalty percentages.

Whether or not specific clauses of the presumably standard contracts are negotiable is unknown. To the extent they are negotiable, the provisions of the standard contracts available are not representative of those actually being used. A C. A. O. study of a few S. B. A. loans found that, in one District Office, loan officers were able to negotiate modifications in some franchise agreements with some franchisors by, in effect; threatening to withhold approval of loan guarantees until such modifications were made. This suggests some flexibility of terms but it is not clear that, in the absence of such a threat, any modification of standard terms would be made.

Finally, the biggest single drawback to using contracts as research data is that they do not speak to some of the crucial points of this project. Before enlarging on this point, it is necessary to take a brief look at the contents of a typical franchise agreement.

### Contract Contents

While there is no standard franchise agreement, there are a fairly standard set of issues covered by most agreements. Table 3 presents an outline of a typical contract.

To develop the data for this study, it was necessary to examine each contract for the way each of several issues was handled. A six-step, "content analysis" procedure was followed (based on Krippendorf, 1980).

1. A contract issue was identified to be consistent with the independent and dependent variables of each hypothesis.
Categories describing the varieties of contractual provisions covering each issue was developed which operationally defined the potential states of each of the variables.

Raters were trained to read each contract and categorize the relevant variables.

The categorized data were tabulated and checked for consistency with other categories on other related variables.

Raters' categorizations were cross-validated by an independent categorization by another rater. Almost no discrepancies were found but those that were found were resolved by the Principal Investigator.

Some categories were collapsed for purposes of hypothesis testing.
CHAPTER 5
OPERATIONALIZING THE VARIABLES

The previous chapter described the available sources of data and their general strengths and weaknesses. To test the above hypotheses it is necessary to operationalize their variables in terms of the available data. That is the purpose of this section which discusses the independent variables before turning to the dependent variables.

Independent Variables

Managerial Discretion: The independent variable of the first hypothesis is "the degree of managerial discretion in the sale and service of the final product." Rubin (1978), from whom Blair and Kaserman (1982) borrowed this hypothesis, claimed that "Businesses can vary in two relevant dimensions: the amount of discretion available to managers and the value to the business of the trademark" (Rubin, 1978, p. 229). He does not define "the amount of discretion available" but implies that it is a function of the number of managerial decisions to be made by the franchisee (p. 230).

In principle, this sort of managerial discretion would vary from system to system and be reflected in relevant contract terms. However, the franchisor's specification of the franchisees' day to day activities is usually contained in a manual of operations rather than in contractual clauses. Indeed, all but 23 of the available 140 contracts required the franchisee to follow the franchisor's instructions as contained in a manual. Of those 23 exceptions, only 2 specifically allowed the franchisee to deviate from the manual; the remaining 21 did not mention a manual in the contract. Most of the 23 exceptions were for systems which involve the sale of trademarked products from franchisor to franchisee and, in fact, such purchases are required in 15 of these 23 contracts. In other words, for almost all of the
"business format" franchises, the franchisees' managerial discretion is largely defined and circumscribed by a manual which is unavailable to researchers making this variable non operationable in this sense.

By contrast, Blair and Kaserman (1982) alter Rubin's concept of managerial discretion by redefining it as the degree to which "future period demand is relatively dependent on the behavior of the franchisee as opposed to the franchisor" (p. 501). Obviously, this conception of discretion is not operationalizable, even in principle, in the clauses of franchise agreements. In fact, it appears that it may only be the obverse of the next independent variable.

**Trademark Value:** The second hypothesis introduced the independent variable, "the relative value to the franchisee's business of the trademark." Rubin's (1978) rationalization of this hypothesis hinged on the policing of franchisee's behavior by the franchisor. In those systems where the relative value of the trademark is high it must be protected by greater policing effort but also, one would assume, it is much easier to accomplish. This view of the value of the trademark suggests that its magnitude could vary from system to system such that the value of a well known trademark would be greater than that of a lesser known trademark. In this study, the second hypothesis will be tested using the number of establishments in a system as a measure of that system's degree of consumer acceptance and as a proxy for "value of the trademark" in Rubin's sense of that term.

On the other hand, Blair and Kaserman (1982), in discussing this variable, say "In our model, a greater value of the trademark means that future demand will be more dependent upon the post-contractual behavior of the franchisor in policing the performance of other franchisees to avoid devaluation of the trademark" (p. ). Looking to the contracts, those portions
which specify the duties of the franchisor are nearly identical from contract to contract and are very general in nature. While it may be presumed that franchisors have every reason to avoid the devaluation of their trademarks, there appear to be differences in the incentives to do so; this line of reasoning was pursued in Chapter 3 and will be discussed below in connection with "quality assurance problems."

In a more general sense, Blair and Kaserman's model views the primary responsibility for the success of any given system as lying with the franchisee (a high degree of "managerial discretion") or with the franchisor (a high "value of the trademark"). Thus, these two variables are, to Blair and Kaserman, two sides of the same coin - the behavior of each party during the duration of the contract.

To operationalize this "coin" it can be argued that the success of any franchisee's business depends on consumer satisfaction. When the product is manufactured by the franchisor and sold by the franchisee, ultimate responsibility for customer satisfaction rests with the franchisor. In other words, while the franchisee's contributions to the success of its own business are not negligible in such cases, if the franchisor manufacturers an inferior product the market will eventually realize this and all the franchisee's efforts will go for naught. On the other hand, when the product in question is a good or service produced by the franchisee, the ultimate responsibility for product quality at any given location rests with the franchisee. Granted that there may be some locations which allow the franchisees the opportunity and incentive to cheat on quality indefinitely. But, for the locations which depend to some degree on repeat business, none of the franchisor's advertising or efforts to police other franchisees can help an offending franchisee overcome the effects of producing an inferior product. All of this suggests
that, in the Blair and Kaserman sense of the terms, both "managerial discretion" and the "value of the trademark" may be proxied by the proportion of the franchisee's costs which are purchases from the franchisor of trademarked goods for resale. The larger that proportion, the greater the ultimate responsibility of the franchisor for the success of the franchisee's business and the greater the value of the trademark. Conversely, the smaller the proportion of the franchisee's costs which represent the purchase of goods from the franchisor for resale, the more responsibility rests with the franchisee and the greater the "managerial discretion."

Ideally, the proportion of the franchisee's costs which are purchases from the franchisor of trademarked goods would be available on a system by system basis. Unfortunately, this is not deducible from available contracts and disclosure documents. However, sector data are available from the Department of Commerce surveys and will be used to test the first and second hypotheses from the Blair and Kaserman point of view.

System Maturity: The third hypothesis contains an implied independent variable, "the maturity of the system." Knowing a system's founding date does not indicate its maturity which is a matter of its nearness to saturating its market. Since that is as much (or more) a sector-wide as a system-specific phenomenon, it seems quite legitimate to operationalize "maturity" in sector terms. In this study, a mature system will be defined as any system which is part of a sector in which the total number of franchised establishments is growing at a continuously diminishing rate.

Hypotheses 4 and 5 have the same independent variables as hypotheses 1 and 2 respectively. For testing, these will be defined in the Blair and Kaserman (1982) sense as described above. Hypothesis 6 is really the alternative statement of hypothesis 3 (and its two derivatives, hypotheses 4 and 5) and will be tested, in effect, at the same time.
Quality Assurance Problems: The independent variable of Hypotheses 7 and 8 is the degree to which outlet specific quality assurance problems are important to the franchise system's success. As pointed out in Chapter 3, these quality assurance problems are less severe when the buyer is able to determine quality before purchase or when any one buyer is likely to make a large number of repeat purchases at any one location. For example, the quality assurance problem is relatively low for convenience stores which depend on selling branded, pre-packaged merchandise to buyers located in the immediate neighborhood.

