9. Franchising: The Nature of the Contract

The franchise is an organizational structure that lies on the spectrum between independent business units and multiple business units owned by a single corporation. In the franchise the units are operated as independent profit centers with the owner claiming the residual profits. The association between the units occurs through the contract with the franchisor. As we move away from independent units along the organization spectrum, the problem of shirking grows. To compensate for this increased management cost, there must be some benefit.

Franchising is a ubiquitous phenomenon in business today, and seemingly it has grown in importance. However, it is not always easy to observe the existence of franchise establishments. Many organizations have both franchise outlets and company owned stores. In smaller enterprises, many times owners give an ownership claim to managers which vests after several years. This is a common place in the small chain restaurant industry. Moreover, there are degrees of franchises. For instance, are Ace Hardware stores a chain?

The question raised in the theory of franchising is, What service is being supplied by the franchisor? Arguably it could be managerial expertise. Both McDonald's and Burger King have hamburger schools. There is a lot of value in having the knowledge of how to profitably run a business. Even so, this argument seems to evaporate upon close inspection. If it were nothing but start-up services provided by franchisors, then the franchise relationship would terminate after a point. These kinds of contracts do happen, of course. (The Clemson golf course had such an arrangement with a golf course management company.) But we don't think of them as franchises.

The thing that makes a franchise is an on-going, infinite horizon association between an outlet and a central agent. The think that characterizes a franchise is a brand name that is identifiable to the consuming public. The social value of a franchise seems to be the information conveyed to consumers by this brand name.[1] Brand names are unquestionably of growing importance and value in marketing and many brand named products are distributed through franchised outlets.

That benefit in the franchise setting is the value of the information conveyed to the consumer by the brand name associated with multiple business units. The franchise organization is a way of contracting among the business units to enhance and protect the brand name while minimizing the costs of shirking at the individual sites.

The contracting problem that must be confronted in this organizational setting it that each franchise unit has an incentive to shirk on quality. Quality reductions by one franchisee are partly offset by the quality expectations generated by other franchise units. Presumably this is more important in businesses where there are a lot of non-repeat customers, but it will also come into play even in repeat business endeavors. Brand names are quality assuring devices. If the McDonald's where you eat everyday serves you a cold hamburger, you will still go back the next day expecting it to be hot because the unit is still a McDonald's. Either by a little or by a lot, the

[1] I say "seems" because there is always great debate about whether information is valuable and about whether consumers are duped into consumption patterns. For the most part, I dismiss this view of the world. However, there is no incontrovertible evidence that brand names are valuable because of information.

franchise units have an incentive to reduce costs by cutting quality because it will increase their profits.

Mechanisms for Quality Control—Termination

The main leverage that the franchisor has for promoting quality is the cancellation of the franchise agreement with a franchisee.[2] This has to cost something. One way to make the franchisee post a bond that is forfeited if the franchise is canceled is to require a large lump-sum payment. Many franchises do this. Another is to make the franchisee rent from the franchisor. In this way the building and improvements are taken over by the franchisor if the franchisee is terminated. Court records from the McDonald's and Baskin-Robbins cases (1980 and 1982, respectively) indicate that both were the primary leaser of locations to their franchisees. Finally, the franchisor may make the franchisee build a funny looking building that has little value if the franchise agreement is canceled.

Why are there quite often queues of potential franchisees?[3] Why doesn't the franchisor charge a price high enough to clear the market? One argument focuses on the variance in the return to the franchise investment. If a potential site has uncertain value, then the franchisee must make enough in the bad times to cover the franchise investment. Hence under the expected outcome, there are excess returns. For instance, there may be a cost to shutting down a franchise. The empty unit or renamed facade creates a negative externality for the franchise. To insure the value of the brand name, the franchisees must make an extra return.

A more important factor is that the franchisor must share some of the wealth of the franchise as a bond of its (the franchisor's) behavior. If the franchisee posts a bond that equals the harm imposed on other units if it cuts cost, the franchisee must fear that the franchisor will opportunistically terminate it and expropriate the bond. The franchisor can make termination costly to the franchisee without putting the franchisee at risk by sharing some of the value of the franchise with the franchisees. This generates a queue of potential franchisees.[4]

The franchisor allows the franchisee to share in the profits by restricting the number of units below the level that would exist if there were no threat of cancelation. The fact that the franchisee makes extra-profits by having some monopoly power has implications about store hours and prices. The franchisee will be tempted to raise prices and cut store hours in order to increase profits more than royalties. Hence, franchisors will impose price and hours restrictions.

