

# CONTRACTUAL COMPLEXITY AND COMPLETENESS TO CONTAIN OPPORTUNISM IN FRANCHISE AGREEMENTS

**Authors:** Vanesa Solis-Rodriguez and Manuel Gonzalez-Diaz

**Contact Address:**

Vanesa Solis-Rodriguez  
University of León  
Faculty of Economics  
Campus de Vegazana s/n  
León, 24071  
Spain  
Tel: +34987291000 Ext. 5527  
Fax: +34987291454  
E-mail: vanesa.solis@unileon.es

Manuel Gonzalez-Diaz  
University of Oviedo  
Faculty of Economics  
Avenida del Cristo s/n  
Oviedo, 33071  
Spain  
Tel: +34985102807  
Fax: +34985103708  
E-mail: mgdiaz@uniovi.es

# CONTRACTUAL COMPLEXITY AND COMPLETENESS TO CONTAIN OPPORTUNISM IN FRANCHISE AGREEMENTS

## Abstract

This paper sets out to analyze contractual complexity and completeness in the context of Spanish franchise chains. First we examine whether franchise chains differ according to the complexity and completeness of their contracts, and then we analyze the factors that influence the degree of complexity of those contracts. For that purpose, 64 contracts held by different franchise chains operating in Spain have been taken as a sample. The results indicate, on the one hand, that there are two kinds of contracts in terms of their degree of complexity and, on the other hand, that *i)* the larger the relationship-specific investments, *ii)* the broader the experience of the chain in the market, and *iii)* the more important the effort of the person in charge of the outlet is to the success of the business, the more complex the contracts drawn up by the franchisors will be. The franchisor's reputation, however, does not appear to influence the degree of detail with which the contract is drawn up.

## Key words:

Franchise; Contracts; Complexity; Completeness

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## 1. INTRODUCTION

A great deal has been written about the individual safeguards used to avoid the risks associated with inter-firm relations, especially in the case of franchise agreements<sup>1</sup>. Studies have been conducted on the franchisor's reputation (Arruñada, Garicano y Vázquez, 2001), optimal contract duration (Brickley, Misra and Van Horn, 2006), an appropriate royalty and fee (Blair and Kaserman, 1982, Lafontaine, 1992, Vázquez, 2005) and on the idea of using the ownership structure to contain opportunism (Brickley and Dark, 1987; Lafontaine, 1992; Lafontaine and Slade, 2001).

Yet very little research has been done on the degree of detail with which the parties specify (in writing) in the contract the contingencies that they consider to be important and the way they are to be dealt with. The number and stringency of the provisions employed in the contract are what defines their "complexity" (Reuer and Ariño, 2003). Although this has been examined in other kinds of partnership agreements or alliances<sup>2</sup>, it has not been done in franchise contracts, where a variety of opportunistic patterns of behavior have been identified. Unlike other papers, rather than trying to associate a problem with a particular clause, we are trying to associate a problem of opportunism with the number and degree of detail of the clauses in the contract (complexity).

This paper therefore sets out to analyze the complexity of the contract that governs or structures the franchisee-franchisor relationship. Specifically, to establish, in the first place, whether there are differences between the contracts designed by the different chains and, secondly, what factors make those contracts more or less complex.

The remainder of the paper is organized as follows. After this introduction, section two deals with the theoretical aspects of contractual complexity and the factors that determine its intensity. The data-gathering process, the sources of information used and the econometric models employed are discussed in the third section, and the results and conclusions of the study are set out in the fourth and fifth sections respectively.

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<sup>1</sup> A good summary can be found in Blair and Lafontaine (2005).

<sup>2</sup> See, among others, Parkhe (1993), Deeds and Hill (1998), Poppo and Zenger (2002), Luo (2002), Reuer and Ariño (2002, 2003, 2007), Ryal and Sampson (2003) or Reuer, Ariño and Mellewigt (2006).

## 2. THEORETICAL REVIEW

A franchise is an agreement between two legally separate and independent firms<sup>3</sup>: the franchisor and the franchisee<sup>4</sup>. The franchisor is a firm that has developed a business idea and comes to an agreement with the franchisee to put it into operation. In that way, the former grants the latter the right to use his brand and business model for a particular period of time, in exchange for which the franchisee pays a franchise fee and some royalties. Given the economic importance of these operations, they may give rise to opportunistic behavior on the part of the franchisee or of the franchisor.

