27. The governance of franchising networks

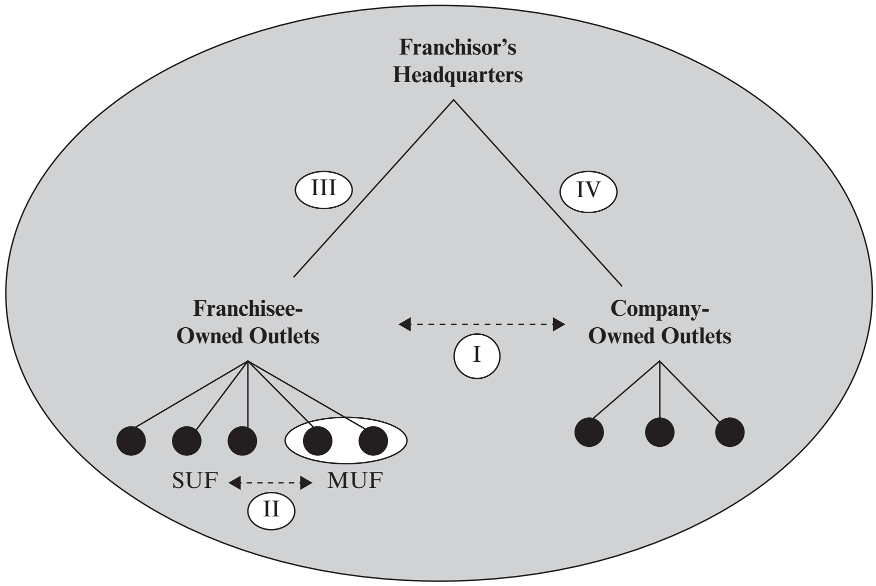
Josef Windsperger

The aim of the chapter is to provide an overview and comparison of major research results regarding the governance structure of franchising networks based on different theoretical perspectives. In addition, I focus on the contribution the property rights theory can make to the franchise literature. Although franchising has been dealt with extensively in the organisational economics and management literature, the relation between residual decision and ownership rights in franchise firms remains largely unexplored. Most studies have focused on the explanation of the incentive structure (fees, royalties and other contractual restrictions) and the proportion of company-owned outlets (e.g. Rubin 1978; Brickley & Dark 1987; Norton 1988; Lafontaine 1992; Dnes 1992, 1996; Lafontaine & Kaufmann 1994; Bradach 1997; Combs & Ketchen 1999; Dahlstrom & Nygaard 1999; Dant & Kaufmann 2003; Lafontaine & Shaw 1999, 2005; Blair & Lafontaine 2005; Bürkle & Posselt 2008; Castrogiovanni et al. 2006a, 2006b; Combs et al. 2009; Barthélemy 2011; Hendrikse & Jiang 2011; Gonzalez-Diaz & Solis-Rodriguez 2012) without investigating the governance structure of the franchise firm as an institutional entity that consists of two interrelated parts: decision rights and ownership rights, the latter of which includes both residual income rights of franchised outlets and company-owned outlets. The franchisor therefore has to set up an efficient network architecture, consisting of contractual relations between the franchisor and the franchisees and hierarchical relations between the headquarters and the managers of the company-owned outlets. Since ownership rights are diluted in franchising network through the division of residual income stream between the franchisor and franchisees, ownership surrogates are used to simulate the incentive effect of undiluted residual income rights in franchise contracting (Windsperger 2003). For instance, the franchisor's diluted residual income rights under franchised outlets may be compensated by using the following contractual provisions as ownership surrogates: tying arrangements, resale price maintenance, lease control, exclusive dealing clauses and buy-back arrangements.

I start with the description of the governance structure of the franchise firm. Next, I present and compare major research results on ownership and contract structure of franchising networks. Finally, I discuss research strategies for the future.

