Journal of Retailing 87 (3, 2011) 332–344

An Incomplete Contracting Model of Dual Distribution in Franchising

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Abstract

Dual distribution in franchising is addressed from an incomplete contracting perspective. We explicitly model cooperative (dual distribution) franchising as an organizational form, next to wholly-owned, wholly-franchised, and dual distribution franchise systems. Key conclusions of the model are: (1) dual distribution as an efficient governance mechanism does not depend on heterogeneous downstream outlets, and (2) whether dual distribution or some other organizational form is efficient depends on the size of the benefits to dual distribution relative to the parties' costs of investing.

Keywords: Franchising; Dual distribution; Cooperative franchising; Incomplete contracting

> 'Franchising has been the big success story in the second half of this century–an entirely new form of organization that has spread rapidly. But it has been running into problems, where growth has slowed and the imbalance in power has allowed franchisers to exploit franchisees. The law has began to protect franchisees in the same way as employees, but an alternative and perhaps better solution could be to have the franchise become a cooperative with diluted incentives for exploiting the membership.' Holmström (1999, p. 416)

Introduction

Franchising is an important business phenomenon in retail. There are about 1500 franchise chains with more than 760,000 franchisees operating in the U.S; over 18 million people are employed by them; they are responsible for over $1.53 trillion in economic output; and sales through franchise have accounted for a significant portion in the following industries: quick service restaurants (56.3%), lodging (18.2%), retail food (14.2%) and full service restaurants (13.1%) (Reynolds 2004).

There is considerable governance structure variety in franchising (Maness 1996). Blair and Lafontaine (2005, p. 88) provide statistics regarding the number of wholly franchised chains (where all outlets are franchised), dual distribution chains (where some outlets are franchised), and wholly-owned chains (where no outlets are franchised, i.e. all outlets are company-owned). Well-known examples of the first type are Baskin-Robbins USA Co., and Allegra Print & Imaging. McDonalds, 7-Eleven Inc., and Jackson Hewitt Tax Service are examples of dual distribution chains. Sears, Wallmart, K Mart, Red Lobster and Starbucks are examples of the third type, i.e. they are 100% company-owned in the U.S.

Dual distribution franchising is most widespread of these governance structures. Evidence regarding dual distribution franchising shows that it is stable over time, i.e. the percentage of franchised units remains fixed after the early years in franchising. Lafontaine and Shaw (2005) show that the percentage of franchised outlets of experienced franchisors is about 85% on average. There are substantial cross- and within-sector differences. For example, restaurant chains have a higher percentage of company-owned outlets on average than the construction and maintenance sectors. For example, the car rental companies Hertz and National have high levels of company ownership (66% and 40%, respectively), while Budget, Thrifty, and Dollar have much lower levels of company ownership. Franchises establish a stable percentage usually after seven years. Their empirical results show also a strong positive relationship between brand value and the percentage of company-owned outlets. Our equilibrium model is addressing these features of established franchises. One of the main contributions of this article is to

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0022-4359/$ – see front matter
doi:10.1016/j.jretai.2011.01.003

delineate the circumstances when dual distribution franchising is the unique efficient governance structure.[1]

These governance structures in franchising are well known ways of organizing franchising, like the public corporation being the dominant way of organizing production in the economy at large (Rajan and Zingales 2000). However, other governance structures are adopted in the economy, like supplier cooperatives, worker cooperatives, and nonprofits (Hansmann 1996). Franchising shows also more variety than the above three types. For example, franchisees own the brand and the business format of Best Western hotels. Other examples are ACE Hardware, True Value hardware, and Straw Hat Pizza. These cooperative (dual distribution) franchising governance structures are not limited to the USA. For example, drug store DA, retailers Intres and Euretco (fashion, sports, furniture), Primera convenience stores, Top Movers and Motoport are examples of cooperative franchises in the Netherlands. Retail chain Intermarché in France has members and franchisees developing franchising. It consists of supermarkets, some hypermarkets and other stores specialized in clothes (Vêti), fast food (Restaumarché), Do It Yourself (Bricomarché), and hard discount stores (Netto). Système U in France consists of convenience self-service stores (Marché U), supermarkets (Super U) and some hypermarkets (Hyper U). These companies are cooperatives with a bottom up governance system. Intersport and 3e AG are cooperative franchises in Austria. In these cooperative franchise chains, either all outlets together own the brand and the business format, or some outlets own the brand and the business format. We label the former as cooperative franchising and the latter as cooperative dual distribution franchising. Another main contribution of this article is that we explicitly model cooperative (dual distribution) franchising, which has received little attention in organizational economics.

