Innovation and Authority in Franchise Systems: An Empirical Exploration of the Plural Form

Shira B. Lewin-Solomons *
University of Cambridge and Iowa State University
shirabatya@post.harvard.edu

July 1999.

1 Introduction

The fast-food industry constitutes a very interesting example of the interaction between organizational arrangements. Individual stores are organized in two very different ways. On the one hand, there are the company stores, in which managers are salaried employees with rather weak incentives and little freedom to exercise initiative. On the other hand, there are the franchisees, independent businesspeople who enter a long-term business relationship with the chain. The interesting thing about the fast-food industry is the fact that so many chains contain a large proportion of both types of store, rather than being composed almost entirely of one type or the other (see Table 1).

A simple explanation of this phenomenon would observe, quite correctly, that different economic circumstances require different organizational solutions. Whereas company stores are best in some circumstances, franchises are best in others. For example, close to company headquarters, company stores are easy to monitor and manage, whereas in far-off locations, monitoring difficulties necessitate the use of franchises. Such has been the approach employed by almost all work on franchising,[1] and it has much merit, but it does not tell the whole story. If one talks to actual participants in franchise systems, one finds that they often care quite deeply about the relative sizes of the franchised and company sectors and believe that a "balance" is necessary to ensure competitiveness of the chain (See Bradach [5]). In particular, the presence of a company sector is essential to the relationship between franchisees and their chain.

Thus, when deciding whether to franchise a new store or operate it within the company hierarchy, a chain must consider more than the conditions affecting that individual store. As Bradach

*Special thanks to my thesis committee, Jeffrey Bradach, Oliver Hart, and Eric Maskin, for their ongoing advice and encouragement, and to Victoria Alexander for the course which generated the idea for this work. Thanks also to Stephen Marglin, participants at numerous seminars, and two anonymous referees for helpful comments and/or discussions. Journal paper No. J-18005 of the Iowa Agriculture and Home Economics Experiment Station, Ames, Iowa, Project No. 3530, and supported by the Hatch Act and State of Iowa funds. This research was supported by graduate research fellowships from the National Science Foundation, the Earl E. Chiles Foundation, and the Alfred P. Sloan Foundation, as well as by the Department of Economics at Harvard University. Last but not least, many thanks to the dozens of people who agreed to be interviewed for this study. All errors are my own.

[1] Cf. Brickley & Dark [7]; Caves & Murphy [9]; Katz & Owen [13]; Lafontaine & Slade [14]; Maness [20], Mathewson & Winter [21]; Norton [22]; Thompson [24]; Walker & Weber [25]. For two good summaries of recent theoretical and empirical work on the economics of franchising, see Dnes [10] and Lafontaine & Slade [15].

Chain	Company Stores		Franchised Stores		% Franchised	
	1988	1997	1988	1997	1988	1997
McDonalds	1,758	1,798	6,149	10,582	78	85
Pizza Hut	2,770	3,823	2,937	4,875	51	56
Burger King	758	514	4,454	7,025	85	93
Kentucky Fried	1,262	1,850	3,637	3,270	74	64
Domino's Pizza	1,370	766	3,665	3,543	70	83
Wendy's	1,076	1,140	2,445	3,435	69	75
Hardee's	1,038	863	2,038	2,081	66	71
Taco Bell	1,691	2,149	1,187	4,619	41	73
Subway	30	0	2,828	11,165	99	100
Little Caesar's	488	1,265	1,636	3,560	77	74
Arby's	209	0	1,840	2,925	90	100
Long John Silver's	1,007	909	462	486	31	34
Dunkin' Donuts	16	0	1,427	3,436	99	100
Church's	998	480	283	590	22	55
Denny's	1,001	884	233	708	19	44
Sources: The 1988 and 1997 Technomic Top 100						

Table 1: Top Restaurant Chains in the U.S.

and Eccles argue [6, p. 112], we cannot evaluate the efficiency of one transactional relationship without considering how it is "embedded in a context of *other transactions,* as well as in a social context." By choosing to franchise some of their stores while owning others (i.e., by choosing a plurality of organizational forms), franchise systems can achieve dynamic efficiency that would be impossible in a system containing only one type of store. After Bradach and Eccles [6], we call such a system a *plural form.* By this we mean that the interaction of organizational forms (in this case franchised and company-owned stores) produces a whole that is more than the sum of its parts.

This paper helps us to understand the dynamics of the plural form in franchising by exploring the actual operation of five franchise systems, ranging from Subway, which is entirely franchised, to Denny's, which is primarily company-owned. (The other three chains are KFC, Pizza Hut, and Burger King.) A series of interviews was conducted between December 1995 and March 1996. These interviews provide a rich description of the structure of franchise systems, and in particular, they help us to understand how these systems operate very differently when the ratio of franchised to company stores is different. Currently, we are conducting a follow-up study of 40 chains in order to verify the broader relevance of these very focused results. As summarized in section 5.1, premilinary results of this study confirm our basic conclusions.

The interviews indicate the following story: A major challenge faced by franchise systems is to facilitate innovation and change while protecting franchisees from potential opportunism on the part of the chain. If the chain has too little power, then franchisees can block changes that are beneficial, and therefore innovation will languish. If franchisees have too little power, then unprofitable changes may take place (despite being inefficient). Many chains find a solution to this dilemma by retaining a sizable company sector. Thus, the chain's interest is aligned with that of its franchisees, and opportunism is unlikely. When few company stores exist, other strategies must be employed to protect franchisees.

The basic structure of this paper is as follows: First, section 2 explains the basic structure of

franchise systems. Then, section 3 provides a basic theoretical explanation of the importance of the plural form, and outlines the empirical predictions of the models in Lewin [17] and [18]. Sections 4, 5 and 6 then discuss the results of the interviews and the actual operation of the plural form. Section 7 concludes.[2]

2 A Plurality of Two Forms

As mentioned above, franchise systems are an interesting combination of two sharply contrasting organizational forms: company stores and franchises. Before we can discuss how these forms influence each other, we need to understand how they are structured and why. Why is it not possible to obtain the benefits of a plural form by making all stores an identical hybrid of the characteristics of these two forms? In short, why is a plural form necessary?

In this and following sections, we use λ to denote the fraction of stores in a chain that are franchised. If there are a total of N stores, then there are λN franchised stores.

2.1 Company Stores

Company stores operate within a standard corporate hierarchy. Store managers are simply employees at the bottom rung on this hierarchy. Therefore they have very little autonomy and are not expected to exercise much initiative. The dynamism of the corporate sector does not come bottom-up from store-level operations. Rather, it has a top-down nature. Chains hire specialists to work in research and development and marketing departments, in which new products and other new ideas are developed and refined. Only in the final testing process do company managers play an active role, and even then, these managers are unlikely to express strong opinions because they do not want to antagonize their superiors (Bradach [5], p. 44).

All the company personnel interviewed agree that franchisees are much more likely to suggest changes in operations than company managers. As a Pizza Hut franchise business representative noted, "franchisees are more independent." They can experiment whereas, he says, "I wouldn't want my own folks experimenting" because they lack the knowledge and experience of franchisees. Similarly, a Denny's official commented that a franchisee is probably "more entrepreneurial. He doesn't have the company to actually answer to, as far as being an employee, maybe isn't afraid to make some strong recommendations." By contrast, company personnel will usually keep their ideas to themselves, or if they do speak up, "they'll state their opinion and then do what they're told."

2.2 Franchises

By contrast, a franchisee is an independent entrepreneur who signs a long-term contract with the chain in order to make use of a trademark, and in order to obtain assistance from the chain and gain from its business expertise. In the fast food industry (which is our focus), franchise contracts usually last for approximately twenty years.[3] These contracts specify a franchise fee that must be

[2] An appendix providing details on the interviews and a compilation of the results in a less interpreted form is available from shirabatya@post.harvard.edu.

[3] In a 1999 survey of 42 food industry franchise systems, in 25 (60%) the franchise term was at least 20 years, and in 22, the term was exactly 20 years. Another 11 chains had terms of 10-15 years with an option to renew, making the total expected term at least 20 years. Only 6 chains (14%) had shorter terms, did not include a renewal option, or were unclear about contract length.

paid up front, as well as royalty and advertising fees that franchisees pay as a fraction of their revenues. Royalties go directly to the chain as earnings; but advertising fees go into a special fund, which is administered either by the chain or by an independent committee whose members may be either franchisees or company employees. In different systems, the chain has differing degrees of power over advertising decisions. Often, franchisees have more power over local advertising decisions, especially when their region is predominantly franchised.

In addition to these financial considerations, the franchise contract also specifies a long list of standards with which a franchise must comply. Usually the chain has some authority to change these operation standards at its discretion. In order to assure that their franchisees are capable of adhering to company standards, chains require entering franchisees and their managers to complete a training course. Such a course may last for two weeks, or even sometimes for three to four months, depending on the complexity of the business.