In the case of the former, the remuneration of the franchisee with the residual income of his outlet creates highly powerful incentives that may lead him to try to maximize his own results, even at the expense of the results of the whole chain, by offering, for example, lower-quality products. The explanation for this behavior is that the cost will not be met solely and exclusively by him, but by the other business units in the chain, in terms of loss of customers, and by the franchisor, in terms of the loss of value of the brand in future<sup>5</sup>. In short, we have here a problem of “free-riding” (opportunism or collective action) on the part of the franchisee.

However, problems of free-riding on the part of the franchisor may be encountered as well (Rubin, 1978; Lal, 1990; Lafontaine, 1992). The success of a franchise network depends, ultimately, on the franchisor, because he is the person who provides the brand image and ensures that it keeps its value and that the value increases over time (Perales and Vázquez, 2003). To do so, he centralizes promotion actions for his products and/or services, updates the skills needed to run the business (López and Ventura, 2002) and provides the outlets with training and assistance in order to maintain the uniformity of the chain. However, the franchisor does not reap the full benefit of his efforts, as he has passed on a certain percentage of outlets in franchise. So, he shoulders all the costs and only part of the results. This may lead him to neglect his obligations, trying to achieve the maximum short-term benefit from the royalties and fees the franchisees pay, and letting the chain and the brand lose their value completely. From the point of view of a franchisee, this is a big problem because, were that to happen, he would forfeit a large part of his investment.

The signing of a contract by and between both parties is a frequent solution to situations such as this. In general, a contract sets out each party’s roles and responsibilities, the localization of the control and decision-making rights, the steps to take in the event of certain contingencies, how the

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<sup>3</sup> Although they are legally separate and independent firms, the economic dependence between them is so strong that the agreement is similar to a labour relationship (Rubin, 1978; Mathewson and Winter, 1985; Hadfield, 1990).

<sup>4</sup> A large number of authors have tried to define the notion of franchise as accurately as possible. A collection of the most important definitions can be found in Stanworth and Curran (1999).

<sup>5</sup> This argument is developed by Brickley and Dark (1987) and Williamson (1989) and analysed analytically by Blair and Kaserman (1994) and Nault and Dexter (1994).

parties will communicate with each other and how disputes will be settled (Argyres and Mayer, 2004). In this way, a contract can be said to be complete when it makes provision for all the matters that have bearing on the relationship and foresees possible future contingencies and ways of dealing with them (Luo, 2002, pp. 904-905). Although complete contracts as such do not exist, because something can always happen that neither party had planned for, the parties do in fact try to resolve all possible contingencies. So the nearer we get to a complete contract, the more clauses and details it will contain, avoiding any misunderstandings about the undertakings it describes and thereby mitigating interest in opportunism.

The clauses contained in franchise contracts therefore pursue three objectives: a) to provide incentives for the effort and dedication that the franchisee puts into running his store (Rubin, 1978); b) to restrict his ability to impose negative externalities on the other franchisees or on the chain (Lafontaine and Rayaud, 2002); and c) to encourage the franchisor to take whatever steps are necessary to maintain the brand value (Bercovitz, 2000). The first objective would be achieved through the franchisee's right to receive the residual income of his outlet; the second, through self-enforcement, i.e. with self-enforced mechanisms, such as paying the franchisee an ongoing stream of rent that he would stand to lose if he were expelled from the chain when his opportunistic behavior was discovered; and the third, through the compensation the franchisor receives for taking those steps.

Literature and empirical evidence on franchise contracts have focused mainly on analyzing specific clauses in order to explain how they enable these objectives to be achieved. Undoubtedly the clauses studied most have been those to do with the payment terms of franchise agreements (for a theoretical analysis, see Blair and Kaserman, 1982; Charnes, Huang and Mahajan, 1992; Lal, 1990, Mathewson and Winter, 1985; for an empirical analysis, see Lafontaine, 1992, 1993; Sen, 1993; Vázquez, 2005). These usually consist of a franchise fee, which is a fixed sum paid at the start of the relationship, plus some periodical fees comprising two parts – the royalty and the advertising fee – which are usually established as a percentage of the franchisee's sales (Caves and Murphy, 1976; Rubin, 1978)<sup>6</sup>. The investment made by the franchisee and his variable earnings, linked to the residual income of the business, creates a system of incentives that helps achieve these three objectives.