CHARACTERISTICS OF THE GOVERNANCE STRUCTURE OF FRANCHISING NETWORKS

The governance structure of a firm refers to the structure of decision and ownership rights (Baker et al. 2008). In franchising, decision rights refer to the transfer of authority over the use of system-specific assets and local market assets through franchise contracts. Ownership rights refer to outlet ownership (proportion of company-owned outlets, multi-unit versus single-unit ownership) and residual income rights (royalties),



I: Proportion of Company-Owned Outlets (PCO)
II: Ratio between Multi-Unit and Single-Unit Franchising

III: Franchise Contracts
 Residual Income Rights (Royalties)
 Decision Rights
 Ownership Surrogates
IV: Employment Contracts
 Performance-based Incentives

Figure 27.1 Organizational characteristics of franchising networks

as well as ownership surrogates. Ownership surrogates are contract provisions that help to compensate both franchisees and the franchisor for the dilution of residual income rights (Windsperger 2003). Ownership surrogates that increase the franchisees' investment incentives are exclusive territory and exclusive customer clauses, as well as lease and alienation rights; ownership surrogates that increase the franchisor's investment incentives are tying arrangements, resale price maintenance, lease control, exclusive dealing clauses and option rights, such as buy-back arrangement and approval rights and termination rights.

What are the main organisational characteristics of the franchising network (see Figure 27.1)? Most of the franchise systems are characterised by a dual ownership structure as a mix of company-owned and franchised outlets (see I, Figure 27.1). Under a given proportion of company-owned outlets (PCO), the franchisor can assign single- and multi-unit ownership rights to the franchisees (see II, Figure 27.1). In addition, the contract relations between the franchisor and franchisees regulate the allocation of decision rights, residual income rights and ownership surrogates (see III, Figure 27.1). Furthermore, the relations between the franchisor and the managers of company-owned outlets are regulated by employment contracts with performance-based incentives (see IV, Figure 27.1). As a result, when the franchisor sets up a franchise system they have to make the following governance decisions: what is the optimal ownership structure, i.e. PCO and ratio between multi-unit franchising (MUF) and single-unit franchising (SUF)? And, what is the efficient contract structure? The latter refers to the allocation of decision rights, residual income rights and ownership surrogates between the franchisor and franchisees as well as the use of incentive contracts between the franchisor and the managers of company-owned outlets.

OWNERSHIP STRUCTURE OF FRANCHISING NETWORKS

The Proportion of Company-Owned Outlets

The majority of franchise systems have a dual ownership structure, that is, they consist of both company-owned and franchised outlets. The coexistence of franchised and company-owned outlets was examined from different perspectives. Starting from the ownership redirection hypothesis in marketing (Oxenfelt & Kelly 1968; Dant et al. 1996; Baker & Dant 2008), an increase in the proportion of company-owned outlets was predicted during the organisational life cycle, because scarcity of the franchisor's resources (managerial and financial resources and local market knowledge) declines in later stages of the cycle. According to this resource scarcity view, the mix of franchised and company-owned outlets arises because it allows firms to gain access to scarce financial, managerial and information resources (Caves & Murphy 1976; Norton 1988; Minkler 1992; Baker & Dant 2008).

Since the 1980s, agency-theoretical explanations have been developed and tested (e.g. Brickley & Dark 1987; Brickley et al. 1991; Lafontaine 1992; Affuso 2003; Lafontaine & Shaw 2005; Castrogiovanni et al. 2006a; Combs et al. 2011; Penard et al. 2011). Agency theory offers the following explanation: under low monitoring costs company-owned outlets as low-powered incentive mechanism are more efficient than franchised outlets. When the monitoring costs rise due to local market uncertainty and opportunism, franchised outlets are more efficient, due to their high-powered incentive effects. Therefore, monitoring costs can be reduced through transferring residual income rights to the franchisees, because franchisees as residual claimants have higher incentives to use the specific market knowledge (e.g. Norton 1988; Lafontaine & Slade 2002; Vazquez 2007). Recently, Castrogiovanni et al. (2006b) integrated the resource-based and agency-theoretical perspective in order to explain the proportion of company-owned outlets.

Since the 1980s, transaction cost explanations of the ownership structure of franchise firms have been developed (Williamson 1985; Manolis et al. 1995; Klein 1980, 1995; Bercovitz 1999). The transaction cost explanation is based on the assumption that differences in asset specificity and uncertainty may explain the ownership of the individual outlets. Primarily, the influence of transaction specificity on the tendency toward vertical integration by company-owned outlets was investigated. Due to the hostage effect of the outlet-specific investments, the franchisor's opportunism risk is reduced, resulting in a lower proportion of company-owned outlets (Dnes 2003). On the other hand, franchising as a high-powered governance mechanism may increase free-riding costs (Klein 1995; Dnes & Garoupa 2005). The franchisor will choose franchised outlets when the shirking costs of company ownership exceed the free-riding costs of franchising (Bercovitz 2004).

