The Impacts of Efficiency and Bargaining Power on Contract Structure: Evidence from Franchising

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ABSTRACT

This paper investigates the impact of independent franchisee associations on contract structure in franchising. We argue that such associations are able to exert bargaining power to win more favorable contract terms for their members. Thus, while most of the literature on franchising emphasizes the importance of efficiency consideration in determining contract terms, we find an important role for bargaining power, even when efficiency considerations are accounted for in the analysis.
INTRODUCTION

Following a few studies in the 1990’s and very few earlier, the strategy and entrepreneurship literatures have recently seen a surge of research into the factors that determine the provisions of important business contracts (e.g., Pisano 1990; Parkhe 1993; Gulati 1995; Azoulay & Shane 2001; Shane 2001; Oxley & Sampson 2004; Kalnins & Mayer 2004; Mayer & Argyres 2004; Sampson 2004; Reuer, Ariño & Mellewigt 2006; Mayer 2006; Argyres, Bercovitz & Mayer 2007; Reuer & Ariño 2007). Strategy and entrepreneurship scholars have been interested in how various kinds of contractual forms impact the value of exchange relationships, and how such forms evolve over time. Many of these scholars apply theories of contractual relationships that assume contractual efficiency, particularly agency theory and transaction cost theory. The economics literature has shown that these theories can explain critical categories of contractual provisions such as contract duration, payment terms, equity participation, and restrictions of various kinds (e.g., Joskow 1985, 1987; Masten & Crocker 1985; Goldberg & Erickson 1987; Crocker & Masten 1988; Lafontaine 1992; Oxley 1997; Lafontaine & Slade 1997; Lerner & Merges 1998; Brickley 1999; Anand & Khanna 2000; Arruñada, Garicano & Vázquez 2001; Brickley, Misra & Van Horn 2006).

The dominance of the contracting efficiency perspective in economics has largely carried over into strategy. This has resulted in relatively little empirical investigation of the potential impact of bargaining power on business-to-business (as contrasted with business-to-labor) contractual relationships in the strategy literature. This is despite the fact that the strategy literature has long emphasized the importance of resource dependence (Pfeffer & Salancik 1977) and bargaining power (e.g., Porter 1980) in determining firm financial performance, and that certain theoretical models (e.g., Aghion & Tirole 1994) and empirical findings (e.g., Lerner & Merges 1998; Brickley 1999; Brickley et al. 2006) in the economics literature do point to the potential importance of

1 An exception is Michael (1999), who finds that franchisors can reduce the number of franchisee lawsuits they face if they own more of their own units, choose less experienced franchisees, and require longer training programs. He assumes that fewer franchisee lawsuits are indicative of greater franchisor bargaining power. He does not, however, investigate the determinants of contract terms, which is the focus of the current paper.
bargaining power considerations in affecting contract structure. In this paper, we explore the impacts of efficiency-related and bargaining power-related variables on key terms of the franchise contracts offered by a sample of franchise systems from the U.S. quick-service restaurant and automobile repair industries.

The question of whether contract terms tend to be determined by efficiency or bargaining power considerations lies the heart of debates between the three major economic approaches to strategy: the resource-based view of the firm (RBV), transaction cost economics (TCE), and the Porterian I.O.-based paradigm. The RBV and TCE emphasize the difficulty firms have in sustaining competitive positions based on the exploitation of market power. These approaches argue, for example, that entry barriers are temporary at best, and therefore cannot be relied upon as a way to sustain above-normal profits (e.g., Williamson 1991; Barney 2002). The RBV and TCE therefore advise firms to focus, respectively, on developing unique, firm-specific resources and achieving efficient organization (e.g., Barney 1991; Williamson 1991). Porter of course focuses on achieving competitive positions that create market power, and sustaining those positions through difficult-to-imitate configurations of activities (Porter 1980, 1996).

The three economics approaches to strategy might therefore emphasize different kinds of strategies for profiting in business format franchising, the empirical setting we study in this paper. For example, the TCE approach to strategy would advise a new franchisee to focus on running his/her unit efficiently, particularly by aligning governance structures and transaction characteristics so as to achieve an efficient organizational form. The RBV might advise a new franchisee to seek unique and valuable resources in strategic factor markets, such as unique locations, that can be acquired at below-market prices. Because franchisors tend to offer standardized contracts to all potential franchisees (Lafontaine & Slade 1997), the RBV and TCE approaches might advise new franchisees to operate under the assumption that the basic structure of any contract they are offered by a franchisor is efficient, if it has been accepted in the market, and has “stood the test of time” (e.g., Williamson 1996). Arguably, neither approach would place participation in, or formation of, a franchisee association high on its list of priorities, the assumption being that because new franchisees can easily enter, any bargaining power such associations might earn will erode quickly. The Porter I.O.-based
approach, however, might well emphasize the potential benefits to a franchisee from joining or helping to form a franchisee association to improve its bargaining power (without denying the value of efficiency). It might also emphasize the importance for franchisors to take actions aimed at preventing the formation of such associations, providing alternative organizations which franchisors can control, or otherwise undermining them where they already exist. This paper, then, by investigating whether franchisee bargaining power is an important determinant of franchise contract structure, sheds light not only on effective strategies in franchising, but on broader debates in the strategy literature regarding various routes to superior profitability.

Our study focuses on measuring the determinants of several key contractual rights that are commonly specified, and have been shown to vary, in business format franchise contracts: (1) contract duration; (2) franchisor rights to restrict competition from former franchisees; and (3) franchisor and franchisee rights to terminate the contract before the end date. We find that while our efficiency-related variables are significant predictors of contract duration and non-compete restrictions, our bargaining power variable is also an important predictor of both types of provisions. Bargaining power is also an important predictor for franchisee, though not franchisor, rights to terminate. These results together suggest that a thorough understanding of contract structure can require consideration of efficiency and bargaining power considerations simultaneously. Our contribution thereby helps to rebalance a contract structure literature that has tended to emphasize efficiency considerations only.

Our research strategy is to begin with empirical models of our three types of contract provisions that are similar to the efficiency-based models in the literature, and then to examine how the models’ goodness-of-fit, and the coefficients of the models’ standard explanatory variables, change when we add our bargaining power variable. The efficiency-related variables we use therefore mirror those used in other studies to predict franchise contract terms, while the bargaining power variable is unique in the literature. For example, a key variable in the standard double-sided moral hazard model of

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2 Consistent with this conclusion, Lerner & Merges (1998) found that intellectual property rights in biotechnology contracts were allocated mostly according to smaller partner’s bargaining power, not according to efficiency considerations. They measured this power according to the degree to which capital constraints on the small companies were binding at the time at which the contracts were negotiated.
franchising in the economics literature is the potential loss to the franchisor from franchisee free-riding (e.g., Rubin 1978; Mathewson & Winter 1985; Lal 1990). Our measure of this variable, franchisors’ investments in brand name value, follows from Lafontaine and Shaw (2005). A second important variable in the standard economic model is the potential loss to franchisees from franchisor expropriation. Our measure of this variable follows Dnes (1993) and Brickley et al. (2006), who measured these hazards by the amount of investment made by franchisees that is specific to a franchise system and hence non-redeployable to other systems should the franchisor act opportunistically.

Our measure of bargaining power, on the other hand, has not yet been used in the franchising literature to our knowledge. We measure franchisee bargaining power according to whether the franchisees within a given franchise system have formed an independent franchisee association. During the 1980’s and 1990’s, growth in the number and size of franchisee associations surged in the U.S. (Franchisee Voice, March 2006) These associations were formed to look after franchisee interests vis-à-vis franchisors. The movement may have been caused in part by increasing instances of franchisor encroachment as systems launched in the 1950’s began to achieve geographic saturation in the U.S. Increasing saturation may have tempted franchisors to begin to authorize new franchisees to locate close in distance to existing franchisees, or perhaps to take other actions that squeezed the profits of the existing franchisees while increasing total franchisor royalties. Whatever the cause, however, we argue that franchise systems in which franchisee associations are present will feature contract terms that are more favorable to franchisees than systems without such associations. Indeed, we find that whether a franchise system features an independent association or not is an important predictor of three of our four contract provision types, even after controlling for the standard efficiency variables.