The incentive for franchisee cheating and, therefore, the quality assurance problem is greatest when there is little repeat purchasing at any one location. In turn, this is a function of two factors, the nature of the product and the location of the outlet. Durable goods and certain services tend to be infrequently purchased by any one household. In the case of most durable goods, the quality assurance is likely to be made directly from the manufacturer to the buyer through the brand name and/or a specific product warranty. While this may be a less-than-perfect mechanism for assuring quality, particularly if the franchisee is to provide post-purchase service for the good, it does represent some degree of assurance to the buyer, thereby, taking the responsibility for quality assurance out of the franchisee's hands. In the case of infrequently purchased services (e.g., real estate brokerage, auto transmission repair, furnace cleaning) there may be opportunity for "warranties" but these tend to be given by the franchisee as provider of the service. To the extent such services are major purchases to any one buyer, post-purchase dissatisfaction will tend to generate negative word of mouth communications and provide some degree of market control over quality (Richins, 1983). However, as the complaint logs of most consumer
protection agencies attest, these are the sorts of purchases which seem to
generate the largest volume of complaint behavior, suggesting that major
quality assurance problems remain.

From the franchisor's perspective, the most serious quality assurance
problem arises in the situation where any one buyer is likely to purchase the
product or service frequently but at more than one location. An example would
be the restaurant located at a relatively remote highway intersection. The
unlikelihood of any one buyer returning gives an incentive to franchisee
cheating while the likelihood of that same buyer repurchasing soon in another
location serves to exacerbate the externality problem.

It is possible, a priori, to specify the market conditions and,
therefore, products and locations which provide a greater or lesser quality
assurance problem. Translating these into variables available to this study
is another matter. Many of the sectors contain systems which are so heteroge-
neous with respect to their product's repurchase patterns that their data
would be unsuitable to test hypotheses. "Accounting, credit, collection
agencies and general business services," "Printing and copying services," "Tax
preparation services," "Convenience stores," and "Laundry and drycleaning
services" represent relatively "pure cases" of location specific repurchasing
and, consequently, relatively lesser quality assurance problems. At the other
extreme, while one can think of some systems which would likely have a strong
quality assurance problem, only "Auto-truck rental services" would seem to be
a relatively "pure case" sector, with "Hotels, motels and campgrounds" being a
considerably less homogeneous sector in this regard.

System-by-system data would be desirable for some of the more
heterogeneous sectors. For example, the "Automobile products and services"
sector contains systems of tire stores and systems of carwashes and parking
lots. However, because the truly serious quality assurance problems arise from the peculiarities of particular locations, even system-by-system data would be inadequate to truly operationalize this variable. In the end, all sector-by-sector data is inadequate for testing purposes.

**Contract Purpose**: The implicit independent variable of hypothesis 9 is the purpose for which the contract is drawn. Presumably contracts other than franchise agreements, although for similar purposes and lengths of time, are less complex. Employment contracts and real estate leases would be two suitable candidates for a comparison group. No such contracts were collected for this study.

**Bargaining Strength**: The independent variable of hypothesis 10 should capture the bargaining strength of each franchisor vis-a-vis prospective franchisees. Presumably this strength grows out of the prospective franchisee's estimate of the future earnings of each establishment bearing the franchisor's trademark, in other words, an estimate of future market acceptance. As pointed out above, the number of establishments in a system is a measure of that system's market acceptance. Unfortunately it is a measure of past success and is a proxy for bargaining strength only to the extent that prospective franchisees believe that a system's past is an indicator of its future. However, accepting that reservation, we shall operationalize "bargaining strength" in hypothesis 10 as the number of establishments within a system.

**Dependent Variables**

**Reliance on Fees and Royalties**: Flair and Kenevan's hypotheses predict the relative degree to which franchisors rely on royalties and initial fees as part of their return from their franchisees. For those contracts which specified an initial fee, a royalty rate which was constant over a wide range
of sales and a fixed term, this dependent variable was operationalized by calculating the annual sales volume which would provide a stream of royalty payments whose present value equals the initial fee. For example, if Franchise System X's agreement runs for 20 years and calls for an initial fee of $10,000 and a royalty of 4% on sales, annual sales of $39,940 for each of the next 20 years would yield an annual royalty of $1,597.60. Discounted at 15%, this stream of annual earnings has a present value of $10,000 (the initial fee).

A larger "required sales volume" (as calculated above) indicates a greater reliance by the franchisor on the initial fee. For example, Copy Service A's required sales volume is $42,754 while Copy Service B's is $111,384. If Franchisee A and Franchisee B each have an annual sales volume of $111,384, Franchisor B will earn a royalty whose present value exactly equals the initial fee charged Franchisee B while Franchisor A will earn a royalty whose present value is 2.6 times the initial fee charged to Franchisee A.

As a measure of relative reliance on fees and royalties the above calculation has at least two limitations. First, it is obviously more useful for comparing systems where expected sales volumes are reasonably homogeneous. The establishments in some sectors such as "copy service" are likely, at least on average, to have this sort of homogeneity while other sectors such as "auto parts and services" or "non-food retailing" include so many diverse types of businesses any sector-average sales volume is meaningless.

A second and more important limitation derives from the fact that many of the contracts available for this study are structured so that the above calculations were not possible. Of the 140 contracts from the South Dakota
file, 28 were for restaurants. Every one of these agreements had an initial fee, a flat royalty based on sales, and ran for a fixed term, although the exact number of years was missing from 5 of the contracts. However, among the 112 non-restaurant agreements, only 48 provided for an initial fee, a flat royalty rate and a fixed term. In 16 systems, the franchisor earned part or all of any “royalty” as part of the price charged to franchisees for goods and services sold to them; in 5 other systems the agreements provided for a zero fee or a zero royalty, although it was not totally clear that the franchisors sold substantial quantities of goods or services to franchisees in these systems. Of the remaining contracts, 8 provided for a perpetual term, 22 had variable initial fees (usually based on some proxy for market size) and 6 had royalties based on some factor other than sales volume, while 7 more had royalties with rates which declined as sales volume increases. Thus, of 112 non-restaurant contracts, only 48 fit the stereotypical notion of a “franchise agreement.” Of those, 2 had royalty structures which provided for two or more rates based on some categorization of revenues and 4 others had “fixed lengths” which were indeterminate because they were coterminous with whatever real estate lease the franchisee could negotiate.

In other words, franchise agreements which contain a stated initial fee, a flat royalty based on sales (with or without a minimum) and a fixed term are characteristic of restaurants but not necessarily of other sectors. While the agreements available for printing and copy services fit the “standard” pattern, those for business services, motels, car-rental services and construction/maintenance/cleaning services generally did not.

Vertical Integration: Hypotheses 3 through 5 predict the franchisor’s incentive to integrate vertically. While the intention to integrate is unobservable, measures of vertical integration behavior exist. Ideally such
data would be available for both systems and sectors but, unfortunately, only sector by sector data are available. For each year of the Commerce Department's survey, the following are reported: (a) the proportion of establishments which are franchisor owned, (b) the proportion of sales generated by franchisor owned establishments, (c) the relative size of franchisor and franchisee owned establishments and (d) the number of establishments repurchased by the franchisor and the number returned to franchisee ownership.

Obviously, there are several mechanisms through which a franchise system can become vertically integrated, although the non-empirical literature has tended to focus on franchisor buy-backs. Table 4 presents data on net buy backs by sector. Years or time periods in which franchisors purchased more franchised units than they returned to franchisee ownership are indicated by a plus (+) while years or time periods with a net conversion of units to franchisee ownership are indicated with a minus (−). The "repurchase index" is the proportion of the total buy-back and sell-off activity represented by the "net effect." Thus, if there were all buy-backs and no sell-offs during the period, the index would have a value of +1.0; all sell-offs and no buy-backs would yield an index value of −1.0.