According to the property rights theory (PRT) (Grossman & Hart 1986; Hart 1995;

Maness 1996; Windsperger & Dant 2006), the contractual mix between franchised and company-owned outlets depends on the distribution of non-contractible (intangible) assets between the franchisor and the franchisees. What are the intangible assets in franchising? Franchisees' intangible assets refer to the outlet-specific know-how in local advertising and customer service, quality control, human resource management and product innovation (Sorenson & Sorensen 2001). The franchisor's intangible assets refer to the system-specific know-how and brand name assets (Klein and Leffler 1981). They include knowledge and skills in site selection, store layout, product development and procurement. The higher the franchisor's fraction of intangible system-specific assets relative to the franchisees' intangible local market assets, the more ownership rights should be transferred to the franchisor and the higher the percentage of company-owned outlets (PCO) should be. Therefore, if the intangible system-specific assets are relatively more important for the creation of the residual surplus (compared to the intangible local market assets), the PCO should be relatively high. Conversely, if the local market assets of the franchisees are relatively more important compared to the system-specific assets, the PCO should be relatively low. Data from the Austrian franchise sector provides evidence that non-contractible system-specific and local market assets influence the contractual mix between company-owned and franchised outlets (Windsperger 2004a).

In addition, the PRT can also offer an explanation for ownership redirection in franchising networks, specifically for a decrease of the PCO during the initial stages of the organizational life cycle. The ownership-redirection hypothesis was first proposed by the resource scarcity view of Oxenfeldt and Kelly (1968). According to this view, during the initial stages of the organizational life cycle, the mix of franchised and company-owned outlets arises, because it allows entrepreneurial-minded franchisors to efficiently and quickly obtain access to scarce financial, managerial and informational resources by partnering with franchisees. This need is expected to decrease as the franchise systems grow and mature, thereby fostering a tendency toward a higher proportion of company-owned outlets during the later stages of the organisational life cycle. Empirical results provide little evidence that franchising follows the pattern described by the resource scarcity theory (Dant et al. 1996; Combs et al. 2004). The PRT provides a solution to the theoretical and empirical problems of the resource scarcity view. According to the Windsperger and Dant (2006), the differentiation between contractible and non-contractible resources is critical for the explanation of asset ownership. As Baker and Hubbard (2004) have argued, increasing the contractibility of assets may explain changes in the ownership structure. Ownership redirection is expected to result from an increase in contractibility of the franchisee's local market assets (local market knowledge and financial assets), and hence from the increase of franchisor's bargaining power during the contract period.

Multi-Unit versus Single-Unit Franchising

When the franchisor sets up a franchise system, they have to determine the proportion of company-owned outlets and decide if the franchisees receive single-unit or multi-unit outlet rights. The growth of franchising networks by opening up franchised outlets can be therefore based upon two ownership strategies: single-unit franchising (SUF) and multi-unit franchising (MUF). Under SUF, a franchisee operates only one outlet, while in the case of MUF arrangement a franchisee operates two or more outlets at multiple geographical locations in the same franchise system (Kaufmann & Dant 1996; Grünhagen & Mittelstaedt 2005).

Previous research primarily focuses on resource scarcity and agency cost perspectives to explain MUF. According to the resource scarcity view, the franchisors do not possess enough financial and managerial resources at the beginning of the franchise life-cycle (e.g., Kaufmann & Dant 1996). Financial resources scarcity of the franchisor may result in higher tendency towards MUF to finance the expansion of the system. MUF offers additional growth opportunities for the franchisor compared to the SUF, because the multi-unit franchisees are less constrained in financing the local investments compared to the single-unit franchisees. Agency cost explanations focus mainly on moral hazard, free-riding and adverse selection problems that can be mitigated by using MUF. The findings of these studies suggest that MUF can address a number of agency problems in a more effective way, compared to SUF (Bercovitz 2004; Garg & Rasheed 2003, 2006; Kalnins & Lafontaine 2004; Kalnins & Mayer 2004; Weaven 2009; Weaven & Frazer 2007; Gillis et al. 2011; Gomez et al. 2010; Chen 2010; Jindal 2011). Geographical contiguity of franchised units is one of the important factors that plays a role in the adoption of MUF. The franchise systems with a higher number of geographically contiguous units are more likely to use a higher proportion of MUF. The franchisor especially prefers MUF to SUF when the firm has a strong brand name, which reduces the risk of free-riding (Bercovitz 2004; Brickley 1999; Kalnins & Lafontaine 2004; Vázquez 2008). Recently, Gomez et al. (2010) show that franchisors use MUF as an incentive mechanism to help reduce the adverse selection and moral hazard risk involved in SUF. In addition, Jindal (2011) argues that franchisors use MUF to reduce the cost of internal hierarchy, hence shifting the burden of monitoring to the multi-unit franchisees, as they are better motivated to reduce monitoring costs than company-employed monitors. Gillis et al. (2011) argue that franchisors use multi-unit franchising as a reward in a tournament to reduce agency problems. The prospect of rewarding franchisees with additional units mitigates adverse selection and monitoring problems.