We proceed by reviewing the literature on franchise contracting, focusing on the standard economic model of efficient contracts. We then provide background on independent franchisee associations and underlying sources of franchisee bargaining power. We develop our hypotheses regarding the impact of these bargaining power considerations on three categories of franchise contract terms. Next, we describe our data and methods, present and discuss our results, and discuss directions for future research.
BACKGROUND

Business Format Franchising and the Double-Sided Moral Hazard Problem

Business format franchising is an organizational form in which a franchisor licenses a franchisee to use the trademarked brand name owned by the franchisor. In addition to the brand name, franchisees are typically required to adopt the franchisor’s “business format”, which can include selling specified products, and using specified signage, operating methods, inputs, etc. Franchisees typically pay the franchisor an upfront fixed fee for the rights to the format, as well as a royalty calculated as a percentage of the franchisee’s revenues. Business format franchising offers potential franchisees an opportunity to purchase and run a proven business of which he/she is the sole owner: the so-called “residual claimant”. This residual claimant relationship implies that the franchisee is highly financially motivated to exert effort in the running of the business – more financially motivated than if the franchisee were instead an employee of a company-owned outlet. The franchisor also benefits from these powerful incentives because the greater effort they stimulate yields royalty payments (net of the costs of monitoring franchisees) that are expected to be higher than the revenues that the franchisor could earn from the outlet were it to be company-owned. It is this close “incentive alignment” between franchisee and franchisor that is most often said to account for the prevalence of business format franchising (e.g., Brickley, Dark & Weisbach 1991a). As of the late 1990’s, business format franchising was estimated to account for 3.5% of U.S. GDP (Lafontaine & Shaw 1999) and 25% of U.S. retail sales.

The business format franchising relationship, however, also creates some incentive misalignments. In particular, it creates problems of moral hazard by both the franchisee and franchisor, hence the term “double-sided moral hazard” (e.g., Lafontaine 1992; Battaharyyya & Lafontaine 1995). These moral hazard problems, and the kinds of contract structures that are adopted to offset them, are important subjects in the franchising literature. One of the most important of these problems is the potential for free-riding by franchisees on franchisors’ investments in brand name capital (e.g., Klein 1980; Brickley & Dark 1987). In a business format franchising relationship, a franchisee is less financially motivated to ensure that value of the franchisor’s brand name is
preserved than the franchisor would be if the franchisor owned the outlet in question. This is because any franchisee action that degrades the value of the brand in customers’ eyes will result in revenue losses for outlets that the franchisee does not own. This negative externality has been shown to carry implications for franchise contract structure. Brickley (1999), for example, shows that when such externalities are high, in particular when a franchise system’s outlets tend to serve non-repeat customers and therefore have a greater incentive to shade quality, then contractual provisions aimed at preventing such behavior are more likely to be observed. Area development plans that commit the franchisor to selling several franchises to the same franchisee in a given area, thereby helping the franchisee internalize the externality, for example, are more frequently observed in franchise contracts for systems serving more non-repeat customers (Brickley 1999). Consistent with this finding, Arruñada et al. (2001) find that Spanish automobile franchisors retain more rights to monitor the financial performance and input choices of their franchised dealers when the dealer network is large, and therefore when franchisee free-riding imposes a greater cost on the franchisor. Such monitoring presumably limits such free-riding. Relatedly, shorter contract terms and/or expansive termination conditions are argued to provide the franchisor with a credible termination threat if free-riding behavior is suspected (Klein 1980; Klein & Leffler 1981; Williamson, 1985).

Moral hazard on the part of the franchisor is also an important problem in franchising relationships. The most prominent of these is the so-called “encroachment problem”, which occurs when a franchisor agrees to franchise a new outlet with a new owner close in distance to an existing outlet (Rubin 1978; Mathewson & Winter 1984). Franchisors have a financial incentive to encroach in this way because they have no incentive to consider franchisee profits in their location decisions. The incentive to encroach exists whenever the revenue gains to the franchisor from the new outlets exceed the revenue losses from existing outlets, regardless of the effects on franchisee profits.

3 Besides adjusting the contract, franchisors undertake other practices to reduce the severity of franchisee free-riding. Kalnins & Lafontaine (2004), for example, find evidence that the practice of franchising multiple outlets to the same owner (even if not part of a contractual-specified area development plan) is used partly to overcome such free-riding. Lafontaine & Shaw (2005) find that franchisors with more valuable brands tend to own more of their outlets, also thereby reducing the severity of the free-riding problem.
(e.g., Kaufmann & Rangan 1990). Kalnins (2004) showed empirically that the negative effects on franchisee revenues from franchisor encroachment can be quite significant. Franchisors may act opportunistically in other ways as well, however. For example, franchisors may attempt to raise the prices of goods, services, or leases that the franchisees are contracted to buy from the franchisors after the franchisee has invested in developing his/her business. Franchisors might also seek to increase the sales quota or renovations that the franchisee must make in order to keep the franchise. If the franchisee fails to meet these new terms, the franchisor can opportunistically terminate and expropriate the franchisee’s specific investment. Extended contract duration (Joskow 1985, 1987), exclusive territory assignment (Mathewson and Winter 1994), and constrained termination rights (Dnes 1993) have all been nominated as provisions that may effectively limit franchisor moral hazard.

The business format franchising relationship, then, while a powerful form of economic organization, also suffers from incentive conflicts that take the form of double-sided moral hazard. Taking this double-sided moral hazard model as its starting point, the economics literature on contract structure in franchising asks about the contractual provisions firms adopt to mitigate the underlying moral hazard problems on both sides, thereby to achieve contract efficiency. Bargaining power explanations for particular terms in franchise contracts are, however, much less considered in the empirical economics literature. Several theoretical models exist, however, in which restrictions on franchisee behavior are explained in terms of attempts by franchisors to appropriate returns from monopolistic assets lying upstream (e.g., Blair & Kaserman 1982; Lee 1984). These models have not been tested empirically, likely because, as Norton (1988) explained, “…the argument does not easily provide refutable empirical tests because market power is difficult to measure…Thus, empirical tests of market power may not be tractable” (p. 200). Our concern in this paper is not, however, with the effects of market power by franchisors on contractual provisions, but with the effects of franchisee bargaining power on such provisions. As we discuss below, the existence of an independent franchisee association seems to be a reasonable measure of such power.
Independent Franchisee Associations

To our knowledge, the potential impact of independent franchisee associations on franchise contract structure has not been systematically assessed in the literature. Yet it appears that franchisee associations have become more prevalent in the U.S. over the last twenty years. Moreover, there are indications in the trade press that such associations have succeeded in negotiating contracts featuring improved terms for franchisees. For example, in 1999 the Meineke Dealers’ Association negotiated a new contract with Meineke Muffler that the association considered to be a significant improvement for its members relative to previous contracts (Franchisee Voice, Winter 2007). More recently, the Culligan Water dealer’s association, after what was described as “gut-wrenching” negotiations, agreed to a new contract with the franchisor that the association boasted, “…could become a model contract for other franchise businesses” (Wall Street Journal, Nov. 21, 2006).

The history of franchisee associations in the U.S. has yet to be written, but one of the earliest such associations was formed in 1965 by Kentucky Fried Chicken franchisees in the Southeastern U.S. The founder of the company, Colonel Sanders, feared that some of the franchisees with whom he was friendly might be terminated by the new franchisor to which he sold the company. He encouraged them to form an association to help protect the vulnerable franchisees. During the 1960’s and 70’s, additional regional associations formed, and in 1974, a national association, the Association of Kentucky Fried Chicken Franchisees (AKFCF), consolidated these regional associations and became incorporated. One of the most important functions of the AKFCF was to negotiate the national franchise contract with the franchisor. According to the association’s website:

Through the years, the AKFCF has seen challenges along with its growth. KFC Corporation has changed ownership numerous times and with this, has introduced restrictive addendums to the franchise contract on several occasions, sometimes without prior notice to franchisees… These contractual issues were met by members of the Association with a spirit of solidarity and willingness to stand its ground if negotiations could not be successfully achieved. Negotiations with KFC Corp. eventually reached a successful outcome, producing a contract acceptable to the system’s U.S. franchisees. (http://www.akfcf.com/history.html).