The general picture which emerges from Table 4 is that, during the mid 1970's, there was a general shift from buying back toward a net sell-off. Taking the years 1976-1980 as a whole, only 3 sectors (Business Aids and Services, Convenience Stores and Auto-Truck Rentals) exhibited a net buy back of franchisee owned units by franchisors. Incidentally, over the five year period, the net number of establishments repurchased by franchisors in each of these sectors was 26, 8 and 6 respectively, so that buy backs were not an especially important phenomenon even in the sectors where they occurred.
Tracking the other specific mechanisms by which systems could integrate is nearly impossible. However, the net effect of all such efforts would eventually show up in the aggregate establishment and sales data. Evidence for franchisors integrating vertically should be found in a trend toward a larger proportion of establishments being franchisor owned. Further, it is possible that franchisors might integrate by taking ownership, one way or another, of only the larger (and, presumably, the more profitable) establishments. In the latter situation there should be evidence of a clear trend toward a larger proportion of sales being generated by franchisor owned establishments and an increase in the relative size of the franchisor owned establishments compared to the franchisee owned establishments.

As noted earlier, hypothesis 6 is really the alternative statement of hypotheses 3, 4, and 5. It will be tested simultaneously with those hypotheses.

Franchisee's Investment in Specific Capital: Unfortunately, the dependent variable of Hypothesis 7, the franchisee's investment in specific capital (i.e., the franchise fee plus non-salvageable physical and human capital), is impossible to operationalize with existing data. Initial fees are known from the contract data, although some are only stated as ranges. It is true that the disclosure documents detail the franchisee's required initial investment; beyond the franchise fee they often are required to purchase various goods and services (including, sometimes, training) from the franchisor or another designated business in which the franchisor has an interest. What is not known, and cannot be estimated from available documents, is the possible premium paid for these assets by franchisee to franchisor.

However, the greatest difficulty involves estimating salvage value of the franchisee's capital investment. Conceptually, physical assets and human
capital present different problems. Physical assets tend to be fixed in location and, in many cases, are leased from the franchisor. "Know-how," by contrast, is inseparable from the franchisee but, because it has zero value at death and/or retirement, has a continuously diminishing value once it has reached some peak of proficiency. Further, the value of any sort of capital is dependent on the circumstances in which it must be "salvaged." Three sets of circumstances are discussed below.

First, if the physical assets can be transferred to another party as a "going business" their salvage value is high and, consequently, their specific value is very low. In fact, if the franchisee could sell the business with any amount of good will, the specific capital might be negative with no bonding value whatsoever. In this regard it should be noted that every contract examined but 2 allowed the franchisee to sell the franchised business to a buyer who must be approved by the franchisor. Further, almost every contract examined provided some mechanism for the transfer of the business in the event of the franchisee's death. Thus, selling or transferring the physical assets as part of a going business seems to be quite possible under existing contracts.

Second, with the exception of those few contracts whose term is "until termination," all agreements eventually expire. Some have automatic renewal provisions but, almost always, these are limited to a definite number of renewals of specified length. Many of the renewal provisions require the franchisee to make further infusions of capital, occasionally in the form of a new full or partial fee but, more often, in investments in physical or human capital to bring the business up to the standards then being required of new franchisees. Eventually, if a contract is not renewed, the effect is nearly identical to termination. In fact, the clauses which specify the effects of
termination almost always include "expiration" as one of its several forms. Therefore, we now turn attention to this situation.

Third, almost all contracts give the franchisor the right to terminate the contract "for cause," usually on fairly short notice. Some circumstances (e.g., franchisee bankruptcy) usually result in immediate and automatic termination. Others (e.g., failing to follow the agreement, taking actions detrimental to the franchisor or other franchisees) typically require that the franchisee be given notice and a time period (usually 5 to 30 days) to correct the noted deficiency. In any event, these clauses seem to give the franchisors fairly broad power to terminate the relationship. However, the effect of termination on the salvage value of assets depends on the ability of the franchisee to use his/her capital in a business which continues to operate under a name different from that of the franchisor.

A priori, physical assets vary considerably in their salvage value. Equipment designed to produce a particular product and signs would represent nearly pure cases of specific investment. On the other hand, rental automobiles, motel rooms and restaurant buildings would probably have a rather high salvage value. Obviously, the value of any assets would be enhanced to the degree they could be employed in a manner most consistent with their intended use. On the other hand, most of the business format franchises require relatively little physical capital but, presumably, endow the franchisee with some degree of know-how. While this human capital is ostensibly transferrable, its salvage value is determined by the degree to which the franchisee is able to engage in a business similar to that of the terminated franchise.

In short, the real salvage value of both physical and human capital at termination is largely dependent on the ex-franchisee's ability to survive as
a business. Many factors are involved but an important one is the presence in the contract of a covenant not-to-compete which prohibits the former franchisee from engaging in a similar business for specified time within a specified area. Such clauses obviously reduce the salvage value of both physical and human capital and, therefore, raise the value of the specific capital or "bond." In regard to these clauses several points should be made. As noted earlier, the South Dakota contracts are known to be non-representative of the universe of contracts on this particular point and any frequency count would be largely meaningless. Further, a great number of these clauses are part of the franchisor's attempts to protect its trade secrets. What is or is not a protectable trade secret varies from state to state as does the willingness of courts to enforce covenants not-to-compete as an appropriate remedy for the breach of a trade secret agreement. Finally, trade secret law aside, the enforcement of these clauses in the context of franchising seems to have engendered very little case law.

In summary, the franchisee's investment in specific physical and, especially, human capital appears to be enhanced by the franchisor's ability to terminate the agreement. It is further enhanced, if not largely determined, by the existence and enforceability of covenants not-to-compete. The ability to terminate for cause is nearly universal. We cannot estimate accurately the existence of covenants not-to-compete except to note that they appear to be part of most contracts; their degree of enforceability is still being discovered.

Buy-Backs and Non-Renewals: The dependent variable of hypothesis 8 is as explicit as it is unobtainable. Location-by-location information on buy-backs and non-renewals would be required to operationalize this variable.
Contract Complexity: Hypothesis 9 makes a prediction concerning contract complexity. In this context, complexity refers to the number and variety of behaviors prescribed and proscribed by the agreement. Table 3 showed the topics covered by the typical franchise agreement and, indeed, every contract examined in this study addressed all, or nearly all, of those issues. What is lacking is information on other contracts of similar purpose and length, e.g., employment contracts and real-estate leases.

Unfair Contract Provisions: Hypothesis 10 concerns the presence of seemingly unfair contract provisions. Klein (1980) appears to have equated unfairness with the franchisor's ability to terminate the contract. However, as argued above, the real penalty of termination or non-renewal derives from covenants-not-to-compete. The presence and nature of these clauses would best operationalize unfairness. Unfortunately, as pointed out earlier, the South Dakota contracts are not representative in this particular matter.
Table 5 summarizes the ten hypotheses and the independent and dependent variables of each. This section presents and discusses the evidence available for each hypothesis in turn.

Hypotheses 1 and 2

As previously discussed, there are at least two ways of looking at the independent variables of the first two hypotheses. Further, from Blair and Kaserman's perspective, both are really one hypothesis for testing purposes.

In Table 6 the 14 franchising sectors are arranged according to the importance of sales by franchisors to franchisees of goods for resale; excluded are incidental goods such as paper supplies which are unlikely to bear on the quality of the products in question. Thus, according to this operationalization, systems in the "Automotive Parts and Services" sector rely most heavily on the value of their trademarks while systems in the "Auto and Truck Rental Services" sector have the greatest "managerial discretion."