According to the PRT (Hussain & Windsperger 2010a, 2010b), the franchisor's choice between SUF and MUF depends on the contractibility of assets. Local market knowledge can be more efficiently acquired by SU franchisees when compared to the employees of the mini-chains of MU franchisees, because SU franchisees as residual claimants have higher entrepreneurial capabilities (Bradach 1995, 1998) and are more motivated to exploit the profit opportunities at the local market. Conversely, MUF offers additional growth opportunities for the franchisor when compared to SUF, because MU franchisees are less constrained in financing local investments compared to SU franchisees. Since MU franchisees have easier access to financial resources from external lenders than SU franchisees, they help to alleviate the financial scarcity problem of the franchisor, especially when the local market know-how is tacit and hence less contractible. Data from the German franchise sector (Hussain & Windsperger 2010b) provides some support for these hypotheses.

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Comparison of the Different Perspectives

Compared to the PRT, agency theory does not distinguish between performance incentives and ownership incentives, because it implicitly assumes that 'a contract that provides full incentives to an individual is fundamentally the same as selling the firm to this individual' (Hubbard 2008: 349). According to Hart (1995, 2003), agency theory therefore cannot explain the allocation of ownership rights as residual rights of control, due to the complete contracting assumption. Furthermore, in contrast to the agency theory, PRT does not require the assumption of heterogeneous outlet characteristics. Moreover, Whinston (2003) criticised the transaction cost theory developed by Williamson (1979, 1985) and Klein et al. (1978; Klein 1980), because it does not differentiate between the various types of specificity that matter for integration decisions, for instance between contractible and non-contractible specific assets. Similarly, the resource scarcity perspective that focuses on information, managerial and financial resources as determinants of the ownership structure does not differentiate between contractible and non-contractible resources. According to the resource scarcity view, the PCO varies negatively with the franchisor's restraints in financial, managerial and informational resources. The empirical results of Windsperger and Dant (2006) are supportive of the information scarcity hypothesis measured by the impact of the franchisee's innovation assets on the PCO. However, they do not support the managerial scarcity hypothesis measured by the impact of the franchisee's operation assets on the PCO, because these assets show a relatively high degree of contractibility and, as predicted by the PRT, do not influence asset ownership. In addition, the data partially supports the financial scarcity hypothesis. According to the property rights interpretation, financial assets only influence asset ownership if the underlying operating assets (informational and managerial resources) are non-contractible. To summarise, the differences between the resource scarcity interpretation and the property rights results are due to the fact that, contrary to the property rights approach, the resource scarcity view does not differentiate between intangible (non-contractible) and tangible (contractible) resources.

CONTRACT STRUCTURE IN FRANCHISE RELATIONSHIPS

In addition to the ownership structure, the franchisor has to set up an efficient contract design that supports the combined use of the franchisor's system-specific know-how and the franchisee's local market know-how to maximise the residual income stream. Franchise contracting regulates not only the allocation of decision and residual income rights, but also ownership surrogates to mitigate the disincentive effect of diluted residual income rights (Windsperger 2003) (see Figure 27.1).

The Structure of Residual Income Rights

Franchisees have to pay initial fees when entering a franchise system and royalties (based on sales) during the contract period. Agency theory predicts a negative relationship between initial fees and royalties. According to the agency theory (e.g. Mathewson & Winter 1985; Lafontaine & Shaw 1999; Lafontaine & Slade 2002), royalties are chosen as a function of risk and incentives and the initial fees extracts rents left downstream by the royalty rate. With the exception of the work of Vazquez (2005), many of the findings do not support the negative relationship between royalties and initial fees (e.g. Lafontaine 1992; Scott 1995; Lafontaine & Shaw 1999; Brickley 2002).

