

# A Preliminary Investigation of Ownership Conversions in Franchised Distribution Systems

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## Abstract

*Franchised business networks consist of corporately managed and independently owned channel outlets. This analysis employs transaction cost economics and agency theory to explain net ownership shifts between franchisors and franchisees. Hypotheses are developed and a preliminary test is made using secondary data. The results indicate that net conversions to franchisor ownership are associated with quality control factors, projected growth, and revenues.*

## Introduction

Franchising represents an important distribution strategy, and the level of franchising is rapidly growing (*Franchising in the Economy*, 1971-1986). Managers of these channel systems evaluate the benefits and disadvantages associated with alternative contracts. *Independent agents* have high powered market incentives but are inclined to reduce their costs by limiting quality. In mobile markets all agents bear the burden of inferior service offered by a single outlet. *Integrated agents* offer greater control over distribution systems but shirk responsibilities by reducing operating hours and otherwise limiting performance. Moreover, internal agents have motives to influence company decisions to affect distribution of resources (Pfeffer and Salancik, 1978). Such actors may take part in collusion and other sub-optimal activities to maximize personal welfare.

While some networks employ independent or integrated agents exclusively, multiple forms of contracting are often employed by the same firm. For example, Kentucky Fried Chicken operates 1909 company-owned stores along with 5680 franchises (*Entrepreneur*, 1989). Information gained from internal agents about product and service quality enables a company to monitor franchisees. In addition, knowledge gained from franchisees enables the firm to control internal agents. Thus, firms can utilize information gained in one contractual form to manage its intra-system rivals (Harrigan, 1984). Despite the advantages offered through these multi-contract systems, analyses of the phenomenon have been limited (cf. Weiss and Anderson, 1992).

The purpose of this research is to analyze changes in

ownership in franchised distribution outlets. Institutional economics primarily addresses the amount or likelihood of integration, but analyses which address changes in the boundary of the firm are rare (Walker and Poppo, 1991). We offer a preliminary investigation of ownership changes in franchised distribution channels. The paper proceeds as follows. The next section highlights recent theoretical contributions in multi-contract channels. We subsequently present a model of franchise ownership changes. After reporting the results of our empirical study we discuss the implications for retail management and channels research.

## Literature Review

In the tradition of institutional economics (Coase, 1937) and Williamson's (1985, p. 96) transaction cost reasoning, dual distribution, or the hybrid organizational phenomenon, represents a stable equilibrium in virtually all industrialized economies. Franchising can be viewed as a hybrid organizational form (Brickley and Dark, 1987). As an area of study, the hybrid organizational phenomenon has received sporadic attention in a diffuse literature base. Although a comprehensive review of this literature is beyond the scope of this manuscript, theoretical contributions that frame the development of the paper are chronologically outlined.

In her seminal article on vertical integration strategies, Harrigan (1984, pp. 640-641) argued that the concept of vertical integration as being 100% owned operations that are interconnected to supply 100% of a firm's needs is outmoded. Harrigan proposed *hybrid* strategies whereby firms forge vertical systems through the use of outsiders in addition to their own business

units. For instance, Harrigan (1984) identified "quasi-integration" as a viable alternative to full integration. In a quasi-integrated arrangement, the bond between firms takes the form of cooperative ventures or loans or loan guarantees (Harrigan, 1984, p. 643).

Anderson and Weitz (1986) proposed a similar framework for analyzing distribution issues. Although their article focused on the two vertical integration alternatives of make and buy, they noted that many situations do not possess all the characteristics for a clear "make" or "buy" decision. Accordingly, Anderson and Weitz called for the use of "obligational contracting," or hybrid systems. A firm's specific capabilities and the reduction in marketplace competition combined with free-riding potential warrant some combination of market-based and integrated control. Thus, a hybrid system complete with penalties for noncompliance is necessitated.