Finally, franchise contracts usually specify conditions for expansion and renewal. A franchisee who remains "in compliance" may be able to open additional stores and also will find it easier to renew her franchises for existing stores.[4] The renewal fee varies among chains, some offering free renewals and others requiring a full franchise fee. Franchisees may also pay a discounted franchise fee when they build many additional stores. Thus, the chain can use its power over renewals and expansions to reward or punish franchisees for following or disobeying company policy. Rarely does the chain need to utilize a more heavy-handed approach such as threatening to revoke the franchise of a recalcitrant franchisee. Nevertheless, franchise terminations do sometimes occur, and franchisees know this.

Typically, as well as dealing directly with the chain, franchisees can participate in franchisee organizations or committees, in which franchisees share business expertise and discuss the pros and cons of corporate initiatives. The power of such franchisee organizations varies widely across chains. Often, these organizations simply facilitate communication among franchisees and between the corporation and its franchisees. They promote a cooperative corporate culture in which franchisees feel a personal commitment to a system whose participants are often not simply colleagues, but lifelong friends. A "franchise community" exists. Franchisee organizations also provide the chain with helpful advice and feedback. In some systems, the role of franchisee organizations transcends the social and communicative functions just mentioned. Franchisees may wield a great deal of formal or informal power over the system. For example, the chain may be required to consult franchisee representatives before it makes decisions that impact the franchise community.

2.3 Two Fundamental Differences

As the descriptions given previously suggest, company stores and franchisees are different in two fundamental ways. (See section 4 for specific illustrations of the claims below.)

First, a franchisee receives high-powered incentives. With the exception of her royalty payment, she keeps the full profit produced by her stores. By contrast, a company manager's incentives are

[4] The interviews included no questions explicitly about the compliance pressure that results from pending renewals or expansions. Nevertheless, Burger King's F1 and F3, KFC's F1, F3, and FOM, and Subway's F3 all spontaneously mention this issue. Subway's F3 notes that he complies with all of the chain's requests because he wants to add more stores (and only a franchisee "in compliance" can do so). KFC's F1 and FOM note that the chain was forced to provide franchisees with financial incentives to upgrade their stores. The alternative was waiting until contracts came up for renewal. At renewal time, the chain will come with a "wish list" and a franchisee will be under tremendous pressure to comply (KFC's F1). (See appendix A for a directory of code-names.) To alleviate such pressure, several states do have laws restricting termination or nonrenewal of franchises. For details, see [4] and [8].

low-powered. She receives a salary and perhaps a small bonus, and therefore is less concerned with explicit outcomes such as sales or profits. She will be rewarded for good performance primarily by a stable job, a pay rise, or perhaps the prospect of promotion within the corporate hierarchy. Second, franchisees are much more independent than company managers. Whereas a company manager generally follows orders, a franchisee often chooses actions on her own.

These two differences are closely related. Because a company manager is concerned primarily with job security and promotion prospects, her focus will inevitably be on not making waves and on proving that she is a good team player. Obedience to authority is her best strategy, not independence and creativity. By contrast, a franchisee, who receives strong incentives to raise profits in her own stores, will constantly look for ways to raise profits.

Even in the most tightly controlled and standardized chains, franchisees exercise a great deal of initiative to make their stores successful. Many programs that are mandatory in company stores are optional in franchises. Chains frequently encourage franchisees to be creative, and they often turn a blind eye when a reliable franchisee deviates from normal operating standards in the search for a better way to do something. Thus, franchisees possess a great deal of informal power due to their expertise. Chains tolerate and even encourage experimentation because they know that franchisees can be trusted to make good decisions. Formal contractual standards exist partially as a guide to operations, but more importantly, they serve as a formal safeguard. Because formal standards exist, the chain can crack down on inexperienced and opportunistic franchisees who may damage the brand's reputation, just as a landlord often will enforce a "no pets" policy only when the pet creates a nuisance for neighbors.

Experimentation by franchisees takes a variety of forms. Without obtaining permission, one Denny's franchisee eliminated from his store the late-night menu, which offered fewer products at higher prices. Technically, this was a violation of the operations manual, but, he says, "Nobody gave me any grief over it." At KFC, products have at times spread from store to store before gaining formal approval. Such was the case with "chicken-fried steak," which was approved after the fact because it sold so well. Subway had a similar experience when franchisees decided to leave meat in a stack, rather than laying it on set-up paper as required by the operations manual.[5] When franchisees come up with major ideas, they must go through an approval process. For example, a Burger King franchisee came up with an idea for a new building design which allowed for an indoor playground. This design was refined by the chain, and is now being adopted by many stores. Similarly, a Denny's franchisee developed a new restaurant design as well as a new menu for people on a restricted diet. Both ideas were approved by the chain prior to adoption. At KFC, many products have been developed by franchisees, and then refined by the chain and rolled out nationally. Among them are crispy strips, rotisserie chicken, and buffets.

By contrast with their encouragement of franchisee initiative, chains usually discourage their own managers from experimenting, because company managers cannot be trusted — their incentives are not strong enough. As a director of field services at Denny's commented, franchisees "basically have their whole life at stake, in terms of what they do in their restaurants. So they seem to be a little more calculated in their risk-taking," whereas company managers "don't own the building, the business" and are therefore more willing to take irresponsible risks. Some chains have experimented with providing more autonomy and responsibility to company managers but, as explained in Lewin [17], this autonomy can never even approach that of franchisees. A company

[5]Laying meat on set-up paper speeds customer service. However, franchisees found that customers were often dubious about the freshness of such meat. Some franchisees therefore decided to take meat from its original stack as sandwiches were made.

manager is by definition an employee working on company property. As such, she can be fired and she must be monitored closely. Both of these conditions restrict autonomy enormously.

A franchise system must strike a balance between consistency and autonomy. It can foster more or less franchisee initiative and innovation by providing franchisees with more or less freedom in their day-to-day operations. In some systems, such as KFC, franchisees have enormous autonomy. This autonomy encourages franchisee innovation, but it also undermines the consistency of the brand.[6] Innovation is a by-product of initiative, and initiative has a large payoff only when franchisees have the autonomy with which to exercise such initiative. Subway encourages its franchisee to be creative by allowing each to sell two hot and two cold sandwiches of her choice. Successful sandwiches will then spread from store to store. In other chains, such as Denny's, franchisees are far more limited in their freedom to experiment and deviate from strict standards of operations. As a result, Denny's is more consistent in its operations than KFC, but Denny's franchisees are also far less innovative than those at KFC. They focus most of their energies on implementing programs proposed by the chain, and most do not expend much effort on being creative.

2.4 Chains within chains

In-between the pure franchise and pure company store forms is the multi-unit franchise. Although some chains (such as Subway) emphasize the "Mom and Pop" store and have thousands of small franchises, other chains (such as Pizza Hut) prefer to deal with a few large franchises, each of which is a mini-chain. As Bradach [5] explains, the advantage of a multi-unit franchise is that top-down decision making is easier. Only one franchisee need be persuaded, and a change will go through in perhaps hundreds of stores. The disadvantage is that individual store managers will be less creative and more like company managers. Thus, multi-store franchises lie somewhere in-between classic franchised stores and company-owned stores in terms of the consistency / autonomy trade-off. When asked to compare the efficiency of franchised and company-owned stores, one KFC franchisee answered that multi-unit franchises become less efficient with each store they add because "you can't be everywhere all the time." The mother company faces an extreme form of the same problem in managing its own stores. It is essentially a huge franchise – perhaps too huge.

3 A Brief Model

If, as appears to be the case, franchisees are more innovative and adaptive than company managers, then what is the advantage of retaining company stores? (Even if top-down decision making is important, why not replace the company sector with large multi-unit franchises? Why own any stores at all?) This section provides a theoretical answer, summarizing the model in Lewin [18]. We argue here that the presence of company stores improves the relationship between the chain and its franchisees, facilitating efficient adaptation. Although this model cannot capture all of the richness of the interview results, we find that its broad predictions fit our observations quite well.

[6] For example, a KFC franchisee related how several franchisees added a product called "chicken-fried beef" — fried beef strips. This was not an approved product at the time. However, by the time the chain noticed what was happening, so many restaurants were offering the product and making money off it, that KFC Corp. "found a way" to let them continue. The same happened when several franchisees bought dishwashers without approval. Most extremely, one franchisee in Alabama has sold a "cold breat fillet" made of muscle fish for 20 years. The chain looks the other way, because the product sells well and he has a niche clientelle. Nevertheless, one franchisee notes that "It used to be that people were selling all kinds of stuff" and that hurt the brand, so freedom to experiment must be limited.

Again, consider a chain that has N stores, of which a fraction λ are franchised. We want to know why $\lambda < 1$ might be optimal.