The column labeled "Required Sales Volume" shows, for the contracts available in each sector, the average required sales volume as described in the section above. It will be recalled that, as this sales volume becomes larger, it represents increasing reliance by the franchisor on the contract's initial fee as compared to the output royalty. Hypotheses 1 and 2 predict that this required sales volume should increase as one moves down the table. Unfortunately there appears to be no particular pattern to the required sales volume data.

Obviously there are considerable inadequacies with the data used to test these hypotheses. As noted earlier, the dependent variable is calculable for 25 of the 28 restaurant system contracts but for only 42 of the 112 non-
restaurant systems. Part of the problem stems from the necessity to test on a sector-by-sector basis because some sectors contain systems which, a priori, differ widely in their purchases of trademarked goods. For example, the sector "Automotive Parts and Services" contains, in the Commerce Department data, the dealers of major tire manufacturers and, at another extreme of the purchase of goods, parking lot operators. Further, several sectors contain systems which are likely to vary considerably in terms of sales volume per output. For example, "Business Aids and Services" sector contains the subcategory "Accounting Services" with average 1980 revenues per franchisee-owned establishment of $48,000 and the subcategory "Employment Services" with average 1980 revenues per franchisee-owned establishment of $299,000. In any non-pilot extension of this study, individual franchisors should be contacted regarding sales to franchisees of goods for resale.

Testing Hypothesis 2 with the "value of the trademark" operationalized in keeping with Rubin's (1978) view as the number of establishments within a particular system overcomes, in principle, the objections which arise from making sector by sector comparisons. Table 7 presents data arraying systems within a given sector or subsector according to the rank of their number of establishments; also shown is the relative reliance of each system on an output royalty. There were only 3 relatively homogeneous sectors or subsectors for which data could be developed for more than 2 systems, again reflecting the small number of contracts available for the study.

In both the "Restaurant - Hamburger" and "Restaurant - Chicken" subsectors, the largest franchisors ("Moulin Rouge" and Kentucky Fried Chicken, respectively) rely more heavily on the use of an output royalty than do those of their competitors whose contracts were available for this study. Inspection of Table 7 suggests that little else conforms to the prediction that
franchise systems whose trademarks have greater consumer acceptance (as proxied by the number of their establishments) will rely more heavily on an output royalty as compared to an initial fee.

**Hypothesis.**

Whatever their respective approaches, nearly all writers with a traditional conceptualization of franchising have agreed that, in mature systems, franchisors would gradually come to own an increasing proportion of all establishments. Besides the previously cited predictions of Blair and Kaserman (1982) and Caves and Murphy (1976), other writers who have predicted a similar course of development are Oxenfelt and Kelly (1968-69) and Hunt (1973) who both forecast a gradual conversion of franchise systems to fully integrated chains; Lillis and Narayana (1976) along with Hunt (1973) presented some evidence that such a trend was observable among restaurant systems. By contrast, the data presented in Table 8 suggests that this expected conversion process is not yet underway in many sectors of franchising; in fact, a contrary phenomenon occurred in a number of sectors during the period 1971-1980.

In Table 8 the sectors have been divided into two categories, "mature" and "declining". The total number of establishments in each sector was examined for a statistically significant fit to a hypothesized pattern of continuously diminishing growth.* Four sectors or subsectors ("Educational Products and Services," "Employment Services," "Auto-Truck Rental Services" and the "Miscellaneous" category) showed no clear pattern of growth or decline and were not considered for purposes of testing this hypothesis. Three points

*Specifically, a series growing at a diminishing rate should be modeled by \( Y = aX^b \), where \( Y \) = the number of establishments; \( X \) = time; \( a = a \) constant; and \( 0 < b < 1.0 \). Modeled equivalently as \( (\log Y = a + b : \log X) \), \( b \) should be significantly different from zero.
should be noted. First, due to the general magnitude and, more importantly, the year-to-year differences in inflation rates, available sales volume series were rejected for measuring sector maturity. Second, a declining industry may differ substantially from one which is mature but the expected behavior of franchisors in a declining sector has never been explicitly hypothesized. Thus, the declining sectors have been separated although we have assumed that they, too, should exhibit a trend toward integration. Finally, although sector data are not ideal for testing Hypothesis 3, it is difficult to imagine a sector which exhibits maturity or decline in which any appreciable number of systems are still expanding rapidly.

Data for 1971-1980 for the proportion of establishments in each sector which are franchisor-owned were examined for evidence of a linear trend whose value of "b" was significantly different from zero. When no significant linear trend was found, tests were conducted for simple non-linear trends using logarithmic, exponential and power functions. A plus (+) in the first column in Table 8 indicates that a trend was found consistent with the prediction of Hypothesis 3(a); a "0" indicates that the value of "b" was not significantly different from zero and failed to support the hypothesis; a minus (-) means that there was a significant trend in the direction contrary to the prediction of the hypothesis (i.e., an increasing proportion of franchisee-owned establishments.) Likewise, Columns 2 and 3 show data for the proportion of sales within a sector which are generated by franchisor-owned establishments and the relationship of the average sized franchisor-owned establishment relative to the average sized franchisee-owned establishment. Column 4 presents the proportion of each sector's total establishments which were franchisor-owned in 1980 and Column 5 shows each sector's repurchase index for the years 1976-1980.
Taken as a whole, the data presented in Table 8 do not lend much support to the third hypothesis, no matter which dependent variable is considered. To start, there was a net buy-back in only two sectors, "Business Aids and Services" and "Convenience Stores;" all other sectors exhibited a net sell-off of franchisor-owned units for the 5 year period 1976-1980. In the "Business Aids and Services" sector there was a significant trend toward dis-integration and, indeed, there was no significant trend toward integration in any of the subsectors of that category. In the "Convenience Store" sector, the net buy-back of franchisee-owned establishments was consistent with the trend toward greater integration. Between 1976 and 1980 the net increase in franchisor-owned convenience stores was 562; however, the net buy-back during this same period was only 8 establishments. Thus, in the only sector in which there were buy-backs supporting a trend toward greater integration, the contribution of the buy-backs to that trend was minimal.

Trends toward a larger proportion of franchisor-owned establishments were evident in only 4 sectors, "Convenience Stores," "Non-Food Retailing," "Restaurants," and "Construction, Home Improvement, Maintenance and Cleaning." The first three of these sectors were among the four most integrated sectors in 1980 with, respectively, 62.0%, 35.6% and 29.7% of all establishments being franchisor-owned. In three of these four sectors there was also a clear trend toward a larger proportion of sales being generated by the franchisor-owned establishments. While many have thought that integration would be accomplished by franchisors buying back the more profitable (and, presumably, larger) franchisor-owned establishments, buy-backs were not a factor toward greater integration in any of these three sectors, all of which show a net sell-off of franchisor-owned establishments over the last 5 years. Strangely, in two of the sectors ("Restaurants" and "Non-Food
Retailing”), in spite of increased integration, the size of the average franchisee-owned establishment was clearly growing in relation to the size of the average franchisor-owned establishment as evidenced by the negative trend values in Column 3 for those sectors.

Even more intriguing is the clear and significant trend toward disintegration in several segments and subsegments, most notably “Automotive Parts and Services,” “Hotels, Motels and Campgrounds,” and “Business Aids and Services.” Although some writers coming from a traditional perspective on franchising have tempered their predictions of integration with discussions of various barriers to that process, none have ever predicted dis-integration.

In summary, there is very little support for Hypothesis 3 in these sector-by-sector data.