As with AKFCF, most independent franchisee associations appear to consider their primary mission to be ensuring that franchisees get a “fair deal” from franchisors.
The Denny’s Franchisee Association’s (DFA) mission statement, for example, includes as its first point to “Communicate with a united voice between association members and Denny’s management for the purpose of enhancing profitability of DFA member restaurants” (http://www.dennys.org/story.asp). The Independent Hardee’s Association mission statement similarly emphasizes, “Communicating in a recognized and unified voice from the franchisees to the franchisor” (http://www.ihfa.com/about.html). While some more developed franchisee associations offer a variety of additional services to franchisees, including education about business practices, procurement cooperatives, legislative lobbying on behalf of members, and the like, negotiating with the franchisor over issues in the franchise relationship appears to be their central aim.

One potential source of bargaining power for franchisees and their associations in negotiations with franchisors is the threat of a lawsuit. If franchisors refuse to negotiate, or take a hard line in negotiations, franchisees can often threaten to file a lawsuit against the franchisor alleging, for example, anti-trust or contract law violations. Such lawsuits are often pursued by a franchise association itself, which organizes a class action suit on behalf of its members. Indeed, franchisee associations can be particularly effective mechanisms for organizing the collective action need to launch these suits. For example, the North American Association of Subway Franchisees recently filed suit against the Subway franchisor on behalf of its 14,500 members for violating franchisee rights to transfer and renew their franchises under the terms of the franchise contract. One of the landmark class action suits in franchising was filed by the Meineke Dealers’ Association in 1993. The suit alleged that the franchisor mis-appropriated franchisee advertising funds, and resulted in the largest verdict in the history of franchising in favor of the Association: $600 million. The judgment was overturned on appeal, but eventually led to a favorable settlement for the Association.

In other cases, a lawsuit is filed by an individual franchisee, but with legal, financial and other assistance from its franchisee association. The history of franchising in the U.S. is littered with an untold number of these types of lawsuits, reflecting the highly contentious nature of the franchise relationship, as well as uncertainties about the legality and enforceability of various kinds of restrictions in franchise contracts (e.g., Brown 1971; Hadfield 1990). For example, the legal doctrines of adhesion and
unconscionability have been used by many courts to invalidate contracts that were voluntarily entered into by franchisees but which franchisees later challenged (Pitegoff 1989). In other cases very similar contracts were upheld as legal and enforced by the courts. This legal uncertainty can make franchisors wary of the U.S. legal system. This wariness can be exacerbated by the fact that many judges and juries tend to feel more sympathy toward smaller businesses (e.g., franchisees) than to large corporations (e.g., franchisors) (Dunham 2002). The legal uncertainty and potential for court bias in favor of franchisees adds to the credibility of franchisee threats to sue.

Another factor that may contribute to the bargaining power of franchisees and their associations is the presence since the early 1990’s of two associations of franchisee associations, the American Association of Franchisees and Dealers (AAFD), and the American Franchisee Association (AFA). The AAFD is the larger of the two, currently counting 26 franchisee associations among its members. Its mission statement includes the following: “Above all else, the heart and soul of the American Association of Franchisees and Dealers is helping franchisees develop greater market power, especially negotiating leverage, so that fair and equitable franchise relationships can develop over time” (http://aafd.org/index.php?option=com_content&task=view&id=6&Itemid=6). In pursuit of this goal, the AAFD supports its member organizations with legal support and referrals, updates on legal cases, lobbying efforts, advice on business practices, etc. For example, the AAFD, along with the AFA, have been involved in lobbying state legislatures to enact legal restrictions on franchisor rights to terminate franchisees. In addition, the AAFD organizes an accreditation program in which it awards its “Fair Franchising Seal of Approval” to those franchisors that meet its “fair franchising standards”. These standards are laid out in the AAFD’s “Franchisee Bill of Rights,” and are applied in its franchisee grading initiative, in which AAFD-affiliated attorneys and

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4 The AFA is a smaller organization with a reputation of being more militant in its tactics than the AAFD.
5 Fourteen states already have franchise termination laws, laws which require the franchisor to show “good cause” in order to legally terminate a franchisee. These states (and the year the law was passed) include Arkansas (1977), California (1980), Connecticut (1972), Delaware (1971), Hawaii (1974), Illinois (1980), Indiana (1976), Michigan (1974), Minnesota (1973), Nebraska (1978), New Jersey (1971), Virginia (1972), Washington (1972), and Wisconsin (1974). Mississippi and Missouri have termination laws that specify minimum periods of notice prior to termination but these statutes do not require cause. Brickley et al. (1991b) found that laws limiting termination are associated with more company ownership at the expense of franchising.
AAFD executives grade franchise contracts against the standards. By publicizing the results of its accreditation program, the AAFD aims to influence potential franchisees’ choices of franchisor, and thereby promote widespread adoption of its “franchisee rights”. The AAFD has even become involved in direct negotiations with certain franchisors over their contracts (Franchisee Voice, March 2006).6

To sum up, then, there are strong reasons to believe that the terms of franchise contracts reflect not only the efficiency demands that arise because of the double-sided moral hazard problem, but also the degree of franchisee bargaining power. This bargaining power may be exerted through threats to sue that carry credibility, as well as through successful efforts, and ongoing threats to expand efforts, to change state laws regulating franchise contracts in ways that favor franchisee rights. Moreover, a reasonable measure of this power may be the presence or absence of an independent franchisee association for the franchise system in question. Our next step is to outline a set of hypotheses concerning how we predict the presence of an independent franchisee association will impact specific terms in the franchise contracts we study.

**HYPOTHESES**

**Contract Duration**

The duration of a contract is one of its most important features from the standpoint of the transaction cost theory of contracting. Transaction cost theory argues, for example, that longer term contracts act as an important safeguard against opportunistic action by the less dependent party, and thereby enhance exchange efficiency in situations of bilateral dependency (Williamson 1985). Crawford’s (1990) economic model shows how shorter term contracts allow for efficient investment when investments are reversible, but cause investment distortions when investment is sunk and

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6 Another type of franchisee organization is the “franchisee council.” These organizations are groups of franchisees selected by the franchisors to discuss issues, and occasionally to negotiate contracts with, the franchisor. Because franchisee councils are not independent of the franchisor, and have reputations as analogous to “company unions”, we expect them to have much less bargaining power than the truly independent franchisee associations we study in this paper. Cochet & Ehrmann (2007) find evidence that franchisee councils in Germany serve to increase the credibility of franchisor commitments not to act opportunistically against franchisees. Some franchisee councils in the U.S., however, notably the council of Denny’s franchisees, declared their independence of the franchisor after being unsatisfied with the performance of this function of the council, and became independent associations instead.
therefore cannot be withdrawn. Economic efficiency therefore implies that longer term contracts are chosen to govern exchanges in which one or both parties make significant investments that are not re-deployable. The findings of key empirical studies in the transaction cost literature are consistent with this hypothesis (e.g., Joskow 1985, 1987; Crocker & Masten 1988; see also Shelanski & Klein 1995).

This efficiency logic from transaction cost theory has recently been applied to franchise contracts. In particular, Bercovitz (1999) and Brickley et al. (2006) argue that longer term contracts protect franchisees from potential franchisor opportunism. Longer term contracts prevent the franchisor from opportunistically raising royalty rates, lease payments, advertising charges, required input prices, sales requirements, etc., until after the contract term is completed. A long term contract protects the franchisee by fixing the levels of these kinds of variables over a longer period. This kind of protection would have little value to a franchisee were the franchisee able to switch franchisors at zero cost. As Brickley et al. (2006) emphasize, however, franchisees do make upfront investments to start a franchise that could be difficult to recoup should a franchisee be subject to opportunistic action by the franchisor. The investments include the initial fixed fee, investments in training and property improvement, etc. Because these investments are typically specific to a particular franchisor, the franchisor can expropriate franchisees’ quasi-rents by “holding up” the franchisee (Williamson 1975; Klein, Crawford & Alchian 1978). Hold-up threats are particularly salient for relatively new franchisees because franchise businesses require as much as three years to realize a normal return on their initial investments (Brickley et al. 2006). The greater the value of these specific investments, the greater is the franchisor’s leverage, and therefore the greater its temptation to take advantage of the franchisee. Transaction cost theory therefore predicts that contract duration will be longer in the presence of larger specific investments. Bercovitz (1999) and Brickley et al. (2006) found evidence supporting this hypothesis in the context of franchising.