As mentioned above, franchisees always pay a royalty that is a fraction of their revenues, whereas company managers receive a fixed salary. If the royalty is $\beta \in (0, 1)$ and a store has revenues R and costs C, the payoffs to the franchisee (f) and the chain (h) are

$$U_{\text{f}} = (1 - \beta) R - C$$
$$U_{\text{h}} = \beta R$$

We notice immediately the potential conflict of interest. If revenues in each store change by ΔR, the chain obtains $\beta \Delta R$, whereas each franchisee obtains $(1 - \beta) \Delta R$. Any cost change ΔC is borne entirely by franchisees. Efficiency dictates that a change $(\Delta R, \Delta C)$ (called a *project*) be implemented if and only if $\Delta R - \Delta C > 0$.

Given the fact that neither the chain nor franchisees receive such a payoff, two principal problems might arise in attempting to implement such a rule:

A. Because $\beta > 0$, it is possible that $\Delta R - \Delta C > 0$ while $(1 - \beta) \Delta R - \Delta C < 0$. A franchisee might refuse to accept a project even if it is efficient, because she must remit a portion of the gains to the chain.

B. Because the chain does not bear any costs at all, it is possible that $\Delta R - \Delta C < 0$ while $\beta \Delta R > 0$. The chain might want to force franchisees to adopt projects that are inefficient.

We call projects with these characteristics projects A or projects B.

As an illustration of this issue, consider the common controversy over the use of "price points." Franchisees mentioned this issue at Denny's, Pizza Hut, and KFC (three of the five chains studied). Because the chain receives a royalty on franchise revenues, and because company stores usually operate in highly competitive urban areas, these chains often promote specials, or price-points, in which particular products are discounted to drive up sales. By advertising these specials, the chain effectively forces franchisees to participate. Franchisees are less enthusiastic about price points because they do not keep all the revenues earned, and because they often operate in rural markets in which market power is higher and demand elasticity is lower. We can think of project A as a price-point scheme which is profit-increasing, but which is not worthwhile for franchisees because of their royalty payments. We can think of project B as a price-point scheme which raises revenues for the chain (by drumming up sales) but which is not economically profitable because of the rise in franchisee costs.[7]

Of course, one might ask why chains do not simply adopt a more complicated franchise royalty that takes costs into account. If such a royalty were possible, then the chain's incentives would not need to be distorted, and therefore (assuming all stores are identical) no controversy or conflict would exist. As explained in Lewin [17], royalties based on costs are incompatible with the informal autonomy that characterizes franchising. In order to monitor costs adequately, the chain would need to engage in micromanagement,[8] which would eliminate a franchisee's incentive to act

[7] This model does not address the difference between rural and urban marketing preferences.

[8] Chains inspect franchised stores only occasionally. In many chains, inspections take place only every few months, so that even once a month would be perceived as frequent monitoring. Company store costs cannot be used as a proxy for costs in franchised stores since the incentive effects of a proxy are not equivalent to those of an actual measurement.

independently since interference from the chain would be inevitable. Thus, chains are forced to use a revenue-based royalty.

Given this structure, a franchise system faces the challenge of preventing projects B from being adopted while at the same time not interfering with the implementation of projects A. This challenge is compounded by the fact that project characteristics are noncontractible. Thus, implementation decisions will depend not on ΔR and ΔC, but rather on the relative power of franchisees and the chain — in particular, on the level of *veto power* possessed by franchisees.

Three possibilities exist. Franchisees may have *no veto power,* in which case the chain implements any project it desires. In such a chain, the contract allows the chain to change the operating standards at its discretion with no limitations.[9] Thus, both projects A and projects B will be adopted in franchises, though B will not be adopted in company stores.

On the other extreme, franchisees may have *complete veto power* so that no project is adopted without their approval. In such a chain, either no clause exists allowing unilateral changes to change operating standards, or the contract limits such changes, or franchisees control a crucial organ such as the Advertising Committee, so that no change can in practice be implemented without their coopearation.[10] When complete power exists, neither A nor B can be adopted unless the chain bribes its franchisees to obtain permission. Even if such negotiations are successful, the transaction costs can be huge.[11]

Finally, a third option exists: Franchisees may have the power to veto only those projects that are not adopted in company stores. We call this *limited veto power.* In such chains, the contract allows the chain to change standards unilaterally, but it requires franchisees to abide only by standards enforced in the entire system.[12] Thus the chain will have no problem implementing A since it wishes to put this project in its own stores in any case. However, the chain now cannot implement B in franchises without also implementing it in its own stores. If λ is sufficiently low, the chain will choose not to implement B at all, and the first-best is obtained. If λ is too high, then B will be adopted chain-wide, so that the outcome is even worse than that under no power. Only if the chain maintains a sufficiently large company sector is the efficient outcome possible.

Let λ_{B} be the critical level of λ at which the chain's decision changes. It is determined by the condition

$$\lambda_{\mathrm{B}}\left(\beta \Delta R_{\mathrm{B}}\right)+\left(1-\lambda_{\mathrm{B}}\right)\left(\Delta R_{\mathrm{B}}-\Delta C_{\mathrm{B}}\right)=0 .$$

[9]For example, the Arby's license agreement states (section 4:1:1): "During the term of this License Agreement, Licensee shall operate the licensed business strictly in conformance with the Manual provided by Arby's.... It is understood and agreed that Arby's may modify or revise the Manual from time to time and that Licensee shall operate the Licensed Business at all times in conformance with the Manual as then in effect...."

[10]Such an arrangement is rare but does sometimes exist. In a 1999 study of 40 franchise systems, in three chains, franchisees unambiguously had complete veto power. In another four chains, franchisees had some degree of complete veto power due to their influence on advertising.

[11]For example, at KFC, the chain must obtain 70% compliance with a new product before it can be mandated. As a result, the chain has at times been forced to pay off franchisees who adopt the product until 70% compliance is obtained. (This happened, for example, in the case of rotisserie chicken.) This necessity slows down the pace at which new products can be implemented. To eliminate such delays, the chain introduced a new contract requiring only 30% compliance before a product becomes mandatory. (See section 4.4 for details.) Of course, franchisees fear that the new contract will simply streamline the adoption of inefficient products.

[12]For example, the Steak & Shake franchise agreement requires periodic remodelling of stores. "Such changes will be made by Franchisee by the time the Company completes these changes to substantially all of its Company Restaurants." A contract may also express limited veto power by giving the chain power to change the "System" rather than giving it power to change the "Manual", or it may specify that the "Manual" applies to the entire "System". In chains with no veto power, such an emphasis on the "System" will be absent.

Then we can summarize our conclusions with the following table:

	Project Adoption		
Veto power	**Type A**	**Type B**	**Store Mix**
complete	C,f		$\lambda \leq \lambda_B$
limited	C,F		
none	C,F	F	
complete	C,f		$\lambda > \lambda_B$
limited	C,F	C,F	
none	C,F	F	

Here, "C" indicates that the project is adopted in company stores, "F" indicates that the project is adopted in franchises, and "f" indicates that the project is adopted only if the chain pays a bribe (which, as mentioned in note 11 above, results in transaction costs). We discount the possibility that franchisees bribe the chain to prevent projects B since the project could be reintroduced with slight modifications, and thus such bribes are ineffective. (See Lewin [18].)

We can see from the table that when $\lambda \leq \lambda_B$, limited veto power is unambiguously the best arrangement. When $\lambda > \lambda_B$, the results are less clear. Now limited veto power leads to adoption of B chain-wide, whereas no power leads to adoption only in franchises. Nevertheless, if λ is not much higher than λ_B, given limited veto power, the chain's benefit from projects like B will be close to zero, and thus limited veto power continues to be the best arrangement, since it discourages the development of projects B in the first-place. For higher levels of λ, projects B will be a serious problem, and either no power or complete power may be a better arrangement, though neither is perfect.

The level of λ in any given chain is of course a result of numerous factors. As you will discover below, often historical or structural conditions, such as the skill or enthusiasm with which the chain's founders operated stores or marked franchises, will have a large impact on λ. The critical level λ_B is also likely to be different for different chains. Thus there is no one "right" level of λ. However, we do expect that, if franchise systems are able to choose levels of veto power that are efficient, then as λ rises, the control rights allocation will tend to become more polarized.[13] Moreover, whatever the control rights allocation, conflict in the chain will tend to increase as λ rises. Whether chains are in fact able to choose their control rights allocations is again a separate issue which we discuss in section 6 below.

4 Five Contrasting Systems

We now turn to an examination of how franchise systems actually operate. In order to achieve as broad a perspective as possible on this question, this study considers five systems that span the range of levels of λ, .selected from among the top 20 fast food chains in the USA. Table 2 provides some basic information on these chains. All are large chains, but they differ markedly in

[13]It is of course true, as Holmstrom and Milgrom [12] point out, that depending on the outside forces influencing both λ and the control rights structure, the fact that these two attributes of a chain exhibit complementarities does not necessarily imply that one will find an empirical relationship between them. However, lacking a model of the exogenous determinants of either λ or control rights structure (since both are heavily influenced by institutional details that are almost impossible to model), we cannot determine whether sufficient conditions for correlation are in fact satisfied. However, we suspect that no perverse exogenous effects exist, since the empirical results show such a strong relationship between λ and control rights structure.