Hypotheses 4 and 5

Table 9 rearranges the data of Table 8 according to the purchases of goods for resale by franchisees from franchisors. Because this variable is not available for the sub-sectors of the Business Aids and Services category, that sector has been recombined in Table 9.

There are only 4 sectors which evidence any trend toward integration, so, in that sense, there is very little support for either of these hypotheses.

On the other hand, these hypotheses predict a greater degree of integration when the value of the trademark is higher and a lesser degree in the presence of a high degree of management discretion and lead to the prediction that the integrating sectors would be found among those where franchisee purchases are greater. A look at Table 9 fails to show much support for these hypotheses.

Hypothesis 6

The traditional conceptualization suggests that, at maturity, franchising systems will gradually convert to corporate chains. By contrast, the alterna-
tive conceptualization suggests that, because franchising has benefits to the franchisor which exceed the possible capture of any economic surplus, franchisees will continue to play a major role in franchise systems and, indeed, in retailing generally.

Not only is this hypothesis supported by the same evidence which failed to support hypothesis 3 but, more broadly, one additional point should be added. In an earlier study (Mittelstaedt and Peterson, 1982) it was reported that one out of every eight new (net) retail and service establishments between 1972 and 1977 was franchisee-owned. This statement was based on a comparison of Commerce Department survey data and the Censuses of Business for those two years and excluded gasoline service stations, automobile dealers, soft drink bottlers and professional services (e.g., lawyers) covered by the Census. Although it remains to be seen if this trend will still be evident when the 1982 Census of Business data are available, during the 1972-77 period franchising was expanding more rapidly than retailing in general.

Franchisees, by collectively holding their own within franchise systems, were becoming an increasingly important part of total retailing and service provision.

**Hypotheses 7 and 8**

As pointed out earlier in Chapter 5, the variables of these hypotheses are nearly impossible to operationalize with existing data. While these hypotheses have considerable promise for further study, it is clear that they cannot be tested with either the Commerce Department survey data or an analysis of contracts. Only a properly designed survey of a sample of establishments would be adequate to test these important hypotheses.

**Hypothesis 9**

Although no contracts other than franchise agreements were available for
this study, a reading of all the contracts collected strongly suggests that they are complex by any standard. Not only do they cover a wide range of topics but, as noted earlier, almost every contract requires the franchisee to adhere to a manual of operations. While these manuals were not available to this study, the language of some contracts implies and other studies have reported (e.g., Lewis and Hancock, 1963) that they are very detailed in their specifications of behavior. Equally important, they are subject to change at almost any time. Thus, the manuals not only substantially increase the complexity of the contracts but make many details subject to what is, in effect, unilateral revision. This is not common in real estate leases or employment contracts.

**Hypothesis 10**

If "seeming unfairness" in a contract is the presence of a clause or clauses which allow the franchisor to terminate the agreement on relatively short notice, all contracts examined contained such clauses and were essentially equal in that regard. Those of new and small franchisors read the same as those of the large and well established systems. These similarities may be explained by asserting that lawyers who draw up agreements for the newer franchisors pattern them after the well established. True as that may be, it completely fails to explain why any franchisee would sign an "unfair" contract with a system lacking in economic power - unless there is some other explanation for such behavior. In short, the fact that people sign contracts which can be terminated with small as well as large franchisors appears to demonstrate that the franchisor's economic power is a very inadequate explanation of the provisions of such contracts.

Finally, it should be reiterated that the real force of termination clauses derives from the inclusion of covenants not-to-compete. While it
appears that these covenants are also part of nearly every franchise agree-
ment, the peculiarities of the South Dakota contracts preclude anything being
said about apparent differences in their inclusion in contracts. Agreements
available through other states' disclosure programs could be used to explore
this question and test this hypothesis more thoroughly.
CHAPTER 7
CONCLUSIONS AN IMPLICATIONS FOR PUBLIC POLICY

Before summarizing the findings of the study and discussing their implications for public policy, it is necessary to urge a degree of caution in assessing the results. As was emphasized in Chapter 4, the data available for this study are less than ideal.

Limitations of the Data

The only statistical data come from the Commerce Department's annual survey of franchisors and, while very useful, questions do exist about what is or is not included as "franchising" in general or in any of the several sectors by which the data are reported. Publication of the Department's methodology would clear up many of the questions but would not, by itself, obviate the problem of non-homogeneity of many of the sectors.

The contract data were developed as a specific task in this study. It will be recalled that the original proposal called for the analysis of the South Dakota contracts to be a pilot project to develop a methodology for analyzing a larger body of contracts from some other State's disclosure program. Unfortunately, the funding allowed only the pilot project to be conducted and the set of contracts available for analysis is very small. When divided into sectors, many have so few contracts as to make meaningful analysis impossible.

Two unanticipated problems arose with the contract data. First, a large number of non-restaurant contracts did not conform to the stereotypical "fixed fee, royalty and term" model. Expanding the size of the contract pool would yield more of the "standard form" contracts but would be unlikely to change the proportion. In other words, the problem here was not with the data but with our pre-conceptions. A correctable problem arose from the choice of
South Dakota as a source of contracts. The anti-trust laws of that State prohibit territorial restrictions and covenants not-to-compete, except under tightly defined circumstances. As a result, these contracts are not truly representative of even the self-selected sample of systems which choose to file under that State's disclosure statute.

**Conclusions About the Two Conceptualizations**

Chapters 2 and 3 presented two conceptualizations of franchising. We were, and remain, opposed to referring to them as "models" for two reasons. First, we wish to avoid creating the impression that they are competing in the usual sense of that term. Rather, they start from different perspectives of the phenomenon of franchising and, as a result, address somewhat different questions. Second, there are any number of models which might be developed and tested within either conceptualization. For example, although Imaba (1980) and Blair and Kaneman (1982) share common assumptions about the nature of franchising and strive to answer the same question, they developed models which appear to generate opposite conclusions. All of this suggests that models may be developed in the future from either of these conceptualizations which will generate hypotheses that may or may not be confirmed by ours, or other, data.

We called one of the conceptualizations "traditional" because it predominates as the view held by those who follow the analytical convention of ignoring transaction costs, informational asymmetries and, therefore, incentive problems. In this view, franchising is seen as a relationship between a large, powerful franchisor and small, powerless franchisees. Anxious to be in business for themselves, these mom-and-pop entrepreneurs contribute their capital and efforts to allow the franchisor to grow larger and stronger. The contract between the parties gives the franchisor such
control as to make the franchisees' establishments virtual chain outlets and, if the outlets produce an economic surplus, the contract is designed to allocate most (if not all) of this surplus to the franchisor. In the end, the franchisor will exercise the rights given it by the contract and, in an attempt to capture all of the economic surplus, will acquire ownership of the establishment and, eventually, all of the system.

For whatever reason, this traditional view seems to have widespread appeal and underlies a large portion of both economic analysis and the justification for public policy. However, in light of the data developed in this study, it seems to have at least three serious shortcomings. First, the traditional conceptualization has difficulty explaining the beginnings of a franchise system. The "standard explanation," that franchisors seek franchisees to furnish capital for rapid expansion, appears to be logically flawed. Since franchisees bear greater risk than franchisors, the capital supplied by them is more costly to them than that from other sources. Second, if the franchisor's power derives from the acceptance of its trademark in the marketplace, the observed use of complex and, presumably, "one-sided" contracts by new and small franchisors is not explainable by differential power between the parties.