Similar to other writers addressing the multi-system genera of distribution channels, Bradach and Eccles (1989) called attention to the various organizational forms that exist along with markets and hierarchies (vertically integrated systems). Analyzing organizational formats from the standpoint of control mechanisms, Bradach and Eccles (1989, p. 112) coined the term "plural forms" to describe an arrangement where distinct organizational control mechanisms operate simultaneously for the same function by the same firm. In particular, Bradach and Eccles (1989) maintained that the franchise system is a distinct plural format wherein a hybrid price-authority mechanism (the franchisee-owned unit) is coupled with an authority mechanism (the company-owned unit). Bradach and Eccles (1989) emphasized the necessity of investigating how ongoing plural forms (e.g., the simultaneous utilization of both company- and franchisee-owned outlets) serve the strategic macrolevel objectives of an organization, versus analyzing which particular form is likely to be the obvious superior choice in a particular instance.

In their recent review of agency theory, Bergen, Dutta, and Walker (1992) discussed several facets of multi-contract systems. They noted that agency relationships (i.e., one party depending on another party to undertake some action on the first party's behalf) are present in various forms of contractual arrangements, from employment relationships to fee-for-service or commission-based arrangements. They further suggested that most agency theory applications have addressed explicit, formal (legal) contracts, but the theory can also be applied to the myriad of mutual agreement-type contracts (e.g., social norms).

It is clear from this brief review that the hybrid organizational phenomenon is a mainstay in contemporary institutional economics. The review provides a theoretical base for the subsequent model of franchise

ownership changes.

### A Model of Net Ownership Conversions

In this section the conditions which favor modifications in the ownership of franchised outlets are developed. Transaction cost economics (TCE) and agency theory (AT) provide the rationale for a model which treats quality control, repeat purchases, projected growth, and sales revenues as determinants of net ownership changes.

#### *Quality Control Violations and Net Conversions*

Quality control serves as a means for retaining and establishing a firm's reputation. Reputation effects have an impact upon the costs associated with managing alternative governance systems (Caves and Murphy, 1976; Williamson, 1991, p. 291). Reputation involves the corporate image that individuals possess prior to an exchange. For example, individuals entering a McDonald's restaurant have expectations regarding product quality.

Franchisors must assess quality in corporately-operated and franchised locations. Franchisees, however, have additional incentive to limit quality when there are profit incentives from engaging in such behavior (Klein, 1980). The dedication of human assets to ensure quality raises the costs associated with franchisee operations. The franchisor has two means by which to reduce these transaction costs. When franchisees excessively shirk obligations over an extended period of time the franchisor may terminate the franchisee's contract. Alternatively, as the costs of franchisee operations approach those of franchisor operations the franchisor may convert the location to corporate ownership. Corporate employees, in contrast to franchisees, have less incentive to act independently. Therefore the following hypothesis is proposed:

- H1:** Net conversions to franchisor ownership are positively associated with the number of terminations due to quality control violations.

#### *Quality Control Violations, Repeat Sales and Net Conversions*

A potential moderator of the relationship between the incentives of franchisees to shirk on quality and the cost of franchising relative to company ownership is repeat sales. Caves and Murphy (1976) were among the first to suggest that the propensity of customers to make repeat purchases was a factor favoring company ownership in a franchise system. Their research indicated that in industries where customers are mobile and not prone to repeat purchases there are more reputation and free-rider problems and a trend toward company ownership.

In particular, Caves and Murphy (1976) specified restaurants, hotels and motels, and auto rental services as non-repeat industries.

Subsequent analyses have supported Caves and Murphy's contention (Brickley and Dark, 1987; Brickley, Dark, Weisbach, 1991). Generally results indicate that franchised units are more prevalent in industries which involve repeat customers. Firms in "repeat customer industries" are likely to cater to local populations and may include sport, department, and clothing stores (Brickley and Dark, 1987, p. 416).

Quality control responsibilities shift to agents when repeat customers are involved because clients are likely to return to specific outlets. In contrast, quality control may be more important to the principal in non-repeat purchase settings (cf. Akerlof, 1970). Under these conditions the franchise system suffers when agents act opportunistically. Although a relationship between standards of quality, repeat purchases, and the likelihood of franchising has been suggested in the literature (e.g., Brickley, Dark, and Weisbach, 1991), empirical analyses of the relationship are sparse. Thus the following hypothesis is proposed:

**H2:** Net conversions to franchisor ownership are positively associated with the number of terminations due to quality control violations in non-repeat purchase settings.