	Subway	Burger King	KFC	Pizza Hut	Denny's
Company 1988	30	758	1,262	2,770	1,001
1995	0	447	2,031	5,078	933
Franchised 1988	2,828	4,454	3,637	2,937	233
1995	10,093	6,155	3,111	3,615	596
λ **1988**	99%	85%	74%	51%	19%
1995	100%	93%	61%	42%	39%
Training (hours)	90	675	160	145	650
Sales* ($1000)	$258	$1,040	$643	$502	$991
Investment ($1M)	.066 - .11	1.0 - 1.9	.95 - 1.4	.33 - 1.4	1.2 - 1.9
Franchise Fee	$10,000	$40,000	$25,000	$25,000	$35,000
Renewal Fee	none	$40,000	$9,700	$25,000	$35,000
Royalty Rate	8%	3.5%	4%	6.5%	4%
Total Advertising	2.5%	4% +	5%	4-5%	2-3%
Local Advertising	≈1.25%	?	3%	2%	≈2%
*Sales are average per franchise from the 1995 Technomic Top 100.					

Table 2: System Characteristics

their complexity and scale of operation. On one extreme, Subway franchises small sandwich shops, while on the other, Denny's franchises full service restaurants. We selected large established chains for two reasons. First, we suspected that cooperation would be more likely when calling a large corporation with a reputation, an interest in pleasing a student who calls, and sufficient resources to provide assistance. Second, this study's porpose is to understand how succesful, established chains operate. It is such chains that are most likely to have arrived at efficient allocations of control rights.[14] As you can see above, the actual levels of λ (in 1995) do not span quite as wide a range as anticipated, since some of these chains underwent substantial changes during the 1990s. Such changes actually add to the richness of the interview results, since chains can reveal how changes in λ have affected them.

4.1 Choice of Participants

In each of these chains, we conducted interviews with five to seven people, in an attempt to obtain the most important perspectives on the chain-franchisee relationship (30 interviews in all). Each interview lasted between 30 and 60 minutes, and was fully transcribed. Statements were then sorted by topic and combined with those of other participants to form summary data for each chain. Ideally, two of the people in each group work for the chain, and another four are franchisees. To assure confidentiality, we refer to participants by code-names, which are set in sans serif type to avoid confusion with acronyms.[15]

The first participant in each group is typically someone who works in the chain's central office, is involved in decision-making about innovation, and is knowledgeable about the franchise sector. The second participant works with franchisees on the local level. This person typically provides

[14] Therefore, it is difficult to extrapolate descriptively to the hundreds of small chains with fewer than 100 stores. Normative extrapolations are possible, however.

[15] Appendix A is a directory of these code-names, and it also gives basic information about each participant.

franchisees with support and operational advice and also conducts periodic inspections to assure that franchised stores are in compliance with corporate standards.

The first two franchisees (code-named F1 and F2) are heavily involved in franchisee committee work and are very knowledgeable about the interplay between franchisees and the chain. Two more (F3 and F4) are randomly chosen, "regular" franchisees.[16] This profile of subjects was chosen because, whereas corporate employees are likely to present an official company line, franchisees need not be at all similar to each other. By including two of each type, we can confirm with another franchisee, information which comes from a single franchisee.[17]

The following sections provide brief descriptions of these five chains, setting the stage for the more holistic analysis that follows. For those who desire less interpreted data, an appendix containing general information and brief, stylized summaries of the empirical results for each chain is available directly from the author.

4.2 Denny's: a case of limited veto power

At one extreme of the company store - franchise spectrum, Denny's is a chain that has historically been dominated by the company sector. Originally, the system was entirely company-owned, and although it slowly began franchising around 1960, only since the 1980s has franchising been a priority. Today, as the franchise sector expands, the Denny's system is experiencing rapid change.

One reason for the dominance of company stores at Denny's is the unusual complexity of the basic concept. Denny's was reluctant to trust others with its trademark. However, in recent years, financial troubles have prevented Denny's from expanding its company sector. Several years of negative profits prevented Denny's from raising money to build new stores, without paying very high interest. Thus, Denny's has turned to new franchisees who are independently wealthy, or who can borrow money on their own merit at reasonable rates.[18] Franchising has become the sole source of growth at Denny's. If the current trend continues, λ should rise above 50% in the next few years.

In order to safeguard its brand, Denny's retains a great deal of control over its franchises, usually inspecting them eight to twelve times a year. Because of the historical dominance of the company sector, the chain dominates innovation and decision-making. Denny's Corp. has sole authority over advertising decisions, and it can unilaterally change the operating standards of the system. Nevertheless, the franchise contract protects franchisees from standards that are stricter than those applied to company stores. Franchisees therefore enjoy limited veto power, but do not possess complete veto power. Although their power is limited, franchisees do not generally worry

[16] At Denny's, three company employees were interviewed because two different types of people work with franchisees in the field. At Burger King, only one "knowledgeable" franchisee could be interviewed; therefore, the conclusions unfortunately depend very heavily on this person's statements. At Pizza Hut, only one "regular" franchisee could be interviewed; but here, the problem is less severe because the difference between knowledgeable and regular franchisees is minimal. Almost all Pizza Hut franchisees have been in the business for decades. (The chain rarely takes on new franchisees, but only adds stores to existing franchises.)

[17] Of course, due to resource constraints and the detailed nature of the interviews, we are still forced to rely on a small number of opinions for our conclusions. Nevertheless, duplication of interviews does mitigate this problem.

[18] Banks were reluctant to lend to Denny's, since in the event of bankruptcy, they might not be able to collect. (Other debts would be paid first.) However, an independent franchisee could borrow funds to build a franchised store (owned by him) by posting his own independently owned collateral (the store). Denny's own creditors have no claim on such collateral, since it owned by the franchisee, not by Denny's. Even if Denny's goes bankrupt, a bank can still collect its debts directly from a financially healthy franchisee.

that the chain will abuse its power because, in the words of F2, "They don't want to lose money either."

Whereas Denny's had historically discouraged franchisee innovation, in recent years, as the franchise sector has grown, franchisee initiative and involvement have received more encouragement. Today, franchisees elect a Franchise Advisory Board (FAB), which advises the corporation on advertising and other matters. The FAB has no formal power, but the chain does respond to franchisee concerns. Denny's also uses the FAB to promote company initiatives among franchisees. Both F1 and F2 believe that franchisee power is on the rise. As F2 says, "Any time you get more franchisees involved in the system, you're going to have more influence from those franchisees." Thus, a few years from now, Denny's may cease to be such a company-dominated system.

4.3 Pizza Hut: from complete to limited veto power

Pizza Hut is a system that is going in the opposite direction from Denny's.[19] Initially, the chain was mostly franchised, and most franchisees have been in the system for decades. Because franchisees are so experienced, the chain is less concerned about compliance violations and exercises much looser control than does Denny's Corp., whose franchisees are mostly newcomers.[20] Franchise terminations almost never occur (only one during 1992-4), and the chain inspects stores only one to three times per year. Franchisees are also very well organized and communication networks are well established.

Until only a few years ago, franchisees exercised enormous power over the Pizza Hut system through the International Pizza Hut Franchise Holders Association (IPHFHA), an organization that still exists but is now weaker. In the Pizza Hut franchise contract, advertising decisions are made by a committee made up of two franchisees and two company representatives. When a disagreement occurs, the deciding vote belongs to the side with the majority of stores. For many years, λ remained steady at 51 to 52% and franchisees controlled advertising decisions. Effectively, they therefore possessed complete veto power, since no new program can be implemented without proper advertising. Franchisees were also very actively involved in innovation.

Then, in the 1980s, PepsiCo purchased Pizza Hut, and it moved to increase both the company presence and the company's authority in the system. Now[21] λ has fallen well below 50%, and franchisees can no longer withhold advertising. They therefore no longer possess complete veto power. Thus, PepsiCo has asserted the ability of the chain to determine the strategic direction of the Pizza Hut system. Franchisees may not appreciate such reduced power, but most appreciate the benefits that an increased company presence has brought. PepsiCo brought creativity to the company (F1), which is now responsible for most innovation.

F1 and F3 note that with the larger company presence, they are more easily persuaded that company initiatives will be beneficial. Franchisees do possess limited veto power. (The franchise contract protects franchisees from requirements that are stricter than those applied to the now

[19]This analysis is written from the perspective of 1996. In the last two years, Pizza Hut has reversed this trend, after yet another corporate take-over by Tricon.

[20]Most compliance problems involve not agency issues, but simple incompetence or a lack of franchisee experience. Chains will, for example, inspect a new franchisee very frequently and insist on strict compliance. Once he has settled in and proved himself reliable, they will allow him more independence. Pizza Hut's FBR comments "Franchisees have a lot of experience, a lot of knowledge, and tenure out there. We respect that." F1 notes that "Most of the time, if you've been in the system for a long period of time and you're a good operator, there are a lot of things that you can do that you don't have to ask."