According to the PRT, initial fees are the remuneration for the brand name assets transferred to the franchisee at the beginning of the contract period (Klein & Leffler 1981). The higher the franchisor's intangible brand name assets at the beginning of the contract period, the higher the rents generated by their system-specific know how, and the higher the initial fees. This reasoning is consistent with the view that the franchisor may recover their sunk investments through the initial fees, as high sunk investments may arise when the system-specific know-how is very important for the success of the franchise system (Dnes 1993). In addition, the more important the franchisor's system-specific investments are relative to the franchisee's intangible local market investments during the contract period, the higher the fraction of residual income created by them, and the higher should be the royalty rate (Rubin 1978). Therefore, PRT predicts a positive relationship between initial fees and royalties (Windsperger 2001). Many of the findings provide support for a positive relationship (Baucus et al. 1993; Kaufmann and Dant 2001; Rao and Srinivasan 1995).

The Structure of Decision Rights

In addition to residual income rights, franchisors use contracts to transfer decision rights across firm boundaries (Baker et al. 2008). For instance, they transfer authority to franchisees to make local advertising and training decisions. Although franchising has been treated extensively in organisational economics, management and marketing in the last two decades, the problem of the allocation of decision rights between the franchisor and franchisees remains largely underexplored (Arrunada et al. 2001, 2005; Azevedo 2009). Arrunada et al. (2001, 2005) and Azevedo (2009) derive hypotheses from an agency-theoretical framework. Arrunada et al. (2001, 2005) investigate the allocation of specific rights in contracts between car manufacturers and their dealers, such as completion rights, monitoring, and enforcement rights. Arrunada et al. (2001) argue that contracts assign more rights to manufactures when the costs of dealer opportunistic behaviour are high and when manufactures have a high reputation. Azevedo (2009) investigates the impact of brand name value and externality on the allocation of authority in franchising networks.

Windsperger (2004b) examines the allocation of decision rights between the franchisor and franchisees from the property rights perspective. According to Jensen and Meckling (1992), two ways for allocating decision rights exist: either knowledge must be transferred to those with the right to make decisions, or decision rights must be transferred to those who have the knowledge. This means that decision rights tend to be centralised in the franchising network when the costs of transferring local knowledge to the franchisor are relatively low. This is the case when the franchisor's portion of intangible assets is relatively high compared to the franchisee's intangible local market assets. On the other hand, residual decision rights have to be delegated to the franchisee when their local market know-how is very specific and consequently knowledge transfer costs are very high. In this case, the bargaining power of the franchisee is relatively strong due to their non-contractible local market assets. The results obtained from the survey of the Austrian and German franchise sector support this property rights view (Windsperger 2004b; Mumdziev & Windsperger 2011). In addition, Mumdziev and Windsperger (2011) disaggregate the structure of decision rights by applying Porter's value chain concept (Porter 1980). Decision rights are disaggregated according to the major value chain activities at the local outlets (such as product decision, procurement decision, advertising decision, price decision, human resources decision, investment decision and accounting system decision).

To conclude, complementary to the agency-theoretical view (e.g. Arrunada et al. 2001; Azevedo 2009), the non-contractibility of system-specific and local market assets explains the allocation of decision rights in franchising networks from a property rights perspective. In addition, Mumdziev and Windsperger (2011) extend this view by disaggregating decision rights according to the major value chain activities at the local outlet.

Complementary and Substitute Relations in Franchise Contracting

The franchise contract regulates the assignment of decision rights, residual income rights and ownership surrogates between the franchisor and franchisees (see Figure 27.1). Although the existing literature investigates interactions between various contract provisions in franchise relations (e.g. Wimmer & Garen 1997; Brickley 1999; Berkovitz 1999; Arrunada et al. 2001; Lafontaine & Raynaud 2002; Vazquez 2008), the PRT focuses on the explanation of the contract design as a bundle of rights consisting of decision rights, residual income rights and ownership surrogates. Windsperger (2003) argues that the contract design is characterised by substitutability between residual income rights and ownership surrogates as well as complementarity between decision and ownership rights (residual income rights and ownership surrogates).