#### *Projected Growth and Net Conversions*

Agency research focuses on the extent to which outcome and behavior-based contracts are employed, and the risk orientation of the contractual partners is fundamental to such analyses. Contracts with franchisees are likely to emphasize outcome-based criteria (e.g., net sales) to a greater extent than agreements made with managers of franchisor-owned locations. Outcome-based contracting makes it possible to align the incentives of agents and principals while transferring risk to the agents (Eisenhardt, 1989). Since outcomes are only partially related to individual activities, such contracts are unattractive to risk averse agents. Moreover, as agents become more risk averse it becomes increasingly expensive to pass risk on to them.

While risk is a critical component of agency theory, analyses of the phenomenon have been limited (Eisenhardt, 1989). MacCrimmon and Wehrung (1986) suggest that managers view risk as associated with negative outcomes. Moreover, their analysis indicates that risk is not seen as quantifiable or probabilistic, yet such orientations to risk are integral to many agency analyses (e.g., Basu, Lal, Srinivasan, and Staelin, 1985).

Risk is a component of the larger idea that choice is

affected by the expected rate of return (March and Shapira, 1987). When high growth is projected firms are able to entice individuals to invest in their organization. Since the expected rate of return is high agents will prefer agreements that enable them to be rewarded for system outcomes. When low growth is projected firms find it challenging to gain and retain investors. Agents operating under such circumstances will prefer to be compensated based on their efforts rather than on their performance.

In a franchising context the level of growth should be related to conversions to franchisor ownership. As the level of growth increases there are few incentives to convert to corporately-run outlets. When the level of growth is low, however, franchisors will utilize internal contracts. Based on this reasoning the following is proposed:

**H3:** Net conversions to franchisor ownership are negatively associated with the projected level of growth.

#### *Retail Sales and Net Conversion*

In conjunction with the analysis of risk, agency theory facilitates analysis of the economies realized in alternative governance mechanisms. Organizational forms survive to the extent they are able to resolve agency problems and deliver products at lower prices than other forms (Fama and Jensen, 1983). The company that operates plural systems is able to assess the trade-offs between integrated and independent agents. As the revenues from the franchisor locations outstrip those from franchisees, the firm will pursue higher levels of retail ownership (cf. Caves and Murphy, 1976). Therefore the following hypothesis is proposed:

**H4:** Net conversions to franchisor ownership increase with the difference between franchisor and franchisee sales.

#### **Method**

Consistent with previous analyses of franchising (Anderson, 1984; Brickley, Dark, and Weisbach, 1991), this inquiry utilized data published by the U.S. Department of Commerce in the *Franchising in the Economy* (1971-1986) series. This publication provides descriptive statistics on seventeen industries which utilize franchising. The franchising data were compiled from mail surveys distributed to every known franchisor operating in America. The list of franchisors was continually maintained by the International Trade Administration. From 1977 to 1986 the number of respondents increased from 1300 to over 2100, but the response rate remained 99%.

**Table 1**  
**Pearson Correlation Coefficients (n=140)**

<u>Variable</u>	1	2	3	4
1. Net Conversions	1.00			
2. Quality Control Terminations	-.23	1.00		
3. Projected Growth in Sales	-.55	.50	1.0	
4. Net Franchisor Sales	.54	-.54	-.84	1.00

**Note:** Correlations with absolute values greater than .20 have *p* values less than .01.

The present analysis was limited to the 1977-1986 period. Two industries, gasoline service stations and soft drink bottlers, were deleted from the analysis due to missing information. Since automotive and truck dealerships were solely independent agents, they were also excluded from the analysis. The resulting sample consisted of reports from fourteen industries over a ten year period. Each of the 140 data points consisted of an industry mean for the independent and dependent variables as reported in the franchising series.

#### Measures

##### Independent variables

The independent measures for this analysis include total quality control terminations, repeat business potential, growth projections, and sales.

The number of franchisee terminations attributed to quality control violations is the independent variable for H1. These violations include sanitation problems, service issues, and other improprieties outlined in the franchise agreement. H2 assessed whether repeat business characterized purchasing in each industry. Consistent with prior analyses (Brickley and Dark, 1987; Caves and Murphy, 1976) the non-repeat business dummy variable equals one if the industry is "restaurants," "hotels, motels, or campgrounds," or "auto rental agencies." Although there is potential for some repeat sales in these industries, the likelihood is substantially lower than in other industries. H3 utilized industry level projections of growth while the difference in sales between franchisor and franchisee outlets was employed to assess H4.