At the same time, other clauses have been studied that also reduce opportunistic behavior on the part of the parties. So, for example, Dnes (1993) focuses on clauses dealing with non-competition, tie-in clauses and those that govern the transfer of the franchisee's assets on termination of the contract, and comes to the conclusion that they protect the franchisor and franchisee from the potential opportunistic behavior of the other party. For his part, Brickley (1999) focuses on clauses dealing with

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<sup>6</sup> The reason why these fees are a percentage of the sales and not of the profit is that it is harder for the franchisor to control the latter, since the franchisee might alter the profits figure, changing the amount of costs (Rubin, 1978).

restrictions on passive ownership<sup>7</sup> and exclusive rights within a designated geographical area, linking them with the risk of opportunism (free-riding) on the part of the franchisee. Lafontaine and Raynaud (2002) study the clauses that have to do with the accounts and regular sales information that the franchisee has to provide the franchisor with, the method and frequency with which that information must be passed on to the franchisor, the store audits that the latter is able to conduct in the franchisee's outlet, and the possibility on the part of the latter to pass the rights and obligations stemming from the franchise contract on to someone else, linking them with the risk of opportunism (shirking) by the franchisee. Lastly, the length of the franchise contract as well as the possibility of renewing it affect the overall earnings that the franchisee expects to obtain from the relationship (Brickley, Misra and Van Horn, 2006)<sup>8</sup>.

However, one matter that has not been addressed in the field of franchises is contractual complexity and completeness, these being understood to be the features in the design of the contract that establish the number and stringency of the clauses it contains (Reuer and Ariño, 2003). This matter, which has been studied in other kinds of partnership agreements or alliances<sup>9</sup>, is important because, while the analysis of a specific clause allows us to draw conclusions on the specific problem that it solves, the analysis of the contract as a whole can help us understand how such clauses work together.

## **2.1. Factors determining contractual complexity**

The main hypothesis is that the more likelihood there is of opportunism on the part of the parties, the greater the number of contractual safeguards and, hence, the more complex the contract (Macneil, 1978; Heide, 1994; Ariño and Reuer, 2005). So the situations in which opportunism is more likely to exist need to be established in order to determine whether or not this has bearing on the complexity of the contract.

### *Investments in specific assets*

Specific assets are understood to be resources that cannot be readily deployed to other relationships or businesses, so their current value is always higher than the value they might have if they were to any alternative use. In the field of franchise, the franchisor and the franchisee both make specific investments. Thus, in addition to paying the franchisor a franchise fee and royalties, the franchisee makes a number of other investments in order to start up the business, such as buying or

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<sup>7</sup> Whether the franchisee is restricted from engaging in outside activities, such as, for instance, that "the franchisee must spend at least X hours per week at his franchised unit" or "the franchisee is obligated to participate in the full-time operation of the franchise business" (Brickley, 1999).

<sup>8</sup> In addition to those mentioned, see also the work by Bercovitz (2000).

<sup>9</sup> See, among others, Parkhe (1993), Deeds and Hill (1998), Poppo and Zenger (2002), Luo (2002), Reuer and Ariño (2002, 2003, 2007), Ryal and Sampson (2003) and Reuer, Ariño and Mellewigt (2006).

leasing the outlet, its design and decor, buying the machinery, training employees, etc. For his part, the franchisor has to provide the franchisee with training and assistance, and even advice on the selection and site of the outlet, on hiring staff, etc. Under these circumstances, the identity of the partner and the continuity of the relationship are especially important (Klein, Crawford and Alchian, 1978; Williamson, 1979), on the one hand, because the franchisor and the franchisee may both be especially motivated to engage in opportunistic behavior in order to pocket the earnings produced by those specific assets and, on the other hand, because if the contractual relationship were to terminate, most of those investments would not be recoverable.

Consequently, in the presence of specific assets, the most suitable course of action is to design more complex contracts (Joskow, 1988) to cover the consequences of its termination and of opportunistic behavior as well (Dyer, 1997; Poppo and Zenger, 2002). Hence, the following hypothesis could be established:

*H1: The complexity of franchise contracts is directly related to the specific nature of the assets.*

#### *Experience*

The franchisor's experience in franchising may also affect the complexity of the contract. Thus, the more experienced he is, the more he learns from past mistakes, gradually including items (contingencies) in the wording of new contracts that had caused him problems in the past but which, out of ignorance, he had not at the time regarded as important enough to be included (Klein, Crawford and Alchian, 1978; Williamson, 1985; Mayer and Argyres, 2004; Ryall and Sampson, 2006; Zeynep and Higgins, 2007). Consequently, the more experience the chain has, the more sophisticated and, hence, the more complex the contracts it designs will be. So the following hypothesis can be established:

*H2: The complexity of franchise contracts is directly related to the experience of the chain.*

#### *Reputation*

If a franchisor has spent several years building up a large network, he will have a very good image among potential franchisees and most of them will be prepared to join the network, as they know that they are joining a thoroughly proven business and that, in the event of breach, the franchisor has a lot of capital to lose reputation-wise (Klein, 1980; Klein and Murphy, 1997; Arruñada, Garicano and Vázquez, 2001). As a result, under these circumstances, when it comes to signing the contract, these prospective franchisees are not going to ask the franchisor for an excessively detailed contract,

as they know that there is very little likelihood of him engaging in opportunistic behavior (Parkhe, 1993; Ciccotello and Hornyak, 2000). In this case, the hypothesis could be formulated as:

*H3: The complexity of franchise contracts is inversely related to the franchisor's reputation in the market.*

#### *Importance of the effort of the person in charge of the establishment*

One of the chief differences between company-owned and franchised outlets is that the franchisees' incentives are far stronger than those of the managers of company-owned stores (Lewin-Solomons, 1998; Perales and Vázquez, 2003). This is because, as they own the outlets they run, they are more concerned about maximizing the residual income (Caves and Murphy, 1976; Mathewson and Winter, 1985; Brickley and Dark, 1987; Norton, 1988). Bearing this in mind, the more important the effort of the franchisee is to the success of the business, the more incentives he needs, which results in the need to include more clauses in the contract which, on the one hand, motivate him to make an effort in carrying on his business activities and, on the other hand, dissuade him from creating free-rider problems. So, in this case, the hypothesis is as follows:

*H4: The complexity of franchise contracts is directly related to the intensity of the effort made by the person in charge of the establishment.*

### **3. METHODOLOGY**

#### **3.1. Data gathering**

To test these hypotheses, from March 2006 to March 2007 we made contact, by telephone and email, with 790 Spanish franchise chains that were operating in Spain from 1996 to 2005, to ask them for information about their company, including information about their franchise contract. We received a reply from 254 franchisors, 74 of whom sent us information about the franchise contract, either a summary of it or the pre-contract or the contract itself.

As our aim is to analyze the complexity of franchise contracts, the first two sets of information were eliminated from the base, so that the final sampling comprised 64 franchise contracts, all of them from companies currently operating in Spain. Table 1 contains the distribution of the sampling observations by business sector, while Table 2 gives a description of the main clauses the contracts contain<sup>10</sup>.

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<sup>10</sup> Appendix I contains all the clauses identified in the franchise contracts analyzed.



**Table 1: Distribution of the sample of franchise contracts**

Sector	Number	% of the sample	Sector	Number	% of the sample
Real-estate agencies	2	3,13	Hairdressing	2	3.13
Food	2	3,13	Advertising-Promotions-Communication	1	1.56
Clothing alterations and mending	2	3,13	Recycling-Consumables	3	4.69
Beauty and personal care	1	1,56	Insurance	1	1.56
Communication-Internet-Telephony	1	1,56	Automobile services	3	4.69
Consultancy	1	1,56	Specialized service	6	9.38
Dietetics store-Herbalist-Parapharmacy	2	3,13	Financial service	1	1.56
Teaching	1	1,56	Textile and accessories	9	14.06
Hotel and catering	11	17,19	Specialist store	2	3.13
Photography	2	3,13	Vending	2	3,13
Printer's-Sign-making	2	3,13	Travel	3	4,69
IT	3	4,69	Total	64	
Optician	1	1,56			

An analysis of Table 2 reveals the following main findings. In the first place, the only clause that is contained in all the contracts analyzed is the one that refers to their duration and renewal, which is logical, as this is one of the most important clauses in franchise contracts (Tractenberg, Calihan and Luciano, 2004). In 86% of the cases analyzed, the franchisee is able to renew the contract, provided that he has complied with all his obligations. This acts as an incentive for the franchisee, as it gives him more time to recover the investments made<sup>11</sup>.

In 95% of the cases, the contract establishes the need for the franchisee to be expressly authorized by the franchisor in order to be able to transfer the rights and obligations stemming from the franchise contract. This makes sense, too, because, as is established in them, the contract is granted on an *intuito personae* basis, i.e. according to the franchisee's personal, financial and worth characteristics. This, however, contrasts with the fact that only 11% of the contracts analyzed make reference to whom should run the business<sup>12</sup>.