At this point the adherent of the traditional conceptualization might reply that there always exists a pool of potential franchisees whose desire to be in business for themselves is so strong that they are willing to accept, or are blind to, any level of risk. Further, it could be claimed that this cluelessness (or lack of sophistication, or both) will lead them to a willingness to sign a contract detrimental to their own interests, even with relatively unknown franchisor. There is no way to refute this P. T. Barnum-type explanation with the data at hand.
A third finding, and one with which the traditional conceptualization has greater trouble, is the lack of consistent evidence of reintegration. Net buy-backs, observable in the early 1970's, have virtually ceased. Not a single sector showed, for the decade under study, a consistent pattern of trends of franchisor-owned establishments accounting for an increased proportion of total outlets, total sales or average sales volume per outlet. This is a serious problem for the traditional view since reintegration is the one consistent hypothesis proposed by all writers holding this view.

The alternative conceptualization views franchising as a contractual relationship between two parties, each of whom has an interest in the success of the system itself and in the performance of the other throughout the life of the agreement. That the franchisee is the owner of the establishment is a potent incentive to produce both sales and control costs. This reduces the franchisor's monitoring costs which would be present in the fully integrated system but probably creates disincentives for the franchisee to produce a good or service of a quality consistent with the franchisor's plan. Here complexities arise for, not only is the franchisor's plan likely to change over time, but the incentives and disincentives produced by market forces will vary by the nature of the good or service produced by the system and, especially, by the location of the particular franchised establishment.

Unfortunately, the alternative conceptualization has not led to the development of rigorous models with readily testable hypotheses. In spite of that, its general outlines seem more consistent with the data of this study and especially with exactly those findings which seem contradictory to the traditional conceptualization.

In the alternative view, the complex contracts exist, not to confuse franchisees and allow the franchisor to siphon off the economic surplus which
may be generated at the outlet but, rather, to try to assure compliance with the system's operational format at the time of signing and in the futures. The franchisee, realizing that success often depends on the performance of everyone in the system, signs a contract agreeing to follow a prescribed format and, in effect, puts up a bond to assure performance. They do this, not because they are dazzled by the glamour of the franchisor's trademark, but because they know all other franchisees in the system are doing the same, thereby helping to assure the success of the system. This seems to explain why new franchisors are able to attract franchisees, even though they are asked to sign "one-sided" contracts. It further suggests why franchisors accept the franchisee's "investment," even though it involves a higher cost of capital to them.

Finally, the alternative conceptualization suggests that franchising will continue to persist because it represents an arrangement which works in many situations to the benefit of all parties. The powerful incentive of being one's own boss, combined with the bonding effect of the contract, gives the franchisee the incentive to produce sales and control costs while maintaining quality. Only when the quality assurance problems become severe enough in particular circumstances and locations to offset the powerful incentive effects will franchisors move to integrate.

Policy Implications

The alternative conceptualization provides a way of analyzing various policy recommendations that yields insights not found in the traditional conceptualization or in nonscientific populist literature. That the alternative conceptualization appears consistent with the data and explains the development of many institutional arrangements in franchising and elsewhere gives us some confidence in developing policy implications.
One problem that has plagued researchers and policy makers is the definition of franchising. The analysis presented here does not yield an unambiguous definition of franchising with which everyone would agree, but rather suggests caution in generalizing about all activities that are usually called franchising. Specifically, the emphasis on quality maintenance suggests that different problems exist in "channel of distribution" franchises versus "business format" franchises. As noted earlier, quality assurance problems are likely to be greater, ceteris paribus, where significant production takes place at the outlet (franchisee) level, and policies appropriate for these franchise systems may be inappropriate for a channel of distribution system. It is also evident that generalizations about trends and cycles in franchise activity must take care not to confound the analysis with other developments that have nothing to do with franchising. The decline in automobile dealerships and gasoline stations has to do with structural or cyclical changes in the economy and not with the fact that franchising is prevalent in these sectors.

Another policy question, the answer to which has varied over time, is should the SBA provide financial assistance to franchisees? Two subsidiary questions arise: Is franchising small business? And, does franchising serve a socially useful purpose? Taking these in reverse order, our analysis indicates that franchising has socially beneficial aspects; specifically it is a cost minimizing method of reducing incentive or agency problems resulting from imperfect information. This contrasts with at least some versions of the traditional view which sees franchising as a licensing of monopoly and thus proceeds to calculate the deadweight loss to society. Furthermore, a traditional prediction is that franchising is merely an intermediate step to total vertical integration and is thus not deserving of support as small business.
Our analysis indicates that this is not the case and that franchising is not primarily a source of capital for large franchisors. Indeed franchisees who otherwise qualify should be eligible as small businesses.

The alternative conceptualizations, which views at least part of the initial investment as a bond posted by the franchisee, raises other questions about SBA financial assistance. One would generally expect that the incentive effect of this bonding is different when the franchisor invests his own funds versus borrowed funds. While this effect would exist with any type of borrowing (known as the agency cost of debt), it would be especially important if franchisees view SBA lenders as being particularly lax in monitoring and collecting loans. The result is likely to be either that franchisors recognize these agency costs and increase the required investment (bond) accordingly or, which is less likely, that franchisors will not recognize these costs and contracts will provide less than the optimal incentive for quality maintenance. Failure to maintain quality is likely to lead to systemwide failure. It should be noted that the same problem exists with proposals to require franchisors to guarantee franchisee loans or in other ways provide financial assistance. To the extent that the franchisor lends funds to the franchisee directly or indirectly through loan guarantees, the bond posted by the franchisee has been reduced. If this requirement were imposed on the franchisor, it is likely that the franchisee fee or other nonsalvagable investment requirement would be increased to maintain quality assurance bonds. One option the franchisor would have would be to finance the land, maintaining ownership and leasing it on a short-term basis to the franchisee. This would allow the franchisor to dispossess the franchisee on short notice and would appear to constitute even greater unfair advantage for the franchisor than those in many existing contracts.
We should note that agency costs are pervasive when debt financing is used and are not confined to situations where debt financing is provided or guaranteed by the SBA or franchisors. Nor does the existence of agency costs imply that debt financing should not be used. Rather, debt financing is used because its benefits in channeling resources to their most productive uses or in achieving other goals exceed the agency costs involved. This does not mean that the agency costs are insignificant and one should therefore not be surprised to observe these costs in the form of monitoring activities by lenders, including the SBA, and in the form of residual losses that result from uncorrected incentive problems.

It has been proposed (Committee on Government Operations 1982) that to protect its interests the SBA require modifications of various provisions of the loan contract. While it is certainly reasonable and prudent for the SBA to protect its investment and insure its lien priority, care must be taken to avoid interference with contract provisions that are necessary to assure quality. As we have seen, these contract provisions include more than those explicitly specifying quality standards and penalties for failure to meet them. In particular, the suggestions such as those that franchisors be required to give 90 days notice of intent to terminate or that if the franchise is not reassigned upon default the franchisor be required to repurchase machinery, equipment and fixtures at fair market value may interfere with the ability of the franchisor to assure franchisee compliance with quality standards.

Disclosure of contract provisions and other information about the franchise system is required in numerous states and by the FTC. Greater use of these data by the SBA has been recommended by the House Committee of Government Operations (1982, p. 30). Our analysis suggests that disclosure
would appear to promote more homogenous contracts within franchise systems. However, this homogeneity may occur anyway, i.e. in the absence of required disclosure, because of information costs involved in determining outlet specific contract terms and because compliance with quality specifications by a particular franchise is likely to be greater if he/she knows that other franchisees in the system are subject to the same contractual conditions.