##### Dependent Variable

The dependent measure was the net conversion to franchisor ownership. Net conversion was the number of conversions to franchisor ownership (from franchisee)

minus the number of conversions to franchisee ownership (from franchisor).

#### **Results**

In this section we test the hypotheses developed within transaction cost economics and agency theory. H1-H4 were evaluated by OLS regression. Due to the time series nature of the data we incorporated assessments of autocorrelation into the analysis. A correlation matrix of the independent and dependent variables is provided in Table 1.

Table 2 provides beta coefficients and a significance test of the overall relationship between the exogenous variables and net conversions. The model is statistically significant ( $F = 18.15$ ,  $p < .001$ ; Adjusted  $R^2 = .33$ ) and warrants further evaluation. Before proceeding with the assessment of H1-H4 we evaluated the model for autocorrelation. The effect of autocorrelation was assessed through a plot of residuals over time and through the Durbin-Watson statistic ( $d$ ) (Chatterjee and Price, 1977, p. 128; Dillon and Goldstein, 1984, pp. 294-295). The plot of the residuals over time evinced no apparent pattern. Furthermore, the 2.12 value for the Durbin-Watson statistic indicates that autocorrelation is not present.

Quality control terminations (QCT) were predicted to have a positive effect upon conversions in H1. In the overall model QCT do not affect net conversions ( $b = -.128$ ,  $p < .41$ ). H2 addressed the interaction of quality control and repeat purchases upon ownership conversions. Consistent with the prediction, QCT in non-repeat industries is positively associated with ownership conversions ( $b = .279$ ,  $p < .06$ ). Thus H2 is supported.

H3 and H4 employed agency theory to predict changes in net conversions. In H3 projected growth was held to be negatively associated with conversions to franchi-

**Table 2**  
**Ordinary Least Squares Regression Analysis of Antecedents to Net Franchising Conversions (n=140)**

<u>Independent Variable</u>	<u>Beta Coefficient</u>
H1 - Quality Control Terminations	-.128
H2 - QCT*Non-Repeat Sales	.279*
H3 - Projected Growth in Sales	-.393**
H4 - Net Franchisor Sales	.286***
Adjusted $R^2$	.32
Overall $F$	18.14***
Durbin-Watson Test	2.11

\*\*\* $p < .01$

\*\* $p < .05$

\* $p < .10$

sor ownership. Consistent with the proposition, projected growth is inversely related to franchisor ownership ( $b = -.393$ ,  $p < .004$ ). Therefore H3 is supported. According to H4 net conversions should be positively associated with the relative performance gains realized from franchisor ownership of outlets. The difference between franchisor and franchisee ownership is statistically significantly related to net conversions ( $b = .286$ ,  $p < .04$ ). Thus, H4 is supported.

### Discussion

Our analysis illustrates that transaction cost economics and agency theory contribute to the understanding of interorganizational alliances in franchising, yet also suggests that these theories are not a complete explanation. We offer some preliminary managerial and policy implications, note the limitations in this research, and make suggestions for future research.

### Managerial Implications

Brand capital is among the most critical assets held by franchisors, and considerable efforts must be exerted to secure their quality. Our study illustrates that franchisors must pay particular attention to service quality and brand equity in industries characterized by infrequent repeat purchases. When franchise patrons are loyal to a particular location the franchisor secures quality by selling franchises to local business persons. These entrepreneurs are likely to provide quality services because their livelihood is highly dependent upon repeat business. The franchisor's challenge to retain quality is exacerbated when customers associate brands with channel systems rather than specific outlets. Under these conditions the franchisor attempts to secure brand equity through stringent adherence to quality control policies. When service provision diminishes the franchi-

sor should consider quality control terminations or ownership changes. These ownership modifications shift responsibilities for operations back to the franchisor. The contracts regulating operations for these franchisor-owned facilities emphasize quality control, and thereby serve to retain brand value.