A standard way of delineating a governance structure is to distinguish income rights, addressing the question 'How are benefits and costs allocated?', and decision rights, addressing the question 'Who has authority or control?' (Hansmann 1996). The value of an efficient governance structure is that it provides all parties with incentives to invest in such a way that the entire franchise system generates the highest value. We focus on changes in the structure of decision rights as an alternative to changes in royalty rates (income rights) and legal protections for franchisees for achieving satisfactory levels of franchisees' investment and motivation. The choice of governance structure is addressed by answering two questions: What is the incentive to invest for each party in the franchise system in each governance structure? Which governance structures are efficient under which circumstances?

These questions will be addressed in an incomplete contracting model with transaction specific investments and dual distribution benefits. We motivate these aspects of our analysis now. Incomplete contracting theory starts with the observation that there are limits to contracting due to the complexity of the real world, like the complexity of a transaction or the vagueness of language. It is too costly to describe all relevant contingencies regarding the exchange ex ante in a contract. Contracts are therefore necessarily incomplete.[2] Meaningful contracts can only consist of clauses which are observable and verifiable by a third party. Clauses which are observable but not verifiable have to be left out of the contract because they are not enforceable. Contractual incompleteness entails that it is hard to verify ex post that a party has made an investment and the associated costs. This occurs with specific, irreversible (or sunk) investments, i.e. investments which have a significant higher value within the relationship than in alternative uses (Klein, Crawford, and Alchian 1978). These investments occur in so many ways that various types are distinguished (Williamson 1985): site-specific investments, human asset specificity, physical site asset specificity, dedicated assets, and brand names. Examples in franchising are local advertising and customer service, quality control, human resource management, and product innovation by the franchisees (Sorenson and Sørensen 2001), and the franchisor investing in system-specific assets like know-how and the brand name (Klein and Leffler 1981; Norton 1988). Specificity of investments entails that the costs of investment are paid by the investing party.

The incompleteness of contracts causes problems when the parties involved in the exchange make specific, irreversible investments. It will give rise to ex post opportunistic behavior regarding the remaining surplus. The reason is that the interests of the franchisees and the franchisor are usually not completely aligned with the interests of the entire franchise system. Illustrations are the concerns about free-riding by franchisees on the brand name and territorial encroachment of franchisors adding new units of their brand proximately to their franchisees' existing units (Kalnins 2004). It will therefore be assumed that each party maximizes its own profit, not the profits of the franchise system.

The investor recognizes his weak bargaining position once the investment has been made, i.e. he anticipates that the other party may take advantage of the contractual incompleteness by claiming a larger share of the ex post surplus than initially agreed upon. He may decide not to invest in the project generating the highest surplus. This is the (inefficient) hold-up problem (Klein, Crawford, and Alchian 1978). A suitable choice of governance structure mitigates or even eliminates the hold-up problem. The allocation of decision rights entails a distribution of bargaining power because it allocates ownership over assets to the franchisor and the franchisees. This has an impact on the incentive

[1] Multiple channels of distribution have been studied before, like the coexistence of employees and subcontractors to perform trucking services (Baker and Hubbard 2004), the coexistence of spot and contract markets in many agricultural markets (Hendrikse 2007), and the marketing literature on dual channels (Chiang, Chhajed, and Hess 2003; Liu and Zhang 2006; Purohit 1997; Zettelmeyer 2000).

[2] There are sometimes simple contracts which may deal with incompleteness, e.g. Nöldeke and Schmidt (1995), but there are a number of reasons why in practice complete contracts can be limited. Tirole (1999) and Maskin and Tirole (1999) discuss the indescribability of contingencies, renegotiation, collusion, wealth constraints, enforcement by human beings, and ex ante asymmetric information.