Firstly, I examine which ownership surrogates can be included in franchise contracts and what are their incentive effects. In a survey of 153 German and (83 Austrian) franchise systems, Windsperger (2002, 2003) found that the following contract clauses were used: 61 per cent (68 per cent) non-binding resale price maintenance, 42 per cent (39 per cent) exclusive customer clauses, 36 per cent (49 per cent) tying arrangements, 44 per cent (52 per cent) franchisors' lease control rights, 67 per cent (56 per cent) buy back and approval rights, 79 per cent (63 per cent) exclusive dealing clauses, 72 per cent (73 per cent) alienation rights and 78 per cent (73 per cent) exclusive territory clauses. Due to the division of residual income rights between the franchisor and franchisees, ownership surrogates serve as incentive mechanism to compensate the franchisor and franchisees for the dilution of residual income rights. For instance, the disincentive effect of franchisee's diluted residual income rights due to high royalties may be compensated by territorial restraints, exclusive customer clause or alienation rights. On the other hand, tying arrangements, resale price maintenance, lease control, exclusive dealing clauses and buy-back arrangements, as well as approval and termination rights, may compensate the franchisor's diluted residual income rights. Therefore, ownership surrogates and residual income rights are substitutes. Secondly, based on the complementarity view of organisational design (e.g. Milgrom & Roberts 1990; Brickley et al. 1995; Grandori & Furnari 2008; Van den Steen 2010), decision and ownership rights are complements, because the residual income-generating effect of the allocation of decision rights to the network partners is enhanced by transferring ownership rights (i.e. residual income rights and ownership surrogates) to those that are best able to maximise the residual income stream. Windsperger (2003) provides some evidence for the substitute and complement relationship.

In conclusion, Windsperger (2002, 2003) extended the concept of property rights in contractual relations. Property rights between contract partners (e.g. franchisor and franchisees) refer to decision rights, residual income rights (e.g. royalties) and ownership surrogates. Since these contract provisions are closely intertwined, the franchisor can only set up an efficient contract design by considering the interactions between the different components of the network architecture. Recently, Grandori (2010) proposed such a view of theory building that focuses on the interactions between the different elements of a governance structure.

IMPLICATIONS FOR FUTURE RESEARCH

Finally, this chapter addresses the question about how to apply the property rights view and other theoretical perspectives in organisational economics and strategic management to new research questions on the governance of franchising networks.

Open Issues and Implications for the Economic Organisation of Franchising

The governance structure of the franchise firm

Since the network architecture of a franchise firm consists not only of contractual relations between the franchisor and franchisees but also of hierarchical relations between the headquarters and the manager of company-owned outlets (see Figure 27.1), the franchisor can only set up an efficient governance structure of the franchise firm by considering the interactions between decision and ownership rights. Previous research on the institutional structure of franchising networks has not investigated the governance structure of the franchise firm as an institutional entity consisting of decision and ownership rights. A first attempt is the study of Windsperger and Yurdakul (2007). They show that the governance structure of Austrian franchising firms is characterised by complementarity between decision rights and ownership rights (i.e. PCO and royalties) and substitutability between PCO and royalties. The substitute relationship between royalties and PCO is compatible with the view of Rubin (1978) and Scott (1995). Penard et al. (2003) provide evidence of a positive relationship. Research is needed to examine the relationship between ownership and decision rights in franchising networks by using a larger sample of franchise firms from different countries.

Relationship between multi-unit franchising and proportion of company-owned outlets

According to Fama and Jensen (1983), the decision structure of the firm consists of decision management and decision control rights. Whenever the decision management rights are divided between partners, due to their specific knowledge, control rights are installed to counter agency problems associated with the dilution of decision rights. For instance, the franchisor's decision rights are more diluted under MUF than under SUF.

Under MUF, the franchisees have more decision rights regarding monitoring of local outlets, local human resource management and knowledge transfer between headquarters and local outlets (Hussain & Windsperger 2010a). In this case, the franchisor may compensate the dilution of decision rights under MUF by an increase of control through a higher percentage of company-owned outlets (PCO). As a result, future research has to investigate the relationship between MUF and PCO.

Governance modes of international franchise firms

Franchise firms that enter foreign markets use non-equity and equity relations as governance modes, such as master franchising, area development franchising and joint venture franchising (Konigsberg 2008; Mumdziev 2011). Under master franchising, the sub-franchisees have residual income rights and decision rights mainly over operational activities, but they have no outlet ownership rights. On the other hand, regarding area development and joint-venture franchising, the local partners have both outlet ownership and decision rights and therefore a higher level of control over the local outlets. The application of PRT may offer new explanations of the relationship between ownership and control patterns in international franchise firms (Dant et al. 2011).

