The Effect of Contract Regulation on Franchising

Comment

by

Andreas Roider∗

In many sectors, such as retailing or fast food, franchising agreements are ubiquitous. On top of its empirical relevance, franchising has developed into a testbed for contract theory, due to its very good data availability. This is highlighted by a recent book by Blair and Lafontaine (2005), which provides a nice overview of the voluminous empirical literature on the topic. For example, franchising data have been employed to investigate the risk–incentive trade-off predicted by moral-hazard models (see, e.g., Lafontaine and Bhattacharyya, 1995), or the relative merit of vertical integration as well as its coexistence with franchising (see, e.g., Lafontaine and Shaw, 2005).

Klick, Kobayashi, and Ribstein (2012) add to the empirical literature on franchising by studying the effects of legal termination restrictions in franchising relationships, using U.S. data. Roughly speaking, in the absence of a termination restriction, the franchisor is allowed to terminate his relationship with the franchisee at will.

First, the authors are interested in the question how the presence of termination restrictions affects the attractiveness of franchising as the organizational form of choice. From an intuitive perspective, the presence of termination restrictions seems to deter franchisor opportunism, but might lead to more franchisee opportunism: franchisees knowing that they cannot easily be terminated might provide less effort, while franchisors might be prevented from taking over successful outlets themselves. Consequently, from a theoretical perspective the effect of termination restrictions on the attractiveness of franchising relative to other organizational forms seems to be ambiguous.

Second, even if termination restrictions are in place, they might not be binding, in the sense that contracting around might be possible. That is, franchisor and franchisee might be allowed to lift termination restrictions by specifying an alternative arrangement in their franchising agreement. Klick, Kobayashi, and Ribstein (2012) hypothesize that, if such contracting around is possible, the presence or absence of legal termination restrictions should not matter for the choice of organizational form (at least in a Coasian world).

∗ University of Heidelberg.
To address these research questions, Klick, Kobayashi, and Ribstein (2012) exploit variation in the legal environment with respect to termination restrictions (TR) across U.S. states as well as across time. In particular, they look at legal changes in Iowa and Washington, DC (see Figure 1), using panel data on franchising activity in the U.S. fast-food industry from the end of the 1980s up to the year 2000.

On the one hand, Iowa introduced binding termination restrictions in 1992, where the possibility of contracting around was explicitly ruled out. On the other hand, Washington, DC abolished its termination restrictions in 1998, but even before that date contracting around this legal default rule was possible. The authors measure the attractiveness of franchising as an organizational form by the number of franchised outlets. They hypothesize that the legal change had an effect on the number of franchised outlets in Iowa, but not in DC.

The empirical analysis shows that Iowa indeed witnessed a statistically and economically significant drop in the number of franchised outlets after its introduction of termination restrictions in 1992. In contrast, in the case of Washington, DC the sign of the respective parameter estimate depends on the empirical specification, which is interpreted as evidence that, due to the possibility of contracting around, the pre-1998 termination restrictions were most likely ineffectual.

In my view, the paper by Klick, Kobayashi, and Ribstein (2012) very nicely highlights the importance of paying close attention to legal detail (such as the possibility of contracting around) in empirical legal studies. As the authors rightly argue, merely looking at the presence or absence of termination restrictions might lead to misleading results. In a similar vein, in future work it might be interesting to investigate whether the legal details of termination restrictions differ across states beyond the possibility of contracting around.

In the following, I would like to make three comments: the first two on theoretical issues and the last one on the interpretation of the empirical results.

First, given that there are differences in the legal environment, the question arises how potential franchisors respond. The present study focuses on the (binary) decision of franchising a given outlet or keeping it company-operated. Of course, one could imagine that potential franchisors respond to changes in the legal environment by adjusting the finer details of franchising agreements to control for potential opportunism, but keep the organizational form constant. Again, the possibility of such contractual adjustments might depend on the legal environment in a given state. In
order to judge to what degree this is the case (and to what degree it affects the empirical results), one would, however, need access to individual franchise agreements. Such access would be all the more desirable in that it would provide direct evidence as to how much contracting around indeed occurred in Washington, DC.

Second, Klick, Kobayashi, and Ribstein (2012) argue that, given that contracting around is possible, the presence of termination restrictions is likely to have only a small effect on franchising activity. In turn, they argue that if they find no effect in Washington, DC, this provides (at least weak) evidence that contracting around indeed occurred in this jurisdiction. However, as, from a theoretical perspective, termination restrictions seem to have opposing effects on franchisor and franchisee opportunism, the lack of an empirical effect might very well arise with no contracting around, but with the two opposing effects just canceling out.

Third, in the empirical analysis of franchising activity of Burger King and McDonald’s in Washington, DC, it turns out that the effect of termination restrictions is statistically significant, but its sign depends on the empirical specification. In particular, without controlling for state-level time trends a positive effect emerges, while when controlling for such time trends the data indicate a negative termination-restriction effect. The authors interpret this apparent lack of stability of the parameter estimate as indication that the weaker DC law did not have a clear effect, which – given the possibility of contracting around – might not be surprising. In the following, I would, however, like to discuss an alternative explanation for these empirical findings that does not rely on any contracting around taking place. To this end, consider Figure 2, which provides a hypothetical example.

Figure 2
An Alternative Explanation for the DC Findings

Note: Result without taking account of time trends: higher average when a TR is in place.

Note: Result with taking account of time trends: lower average when a TR is in place.

Suppose that, as depicted in the left panel of Figure 2, in a hypothetical example the number of franchised outlets follows a negative time trend, and the abolishment
of earlier termination restrictions leads to a positive jump in the number of franchised outlets. Now compare the average number of franchised outlets with and without a termination restriction (TR). As is evident from Figure 2, the difference between these averages might very well be negative with data that are not detrended (left panel), but positive with detrended data (right panel). Hence, it seems that the findings of Klick, Kobayashi, and Ribstein (2012) do not necessarily provide evidence in favour of contracting around.

To summarize, from my perspective, the main contribution of Klick, Kobayashi, and Ribstein (2012) is to highlight the importance of paying close attention to legal detail in empirical legal studies. More work in this vein is clearly desirable.

References


Andreas Roider
Department of Economics
University of Heidelberg
Bergheimer Str. 58
69115 Heidelberg
Germany
E-mail: roider@uni-hd.de