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The Nature of Franchising

A Property Rights Approach

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1. Problem

The franchise relation involves the sharing of intangible assets between the franchisor and the franchisee, especially the brand name of the franchisor and the local know-how or goodwill of the franchisee (Caves, R.E., Murphy, W.F. 1976). These assets represent the "proprietary knowledge" (Teece, D.J. 1980) that cannot be easily transferred because investments in such assets are costly if not impossible to observe and monitor. The franchisor faces the problem of maximizing the returns to his intangible assets when they are dependent on local intangible investments of the franchisee. Therefore, substantial residual risk for local outlets is borne by the franchisee who has the residual rights of control (property rights) of the local promotion and services. Since these investments cannot be specified in the contract, asset ownership is critical to the market success of the product or service. The present article focuses on a property rights explanation of franchising by emphasizing the role of intangible assets as determinant of ownership structure. We argue that ownership should be given to the franchisee when he has to make intangible investments that generate a large fraction of residual income. Ownership increases the bargaining power concerning the division of residual income and therefore gives incentives to make intangible ex ante investments. The appropriate incentive structure is provided by vertical contractual restrictions, such als resale price maintenance, exclusive dealing, exclusive territory and tying arrangements, as well as by the franchise fee/royalty mix.

The paper is structured as follows: In section two we discuss the role of transaction costs and intangibility of assets as determinants of ownership structure. Section three uses the Grossmann, Hart and Moore's property rights approach to analyze the optimal assignment of property rights between the franchisor and franchisee. In section four we apply this framework to answer the question what is the optimal number of franchisees. Section five explains the different vertical contractual restraints that provide the necessary incentives to undertake intangible investments.

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