7 According to Bob Purvin, the founder and CEO/Chairman of the AAFD, one of franchisees’ top concerns is the possibility of future increases in the prices of inputs that franchisors require franchisees to purchase from them (Interview, May 20, 2007).

8 One might predict from this that franchise contract terms will vary according to the length of time that a franchisee has franchised from a given franchisor. The empirical literature, however, finds a high degree of standardization of contracts across franchisees. Lafontaine & Slade (1997) discuss some possible reasons.
Conversely, shorter contract terms are argued to help protect the franchisor from franchisee free-riding by providing the franchisor with a credible termination threat and the means to seize, or render worthless, the franchisee’s specific investment. (Klein 1980; Klein & Leffler 1981; Williamson 1985). Shorter contract terms with a renewal option enhance the franchisor’s ability to credibly threaten the disruption of the franchise relationship as the acceptable criteria for non-renewal – i.e., the franchisee’s lack of “good standing” – is much lower than the “good cause” standard required for mid-agreement termination. According to transaction cost theory, then, the duration of contracts is chosen to promote efficient levels of specific investment by one or both parties to the contract. It is also possible, however, contract duration reflects other considerations, in particular, the parties’ \textit{ex ante} bargaining power. Franchisors, for example, may seek short-term contracts even in the presence of high levels of specific investment by the franchisees in order to enhance their opportunities to extract franchisee quasi-rents. Franchisors may be able to win such contracts if franchisees’ bargaining power is low because their options for outside employment are extremely limited, they are not sufficiently informed or educated to make profit-maximizing investment decisions, or they are simply overoptimistic. Kalnins (2005), for example, finds evidence from international franchising that is consistent with overoptimistic behavior. On the other hand, franchisees, in order to keep their costs below market levels and thereby enhance their profitability at the franchisors’ expense, may seek contracts whose duration exceeds what they strictly require to safeguard their specific investments. Over the longer term, franchisors may choose to exit their industry or acquire its franchisees should franchisee bargaining power erode their profits sufficiently. In the shorter term, however, when exit barriers and barriers to acquiring large numbers of franchisees are still significant, franchisors may give way if franchisees can gain the upper hand. Finally, contract

\footnote{To show good cause a franchisor must provide proof of material breach by the franchisee and establish the existence of a sufficient business justification for all termination actions. Under the broad definition of good standing commonly employed by franchisors -- "Good standing means timely compliance by the franchisee with all provisions of this [franchise] agreement and the manual whether or not the provisions are material" (ATEC Grand Slam 1993 franchise agreement) – mere suspicion of franchisee free-riding would provide sufficient grounds for non-renewal. In General Aviation, Inc. v. The Cessna Aircraft Co 13 F.3d 178 (6th Cir. 1993), for example, the court concluded a franchisor, legally, needs no specific reason to deny renewal to a franchise as long as that same action is taken in regards to "other franchisees of the same class or type" (Eisenberg 1995).}
duration may reflect some degree of bargaining power on both sides, such as is captured
the Nash bargaining solution assumed by Grossman and Hart (1986). Aghion and
Tirole’s (1994) model extends Grossman and Hart (1986) to show how contract terms in
general are determined by both relative bargaining power and relative specific investment
(or “marginal contribution to production”). The empirical findings of Lerner and Merges
(1998) mentioned in footnote 2 above are consistent with Aghion and Tirole’s (1994)
model.

Transaction cost theory downplays the importance of these kinds of ex ante
bargaining power considerations (e.g., Williamson 1985).10 The theory assumes that
parties to a contract are foresighted enough to anticipate attempts at expropriation by a
contractual partner, and to safeguard their investments through choices of governance
mechanisms such as contract terms. Alternatively, if the contractual partner refuses to
accept these safeguards, the theory predicts that the transaction will not be initiated.
Therefore only efficient contracts will be observed in equilibrium. In some cases,
however, bargaining power can emerge in ways that were difficult for the parties to
anticipate ex ante (Argyres & Liebeskind 1999). This, we argue, may be the case with
independent franchisee associations. It would likely have been difficult for franchisors to
have fully foreseen the growth of independent franchisee associations, and associations of
associations, during the late 1980’s and 1990’s, and to have exited or acquired large
numbers of franchisees in anticipation of it. Barriers to exit and barriers to large-scale
acquisition of franchisees are likely to have been non-trivial in the short to medium term
for many franchisors.

Therefore, we hypothesize that franchise systems in which an independent
franchisee association is organized will feature longer term contracts than systems
without such associations, even after accounting for franchisee specific investments and
the threat of franchisee free-riding. Our argument is that these associations exert
bargaining power with franchisors over contract terms. Ultimate sources of franchisee
bargaining power include threats to sue that are made credible by legal uncertainty and

10 Williamson (1996), however, acknowledges that because a firm cannot “vertical integrate,” or offer
ownership to, all of its final consumers or all of its employees, consumer groups and labor unions could
affect the terms of their relationships with firms in a way that reflects their bargaining power.
potentially biased courts, as well as the ability to influence AAFD accreditation of franchisors. We therefore hypothesize that:

**H1:** Franchise systems featuring an independent franchisee association will offer longer term franchise contracts than systems without such associations.

**Non-competition Provisions**

Many franchise contacts contain provisions specifying the period of time during which a former franchisee may not engage in a competitive business. The law and economics literature has addressed the theoretical determinants of non-competition provisions in labor contracts especially. To a large extent, these analyses can be placed within the double-sided moral hazard framework applied to franchising, or within the bargaining power framework we have discussed to this point.

Analyses of non-compete provisions in labor contracts in the law and economics literature often emphasize efficiency considerations. In particular, legal-economic theories emphasize the role of such provisions in protecting employer investments in on-the-job training (e.g., Rubin & Shedd 1981) or in protecting an employer’s trade secrets or other confidential information (e.g., Curley 1994). For example, employers have limited incentives to invest in development of their employee’s generalized skills, because other firms can easily induce those employees to leave after the training is completed, thereby depriving the original employer of sufficient returns to its training investment. Non-competition provisions in labor contracts improve employer incentives to invest in training by limiting an employee’s ability to “take the training and run”. Such provisions can also prevent former employees from sharing, or credibly threatening to share, trade secrets or other confidential information with competitors, thereby improving firm’s incentives to invest in new technology, new business practices, etc. (Den Hertog 2003).

In franchising, the primary form of franchisee opportunism stimulating inclusion of non-competition provisions is unauthorized use by former franchisees of confidential information, trade secrets, and know-how learned from the franchisor while operating a competitive business. Franchisors are concerned that former franchisees may be tempted to “take the secrets and run” by buying a new franchise, but then refusing to renew it in favor of operating a non-franchised business, or a differently-franchised business, often at
the same location, using the original franchisor’s trade secrets and proprietary business practices (Jankowski & Previs 2004). One would therefore expect that where the costs to franchisors of unauthorized use of trade secrets is especially high, non-compete periods would be longer. For example, the value of franchisors’ investments in trade secrets, and therefore the expected cost of franchisee opportunism, is believed to be positively correlated with the franchisors’ investments in brand name value. Thus, we expect franchisor brand name value would be positively associated with inclusion of more stringent non-competition provisions in its franchise contracts. Bercovitz (1999) found evidence that the expansiveness of non-compete terms, in terms of both length and geographic area, is indeed positively related to brand name value and the level of the franchisee free-riding hazard. Franchisees, for their part, might be willing to accept more stringent non-compete terms in exchange for the opportunity to franchise an historically profitable brand.\(^\text{11}\)

While expansive non-compete terms can safeguard the franchisor against franchisee free-riding, they can also raise the potential for franchisor opportunistic hold-up. Post term non-compete provisions prevent the franchisee from leveraging the operational skills gained as a franchisee, the goodwill generated in his local community, and his site-specific investments in a related business, even if this business does not directly infringe upon the franchisors’ trade secrets. The franchisee is further constrained as, at the end of a contract term or in the event of termination, the franchisor generally has the option to assume the franchisee’s lease and purchase franchisee assets at attractive prices. If the franchisee is forestalled from operating a competing business for a significant period of time, the franchisor can opportunistically benefit from the customer development activities of the franchise and by the fire-sale of assets (since the franchisee is foreclosed from using these assets themselves). Shorter non-compete terms can be used to limit the gains to the franchisor from opportunistic termination. Finally, note that the value to the franchisee of free-riding on the franchisor’s investment in training might be represented in the amount new franchisees are required to pay upfront for their own training. If the value of franchisor trade secrets is reflected in the training

\(^{11}\) The franchisees of McDonalds, for example, a franchisee system with very high brand name value, have been found to earn hundreds of thousands of dollars per year in above-normal profits on average (Kaufmann & Lafontaine 1994).
price to franchisees, then when franchisees pay for their own training, the benefits they derive from free-riding on franchisor-provided education will be more limited. One might therefore expect a negative relationship between the level of specific investment and stringency of non-competition provisions.