Decision structure and knowledge transfer mechanisms

In a recent study in the Austrian franchise sector, Windsperger and Gorovaia (2011) found that knowledge attributes (degree of tacitness) influence franchisor's choice of knowledge transfer mechanisms. High tacitness of system-specific knowledge requires more knowledge transfer mechanisms with high information richness (such as meetings, visits, workshops and training), and low tacitness requires more knowledge transfer mechanisms with low information richness (such as data bases, intranet, manuals). Since tacitness results in low contractibility of knowledge, the choice of knowledge transfer mechanisms is closely related to the question of allocation of decision rights between the franchisor and franchisees. For instance, if the decision rights are centralised under non-contractible system-specific knowledge, the franchisor has to use more face-to-face knowledge transfer mechanisms to facilitate the transfer of system-specific knowledge to the network partners. Future research should examine the relationship between the choice of knowledge transfer mechanisms and the allocation of decision rights in franchising networks.

Firm strategy and governance structure

Few studies focus on strategy issues of franchise firms (Muris et al. 1992; Michael 2000; Yin & Zajac 2004; Stanworth et al. 2004; Garg et al. 2005; Barthélemy 2008; Gillis & Combs 2009; Bordonaba-Juste et al. 2010). One very important and underexplored research question concerns the relationship between strategy and governance of the franchise firms. For instance, what is the impact of standardisation versus adaptation (Kaufmann & Eroglu 1999) on delegation and ownership structure? Standardisation implies the existence of more contractible system-specific know-how, which enables the franchisor to transfer more decision rights to local partners without high knowledge transfer and monitoring costs. Research is needed to explain the relationship between strategy and governance of franchise firms.

Relationship between uncertainty and incentives

According to the standard prediction of agency theory, royalties (as performance-based incentives) and risk should be positively related. Empirical results do not confirm this relationship (e.g. Lafontaine & Slade 2002, 2007; Prendergast 2002). In addition, recent theoretical results in organisational economics also question the risk–incentive trade-off (Rantakiri 2008; Shi 2011). How can the PRT offer a solution to this problem in the context of franchising? Based on James (2000), the relationship between risk and incentives in contract relations depends on the underlying governance mechanism (i.e. internal governance versus market or network governance). Under an employment contract between headquarters and outlet managers with more contractible assets, it is more likely that the relationship between risk and performance-based incentives is negative. On the other hand, under a franchise contract with more non-contractible assets of franchisees, it is more likely that the relationship between risk and incentives (royalties) is positive (negative). Therefore, it is expected that the governance mechanism (internal hierarchy versus network relationships) will influence the relationship between risk and incentives in contract relations. Future research has to address this question in the context of franchise contracting.

Relational and formal governance in franchising networks

Transaction costs, property rights and agency models can be enriched by research results from the relational governance perspective. According to the relational view of governance (e.g. Gulati 1995; Zaheer & Venkatraman 1995; Dyer 1997; Dyer & Singh 1998; Gulati & Nickerson 2008), trust as an informal or relational governance mechanism may influence franchisor's use of formal governance mechanisms, such as decision and ownership rights as well as knowledge transfer mechanisms. Trust reduces relational risk and increases information sharing, thereby enabling the franchisor to reduce formal control over operational decisions. For instance, considering trust in the transaction cost theory could supplement the explanation offered by the transaction cost theory on the allocation of decision rights in franchising networks (Mumdziev & Windsperger forthcoming; López-Fernández & López-Bayón 2011). In addition, trust influences the franchisor's choice of knowledge transfer mechanism (Gorovaia & Windsperger 2011). As a result, future research should examine the impact of trust on the use of formal governance mechanisms in franchise networks.

Implications for the use of empirical methods

Investigating complementary and substitute relations in franchising networks is not only a challenge for theory building but especially for empirical testing (Milgrom and Roberts 1990; Fiss 2007; Ennen and Richter 2010). Depending on the number of organisation design variables and their interactions, different methods must be used to examine complementarities and substitutabilities in intra- and inter-organisational relations (e.g. Arora & Gambardella 1990; Ichniowski et al. 1997; Poppo & Zenger 2002; Cassiman & Veugelers 2006). Therefore, the question for future research is how to apply adequate empirical methods to examine the network architecture of the franchise firm.

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The Relations between Organisational Economics and Resource-based Perspectives

Resource scarcity versus resource-based view

The resource scarcity view attempts to explain the use of franchising as a means to overcome the scarcity of resources, that is, financial, managerial and informational resources. For instance, size and age of the franchise system are indicators of resource scarcity. The larger size and the older the franchise system, the easier and less costly is the access to resources. This reasoning is compatible with the market failure explanation due to high transaction costs. From a methodological perspective, based on the 'structuralist view' of theories (Stegmueller 1979), the resource scarcity approach must be criticised, because hypotheses are formulated without defining the 'core' of the theory from which they are derived.

