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International multi-unit franchising: an agency theoretic explanation

Viany K. Garg [a], Abdul A. Rasheed [b,*]

[a] *Department of Management, College of Business Administration, Southwest Missouri State University, Springfield, MO 65804, USA*

[b] *Department of Management, College of Business Administration, The University of Texas at Arlington, Box 19467, Arlington, TX 76019-0467, USA*

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Abstract

In spite of its considerable popularity, multi-unit franchising has been considered an anomaly from an agency theory perspective. This paper addresses this anomaly by attempting a comprehensive agency theoretic explanation of international multi-unit franchising. Although past agency theoretic examinations have mostly focused on single-unit franchising, a closer examination of the international context, which is characterized by significant geographic and cultural distance between franchisors and franchisees, suggests that multi-unit franchising may be more appropriate. This paper examines several agency problems inherent in multi-unit franchising. These include: bonding, adverse selection, information flow, shirking, inefficient risk-bearing, free-riding, and quasi-rent appropriation. Consideration of each of these problems using agency theory perspective leads to the suggestion that multi-unit franchising might address agency problems better than single-unit franchising in the international context.

Keywords: International franchising; Agency theory; Multi unit franchising

Agency theory has been a popular perspective to investigate issues in franchising (Bates, 1998; Shane, 1996a). Agency theory arguments of franchising, however, focus on single-unit franchising (SUF): they are "uniformly couched in terms of the local management of single-unit operations" (Kaufmann & Dant, 1996: 346). This

* Corresponding author. Tel.: +1 817 272-3867; fax: +1 817 272-3122.
E-mail addresses: vkg758f@smsu.edu (V.K. Garg); abdul@uta.edu (A.A. Rasheed).

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preoccupation with single unit franchising seems surprising, given that multi-unit franchising (MUF) is ubiquitous, especially in location-based industries where franchising is most popular. For example, using Bureau of the Census data, Bates (1998:114) noted that "among the recently started restaurant franchise units, 84% were units of multi-establishment corporations". Kaufmann and Dant (1996: 346) note several other examples leading to the conclusion: "It is clear that the typical location-based franchising system (of which the fast-food franchises are the prime and modal example) is populated with multi-unit franchisees". In spite of the wide-spread prevalence of MUF, it "remains a curious anomaly" (Kaufmann & Dant, 1996: 346), without a clear theoretical explanation. Prior research, by and large, has focused exclusively on single-unit franchising on the assumption that agency problems are resolved by having owner operators. The moment they become multi-unit systems, individual units are managed by employees, thereby reintroducing the agency problem. The objective of this paper is to explain this anomaly, using an agency theoretic perspective. We do this in the specific context of international franchising, where MUF appears to be particularly dominant. That is, we examine the question: Why do international franchisors prefer MUF over SUF?

By examining the rationale for MUF from an agency theoretic perspective, we complement the work of Kaufmann and Dant (1996) which suggests that MUF, though an anomaly from an agency theoretic perspective, has merits over SUF as an entry mode from a capital acquisition perspective. Given the success of agency theory to explain various aspects of the principal-agent relationships that characterize the interactions between a franchisor and a franchisee, we believe that this theoretical perspective should be able to explain the preference international franchisors have demonstrated for MUF. Eisenhardt (1989: 59) succinctly expressed the wide scope of agency theory when she wrote: "[T]he domain of agency theory is relationships that mirror the basic agency structure of a principal and an agent who are engaged in cooperative behavior, but have differing goals and differing attitudes toward risk". This scope is no exaggeration, as suggested by a large volume of both conceptual and empirical work in diverse areas (see Sharma, 1997, for some examples). Therefore, the status of MUF as an "anomaly" seems attributable more to the lack of a focused, in-depth theoretical attempt to explain MUF than due to any inadequacy of agency theory itself.

Multi-unit franchising is different from single-unit franchising in that franchisees own, operate, or control more than one outlet (Kaufmann & Dant, 1996). Even within MUF, there are many different types. Incremental or sequential MUF occurs when a single-unit franchisee within a successful system is awarded additional units based upon the performance of existing units. Master franchising, on the other hand, involves the franchisor granting a franchisee rights to multiple units from the outset (Kaufmann, 1992). Area development agreements are a special type of master franchising which requires the master franchisee to open and operate multiple units within a geographical area according to a prespecified schedule. Individual outlets, in turn, are run by employee managers hired by the master franchisee (Kaufmann & Dant, 1996).

In this paper we attempt to take an important, long overdue first step towards