[21]Recall that we write this from a 1996 perspective.

numerous company stores.) One would think that this would be sufficient to eliminate conflict between franchisees and the chain, but some conflict still exists, especially over price-points (described in section 3). Franchisees also express distrust of career-oriented company personnel who are new to the system (F1, F3), or they simply fear that the company will make careless mistakes (F2). Just as Denny's Corp. is learning to make franchisees more equal partners, Pizza Hut franchisees are getting used to their new place in a company-dominated system.

4.4 Kentucky Fried Chicken: complete veto power under dispute

Like Pizza Hut, KFC is an historically franchise-dominated system, which recently acquired a larger company presence after its purchase by PepsiCo. However at KFC, franchisees have been able to retain their power despite PepsiCo's wishes. KFC began as a system of franchises and only later added company stores. Like Pizza Hut franchisees, those at KFC have extensive experience and enjoy great autonomy, more than in any other chain in this study. The chain usually performs inspections only once or twice a year, and at times, new products have spread among franchisees, to be approved by the chain only later.[6] Even today, franchisees dominate innovation, although the chain provides organizational support. KFC views its franchisees as an important source of ideas and expertise.

At KFC, franchisees possess complete veto power. First, they control the National Advertising Committee (NAC). Second, according to the 1976 franchise agreement, the chain cannot make a new product mandatory unless the product is already adopted in 70% of the system. At times, the chain has been forced to offer franchisees special deals in order to obtain the necessary fraction of voluntary compliance.

When PepsiCo bought KFC in 1986, it sought to enhance the chain's power to make decisions unilaterally and easily by eliminating complete veto power. First, PepsiCo moved to reduce λ, buying up several hundred franchised stores. Second, it introduced a new franchise contract, which required only 30% participation for a product to become mandatory, and which established a one-store-one-vote system for the NAC. Because the chain now owns more than 30% of stores, the new contract would have resulted in a new regime of only limited veto power (for new products). According to this contract, KFC Corp. could mandate any new program it desired simply by implementing it in company stores. Franchisees also feared that λ would fall below 50%, eliminating franchisee control over the NAC (another expression of complete veto power). Franchisees sued. After several months of litigation, PepsiCo settled, and for now, franchisees retain both the 70% criterion and guaranteed control over advertising decisions.[22] Thus, complete veto power was reestablished. The chain agreed to this settlement because, apparently, it did not want to jeopardize its relationship with franchisees by going to court (F2).

Despite this recent legal conflict, the effects of the PepsiCo takeover and the fall in λ have not been entirely negative; the growth of the company sector has ameliorated another source of conflict and has enhanced trust in the system. F1 notes that a basic conflict of interest exists

[22]In the settlement, PepsiCo agreed that the wording of the 1976 contract (the 70% criterion) would remain in force until the year 2000. After this, PepsiCo can change the contract in an agreed upon fashion (not unilaterally). In addition, the NFAC (National Franchise Advisory Council) and the NAC are to be combined to form a new body called the NCAC (National Council and Advertising Cooperative). This will contain 13 franchisees and 4 company representatives. (Franchisees maintain a majority.) In this way, franchisees need not fear a change in their relative power over advertising. Any change in the contract must be presented to the NCAC. If no agreement is reached, they must submit to arbitration. If arbitration fails, then the new contract will be implemented, but franchisees may resume their lawsuit.

between franchisees and the chain, since the chain benefits from royalties and is not affected by franchisee costs (as section 3 demonstrates). This has made franchisees distrustful of the chain. Franchisees are also fearful of corporate blunders. In recent years, the level of trust has improved, as has the chain's contribution towards innovation. At KFC, franchisees have been able to enjoy these benefits of a reduced λ while at the same time retaining their power over decision-making.

4.5 Burger King: some complete veto power

Burger King is also a franchisee-dominated system, and it was also taken over in the late 1980s. In this case, however, the new owner, Grand Metropolitan, moved to push λ even higher. Since its offices are in Florida, Burger King consolidated the company presence on the East Coast and sold all West Coast stores to franchisees. The chain now owns only 7% of stores.

Franchisees have little formal power over system-wide decisions at Burger King, with the exception of changes in the current image, which must be negotiated with the Franchisee Advisory Council. We would therefore say that Burger King franchisees formally have "some complete veto power." In other words, there are some decisions over which they have a veto, but for the most part, the chain acts unilaterally. Unlike at the other chains described above, Burger King franchisees do not formally possess limited veto power.

Because the company presence is so small, franchisees are responsible for most innovation. In contrast with the three chains discussed above, at Burger King, even most product testing now takes place in franchises. Thus, in addition to their formal power in current image decisions, franchisees play an informal role in product development decisions. Nevertheless, most franchisees place most of their emphasis on operations, and strict operations standards allow little room for creativity (F4).

The reduction in the company presence has not pleased all franchisees at Burger King. Although F3 appreciates the increased freedom franchisees have (because fewer company personnel are around to interfere with operations), F1 and F4 are not so positive. According to F1, the company now cannot find competent personnel to act as franchise consultants, and it has unfairly shifted the burden of innovation onto franchisees. The necessary balance between the franchised and company-owned sectors has been upset. F4 says that "they're going to put an end to Burger King." He feels that "it's healthy to have a balance" between the two sectors. "As a result of not having enough stores," the company cannot "see what things work and what things don't work before they release them into the system... Their test data isn't valid anymore."

The rise in λ has also increased franchisee distrust for the chain. As at KFC, the possible divergence between the top line (revenues) and the bottom line (profits) is a source of concern at Burger King. The chain cannot easily persuade franchisees to go along with its ideas simply by adopting these ideas in company stores to demonstrate its commitment. As F3 says, "It doesn't hold much water unless you're around a lot of company stores."

4.6 Subway: the importance of informal authority

Finally, at the other extreme, Subway is composed entirely of franchised stores, and has always had this structure.[23] Thus, this system is not truly a plural form. It is included to provide contrast and to illustrate how the presence of company stores changes the relationship between franchisees

[23] Occasionally Subway does own a few stores, but only temporarily after nonrenewal or termination of a franchise, while the chain is looking for a new franchisee to take over the store.

and a chain. Subway also differs from the other systems studied here in its sheer simplicity. The parent company, Doctor's Associates, Inc. (DAI) is a small, private corporation with very few employees. Even the people who supervise franchisees in the field are not employees, but independent contractors called development agents.

Subway franchisees are small business owners, almost all of whom are actively involved in day-to-day operations. Subway does not assume a great deal of business experience on the part of its franchisees, and it limits their autonomy in many areas. For example, franchisees must purchase or rent all major items of equipment through DAI's affiliate Subway Equipment Leasing Corporation (SELC). Rather than a franchisee paying royalties by check, she must pay by automatic withdrawal from her checking account. Finally, franchisees cannot lease their stores directly from a property-owner, but must sublease their stores from DAI. DAI can evict franchisees who violate company standards.

Despite the often paternalistic attitude of DAI toward individual franchisees, as a group, franchisees do exercise some voice over the Subway system, especially over advertising.[24] The chain also receives advice from the Subway Franchise Owners Advisory Council (SFOAC). The SFOAC has no formal power. Nevertheless, because DAI does not run its own stores, it depends heavily on franchisee input in making decisions. The SFOAC's help can also be very important in winning over franchisees to the chain's point of view since franchisees are often skeptical of the chain's expertise.

Therefore, we find at Subway a system in which the formal power of the chain is very great, but franchisees possess a great deal of informal authority due to their superior knowledge of the business. Formally, franchisees have no veto power, but informally, they have some complete veto power, much like their colleagues at Burger King.

5 Confirming Some Basic Predictions

We have analyzed five different systems, each of which utilizes a different strategy to maintain a balance of power and interests between franchisees and the chain. When we combine these observations, we find that the results are remarkably consistent with the predictions made in section 3.[25]

5.1 Veto power

Perhaps the most interesting empirical results are those regarding veto power. Table 3 summarizes the control right structures in the five chains in this study. In the table, "some complete" indicates that franchisees have the power to veto some proposals coming from the chain, independent of whether these proposals are adopted in company stores. For example, Burger King must consult its franchisees about any changes to the current image. We also distinguish between formal and real veto power. In some chains, such as Denny's and Pizza Hut, control rights are spelled out clearly

[24] Most advertising is administered by the Subway Franchisee Advertising Fund Trust (SFAFT). SFAFT's board of trustees consists of 12 elected franchisees. Nevertheless, DAI may choose to use some advertising funds itself, rather than allocating all money to SFAFT. Therefore, the chain does not depend on franchisee approval of its advertising campaigns.

[25] Note that, although the model described here is dated 1998, in its original form it was formulated in 1994 as the first part of my dissertation (Lewin [16]), *before* any case studies were conducted. The basic predictions given here are unchanged from those of that original model. These case studies were specifically designed to test the model's predictions, as well as to enrich it intuitively.