The alternative, bargaining power explanation for non-competition provisions is that they reflect attempts by the employer to forestall competition and pursue monopoly power (e.g., Shadowen & Voytek 1984; Den Hertog 2003). Proponents of this view argue that non-competition provisions are often unfair, and represent illegal attempts to restrain trade. Many U.S. state legislatures have been persuaded of this view, and as a result numerous states either forbid, refuse to enforce, or sharply restrict the use of, non-competition provisions in labor contracts (Blanpain, Richey & Malsberger 1991; Gilson 1999). This market power view implies, however, that in cases where a franchisee association is able to engage in collective bargaining with a franchisor, or support stronger individual franchisee bargaining, it might be able to forestall the franchisor from exerting its market power. Thus, supported by credible threats to sue and/or harm franchisor accreditation prospects, franchisee associations may be able to achieve less stringent non-competition provisions in the contract than a franchisor would have otherwise preferred based on its own desire to exert market power.

Of course, even in cases in which franchisors do not have market power in a franchising relationship, the bargaining power that franchisee associations generate can still impact the stringency of non-competition provisions. In these cases, franchisee bargaining power could still drive the observed level of stringency below the level implied by efficiency considerations alone. Recall that levels of specific investment by franchisee and levels of investment in brand value by the franchisor represent efficiency considerations in the determination of the stringency of non-competition provisions. Therefore, we hypothesize that:

**H2:** Franchise systems featuring an independent franchisee association will offer franchise contracts containing less stringent non-competition provisions than systems without such associations.
Termination Provisions

Another very important set of clauses in franchising contracts concerns termination rights. These clauses specify whether the franchisor and/or franchisee has the right to terminate the contract before its ending date, and they often spell out the conditions under which either or both parties may or may not exercise these rights. Franchisors are strongly motivated to secure strong termination rights in their contracts with franchisees because such rights can be very effective in deterring franchisee opportunism, and in eliminating it when it occurs (e.g., Caruso & Harpest 2006).

Empirical studies have suggested that termination rights in franchise contracts reflect efficiency considerations based on moral hazard problems. For example, Arruñada et al. (2001) found that franchisor termination rights were stronger in those Spanish automobile franchising contracts in which the risks and costs of franchisee opportunism were higher. This finding does indeed constitute evidence for the efficiency view of contracting, but the study did not account for possible effects of bargaining power. Our own arguments, in contrast, suggest that the presence of a franchisee association should affect the way these clauses are written for bargaining power reasons, even after accounting for efficiency considerations. We expect that franchisee associations will use their bargaining power to try to weaken franchisor termination rights in contracts, in order to prevent franchisors from abusing those rights, and terminating franchisees in an opportunistic way. Such abuse can occur because franchise contracts are inevitably incomplete (e.g., Grossman & Hart 1986), there may be many situations in which there is room for interpretation with regard to whether a franchisee can be terminated under the terms of the contract. For example, a franchisor may wish to replace a franchisee who is in full compliance with all terms of the contract, but is performing below the level at which a newly discovered potential replacement could perform. Under these conditions, the franchisor has an incentive to interpret its termination rights in ways that allow it to terminate the franchisee (e.g., Klein 1993). If court remedies are expensive and court outcomes uncertain, franchisors might be able to abuse their termination rights in these

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12 Brickley et al. (1991b) found that states that enacted laws limiting a franchisors’ freedom to terminate franchisees tended to have lower rates of franchising as a result. They interpret this result as suggesting that such laws promote inefficiency. As a positive matter, they explain that the laws themselves resulted from lobbying by franchisees, reflecting franchisees’ political power.
ways. Accordingly, we would predict that franchisee associations will use their bargaining power to weaken franchisor termination rights:

**H3:** *Franchise systems featuring an independent franchisee association will offer franchise contracts containing weaker termination rights for franchisors than systems without such associations.*

Some franchise contracts also contain provisions allowing the *franchisee* to terminate the contract. Such rights are once again valuable because contracts are incomplete and therefore franchisors can have an incentive to act opportunistically *ex post*, i.e., after the contract is signed. For example, a franchisor may attempt to impose a costly new restriction or requirement on the franchisee -- one that is not mentioned in the contract -- in the expectation that because court remedies are expensive and uncertain, franchisees will acquiesce. Franchisee advocates emphasize the importance to franchisees of securing termination rights in their contracts in order to deter opportunistic action by franchisors, and to provide an “exit window” should the franchisors take such action anyway (e.g., Hanson 2004). To our knowledge, franchisee rights to terminate have not been studied in the empirical literature, but the standard double-side moral hazard would suggest that the determinants of such rights should be symmetric to those determining franchisors’ rights to terminate. Once again, our own addition to the efficiency view is that the existence of a franchisee association increases franchisees’ ability to bargain for stronger termination rights. (Just as franchisor rights to terminate can be stronger or weaker as written in the contract, franchisee rights can be stronger or weaker in ways that we describe in the next section). We therefore hypothesize that:

**H4:** *Franchise systems featuring an independent franchisee association will offer franchise contracts containing stronger termination rights for franchisees than systems without such associations.*

**DATA AND VARIABLES**

Our data on franchise contracts were largely collected from filings at the California Department of Corporations. The State of California, along with twelve other
states\textsuperscript{13}, requires franchisors to register and file disclosure documents known as Uniform Franchise Offering Circulars (UFOCs). These documents prepared for prospective franchisees in accordance with U.S. Federal Trade Commission rules contain information on 20 different aspects of the franchise offering and, particularly important for this study, copies of all pertinent contracts including a current franchise agreement. Franchise circulars were gathered from the San Francisco, Los Angeles, and San Diego offices of the Department of Corporations. UFOCs from non-filing franchisors were also gathered.\textsuperscript{14} The analysis in this paper uses data from the UFOCs of a random sample of 135 franchise systems operating in the quick-service restaurant and automotive service sectors.

The dependent variables in our analysis are: (1) the duration of franchise contracts (DURATION) measured in years, and (2) the length of the period in which former franchisees are restrained from operating a competition business (NONCOMPETE), also measured in years, (3) the strength of franchisor termination rights, and (4) the strength of franchisee termination rights. Each of these variables was read directly from the franchise contract that is included in the UFOC.

We measured the strength of franchisor termination rights by the number of contingencies specified in the contract under which franchisees have no opportunity to “cure” the behavior that the franchisor cites as a reason for terminating the franchisee. For example, a typical clause might state that violation of child labor laws is cause for termination. Unless specifically stated in the contract, a franchisee would normally have 30 days in which to cease this behavior and thus avoid termination. If a “no opportunity to cure” clause is included in the contract, however, this grace period is not available to the franchisee. Termination is effective upon discovery of default. We measured the strength of franchisee termination rights on a scale from 0-3: 0 = no termination rights; 1 = franchisee can termination with cause, as when the franchisor breaches the contract and fails to cure its adverse action; 2 = franchisee can terminate without cause but must make

\textsuperscript{13} The thirteen states that require registration and filing are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Two other states have registration laws but do not require filing: Oregon and Michigan.