Perhaps least controversial of recommendations is that the SBA develop, maintain and analyze data on franchising practices and SBA experience with franchise loans. (Committee on Government Operations 1982). We agree that an understanding of franchising has been hampered by lack of a systematic data base and support efforts to gather data suitable for use in loan decisions, policy making and further empirical research.
REFERENCES


Table 1
Franchisors Covered by U.S. Commerce Department Survey with Failures and Departures

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Number of Franchisors</th>
<th>Failures</th>
<th>Departures</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>909</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>1973</td>
<td>1005</td>
<td>33</td>
<td>25</td>
</tr>
<tr>
<td>1974</td>
<td>1051</td>
<td>49</td>
<td>40</td>
</tr>
<tr>
<td>1975</td>
<td>1115</td>
<td>55</td>
<td>48</td>
</tr>
<tr>
<td>1976</td>
<td>1166</td>
<td>39</td>
<td>47</td>
</tr>
<tr>
<td>1977</td>
<td>1281</td>
<td>24</td>
<td>47</td>
</tr>
<tr>
<td>1978</td>
<td>1394</td>
<td>30</td>
<td>44</td>
</tr>
<tr>
<td>1979</td>
<td>1459</td>
<td>55</td>
<td>64</td>
</tr>
<tr>
<td>1980</td>
<td>1584</td>
<td>42</td>
<td>74</td>
</tr>
</tbody>
</table>

Table 2

Sales of Products and Services by Franchisors to Franchisees as a Percent of Franchisee Sales, 1980

<table>
<thead>
<tr>
<th>Kind of Franchised Business</th>
<th>Total Franchisee Establishment Sales*</th>
<th>Total Purchases*</th>
<th>Purchases as a Percent of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobile and Truck Dealers</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Automotive Products &amp; Services</td>
<td>$4,818,470</td>
<td>$1,666,539</td>
<td>34.6%</td>
</tr>
<tr>
<td>Business Aids and Services</td>
<td>5,577,125</td>
<td>47,934</td>
<td>0.8%</td>
</tr>
<tr>
<td>Accounting, Credit and Collection Agencies and General Business Services</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Employment Services</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Printing and Copying Services</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Tax Preparation Services</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Real Estate</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Miscellaneous Business Services</td>
<td>**</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>Construction, Home Improvement, Maintenance and Cleaning Services</td>
<td>1,247,917</td>
<td>113,340</td>
<td>9.1</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>3,098,341</td>
<td>130,711</td>
<td>4.2</td>
</tr>
<tr>
<td>Educational Products and Services</td>
<td>268,681</td>
<td>22,442</td>
<td>8.4</td>
</tr>
<tr>
<td>Restaurants (all types)</td>
<td>18,737,338</td>
<td>793,951</td>
<td>4.2</td>
</tr>
<tr>
<td>Gas Service Stations</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Hotels, Motels and Campgrounds</td>
<td>7,064,872</td>
<td>53,467</td>
<td>0.8</td>
</tr>
<tr>
<td>Laundry and Dry Cleaning Services</td>
<td>262,266</td>
<td>459</td>
<td>0.2</td>
</tr>
<tr>
<td>Recreation, Entertainment and Travel</td>
<td>487,905</td>
<td>4,252</td>
<td>0.9</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>1,873,768</td>
<td>2,292</td>
<td>0.1</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>253,906</td>
<td>19,376</td>
<td>7.6</td>
</tr>
<tr>
<td>Retailing (Non-Food)</td>
<td>5,747,039</td>
<td>1,885,266</td>
<td>32.8</td>
</tr>
<tr>
<td>Retailing (Food other than convenience stores)</td>
<td>5,338,816</td>
<td>639,708</td>
<td>12.0</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>370,769</td>
<td>29,220</td>
<td>7.9</td>
</tr>
</tbody>
</table>

* 000 omitted
** Combined in "Business Aids and Services"
Source: U. S. Department of Commerce, 1982
Table 3

Typical Provisions of Franchise Agreements

A. Parties

B. Establishment of Franchisee's Business Organization
1. Form of Organization
2. Capitalization
   a. How Financed
   b. Minimum Working Capital

C. Grant of Licenses to Use Franchisor's Trade Names, Trademarks, Patents, Secret Formulae, etc.

D. Payments to Be Made by Franchisee to Franchisor
1. Initial Fee
2. Royalties
3. Advertising Expense
4. Administrative Expense
5. Charges for Goods and Services Furnished by Franchisor

E. Location of Franchised Business
1. Territory to be Served
   a. Rights and Responsibilities in Territory
2. Selection of Site
3. Lease or Purchase of Premises
4. Construction of Building

F. Equipment and Furnishings for Premises

G. Duties of Franchisee
1. Training to Be Furnished by Franchisor
2. Standards of Operation
   a. Quality Standards
   b. Sales Quotas
   c. Record Keeping and Accounting
3. Administrative Assistance to Be Furnished by Franchisor
4. Periodic Inspections by Franchisor

H. Settlement of Disputes

I. Termination
1. Cause for
   a. Death or Disability of Franchisee
   b. Insolvency of Franchisee
   c. Breach of Agreement
   d. Failure to Meet Specified Sales Quotas
2. Notice of Termination
   a. How Given
   b. Effect of
3. Winding Up of Business
   a. Accounting
   b. Return of Trademarks, Trade Names, Advertising Materials, and Other Property of Franchisor
   c. Legal Remedies After
   d. Covenant Not to Compete

K. Assignability of Franchise

L. Law Governing

M. Severability of Provisions

Source: Glickman, 1982
Table 4
Repurchase Activity of Franchisors, by Sector, 1971-1980

<table>
<thead>
<tr>
<th>Sector</th>
<th>Net Repurchase Activity*</th>
<th>Repurchase Index@</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td></td>
<td>+.259 -.163 +.059</td>
</tr>
<tr>
<td>Automotive Parts &amp; Services</td>
<td>- + - - - - + - - -</td>
<td>-.293 -.499 -.440</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>+ - + - - + + 0 +</td>
<td>-.329 +.065 -.159</td>
</tr>
<tr>
<td>Construction, Home Improvement Maintenance &amp; Cleaning</td>
<td>- + - + + + + - -</td>
<td>+.174 -.130 +.082</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>- + - - - + - - -</td>
<td>-.231 +.030 -.162</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>+ - + + - + - 0</td>
<td>+.012 -.063 +.018</td>
</tr>
<tr>
<td>Restaurants (all types)</td>
<td>+ + + + - + - -</td>
<td>+.491 -.114 +.161</td>
</tr>
<tr>
<td>Hotels, Motels &amp; Campgrounds</td>
<td>- + + - - - - -</td>
<td>-.019 -.531 -.253</td>
</tr>
<tr>
<td>Dry &amp; Drycleaning Services</td>
<td>- - 0 - - - + +</td>
<td>-.304 -.419 -.340</td>
</tr>
<tr>
<td>Recreation, Entertainment &amp; Travel</td>
<td>- + - + + + - 0</td>
<td>-.097 -.500 -.234</td>
</tr>
<tr>
<td>Rental Services (Auto-Truck)</td>
<td>+ + + + - 0 + -</td>
<td>+.922 +.167 +.870</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
<td>+ + - + + + - +</td>
<td>+.411 -.097 +.330</td>
</tr>
<tr>
<td>Retailing (Non-food)</td>
<td>+ - - + + - - -</td>
<td>+.061 -.273 -.090</td>
</tr>
<tr>
<td>Retailing (Food Other Than Convenience)</td>
<td>+ + + + - - - +</td>
<td>+.695 -.053 +.367</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>0 + 0 + - - - - 0</td>
<td>+.143 -.394 -.234</td>
</tr>
</tbody>
</table>

* A plus (+) indicates more establishments repurchased by franchisors from franchisees; a minus (-) indicates a net "sell off" of establishments to franchisees by franchisors.

\@ The repurchase index is calculated: (repurchased by franchisor - converted to franchisee ownership)/(repurchased by franchisor and converted to franchisee ownership).