	Subway	Burger King	KFC	Pizza Hut	Denny's
λ **1988**	99%	85%	74%	51%	19%
1995	100%	93%	61%	42%	39%
formal veto power	none	some complete	complete	limited	limited
real veto power	some complete	limited, & some complete	complete	limited	limited

Table 3: Veto power allocations in five chains

in the franchise agreement. At Subway and Burger King, however, informal power stemming from asymmetric information is more important to franchisees than their formal power, which is very limited.

It is striking how the control right structures do indeed correlate with λ just as the model would predict. In the chains with the lowest levels of λ, formal veto power is limited. For higher levels of λ, either franchisees have no formal veto power, or they have at least some degree of complete veto power. However for the high λ firms, limited veto power is not formalized. At KFC, Pizza Hut, and Denny's, limited veto power is established formally in the franchise contract. At Burger King, this power is maintained through informal norms instead (though its benefits are limited at $\lambda = 93\%$).

Limited veto power always exists at least informally, since franchisees take this power for granted. If the contract provides a guarantee, then franchisees are appreciative, but formalization is not essential. In fact, many franchisees are not even aware of whether this power is formalized or not — they just assume that the chain would not violate the principle of equal treatment.

Limited veto power operates as such a strong social norm,[26] that any chain that violated it would do so at its peril. Such an action would be viewed as a breach of trust, and it would cause substantial upset among franchisees. As Pizza Hut's F3 says,[27] "You would be breaking with tradition. You know that franchisees would get upset. Why would you do that?" Getting franchisees upset would disrupt the relationship between franchisees and the chain, and this disruption would undermine the productivity of the system. KFC's OMB comments, "I could make you, as an operator, put in a product you hated, but I can't make you sell it or make it right. You have to have their hearts and minds to be successful... The contract enters as an exception."

Yet, most chains still write limited veto power into their contracts, perhaps because, as Baker, Gibbons, and Murphy [3] have observed, even when contracts are implicit, formal power is important because it influences agents' incentives to adhere to their informal commitments. As long as veto power is not formalized, franchisees always face the risk that the chain will change its policies. When asked why KFC franchisees are so concerned about the new franchise agreement (which reduces their formal power), KFC's F2 notes, "When you have something, you don't want to give it up. It may work today, but you just don't know who the owner is going to be, so you want your contract to be strong."

Of course, table 3 includes only 5 chains. However, a preliminary analysis of a 1999 study of 40 chains tells a similar story. Of 32 chains containing a significant number of company stores,[28]

[26]Except at Subway, which has no company stores

[27]See section A for a directory of code-names.

[28]Chains were excluded from this category if from 1994 to 1998, they continually maintained $\lambda \geq 99\%$ or had no

17 (53%) formalized limited veto power in their contracts. Moreover, among the 12 chains with $\lambda \leq 80\%$, franchisees in all but one had such power. The average λ among all 40 chains was 81%. However, among the 7 chains with some degree of formalized complete veto power, the average λ was 94%.

5.2 Trust and Credibility

We have noted that chains value their relationship with franchisees. Even when franchisees do not formally have any complete veto power, chains prefer to win over franchisees by persuasion, not coercion. This persuasion is particularly important when information is not as perfect as has been assumed in the model cited here. For persuasion to be effective, franchisees must believe what they are told. Often, they do so because an atmosphere of trust exists in the system. We mean by trust an expectation by one party that another party will behave in a more benevolent manner than contractual obligations require. When cultural norms are not sufficiently strong to create this sort of trust, the chain may still be credible in the eyes of franchisees if structural conditions provide it with an incentive to make good decisions. A low level of λ plays an important role in engendering such credibility.

A large number of participants acknowledge the fundamental conflict of interest between a franchisee and a franchisor: the top line and bottom line can diverge. At Denny's and Pizza Hut, a low level of λ contributes to the confidence franchisees feel about the company's decision-making. Denny's F2 comments: "Denny's is kind of in a unique situation in that they are not just the franchisor. They have a thousand of their own stores, and there's only 500 franchised stores. So when we get into talking about operations, or how things are affecting the bottom line, they have a lot of input as well, because they don't want to lose money either." By contrast, at Burger King franchisees are more skeptical of the chain, because it now owns so few stores, and in many regions there are no corporate stores at all.

5.2.1 How Company Stores Persuade

Franchisees use the chain's adoption of a project in its own stores as a signal of the project's merits when λ is sufficiently small. When the company sector is large, the chain will be careful not to adopt inefficient projects and will be conscious of a project's impact on costs. When λ is large, the chain might not be so careful and may even be opportunistic. We therefore expect that franchisees will be more distrustful when λ is large, and that adoption in company stores will be less effective as a signal. (See Lewin [18] for a rigorous statement of this claim.) The interviews provide support for this prediction.

Clearly, at Subway, company adoptions can play no role in persuasion, since there are no company stores. At Burger King, franchisees generally do not find company adoptions very persuasive because, they say, the company sector is too small. As F3 comments, "it doesn't hold much water unless you're around a lot of company stores."

By contrast, at KFC and Pizza Hut, franchisees do acknowledge the persuasive importance of company adoptions. When asked whether the company ever uses the argument "We're doing it, so you should trust us that it's a good idea," Pizza Hut's F1 says, "I think the more company stores a franchisor has, the more likely that rationale is to be listened to. I think that we have a tendency to listen to it in the Pizza Hut system, because they operate, now, more restaurants than we do, so the fact is, they are going to try to make the best decisions to grow their sales and profits."

more than one company store.

Nevertheless, this persuasion is not conclusive because of the differences in market environment between franchised and company stores.

The case of Denny's is more complicated. One would think, a priori, that company adoptions should play the most persuasive role at Denny's, since historically, it is the most company-dominated chain. The responses of company employees coincide with this prediction. DFS and FSM both consider the participation of company stores to be important in persuading franchisees to participate in optional programs. As DFS says, Denny's adopts projects in its own stores as well because "We're obligated to show them the results, as opposed to going into an idea blindly." FSM notes that if franchisees "feel that it could affect their profit margin, they're more likely to sit back and wait to see if it's successful at the company." Then franchisees will follow suit. However, both DFS and FSM persuade their franchisees primarily by arguing that a change will raise profits. Franchisees agree, and they downplay the importance of company stores in persuasion. Adoption in company stores has some persuasive value, but it is not conclusive. The main way they persuade, says F4, is "Be successful at what they do."

Of course, this persuasion is effective precisely because the company sector exists. Franchisees know that, in the words of F2, "They don't want to lose money either." Thus, whereas the presence of company stores is important in engendering franchisee confidence in the chain's judgment, the actual experience of franchisees is not one of being persuaded by adoptions in company stores, but rather, one of being persuaded by the facts.

6 Some More Complex Results

Section 5 demonstrates the fundamental consistency between the model and the interview results. Nevertheless, no model can encompass everything, and the interviews bring to light certain interesting complexities of franchise systems which are not emphasized in section 3.

6.1 The Cooperative Nature of Innovation

We begin by recalling that, due to the requirements of theoretical simplicity, section 3 adopts a very stylized (black-box) view of the innovation process. The chain develops projects in its R&D and marketing departments, and then it may or may not have the authority to mandate adoption of these projects. We have not discussed precisely how projects actually come into being or, more importantly, how initial ideas are refined and transformed into concrete proposals. In reality, innovation is a complex, cooperative process in which no one actor can claim full credit for the outcome.

Much (though not all) of the synergism of the plural form comes from the fact that franchisees and the chain make different contributions. KFC's F1 comments, "If we were a total franchise system, I don't think we would be as dominant a player, nor would we be as innovative as we are... because a company operation has a different set of perspectives and a different set of goals than a franchise operation. I think it takes both kinds of goals and perspectives interplaying together. I think there's a synergism of the two that offers us real advantages."

Often, franchisees are the source of an idea, but without the company's R&D resources, the idea could never come to fruition. On the flipside, the company may depend on its franchisees for feedback about the merits of an idea. KFC's FOM notes that company marketing personnel can make mistakes, and often it is the franchisees who "scream and yell" until the mistake is corrected. Similarly, Pizza Hut's FBR comments, "We'll have a program, and we'll test it in a lot of company

markets, but we won't have a lot of company people putting their fingers on it... We have our franchisees as a resource."

The cooperative nature of innovation appears to lie at the root of much of the informal power in these systems. Whereas formal power is contractual, real power accrues to those who have knowledge (Aghion and Tirole [1]; Lewin [17]). Even at Subway, where franchisees officially have almost no power, in effect they wield enormous power, since the chain depends on their advice to make decisions. Innovations that originate at Franchise World Headquarters are always tested in the field, and franchisees provide feedback. Thus, it is quite uncommon for Subway to mandate a change with which franchisees are unhappy. As DA notes (and franchisees agree), "If a decision isn't working out, we'll modify it or change it."[29] Burger King's F1 expresses frustration that the chain is not taking responsibility for testing ideas itself. But clearly, when tests take place in franchises, franchisees acquire power over the test results. Innovation at Burger King is now in practice dominated by the franchisees, even if the chain has formal control.