\textsuperscript{14} Non-filing franchisors include those companies that do not sell units in California and thus are not required to place their UFOCs on file with the California Department of Corporations. The majority of the franchisors that file in California also operate units in other states.
a payment to the franchisor in order to terminate; 3 = franchisee can terminate without
cause and without payment.

Our main independent variable is the presence or absence of a franchisee
association. For this measure, we gathered information from the American Association of
Franchisees and Dealers (AAFD) on all known franchisee associations in the U.S. The
AAFD regularly gathers information on extant franchisee associations in its efforts to
build its membership. The AAFD has identified 81 franchisee associations in the U.S., 26
of which are full AAFD members, and 39 of which attended the AAFD’s May 2006
conference. Twenty-three of the systems in our sample have established franchisee
associations.\(^{15}\)

We constructed several variables to control for efficiency impacts on our
dependent variables. To calculate the dollar amount franchisee specific investment, we
drew information from Item VII (Franchisee’s Required Initial Investment) of the offering
circular. This item describes the franchisee's required initial investment by expenditure
category. We calculated the level of specific investment as the sum of non-redeployable
expenditures. We included expenditures in the following categories: Initial Franchise Fee;
Leasehold Improvements (90%); Equipment and Fixtures (10%); Signage; Uniforms;
Grand Opening Advertising; Training; Professional Fees; and Licenses.\(^{16}\) We calculated
brand name value, a proxy for the level of the free-riding hazard, as the discounted value of
the system’s advertising expenditures in the three most recent years.\(^{17}\) Advertising
expenditure data were drawn from the \textit{AD$ Summary}, published annually by LNA/Media
Watch. This source lists the annual advertising expenditures of companies spending more
than $25,000 annually for advertising placement.

\(^{15}\) Our interviews with AAFD officials, and indications in the business press, lead us to believe that all of
the franchisee associations in our sample were formed prior to the time at which our UFOCs were signed. We are still in the process of independently verifying this for each association, however.

\(^{16}\) Having reviewed numerous equipment lists and spoken to several franchisees, we are convinced that the
portion of equipment expenditures that are relationship-specific is low. This conclusion is reinforced by the
widespread use of leased equipment in franchise operations. As such, we include only 10% of total
equipment expenditures in the specific investment calculation. Conversely, we find that the franchisee's
expenditures on leasehold improvements are highly specific. Almost all approved leases give the franchisor
the right to assume the lease upon disruption of the franchise relationship. As such, leasehold
improvements can (and should) be characterized as site specific assets. Dnes (1993) uses a similar
approach to selectively capture the part of total investment that is specific.

\(^{17}\) Following the historic cost method for valuing intangible assets, the brand name proxy is calculated as
\[\text{BN} = \text{Year}(0) \text{ expenditures} + (0.9*\text{Year}(-1) \text{ expenditures}) + (0.9*0.9*\text{Year}(-2) \text{ expenditures}) \]
(Reilly, 1996; Anson, 1996).
MODELS AND ESTIMATION

Table 1 shows descriptive statistics for the variables in our study, while Table 2 shows their intercorrelations. For our empirical analysis, we (separately) estimated models of our four dependent variables: contract duration (CONTRACT DURATION), non-compete period length (NONCOMPETE LENGTH), strength of franchisor termination rights (FRANCHISOR TERM RIGHTS), and strength of franchisee termination rights (FRANCHISEE TERM RIGHTS).

Because contract duration is measured in years and is an integer variable, we treated it as a count variable and estimated our models of it using negative binomial regression. We re-estimated these models using OLS with no change in the results. Please refer to Table 3 for these models. In our first model (Model 1) we included control variables only. We entered YEARS FRANCHISING because less experienced franchisors may be uncertain about what constitute efficient contract provisions, and for this reason may be reluctant to commit to a longer term contract. We also entered TOTAL UNITS, because franchisors with larger systems are likely to gain more experience since they observe more units. Brickley et al. (2006) found that both of these measures were significant in explaining contract duration.\(^{18}\) TOTAL UNITS also controls for the possibility that larger systems are more likely to have franchisee associations, thereby assuring that our franchise association variable is not reflecting the effects of system size only.

Some U.S. states have strong laws protecting franchisees from early termination by requiring just cause for such termination. We expected that franchisors with a higher percentage of their units in these states would tend to rely on shorter-term contracts so as to facilitate termination of opportunistic franchisees in those states. We therefore entered PERCENT TERM STATES as an additional control variable. We also entered the dummy variable representing industry (AUTO) to control for possible industry-specific effects. Finally, we included a measure of the percentage of franchised units in the franchise system as a control (PERCENT FRANCHISED). Franchisors with more

\(^{18}\) Accounting for franchisor experience is also consistent with recent literature on the importance of learning as a phenomenon in contracting generally (Azoulay & Shane 2001; Mayer & Argyres 2004; Argyres, Bercovitz & Mayer 2007).
wholly-owned units may be pursuing strategies that are more oriented toward ownership of units, and may therefore be more interested in maintaining the flexibility to purchase currently franchised units at some point in the future. Such franchisors would be more motivated to seek shorter contracts with franchisees. We therefore expect a negative sign on the PERCENT FRANCHISED variable.

Model 2 adds our efficiency variables, SPECIFIC INVESTMENT and BRAND NAME VALUE, to the specification. Recall that theories of contract efficiency imply that greater specific investments by franchisees should be associated with longer contract duration, since longer term contracts serve as a safeguard for those investments. Recall that Brickley et al. (2006) found support for this hypothesis in their franchising data. Similarly, we expect a negative sign on the BRAND NAME VALUE variable because franchisors with more sunk investment in brand capital have a greater incentive to change franchisees if a given franchisee acts opportunistically. Shorter contracts facilitate these changes. 19

Model 3 adds our main independent variable of interest, ASSOCIATION, representing the presence of a franchisee association. Our bargaining power arguments imply that we should expect a positive and significant sign on this variable’s coefficient estimate. We tested for heteroskedasticity in Model 3 using the Breusch-Pagan/Cook-Weisberg test available in STATA 8.0. Based on this test, we could not reject the hypothesis of constant error variance (Prob. > $\chi^2 = 0.5622$).

Next, we estimated models of non-competition provisions (NONCOMPETE). Table 4 presents the estimates. Because a number of the contracts in our sample included periods with fractional years (1.5 years was the most common), we used OLS rather than negative binomial regression for these models. Model 4 contains the same control variables as in Model 1. More franchisor experience with franchising, as reflected in YEARS FRANCHISING and TOTAL UNITS, might lead to longer non-compete provisions, as franchisors respond to bad experiences with franchisee opportunism in the past. We included PERCENT FRAN, the fraction of units franchised, because systems

19 While Table 1 shows a correlation of .8122 between BRAND NAME VALUE and TOTAL UNITS, when we entered these two variables together in Models 2, 3, 5, 6, 8 and 9, their variance inflation factors were only the range of 3.0-3.3. Multicollinearity is not thought to become a problem until the factor is 10 or higher (Neter, Wasserman & Kutner 1990).
more oriented toward company ownership might rely more on outright purchases of former franchisees’ units to limit competition from former franchisees, rather than long non-compete periods. States with strong laws regulating termination might tend to be states whose laws favor franchisees in other ways. For example, they may be states in which it is more difficult to enforce long period non-compete provisions through the state courts. We therefore entered PERCENT TERM STATES, expecting a negative sign on this variable’s coefficient. AUTO again controls for industry.

Model 5 adds the efficiency variables, BRAND NAME VALUE and SPECIFIC INVESTMENT. The first acts here as a proxy for the value of potential losses to franchisors from franchisee opportunism in the form of unauthorized use of trade secrets and confidential information. Note that TOTAL UNITS also helps to capture some of these effects. Recall that we expect a negative relationship between SPECIFIC INVESTMENT and non-compete period length, because longer such periods offer a greater opportunity for franchisors to expropriate franchisee investments. Finally, in Model 6 we add our primary independent variable of interest, ASSOCIATION, expecting a negative and significant sign that reflects the bargaining power such associations generate. We expect that franchisee will use their greater bargaining power to negotiate shorter non-compete periods, allowing them more opportunity to use franchisor secrets and information learning should the contract be terminated. Once again, recall that including TOTAL UNITS in the regressions helps control separately for the effects of size, which may be associated with the presence of an association. We applied the Breusch-Pagan/Cook-Weisberg test of heteroskedasticity to Model 6, and rejected the hypothesis of constant error variance (Prob. $\chi^2 = 0.0042$). We therefore adjusted for robust standard errors in our estimations of Models 4, 5 and 6.