While service provision is clearly critical to the level of franchisor ownership, this issue must be weighed against the performance incentives of alternative contracts. Franchisees have fewer incentives to retain brand value, and they have substantial incentives to increase revenues. In contrast, corporate managers have higher incentives to maintain service quality but have less motivation to raise revenues. In industries characterized by few repeat purchases the franchisor seeks to raise revenues while simultaneously securing brand quality. In these industries franchisors should not limit their contractual decision making to "franchisor versus franchisee" alternatives. For example, Shepard (1993) illustrates that franchisors often sell franchise agreements to entrepreneurs operating on the franchisor's property. This hybrid arrangement offers greater control than the pure franchise with performance incentives greater than franchisor-based outlets.

Our analysis illustrates that franchisors should give consideration to the current level of revenues as well as the projected growth in a market. Franchisors that receive higher financial returns from their corporately-held operations should strongly consider the conversion of franchised outlets. Nevertheless, the current returns from these outlets should be viewed in conjunction with contractual incentives of franchisee contracts. Although franchisees are relatively more risk averse than franchisors, the franchisor can pass ownership along to franchisees when markets are growing rapidly. Under these conditions the franchisees should view ownership

propositions as less risky. In addition, franchisors will have converted their operations to contracts which maximize incentives to raise revenues. Thus, current revenues and projected growth are both critical to franchise networks.

### *Public Policy Implications*

In this section, the importance of understanding and predicting franchisor conversions from a public policy perspective is addressed. That is, based on the results of this research, the ways in which regulatory bodies and parties to the franchise agreement might alter their agendas are considered.

Perhaps the most compelling public policy issue with respect to the present analysis concerns Oxenfeldt and Kelly's (1968-1969) infamous ownership redirection hypothesis. Briefly, their hypothesis holds that, over time, franchisors will convert most of the franchisee-owned outlets into company-owned outlets. Ultimately, only marginal sites will be subject to franchisee ownership (Anderson, 1984; Oxenfeldt and Kelly, 1968-1969). Understandably this theme has prompted considerable public concern. From a policy standpoint, the heart of this issue concerns whether expanded regulation (e.g., regulation of franchise termination) should be enacted to prevent franchisors from opportunistically appropriating franchisee-created value. In a recent review on the controversy surrounding the topic, Dant, Kaufmann, and Paswan (1992) concluded that Oxenfeldt and Kelly's (1968-1969) ownership redirection hypothesis is at best inconclusive and that the notion of dual distribution in franchising is more or less a stable equilibrium. The existence of company-owned outlets does not necessarily substantiate ownership redirection since there are distinct strategic advantages from utilizing a plural distributional format. Dual distribution permits franchisors to maintain direct and current familiarity with their businesses. Our results suggest that in non-repeat and low growth industries ownership redirection may not be opportunistic but rather a great service to the franchisee.

A related and very pressing policy issue is the regulation of franchise territory development. Of note is the 1992 ruling wherein the State of Iowa added a section to the Iowa Franchise Law dealing with encroachment (cf. Willems, English, and Storholm, 1993). Briefly, the encroachment section was enacted in an effort to protect franchisees from sales lost to both franchisor-owned outlets and new sites developed by franchisees within an "unreasonable proximity" of an existing establishment.<sup>1</sup> This new form of regulation, if upheld, could be adopted by other regulatory bodies thereby significantly affecting the outlet ownership and the competitive structure of the entire franchising industry (Stassen and Mittelstaedt, 1993). In contrast to other forms of proposed franchise

regulation, this form of regulation could encourage a shift to more franchisor-owned outlets thus offsetting ratios of franchisor- to franchisee-owned locations. For instance, this type of regulation potentially limits a franchise system from growing and remaining competitive through the attraction of new franchisees and the development of new sites.

Legislative bodies considering franchise regulation must understand the factors determining the proportions of franchisor- to franchisee-owned outlets. By understanding the conditions favoring shifts to more franchisor-owned outlets outside of regulation, decision makers will be less apt to enact potentially dangerous encroachment provisions thereby further exacerbating the balance of franchisor-owned versus franchisee establishments, and ultimately weakening the franchise system. As a preliminary investigation of ownership conversions, our analysis suggests that generous encroachment provisions may be particularly disruptive in non-repeat and low growth industries.