6.2 Endogenous Power: The Importance of Informal Authority

This informal source of franchisee power is especially important in chains where λ is high. In fact, franchisee power seems to evolve almost automatically as λ changes.

Three things happen as λ rises. First, franchisees become more numerous, and consequently tend to become better organized. This phenomenon is especially evident at Denny's, where interfranchisee organization and communication have improved dramatically in recent years as the franchise sector has grown. Second, the chain becomes less competent when compared with its franchisees. In high-λ firms, franchisees are less confident about the expertise of the chain, and they are more likely to question the judgment of company personnel. Subway's F2 comments that franchisees "run their stores, they know the daily problems, daily operations. What you run into a lot with headquarters is they are not actually equal to that because they're not in their own stores." Third, the chain becomes more dependent on its franchisees to test new ideas. At Denny's and Pizza Hut, all testing takes place in company stores. By contrast, at Burger King and Subway, almost all testing takes place in franchised stores.

Thus, the chain may encourage franchisees to organize and share in the costs of innovation, but it must then accept the consequences. First, the chain loses expertise relative to its franchisees, and it becomes much more dependent on franchisee advice. The chain's power therefore erodes. Second, and more important, if franchisees form coalitions to overcome the collective action problem posed by innovation, they will surely make use of these coalitions to overcome other collective action problems in which the chain's interests and their interests conflict. As a result, franchisees will acquire some (informal) complete veto power, and the chain may be unable to implement all of its chosen programs, even some efficient ones (category A).

Nevertheless, one should not exaggerate the magnitude of informal authority in these systems. Recall that in table 3, the difference between formal and real power is noticeable but not drastic. Although franchisee power does to some degree evolve automatically as λ changes, institutional contraints remain important, as does the formal franchise contract. For example, whereas Denny's franchisees no doubt have more influence than they once had, the chain still has the power to make decisions unilaterally. No chain brings out the importance of the formal contract so much as KFC, where franchisees were willing to go to court rather than accept a new franchise agreement. (Of

[29] Part of the reason for Subway's cooperativeness may be their ongoing quest for new franchisees. When a chain is expanding, the reputation cost of opportunism may be sufficient to protect franchisees, even if they have no formal or informal power.

course, the chain was willing to settle rather than damage its relationship with franchisees, and so informal norms remain important even here.)

6.3 The Conflict That Comes From Cooperation

Although the cooperation mentioned above is extremely productive, it may also lead to conflict. At times, franchisees may want the chain to put energy into developing an idea, but the chain may not view such development as a high priority.

This divergence of priorities derives mostly from the geographical differences between the company and its franchisees. As mentioned in section 3, franchised stores are often located in smaller towns and rural areas, whereas company stores are normally in large cities. Thus, certain space-intensive practices such as buffets may be good for franchised stores but impractical for company stores. The chain may not act on those ideas to refine them and disseminate them because in the absence of adoptions in company stores, it may not have a sufficient incentive to invest its own resources.[30] The same problem may occur simply because λ is high, and the chain does not have enough stores of its own to reap sufficient benefits from developing ideas.

6.3.1 An Institutional Substitute for Side-payments

When franchisees want an idea developed and the chain does not want to exert the effort, one might think that side-payments could solve the problem. We do not observe such side-payments in practice. One reason for this may be that franchisees prefer to be unable to bribe the chain so that the chain will not expect bribes. However, another reason for the absence of such side-payments is that franchisees can achieve a similar result through other means.

In chains with high levels of λ, franchisees often create their own research committees to explore issues of franchisee concern, and some franchisees are actively involved in the innovation process on a more systemic level. One important example is Burger King. Franchisees there express frustration that, whereas the chain had been more involved in innovation when λ was 85%, now that λ has risen to 93% the chain has placed most of the innovation burden on franchisees. Nevertheless, innovation does take place. Perhaps this innovation is dampened due to free-rider problems, but explicit side-payments are apparently not absolutely essential. By organizing, franchisees effectively mimic the outcome that would arise if side payments did occur, since they share the cost of developing an innovation. Explicit side-payments would of course be somewhat different, since franchisees would not retain control over the innovation process as they do when they organize. Thus, franchisees might prefer to organize on their own, rather than bribing the chain to do research on their behalf.

Recall, however, that even if franchisee organizations can prevent systemic innovation from stagnating in high-λ chains, a high λ generates other costs. When λ is very high, the chain will delegate most productive innovation to franchisees while its own innovation will be heavily biased toward projects such as B described previously — unless franchisees are powerful enough to prevent the chain from acting opportunistically. In such circumstances, the case for complete veto power becomes very strong indeed.

[30] Such was the case at KFC when franchisees with buffets wanted to install dishwashers. The chain was initially totally uninterested, since few company stores had buffets. (FOM)

6.4 Balancing the Two Sectors

The discussions above all point to a single conclusion: that it is important to retain a balance between franchised and company-owned stores. Either too few or too many franchised stores will undermine the effectiveness of a franchise system.

6.4.1 The Importance of a High λ

A large franchise sector is desirable because of its effect on franchisee creativity. Because franchisees are normally more powerful in chains with high levels of λ, franchisees in these chains are more enthusiastic about innovation; they are confident that their ideas will be heard. Many franchisees at Subway, Burger King, and KFC appear to be highly conscious of the important role that they play in innovation because of their sheer numbers and their collective voice. By contrast, at Pizza Hut and Denny's, the chains with lower franchisee presences, franchisees are less innovative because they feel that the chain is responsible for these efforts.

At Pizza Hut, F1 and F2 comment that since the fall in λ, franchisees have become less innovative because, says F2 , "I think franchisee ideas were more accepted by the company before [PepsiCo took over]." Franchisees used to have more power. DFO notes that, just after the PepsiCo takeover there was a period during which franchisees were discouraged from being innovative, as PepsiCo asserted company control over the system. However, the situation has recently improved, as PepsiCo's attitude towards franchisee involvement has mellowed.

Similarly, at Denny's, although the chain seems to encourage its franchisees to be innovative, this innovation is seen as less important than that emanating from the chain, and franchisees generally believe that the corporation thinks that it knows best. In recent years, as λ has risen, franchisee involvement has expanded and they have become better organized, because now franchisees feel that they are a more important part of the system and the chain now encourages franchisee innovation more than it did in the past. Here, the corporation changed its attitude towards franchising in general, and this change led both to an expansion of the franchise sector and to a greater acknowledgment of franchisee contributions to the system.

6.4.2 The Importance of a Low λ

Nevertheless, if the company presence becomes too small, franchisee innovation can become depressed for another reason: a high λ discourages the chain from being an active and responsible partner in the innovation process. Both the absolute and the relative numbers of company stores are essential for effective cooperative innovation. A high absolute number is needed to assure competence, but a high relative number is needed to assure that there is sufficient company expertise to administer the franchise sector effectively. Burger King's F1 comments that the rise in λ has "resulted in significant inabilities to staff the supervisory positions that interface with franchisees."

A large company presence also raises the chain's incentive to invest its own resources in a franchisee's idea. The most innovative franchisees are those who feel that the chain takes their ideas seriously, provides encouragement, and approves good ideas. Some evidence does exist for a positive effect of a low λ on chain responsiveness. Statements like this come from Burger King's R&D; KFC's FOM, F1, F2, and F3; Pizza Hut's DFO and F1; and Denny's F2 and F4.

KFC and Pizza Hut have a special protocol called the "SET Process" (Standard Exceptions Test). A franchisee with an idea submits a "SET request." The chain then evaluates the request,

possibly refines it, and then decides whether to give a franchisee the go-ahead to try it out.[31] The ability to benefit from implementing an idea in company stores plays an important role in encouraging such active participation by the chain. As KFC's FOM comments, "At some point, when the company needs that idea for 2000 [company] restaurants, then it'll be a big idea." Especially at KFC, franchisees believe that their ideas are very important and will not often be rejected.

At Denny's, franchisees work under stricter limitations and know which ideas they need not even propose (new products). Nevertheless, franchisees report that corporate representatives help franchisees to refine more modest ideas. For example, the chain cooperated with F1 on developing a new menu for people with dietary limitations. This help is very motivating. "They not only encourage you, they help you. That's what the franchise partner is for," says Denny's F4. F2 comments, "They're kind of silently encouraging me to try it... If I run a test and I like it, I can roll it tomorrow. So, they can use that ability of mine, to fiddle around with something, to test and find out how it works, to their advantage." The chain treats its franchisees as a resource, and to this extent the presence of company stores makes the chain more, not less receptive to franchisee ideas.

We thus arrive at another purpose for the plural form. Franchisees are most innovative if λ is high enough to make franchisees feel important, but low enough that the chain has a significant stake in the innovation process. The most innovative chains are those whose levels of λ fall in the middle range, not at the extremes (Bradach [5], p. 163).