We next estimated models of the strength for franchisor termination rights (see Table 5). Model 7 includes the control variables only. We also entered our YEARS FRANCHISING and TOTAL UNITS variables on the assumption that as franchisors learn from bad experiences with franchisees, they may become more sophisticated in their demands for termination rights. We therefore expected positive signs on these variables. As before, TOTAL UNITS also controls for the effects of size independent of the existence of an association. We entered PERCENT FRAN, the percentage of units
franchised, because franchise systems with high percentage of company-owned outlets may put less emphasis on strong termination rights. We therefore expected a positive sign on this variable. We also entered our PERCENT TERM STATES, because we expected that when such laws are in place, franchisors would have an incentive to more carefully craft termination provisions, and to make them stronger when possible, in order to partially compensate for state restrictions. We therefore expected a positive sign on this variable. As before, we controlled for industry with AUTO, with no particular expectations as to this variable’s sign.

Model 8 follows the pattern of adding our efficiency variables to these controls. Because BRAND NAME VALUE acts as a proxy for the costs of franchisee opportunism, we expect a positive sign on it. Franchise systems that have more to lose from a given act of franchisee opportunism would be expected to feature stronger franchisor termination rights in their contracts. Conversely, systems for which franchisee specific investment in greater would be expected to possess weaker franchisor termination rights, because franchisees will demand more protection for this investment. We therefore expect a negative sign on SPECIFIC INVESTMENT. Finally, Model 9 adds our variable of interest, ASSOCIATION, on which we expect a negative sign, since franchisees have an interest in using their bargaining power to weaken franchisor termination rights. The Breusch-Pagan/Cook-Weisberg test did not reject the hypothesis of homoskedastic errors (Prob. > $\chi^2 = 0.0964$).

Our final set of models, in Table 6, aims to explain the strength of franchisee termination rights. Because franchisee termination rights are the symmetrical opposite of franchisor termination rights, we use the same variables in Models 10, 11, and 12 as we did in Models 7, 8 and 9, respectively. That is, we followed the same pattern of entering the same controls as earlier, followed by the same efficiency variables, followed by our same bargaining power variable. We expect that the signs on the variables in Models 10, 11 and 12 to be opposite those in Models 7, 8 and 9 respectively (except for the AUTO variable, about which we are agnostic).

RESULTS
The coefficient estimates for our models of contract duration are shown in Table 2. In Model 1, YEARS FRANCHISING, one of our measures of franchisor experience, carries a positive and significant coefficient, as it does in Models 2 and 3. This confirms Brickley et al.’s (2006) finding, and suggests that franchisors are reluctant to offer longer term contracts early in their histories, likely due to uncertainty about optimal contract terms. The coefficient on TOTAL UNITS, however, our other proxy for franchisor experience, is not statistically significant in any of the three models and carries an unexpected positive sign. The PERCENT FRANCHISING variable carries a negative and significant coefficient, consistent with our expectation that less company ownership by franchisors results in more reliance on shorter contracts to control franchisee opportunism.

Model 2 adds the efficiency variables. The coefficient estimate for BRAND NAME VALUE is negative as expected, but is statistically insignificant. The SPECIFIC INVESTMENT coefficient is positive and significant, consistent with our expectations. The signs and significance levels of the control and efficiency variables stay the same in Model 3. The result for specific investment is consistent with Brickley et al. (2006), and suggests that efficiency considerations are important in determining contract duration in our data. In particular, longer contracts are used to safeguard specific investments by franchisees. However, the ASSOCIATION variable, included in Model 4, also carries a positive and significant sign, indicating that bargaining power considerations are important as well. Associations are able to improve franchisee bargaining power, allowing franchisees to win longer term contracts than efficiency considerations alone might indicate. Adding the ASSOCIATION variable also improves the goodness-of-fit of Model 3 over Model 2. We therefore find support for hypothesis 1 (H1).

Table 3 contains the coefficient estimates for our models of non-compete period length. Among the control variables, none is consistently significant across the three models. The signs on the YEARS FRANCHISING, PERCENT FRANCHISED and PERCENT TERM STATES coefficients, are however, consistent with expectations. The coefficient on TOTAL UNITS is not consistent with expectations, nor is that on BRAND NAME VALUE. The coefficient on SPECIFIC INVESTMENT carries the predicted negative and significant sign in Models 5 and 6. This suggests, consistent with contract
efficiency, that when the benefits to franchisee opportunism are fewer because franchisees pay more for their training, non-compete period length is shorter. We therefore do find evidence for importance of efficiency considerations in determining non-compete period length. Once again, however, the ASSOCIATION variable carries a significant coefficient with the expected negative sign when entered alongside the efficiency variables in Model 6, and improves the goodness-of-fit. This suggests that franchisees are able to use bargaining power generated by their associations to limit non-compete term length to less than it might have been if efficiency had been the sole consideration. We therefore find support for hypothesis 2 (H2) in our data.

The coefficient estimates for our models of strength of franchisor termination rights are shown in Table 4. YEARS FRANCHISING appears with a positive and significant coefficient in all three models, consistent with greater franchisor attention to such rights with more experience. The remaining control variables are not significant, through TOTAL UNITS and PERCENT FRANCHISED carry the expected positive signs. The sign on PERCENT TERM STATES is against expectations, perhaps because no-cure termination clauses are less enforceable in those states. BRAND NAME VALUE carries the expected positive sign, but is not significant. SPECIFIC INVESTMENT carries an unexpected negative sign on its coefficient, which is significant. We discuss this finding below. Finally, in Model 9, the coefficient estimate on ASSOCIATION is not significant and carries an unexpected positive sign. Therefore, we find no evidence to support either efficiency explanations of franchisor termination rights strength, or our bargaining power explanation (H3).

Our models of franchisee termination rights strength are weak in terms of total variance explained. Table 5 shows, however, that the coefficient estimate on ASSOCIATION in Model 12 is positive and significant, as predicted by hypothesis 4 (H4). All other variables are non-significant in the models. The signs on YEARS FRANCHISING, TOTAL UNITS, PERCENT TERM STATES and SPECIFIC INVESTMENT (in model 12) are consistent with expectations, while those on PERCENT FRANCHISED and BRAND NAME VALUE are not. We conclude that there is some evidence supporting H4 in these results.
DISCUSSION

Our main finding in this paper is that bargaining power, as measured by the existence or absence of franchisee associations devoted to exerting leverage over franchisors, had a significant impact on three categories of contract provisions in our data: contract duration, non-compete period length, and strength of franchisee termination rights. Moreover, these impacts remained significant even after controlling for the kinds of efficiency considerations emphasized in the law and economics literature on franchising. It is difficult to compare the relative sizes of the two sets of impacts because our efficiency and bargaining power variables are measured in different units. For example, our measure of bargaining power is a dummy variable indicating existence or absence, while our efficiency variables are dollar values. We can conclude, however, that efficiency and bargaining power variables both appear to be important determinants of contract terms in our data. This raises the question of whether those studies of franchise contract structure in the literature that have not accounted for franchise associations are based on empirical models that were mis-specified. A similar question is raised with respect to studies of other types of contracts in other settings that account for efficiency but not bargaining power considerations.

It is interesting that the presence of a franchisee association did not have a statistically significant effect on the strength of franchisor rights to terminate. One possible explanation for this result is that termination rights are exceedingly important to franchisors – more important that contract duration or non-compete period length or franchisee termination rights, for example. One reason for the importance of these rights is that franchisors fear being sued for vicarious liability, i.e., liability for illegal actions by a franchisee. If so, franchisors might be willing to concede on other terms in exchange for strong termination rights.