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[2] Brickley, James A., Frederick H. Dark, and Michael S. Weisbach. "The Economic Effects of Franchise Termination Laws," *Journal of Law & Economics*, April 1991, 101-132.

[3] Mathewson, G. Frank, and Winter, Ralph A. "The Economics of Franchise Contracts," *The Journal of Law & Economics*, October 1985, pp. 503-526. Kaufman, Patrick J. and Francine LaFontaine, "Costs of Control: The Source of Economic Rents for McDonald's Franchisees," *Journal of Law & Economics*, October 1994, p 417.

[4] It would seem that a problem is created when franchisees buy their right from an existing franchisee and pay the full value of the franchise. These repurchased franchisees won't make excess profits or at least not as much as does the original owner.

Tie-in Sales

In many franchise settings, the franchisor requires that the franchisee buy products from the franchisor.[5] There are two arguments for this. First, it is a way of monitoring quality. Second, it is a way of collecting the royalty. The first argument seems fairly straightforward. We expect that the franchisor will either sell supplies to the franchise, force the franchisee to buy from approved distributors, or inspect the supplies used. The franchisor must inspect even if it sells the supplies to make sure that the franchisee is not substituting product. It must also inspect the quality of the alternative suppliers to assure that they do not go into cahoots with the franchisees. To the extent that the franchisor can promote high quality by monitoring inputs, it can reduce the threat of termination as a quality control. Hence, it can reduce the amount of franchise profits it must share with the franchisee.

The second idea is problematic. If the franchisor prices the supplies at cost, then there is no royalty payment associated with the supply sales. If the supplies are priced above cost, then it increases the franchisee's incentive to substitute produce; in this way the franchisee can lower the royalty and quality. On the other hand, royalties based on supply sales can have the effect of varying the royalty payments based on relative demands. For instance, Chicken Delight charged higher markup on supplies for single dinners than for large-order items (chicken buckets). The advantages and disadvantages of such a royalty scheme are discussed below. At all events, the court in the Chicken Delight case took a dim view of such tie-in sales when used to extra royalty payments. Recent cases seem to be returning the viability of tie-in sales to promote quality. Furthermore, we expect the franchisor to offer supplies to the franchisee below cost in order to encourage them to produce high quality.

Royalty Payments

The franchisee pays the franchisor for the right to be part of the franchise. The form of this payment may vary.[6] It can be a lump-sum, up front fee or it can be a royalty constant through time, or a royalty based on some measure of business activity. Of course, it may be a combination of these.

If franchises exist to monitor shirking at the local level by residual claimant status and to monitor the externality effect by the efforts of the franchisor, then we would expect the franchise fee to have some component tied to *sales*. It is important to recognize that the fee is tied to sales as opposed to other business indicators. Each franchisee is concerned about quality protection at all the other stores. Each wants the franchisor to have the strongest possible incentive to stop quality depreciation at the other stores. Since sales will be directly and negative affected by quality declines, the royalty to the franchisor goes down when the franchisor shirks on its monitoring duty. Contrast this to the effect of having the royalty paid as a function of franchisee profits.

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[5] Klein, Benjamin, and Saft, Lester F. "The Law and Economics of Franchise Tying Contracts," *The Journal of Law & Economics*, May 1985, pp. 345-362.

[6] Rubin, Paul. "The Theory of the Firm and the Structure of the Franchise Contract," *Journal of Law & Economics*, April 1978, 223-234.

Note that the more important is the monitoring function of the franchisor, the more the royalty should be calculated on sales. The more the production of the franchise involves managerial oversight, the more the franchise fee should be lump sum. The more the franchise involves advertising and centralization of ordering and supplies, the more the franchise fee should be based on recoupment of franchisor expenses.

Shopping Malls as a Franchise Problem.

The organization of shopping malls are remarkably similar to franchises. Here there is additional twist to the problem: The units are heterogeneous. The mall developer's problem is to put together a package of rental rates that correctly internalize the external benefits generated by the anchor stores. The anchor stores bring customers into the mall some of whom are satisfied by the smaller stores. The package includes design, beautification, and maintenance of the facility.

We expect that the smaller stores pay higher rent than the anchor stores. More interestingly, we expect that this is a function of not only square footage but also sales. The sales component of the rent paid by the small stores gives the mall operator the incentive to beautify and maintain the mall in front of the small stores, which themselves have an incentive to shirk in this regard, free riding on the efforts of others. The large store will have an incentive to maintain its own location and it is affected much less by the common areas. Hence the large store is less likely to pay rent on the basis of sales.