The resource-based view argues that knowledge sharing and creation through firm-specific resources and capabilities result in competitive advantage (or strategic rents) (e.g. Barney 1991; Madhok 1996; Teece et al. 1997). When applied to governance mode decisions, the resource-based view states that governance modes create strategic rents by efficiently sharing and creating knowledge. For instance, contrary to the resource scarcity view, empirical studies show that size and age may be more valid indicators of firm-specific resources and organisational capabilities to create a competitive advantage (e.g. Combs et al. 2004; Weaven and Frazer 2007). We can therefore conclude that the resource scarcity view and the resource-based view are not interrelated, because they address different research questions.

In franchising research, the resource-based theory is seldom applied to explain governance mechanisms (e.g. Thompson 1994). Therefore, future research has to focus on resource-based explanations of governance modes (Combs et al. 2004; Gillis & Combs 2009). For instance, one important application is the explanation of the plural network form (Bradach 1997; Cliquet 2000; Cliquet & Penard 2012). Plural franchise networks have higher organisational capabilities than pure forms, due to the synergy effects between company-owned and franchised outlets. Complementarities between higher exploitation capabilities of company-owned outlets and higher exploration capabilities of franchised outlets increase the governance capabilities and hence the residual income stream of the network (Sirmon et al. forthcoming). Recently, Hendrikse and Jiang (2011) explained these positive externalities in franchising networks with an incomplete contracting model.

Relationship between organisational economics theories and resource-based theory

Organisational economics theories refer to the explanations of governance modes using agency theory, transaction cost theory and PRT. Transaction cost and agency theory examine the impact of environmental and behavioural uncertainty and performance measurement difficulties, as well as asset specificity on the choice of governance modes in franchising. Consequently, the governance modes aim at reducing agency and transaction costs by setting up control and incentive mechanisms. For instance, if the risk of free-riding in the network is high, the franchisor increases control over decision making in the network. PRT focuses on analysing the residual income effect of the governance structure of franchise firms by assigning ownership and decision rights to the agents according to the distribution of intangible (non-contractible) assets. Therefore, governance modes aim at increasing the residual income by assigning decision and ownership rights to the agents with intangible assets. For instance, if the franchisees' local market know-how is more intangible relative to the franchisor's system-specific know-how, it generates a higher proportion of residual income of the network; hence the franchisor delegates more decision rights to the franchisees.

On the other hand, the resource-based view is a strategic theory of the firm (Rumelt 1984). It focuses on the explanation of governance modes as knowledge creation and sharing mechanisms to generate strategic rents by increasing the governance capabilities (Madhok & Tallman 1998; Mayer & Salomon 2006). Governance forms aims therefore at increasing competitive advantage by creating and exploiting firm-specific resources and capabilities. For instance, MUF may increase a franchise firm's organisational capabilities and hence its competitive advantage compared to an SUF-system (Hussain & Windsperger 2010a, 2012).

Consequently, organisational economics theories and the resource-based view of governance focus on fundamentally different research questions: On the one hand, which governance modes reduce transaction and agency costs (agency and transaction cost theory) or increase residual income (PRT), due to uncertainty/information asymmetry or non-contractibility of assets? On the other hand, which governance modes increase competitive advantage (strategic rents) through knowledge sharing and creation? In conclusion, organisational economic theories focus on the choice of governance modes as coordination and incentive mechanisms under given firm-specific resources and capabilities (Barney & Hesterley 1996), while resource-based theories focus on the choice of governance mechanisms to create firm-specific resources and organisational capabilities. Future research on governance structure issues of the franchise firm has to consider these fundamental differences when applying organisational economics and resource-based views.

CONCLUSION

Researchers from different fields in economics and management have examined the governance structure of franchising networks in the last three decades. In this chapter, I have attempted to make three contributions. Firstly, I provide an overview of major research results on the governance structure of franchise firms from different theoretical perspectives. Secondly, I compare the research results from agency theory, transaction cost theory and resource scarcity view with the results based on PRT. Thirdly, I discuss research strategies for the future, specifically new directions for the application of property rights theory, resource-based theory and the relational governance view to explain governance issues in franchising. In addition, I compare the different theoretical perspectives used in franchising and show that organisational economics applications address fundamentally different research questions compared to resource-based applications.

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