Another related possibility is that the interests of franchisees and franchisors are sufficiently aligned that franchisees and their associations do not bargain hard with regard to franchisor termination rights. For example, our measure of strength of termination rights includes “no opportunity to cure” contingencies that franchisees and their
associations might not want to exclude out of fear that such exclusion could so severely damage the reputation of the franchise system that the revenues of individual franchisees could be nontrivially harmed. Some of these contingencies might include violations of public health codes or child labor laws, abandonment, failure to complete training, fraud, misrepresentation or criminal activity, and the like. Were franchisees able to make such transgressions in the knowledge that they have an opportunity to later “cure” them, the revenues of other franchisees in the system could be adversely impacted by the negative reputation effect (e.g., the rats that were recently discovered in a Kentucky Fried Chicken franchise). This could provide an incentive for a coalition of franchisees to bargain softly on franchisor termination rights. Indeed, this consideration might also explain why we found the level of franchisee specific investment to be positively and significantly related to strength of franchisor termination rights. Franchisees with more non-redeployable capital at risk might have greater incentive to help protect the franchisor brand reputation from unscrupulous fellow franchisees.

Yet another possibility is that franchisee associations put less emphasis on limiting franchisor termination rights because franchisees are already protected from opportunistic termination by state laws. While only 14 U.S. states had strong termination laws at the time the contracts in our data were signed, many franchisors operate in multiple states, and may be reluctant to pursue different termination practices in different states, for fear for creating a bad image for potential franchisees.

CONCLUSION

The economic efficiency view of contracts based on agency and transaction cost theories has dominated the economics literature on contracts, and has been influential in the recent strategy literature as well. This dominance is no doubt due to the rigor if its logic and the broad empirical support for its implications. This emphasis on efficiency, however, may be coming at the expense of attention to effects of *ex ante* bargaining power on contract structure, especially in the empirical literature. While a few empirical findings investigating bargaining power do exist, they are far outnumbered by studies including efficiency but not bargaining power variables. This paucity of empirical studies including both sets of considerations simultaneously may in part be due to the difficulties
in measuring bargaining power, and to the absence of contract data more generally. In this paper, we aim to readdress this imbalance in the literature.

In future research, we hope to extend our study into more recent years. Independent franchisee associations began to strengthen in the early 1990’s, but according to practitioners, they became even stronger in the late 1990’s and 2000’s. Therefore, we might expect franchisee bargaining power to have improved further during the 2000’s, and that contract terms have tended to become even more favorable to franchisees where associations are active. Perhaps, for example, we might find effects of associations on franchisor termination rights that we did not find in the current study. It might be the case that even contracts offered by franchise systems in which an independent franchisee association does not exist have tended to become more favorable to franchisees. For example, perhaps franchisors have attempted to deter the formation of associations by making more pre-emptive concessions, similar to “union avoidance” strategies undertaken successfully by companies like IBM. In any case, long-term, secular increases in franchisee bargaining power such as these would be at odds with the assumptions of the RBV and of TCE that bargaining power advantages are fleeting.

A related area of future research could concern the factors causing the formation and growth of franchisee associations, and the organizational mechanisms through which they have their impact on contract structure and thereby franchisee and franchisor financial performance. For example, according to practitioners, independent franchisee associations have some of their effects by providing essentially legal support and education to franchisees. Franchisee associations and the AAFD are active in publicizing the outcomes of franchising lawsuits, and updating members on new franchising law. The AAFD, for example, publishes the Franchisee Voice, websites, and other publications, and hosts conferences that address these areas. Franchisee associations provide references to legal counsel and legal advice that also help to make franchisees more sophisticated about contracting practices. For example, according to Bob Purvin, the founder and Chairman/CEO of the AAFD, franchisees have become more attentive over time to the importance of subtle contract terms, in part because of the greater interactions between franchisees and attorneys that franchisee associations have facilitated. Thus, in earlier periods, franchisees acting alone would tend to focus on broader provisions like
purchasing requirements and exclusive territories provisions in their franchise contracts, whereas the learning facilitated by and through franchisee associations has led them to become more concerned with subtler provisions such as termination rights and non-compete provisions. Hopefully, then, future research can help us understand how firms, such as franchisees, develop contract design capabilities over time (Argyres & Mayer 2007), and the roles that franchisee associations, other types of industry associations, law firms, and other institutions might play in determining the speed and direction in which how those capabilities develop and diffuse within and across industries. This suggests an exciting research agenda that examines the interactions of institutions, organizational learning, and strategy.

REFERENCES


20 Lafontaine and Shaw (1999) found very little change in the royalty rates or franchisee fees charged by an average franchisor during 1980-1992. This period of study ended, however, just as franchisee associations were becoming established on a wider basis in the U.S. In addition, the study did not include analysis of other, non-monetary contract provisions.


Hanson, B. 2004. The incredible vanishing window: Can you really get out of your hotel franchise agreement? *Franchise Review*, July 1st.


### Table 1: Descriptive Statistics

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***p<.01; **p<.05; *p<.1; standard errors in parentheses, one-tailed test
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Table 5: OLS Estimates of Strength of Franchisor Termination Rights

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<tr>
<td>No. of obs.</td>
<td>133</td>
<td>133</td>
<td>133</td>
</tr>
<tr>
<td>Prob. &gt; F</td>
<td>.1769</td>
<td>.1367</td>
<td>.1430</td>
</tr>
</tbody>
</table>

***p<.01; **p<.05; *p<.1; standard errors in parentheses, one-tailed test
Table 6: Ordered Logit Models of Strength of Franchisee Termination Rights

<table>
<thead>
<tr>
<th></th>
<th>Model 10</th>
<th>Model 11</th>
<th>Model 12</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>YEARS FRANCHISING</strong></td>
<td>-.009</td>
<td>-.009</td>
<td>-.020</td>
</tr>
<tr>
<td></td>
<td>(.014)</td>
<td>(.014)</td>
<td>(.016)</td>
</tr>
<tr>
<td><strong>TOTAL UNITS</strong></td>
<td>-.00007</td>
<td>-.0002</td>
<td>-.0003</td>
</tr>
<tr>
<td></td>
<td>(.0002)</td>
<td>(.0003)</td>
<td>(.0003)</td>
</tr>
<tr>
<td><strong>PERCENT FRANCHISED</strong></td>
<td>.616</td>
<td>.618</td>
<td>.628</td>
</tr>
<tr>
<td></td>
<td>(.841)</td>
<td>(.842)</td>
<td>(.856)</td>
</tr>
<tr>
<td><strong>PERCENT TERM STATES</strong></td>
<td>.368</td>
<td>.362</td>
<td>.441</td>
</tr>
<tr>
<td></td>
<td>(.655)</td>
<td>(.657)</td>
<td>(.666)</td>
</tr>
<tr>
<td><strong>AUTO</strong></td>
<td>.290</td>
<td>.286</td>
<td>.166</td>
</tr>
<tr>
<td></td>
<td>(.389)</td>
<td>(.389)</td>
<td>(.400)</td>
</tr>
<tr>
<td><strong>BRAND NAME VALUE</strong></td>
<td>2.58e-6</td>
<td>2.19e-6</td>
<td>2.19e-6</td>
</tr>
<tr>
<td></td>
<td>(5.56e-6)</td>
<td>(5.75e-6)</td>
<td>(5.75e-6)</td>
</tr>
<tr>
<td><strong>SPECIFIC INVESTMENT</strong></td>
<td>-.0002</td>
<td>.0001</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(.005)</td>
<td>(.005)</td>
<td></td>
</tr>
<tr>
<td><strong>ASSOCIATION</strong></td>
<td></td>
<td></td>
<td>1.01**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(.618)</td>
</tr>
<tr>
<td>Log likelihood</td>
<td>-90.98</td>
<td>-90.87</td>
<td>-89.45</td>
</tr>
<tr>
<td>No. of obs.</td>
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<td>133</td>
<td>133</td>
</tr>
<tr>
<td>Prob. &gt; χ²</td>
<td>.7930</td>
<td>.9185</td>
<td>.7074</td>
</tr>
</tbody>
</table>

***p<.01; **p<.05; *p<.1; standard errors in parentheses, one-tailed test