

KNOWLEDGE ASSETS AND THE STRUCTURE OF PROPERTY RIGHTS: THE CASE OF FRANCHISING*

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ABSTRACT

In this paper, we develop a property rights framework to explain the decision and ownership structure of franchising networks. Based on the property rights approach, decision rights must be allocated according to the distribution of knowledge assets (know-how) between the franchisor and franchisee and ownership rights must be assigned to those who have the residual rights of control (residual decision rights). Consequently, an efficient institutional structure of franchising network requires complementarity between decision and ownership rights to maximize the value of the franchisor's and franchisee's knowledge assets. Our property rights analysis derives testable hypotheses concerning the decision and ownership structure in franchising networks.

KEYWORDS

Property Rights, Complementarities, Franchising Networks, Knowledge Assets

1. Introduction

Contractual relations between the franchisor and the franchisees are organized as stable networks based on the combined use of the franchisor's brand name capital and the franchisees' local market know-how to maximize the residual income stream[1]. Due to the incomplete contracting properties of these complementary assets, property rights (i. e. decision and ownership rights) must be assigned according to the knowledge assets (know-how) of the franchisor and the franchisee[2, 3]. Thus the property rights structure depends on the distribution of know-how as knowledge assets that generates the residual income stream of the network[4]. Our thesis of the paper is: The more relevant the party's uncontractible know-how for the success of the franchising network, the more residual decision rights should be assigned to the party who owns this asset, and the more decision rights a party has, the higher should be his fraction of residual income generated by asset usage. Consequently, an efficient institutional structure of franchising implies complementarity between decision and ownership rights[5].

The paper is organized as follows: In the second section we present an overview of the main propositions of the property rights approach. Section three uses the property right approach to examine the relationship between the characteristics of knowledge assets and the allocation of decision rights in franchising networks. In the fourth section we apply this framework to answer the question how to structure the decision and ownership rights between the franchisor and franchisee. In the last section we try to show that an efficient institutional structure of franchising networks requires complementarity between decision and ownership rights. Finally, we derive testable hypotheses from the property rights approach.

2. An Overview of the Property Rights Approach

Based on Alchian and Demsetz[6] and Williamson[7], Grossmann, Hart and Moore[8,9,10] developed the property rights approach as incomplete contracting theory of the firm. According to this approach, the property rights