Hypotheses and Operationalization of Variables

**Hypotheses**

1. **Independent Variable (I)**
   - (Rubin's sense) - Not operationalizable.
   - (Blair and Kaserman's sense) The proportion of the average franchisee's operating costs which are not purchases of trademarked goods for resale from the franchisor.
   - (Rubin's sense) The number of establishments in the franchise system.
   - (Blair and Kaserman's sense) The proportion of the average franchisee's operating costs which are purchases of trademarked goods for resale from the franchisor.
   - Membership in a sector in which the total number of franchise establishments is growing at a continuously diminishing rate.

2. **Dependent Variable (D)**
   - The annual sales volume per franchised establishment which, projected for the contract, would produce stream of royalty payments whose present value, discounted at 15%, would equal the initial fee.
   - Same as 1 above.
   - Trend in proportion of establishments which are franchisor owned.
   - Trend in proportion of sales generated by franchisor owned establishments and trend in relative size of franchisor and franchisee owned establishments.
   - Same as 3(a) and 3(b) above.

3. **Independent Variable (I)**
   - Same as 1(b) above.
   - Same as 2(b) above.

4. **Dependent Variable (D)**
   - Same as 3(a) and 3(b) above.

5. **Independent Variable (I)**
   - Same as 2(b) above.

6. **Dependent Variable (D)**
   - Same as 3(a) and 3(b) above.
Hypothese...
Table 6
Required Sales Volume by Managerial Discretion and Value of Trademark

<table>
<thead>
<tr>
<th>Sector</th>
<th>Purchases of Goods for Resale by Franchisees from Franchisors as a % of Franchisee Sales</th>
<th>Number of Contracts</th>
<th>Required Sales Volume</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive Parts &amp; Services</td>
<td>34.5</td>
<td>5</td>
<td>$51,500</td>
</tr>
<tr>
<td>Retailing (Non Food)</td>
<td>32.1</td>
<td>11</td>
<td>79,076</td>
</tr>
<tr>
<td>Retailing (Food other than Convenience)</td>
<td>11.6</td>
<td>3</td>
<td>40,976</td>
</tr>
<tr>
<td>Construction, Home Improvement, Maintenance and Cleaning</td>
<td>8.2</td>
<td>2</td>
<td>20,403</td>
</tr>
<tr>
<td>Rental Service (Equipment)</td>
<td>6.4</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>7.4</td>
<td>2</td>
<td>43,467</td>
</tr>
<tr>
<td>Educational Products &amp; Services</td>
<td>6.4</td>
<td>1</td>
<td>89,663</td>
</tr>
<tr>
<td>Convenience Stores</td>
<td>4.2</td>
<td>2</td>
<td>14,242</td>
</tr>
<tr>
<td>Restaurants (all types)</td>
<td>3.0</td>
<td>23</td>
<td>61,485</td>
</tr>
<tr>
<td>Recreation, Entertainment &amp; Travel</td>
<td>0.7</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>0.6</td>
<td>14</td>
<td>86,389</td>
</tr>
<tr>
<td>Hotels, Motels &amp; Campgrounds</td>
<td>0.1</td>
<td>2</td>
<td>87,103</td>
</tr>
<tr>
<td>Laundry &amp; Dry Cleaning</td>
<td>0.1</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Rental Service (Auto-Truck)</td>
<td>0.0</td>
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Table 7
Reliance on Royalty By Size of Franchise System

<table>
<thead>
<tr>
<th>Sector or Sub Sector</th>
<th>Size Rank</th>
<th>Reliance on Output Royalty (Rank)</th>
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<tbody>
<tr>
<td>Restaurants (Hamburger)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>System A</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>System B</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>System C</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>System D</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Restaurants (Chicken)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>System E</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>System F</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>System G</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>System H</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Printing and Copy Services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>System I</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>System J</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>System K</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>System L</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>System M</td>
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<td>5</td>
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</table>
### Table 8

Trends in Franchisor-Owned and Franchisee-Owned Establishments and Sales, 1971-1980

<table>
<thead>
<tr>
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<th></th>
<th></th>
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<tbody>
<tr>
<td><strong>NATURE SECTORS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automotive Parts &amp; Services</td>
<td>-</td>
<td>-</td>
<td>0</td>
<td>10.5</td>
<td>-.499</td>
</tr>
<tr>
<td>Business Aids &amp; Services</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td>+.065</td>
</tr>
<tr>
<td>Accounting, Credit &amp; Collection</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agencies &amp; General Business Systems</td>
<td>-</td>
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<td>0</td>
<td>0.9</td>
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<tr>
<td>Printing &amp; Copying Services</td>
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<td>0</td>
<td>5.0</td>
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<tr>
<td>Tax Preparation Services</td>
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<td>*</td>
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<td>Real Estate &amp; Misc. Business Services</td>
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<td>0</td>
<td>-2.3</td>
<td>*</td>
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<tr>
<td>Construction, Home Improvement,</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance &amp; Cleaning</td>
<td>+</td>
<td>+</td>
<td>0</td>
<td>4.1</td>
<td>-.130</td>
</tr>
<tr>
<td>Convenience Stores</td>
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<td>62.0</td>
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<tr>
<td>Restaurants (All Types)</td>
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<td>+</td>
<td>-</td>
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<td>-.114</td>
</tr>
<tr>
<td>Hotels, Hotels &amp; Campgrounds</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>Recreation, Entertainment &amp; Travel</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2.2</td>
<td>-.500</td>
</tr>
<tr>
<td>Rental Services (Equipment)</td>
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<td>0</td>
<td>0</td>
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<td>-.097</td>
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<tr>
<td>Retailing (Food other than Convenience Stores)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>8.0</td>
<td>-.053</td>
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<td><strong>DECLINING SECTORS</strong></td>
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<tr>
<td>Laundry &amp; Dry Cleaning Services</td>
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<td>+</td>
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</tr>
<tr>
<td>Retailing (Non-Food)</td>
<td>+</td>
<td>+</td>
<td>-</td>
<td>35.6</td>
<td>-.273</td>
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</table>

*included in "Business Aids and Services"

<table>
<thead>
<tr>
<th>Sector</th>
<th>Purchases of Goods for Resale by Franchisees from Franchisors as a % of Franchisee Sales</th>
<th>Trend in Proportion of Franchisor-Owned Establishments</th>
<th>Trend in Proportion of Sales Attributed to Franchisor-Owned Establishments</th>
<th>Trend in Size of Average Franchisor-Owned Establishment Relative to Average Franchisee-Owned Establishments</th>
<th>Repurchase Index 1976-1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Parts &amp; Services</td>
<td>34.5</td>
<td>-</td>
<td>-</td>
<td>0</td>
<td>-.499</td>
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<tr>
<td>Retailing (Non-Food)</td>
<td>32.1</td>
<td>+</td>
<td>+</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Retailing (Food other than Convenience)</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>-.053</td>
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<tr>
<td>Construction, Home Improvement, Maintenance &amp; Cleaning</td>
<td>8.2</td>
<td>+</td>
<td>+</td>
<td>0</td>
<td>-.130</td>
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<tr>
<td>Rental Service (Equipment)</td>
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<tr>
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<td>Business Aids &amp; Services</td>
<td>0.6</td>
<td>-</td>
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<td>-</td>
<td>+.065</td>
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<tr>
<td>Hotels, Motels &amp; Campgrounds</td>
<td>0.1</td>
<td>-</td>
<td>-</td>
<td>0</td>
<td>-.531</td>
</tr>
<tr>
<td>Laundry &amp; Dry Cleaning</td>
<td>0.1</td>
<td>-</td>
<td>0</td>
<td>+</td>
<td>-.419</td>
</tr>
</tbody>
</table>