Commonly the rent paid by the small stores is based on sales and this component kicks in only after sales have reached some base level. This means that the sales-effect payoff to the mall operator only occurs if they do a good job. Also stores commonly pay a maintenance fee that is based on a charge back of actual expenses of the operator.

Addenda

In summarizing the franchising issue, let's return to the organizational spectrum that runs from independently owned and operated sites, through franchised units, to company owned stores.

Independent operations need management information, advice, and consulting; they also need capital. Independent operations are efficient in that there is almost always a close relation between ownership and management that improves the quality of management by reducing shirking.

Franchising may be a contractual structure that provides management consulting. It may also be a way of lowering the cost of capital because lenders are more confident in the viability of the operation given the oversight and managerial input of the franchisor.

On the other end of the spectrum we have chains of company owned stores. Chain stores are a vehicle that can be used to capture the gains from brand-naming. Brand names are valuable to final consumers because they provide information. Franchising is also a way to promote brand-name value.

The conclusion, then, is that we expect to see franchising in situations where (1) there is a significant amount of on-site production at dispersed outlets; and (2) there are significant gains from brand-name recognition on the part of consumers.

Empirically, what are the observable causes and consequences of franchising. Some propositions are worthy of consideration:

(a) The form of the franchise payment should be predictably related to the productive function performed by the franchisor. The more important is brand name, the more the franchise payment should come from royalties as opposed to a lump-sum payment. Royalties efficiently align the incentives of the franchisees and franchisor when the principal function of the franchise is to create and protect a brand name. On the other hand, when managerial advice is more important, more of the franchise payment should come up-front in a lump-sum.

This royalty payment prediction is different from a theory that says that the franchise payment is just efficient two-part pricing of the license. Efficient two-part pricing would charge a low royalty price, possibly as a function of profits instead of sales and a high fixed fee. The fixed fees would vary directly with the value of the brand-name license being sold. On this theory, we would expect that a very successful franchise like McDonald's would have the highest initial charge of all. However, it doesn't.

(b) When companies have both franchise outlets and company owned stores, there are two forces at play. One is that the incentive to free-ride on the chain-wide brand name quality is more keen where there are fewer repeat customers. Hence, outlets with a larger proportion of repeat business should more likely be franchised than outlets with a larger proportion of non-repeat customers. The other force, operating independently, is that company owned outlets require more managerial oversight from the company. Where this is more costly to supply, the outlets are more likely to be franchised. To what extent these two separate forces are positively or negatively correlated may vary from one line of business to the next.

(c) The factors that are the strongest in tipping the contractual scales toward company owned outlets as opposed to franchised ones are: 1) the capital requirement of the outlet; 2) the degree of the control of the product by the central agent or main office; and 3) the variation of profitability of outlets across time. The first is obvious. Outlets that require more capital are more likely to be company owned because a large corporation is a more efficient institution for raising capital. Furthermore, if the outlet has a large capital requirement, the management of the site with necessarily have a smaller residual claim anyway.

The second point may be somewhat more obscure. Product control takes away discretion from the on-site manager. Hence, it is less valuable to have franchisee-manager. By product control, I mean things like inventory and buying decisions. In department stores and super markets, a large portion of the economic decision-making concerns what to sell and how much to inventory. Indeed, in department stores, quite often the clerks work on commission so that shirking problems

among the work force are minimized by the labor contracts. Moreover, forcing inventory and product line changes on franchisees is fraught with contention.[7]

Finally, the third point reflects the problem of monitoring quality at the outlets. To the extent that termination is a penalty, the threat of which sanctions quality shortfalls at franchises, variability in profitability mitigates this benefit. The more variable are profits, the larger the average expected quasi-rent to the franchisee must be to enforce quality standards. Furthermore, if failed franchises have a negative effect on brand name, the expected franchisee quasi-rent must be higher the larger is the variability in profit. Finally, if the chain finds value in operating some outlets that lose money for some periods of time, franchising is a problematic contractual structure.[8]

[7] It is said that McD's tries out all of its new products at company owned stores before forcing them on franchised outlets.

[8] Here I am thinking of situations like the Winn-Dixie in Clemson when the new Bi-Lo opened. For several months, the W-D store must have been losing a substantial amount of money. It is not clear that it would have survived if it had been a franchise.