From a policy perspective, our analysis warns against the misuse of regulation aimed at franchisors. First, our findings suggest benign and acceptable motives potentially driving franchisor-ownership redirection. Second, the analysis identifies particular situations and circumstances presumably most vulnerable to the effects of expanded regulation.

### *Limitations*

All studies of an empirical nature have trade-offs associated with data collection. When secondary data are utilized one must select from among variables collected for other purposes (Kerlinger, 1986, p. 470). In this analysis we utilized industry-level data to obtain a preliminary understanding of the decisions made by managers of franchise systems. In their review of agency research, Bergen, Dutta, and Walker (1992) acknowledged this limitation of secondary data, but also referred to the encouraging evidences that these applications contribute to a wide range of marketing issues. Our preliminary findings should be complemented by field research in a single industry utilizing psychometric techniques.

### *Suggestions for Future Research*

Future research should continue to integrate transaction cost economics and agency theory to nurture a keener understanding of interorganizational alliances. For instance, agency theory, in light of its predictive utility in this study, should be utilized to address whether franchisors are more risk neutral than their franchisee counterparts. In addition, analyses should consider other aspects of risk which focus on environmental contingencies. And, interorganizational research

regarding agency theory should address the efficacy of behavior- and outcome-based contracts.

Transaction cost economics and agency theory have subtle yet potentially important differences that need to be reconciled through additional research (Williamson, 1988). For example, agency theory specifies asset specificity (Eisenhardt, 1989) yet does not rely on it (Shepard, 1993; Slade, 1993), whereas transaction cost economics emphasizes asset specificity (Williamson, 1971). Where specific assets are involved transaction cost economics would appear better equipped to explain interorganizational relations. For instance, brand capital may be particularly relevant to fast food franchising (e.g., McDonalds). In other instances, however, asset specificity is not present and hence agency theory would appear more apt at characterizing exchange contracts. For example, some authors argue that asset specificity is not present in product franchising (Shepard, 1993). Indeed, the franchise data utilized in the current analysis supported various agency predictions.

Regarding the behavioral assumptions inherent in these theories, agency theory emphasizes self-interest while transaction cost economics stresses guilish self-interest. The question of which behavioral inclination is most appropriate should be resolved. Assuming a relatively moderate position, some researchers hold that mutual trust characterizes interorganizational alliances (e.g., Bradach and Eccles, 1989), and that excessive opportunistic behavior is not sustainable in exchange (e.g., Hill, 1990). In contrast, others take a more extreme view and contend that despite philanthropic intentions exchange participants will act selfishly, potentially leading to unfulfilled promises or obligations and to the provision of misleading information (Williamson, 1971, 1991). In the case of incomplete economic contracts, however, both theories acknowledge the role of informal control (e.g., trust, norms, etc.). That is, both theories recognize that incomplete contracts are complemented by informal control. Future research should therefore address how informal control factors affect contracts. For example, empirical studies should investigate how norms and trust influence various contractual formats. Furthermore, research on the effects of informal control mechanisms on exchange characterized by differing levels of integration (e.g., market versus hierarchical forms) is needed. Finally, future research should examine the incidence of ethical exchange in various contractual and integrational formats (Gundlach and Murphy, 1993).

### Conclusions

The objective of this research is to analyze changes in ownership of franchised retail outlets. Our analysis incorporates components of transaction cost economics and agency theory to assess ownership conversions in

franchising. Together these theories highlight the importance of the transactional environment upon franchised distribution systems. Our findings suggest ownership changes based on increases in system efficiency rather than changes precipitated by the misuse of franchisor power.

Franchised business systems are highly attractive settings for interorganizational research. The ownership of franchised retail outlets is a critical decision faced by entrepreneurs and franchisors. Although retail locations are selected on the basis of local factors, as the environment changes there is impetus to modify the contractual system. These changes in ownership are anything but trivial for both parties while contracts have long-term ramifications for business and policy strategists. ❁

### \*\*\*Footnote\*\*\*

1. More precisely, the law provides that franchisors offer existing franchisees either the right of first refusal for any site within their territory or compensation for the revenues lost to the new establishment.

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