7 Conclusions

This paper has highlighted two primary functions of the plural form. First, the existence of a company sector safeguards the interests of franchisees by aligning their interests with those of the chain. Such alignment is necessary because neither franchisees nor the chain receives the actual social benefit of projects adopted in franchised stores. When franchisees are too numerous relative to company stores, a chain must choose between two extreme control right structures: one in which franchisees have tremendous power and another in which they have almost none. When franchisees have power to block any innovation they do not like, the result may be excessive delays in adoption of efficient innovations which franchisees dislike. When franchisees have no power at all, the chain may force adoptions of inefficient innovations that yield good revenues. However, if a chain contains a sufficient core of company stores, a third arrangement becomes feasible: one in which the chain can implement innovations unilaterally, but only if they do so chain-wide. As long as the company sector is sufficiently large (and what we mean by this will differ from chain to chain), such an arrangement protects franchisees while at the same time not allowing them to act as a road-block in front of the chain's desired programs.

The plural form also serves a second role. Innovation is a collaborative endeavor involving both franchisees and the chain. If either the chain or franchisees own too few stores (λ is too low or too high), then one or the other will become excessively passive in the innovation process, and adaptation will suffer. Previous work has used joint production to explain the coexistence of franchised and company stores,[32] but such papers have not dealt with the relationship between innovation and authority, which is our main focus here. The interviews reveal that collaboration

[31] One example is KFC's buffet. Each franchisee that offers one requires "dispensation from corporate" (FOM).

[32] See Bai and Tao [2], Gallini and Lutz [11], Lutz [19], and Scott [23].

is very important, but also that its existence results in informal power. Such power will in turn affect the efficiency of decision-making. For example, if franchisees have great informal power, the chain will have difficulty implementing efficient programs, just as when frachisees formally possess complete veto power.

Therefore, a focus solely on allignment of interests, or solely on joint production, cannot provide a full picture of what makes the plural form effective. Ahead lies the challenge of integrating these two phenomena theoretically to create a more dynamic theory of the plural form.

A The People Interviewed

Below is a directory of people interviewed, including their code-names. The code-names are set in sans serif type to avoid confusion with acronyms, which are set in normal type.

Note: If stores are leased from the chain, this is indicated below. Otherwise, one may assume that they are leased from other property owners, such as shopping centers.

A.1 Subway

Note: All franchisee stores are leased or subleased from Subway.

PR: Public Relations Assistant at Franchise World Headquarters.
2 years with Subway.

DA: Development Agent. 9 years with Subway.

F1: Franchisee for 9 years. 2 stores.
Member of Subway Franchise Owners Advisor Council (SFOAC).

F2: Franchisee for 5 years. 3 stores. Member of SFOAC.

F3: Franchisee for 2 years. 1 store.

F4: Franchisee for 3 years. 1 store. Chairman of local advertising fund committee.

A.2 Burger King (BK)

R&D: Vice-President of Brand Research and Development for 2 years. 14 years with BK.

FM: Franchise Manager. 22 years with BK.

F1: Franchisee. 10 stores. 9 owned, 1 rented.
Member of Ops Tech (Operations Technical Committee of the National Franchise Association). 25 years with BK.

F2: No interview.

F3: Franchisee for 10 years. 4 stores. 3 owned, 1 rented from BK.

F4: Franchisee for 4 years. 2 stores. 1 owned, 1 rented.

A.3 Kentucky Fried Chicken (KFC)

OMB: Senior Vice President and Ombudsman. 26 years with KFC.

FOM: Franchise Operations Manager. 27 years with KFC.

F1: Franchisee. 36 years with KFC as employee and then as franchisee. 5 stores. 2 owned, 3 leased. Member of National Franchise Advisory Council (NFAC).

F2: Franchisee for 9 years. 7 stores total. 5 owned, 2 rented. In NFAC.

F3: Franchisee for 30 years. 4 stores. All owned.

F4: Franchisee for 11 years 4 stores. 2 owned. 2 leased.

A.4 Pizza Hut Inc. (PHI)

DFO: Director of Franchise Operations.
Oversees franchise business representatives (FBRs). 18 years with PHI.

FBR: Franchise Business Representative. Reports to DFO.
25 years with PHI, all in operations.

F1: Senior Vice President of Operations and owner in a corporate franchise. 99 stores. Some owned, some rented. Active in International Pizza Hut Franchise Holders Association (IPHFHA). 29 years with Pizza Hut, both with IPHFHA and as a franchisee.

F2: President-CEO and owner in a corporate franchise. 45 stores. All owned. 24 years in business. Served on the National Franchise Board.

F3: Vice President of Operations in a corporate franchise. 36 stores. 26 rented, 10 owned. 30 years with Pizza Hut. Gets a percentage of profits as a bonus.

F4: No interview.

A.5 Denny's

DOD: Director of Development. 1 year with Denny's.

DFS: Director of Field Services. 7 years with Denny's.

FSM: Franchise Services Manager. 13 years with Denny's.

F1: Franchisee for 5 years in corporate franchise. 4 stores. 3 owned, 1 rented. Member of Franchise Advisory Board (FAB).

F2: President and owner for 6 years in a corporate franchise.7 stores. 5 rented, 2 owned. Member of FAB.

F3: Franchisee for 4 years in corporate franchise. 2 stores.
Subleases from Denny's (stores were company-owned before.)

F4: Franchisee for 6 years with corporation. 5 stores, all owned.

References

[1] Aghion, P., and Tirole, J. 1997. Formal and real authority in organizations. *Journal of Political Economy* 105(1): 1-29.

[2] Bai, C., and Tao, Z. 1996. A theory of contract mix and multiple ownership structure. Unpublished paper, Boston College.

[3] Baker, G., Gibbons, R., and Murphy, K. J. 1997. Implicit contracts and the theory of the firm. Harvard Business School Working paper 98-009.

[4] Beales, J. Howard III, and Muris, Timothy J. 1995. The foundations of franchise regulation: Issues and evidence. *Journal of Corporate Finance* 2: 157-97.

[5] Bradach, J. L. 1998. *Franchise Organizations.* Boston: Harvard Business School Press.

[6] Bradach, J. L., and Eccles, R. G. 1989. Price, authority, and trust: From ideal types to plural forms. *Annual Review of Sociology* 15:97-118.

[7] Brickley, J. A., and Dark, F. H. 1987. The choice of organizational form: the case of franchising. *Journal of Financial Economics* 18:401-20.

[8] Brickley, James A., Dark, Frederick H., and Weisbach, Michael S. 1991. The economic effects of franchise termination laws. *Journal of Law and Economics* 33: 101-32.

[9] Caves, R. E., and Murphy, W. F. 1976. Franchising: Firms, markets and intangible assets. *Southern Economic Journal* 42:572-86.

[10] Dnes, A. W. 1996. The economic analysis of franchise contracts: Survey Article. *Journal of Institutional and Theoretical Economics* 152(2): 297-324.

[11] Gallini, N. T., and Lutz, N. A. 1992. Dual distribution and royalty fees in franchising. *Journal of Law, Economics and Organization* 8:471-501.

[12] Holmstrom, B., and Milgrom, P. 1994. The firm as an incentive system. *American Economic Review* (84)4: 972-91.

[13] Katz, B. G., and Owen, J. 1992. On the existence of franchise contracts and some of their implications. *International Journal of Industrial Organization* 10(4):567-93.

[14] Lafontaine, F., and Slade, M. E. 1996. Retail contracting and costly monitoring: Theory and Evidence. *European Economic Review* 40(3-5):923-32.

[15] Lafontaine, F., and Slade, M. E. 1997. Retail contracting: Theory and Practice. *Journal of Industrial Economics* 45(1): 1-25.

[16] Lewin, Shira B. 1997. *Innovation and Authority in Franchise Systems: Toward a Grounded Theory of the Plural Form.* Ph.D. Thesis, Harvard University.

[17] Lewin, Shira B. 1998. "Autonomy, Contractibility, and the Franchise Relationship." Working paper, Iowa State University.

[18] Lewin, Shira B. 1998. "The Plural Form: A Synergism of Market and Hierarchy." Working paper, Iowa State University.

[19] Lutz, Nancy A. 1995. Franchising and company ownership in multi-store retailing. Unpublished paper, Virginia Polytechnic Institute.

[20] Maness, R. 1996. Incomplete contracts and the choice between vertical integration and franchising. *Journal of Economic Behavior and Organization* 31(1):101-115.

[21] Mathewson, G. F., and Winter, R. A. 1985. The economics of franchise contracts. *Journal of Law and Economics* 28(3): 503-26.

[22] Norton, Seth W. 1988. An empirical look at franchising as an organizational form. *Journal of Business* 91(2, April): 197-218.

[23] Scott, F. A., Jr. 1995. Franchising vs. company ownership as a decision variable of the firm. *Review of Industrial Organization* 10(1):69-81.

[24] Thompson, R. S. 1992. Company ownership vs. franchising: Issues and evidence. *Journal of Economic Studies* 19(4):31-42.

[25] Walker, G., and Weber, D. 1984. A transaction cost approach to make-or-buy decisions. *Administrative Science Quarterly* 29:373-391.