Other clauses used in the majority of the franchise contracts analyzed are ones that refer to the fitting-out of the establishment (94%), use of the brand (89%), use of the method (88%), and the range of products (88%) and their supply (78%). All of them lay down obligations that the franchisee must fulfill to be able to form part of the franchisor's network and, basically, specify that the franchisee must decorate the establishment according to the franchisor's instructions, that the franchisee does not acquire any right over the brand or over the know-how that is passed on to him and must only use

<sup>11</sup> FRANDATA Corporation (2000) and Brickley, Misra and Van Horn (2006) establish that 91% of the franchise contracts in the US include the possibility of renewal, a similar percentage to the one obtained in Spain.

<sup>12</sup> In a recent survey, only 23% of Spanish chains consider it "essential" for the franchisee to run the business himself (Sánchez 2006, p. 102).

them in the franchisee outlet and for carrying on the franchise business, and that he must supply and sell exclusively the products of the franchisor and/or of suppliers authorized by the franchisor<sup>13</sup>. So the clauses that lay down the obligations of the franchisee are the main clauses in franchise contracts. In fact, the franchisor's obligations are practically confined to providing the franchisee with training (82%), assistance (80%) and an exclusive territorial area of operation (80%).

**Table 2: Contractual clauses**

<b>Clauses</b>	<b>% contracts</b>	<b>Comments</b>
Purpose of the contract	91	Purpose of the franchise contract.
Independence of the parties	83	No labor relationship between franchisor and franchisee. The franchisee is the only person in charge of the business.
Franchise fee	74	Upfront payment to the franchisor for joining the chain.
Royalty	65	Periodic payments to the franchisor.
Advertising fee	43	Periodic payments for promotion activities.
Running the business	11	Obligation of the franchisee to run the business himself, and time devoted to it.
Transfer	95	On the part of the franchisee. The franchisor's approval is required.
	32	On the part of the franchisor.
Training and assistance	82	Initial training of the franchisee by the franchisor.
	54	Obligation of the franchisee to take advantage of the training provided by the franchisor.
	80	Technical assistance on the part of the franchisor.
Inspections	86	Obligation of the franchisee to allow the franchisor to enter, and/or obligation of the franchisor to conduct periodical control visits.
Accounting register	71	Franchisor's right to inspect the data, periodical handover of documentation.
Non competition	72	During the lifetime of the contract. Not to engage in competitive activities or acquire shareholdings in the capital of other rival companies.
	50	Post-contractual. Limited period.
Confidentiality	77	During the lifetime of the contract
	42	Post-contractual. Indefinitely.
Inheritance	40	Assignment of the franchise in the event of the death of the franchisee.
Trademark	89	Franchisee's obligation regarding use of the franchisor's brands.
	74	Franchisor's obligation to authorize the franchisee to use the brand.
Advertising	69	Franchisee. Approval of the campaigns on the part of the franchisor.
	63	Franchisor. Obligation to conduct periodical promotions for the chain.
Pricing	49	Franchisee. Take into account prices established by the franchisor.
Territory	33	The franchisee cannot make active sales outside his exclusive area of operation.
	80	The franchisor must respect the franchisee's exclusive area of operation.
Outlet	94	The franchisee must fit out the establishment to satisfy the franchisor's requirements.
	84	Exclusive sphere of activity: his outlet.
	49	Advice by the franchisor on the choice and site of the outlet.
Method	88	Compliance with the franchisor's method.

<sup>13</sup> Unless the franchisor expressly consents otherwise.

**Table 2: Contractual clauses (Continuation)**

<b>Clauses</b>	<b>% contracts</b>	<b>Comments</b>
Supply	78	Exclusive supply through the franchisor and/or authorized suppliers or possibility of engaging with other providers.
	11	Minimum level of purchases from central office.
Offering	88	Exclusive offering of the franchisor's products / services or possibility of offering others with the franchisor's consent.
	15	Achieve trade objectives.
	14	Exchange of customers between franchisees.
Opening hours	45	Following the franchisor's indications.
Arbitration / Jurisdiction	95	Jurisdiction and/or arbitration.
Sign employees	55	Franchisee's obligations: comply with legal and qualification requirements, follow the franchisor's indications, etc.
	22	Franchisor's obligations: assessment in staff selection and consent.
Post-contractual obligations	88	Not to use of the method and remove items that remind of franchisor.
	72	Return items to the franchisor (handbooks, etc.).
	31	Franchisor's option right over the outlet and/or inventories.
	38	Stop business / communication.
	54	Payment of sums owed.
Bank guarantees	34	Guarantee for the payment of the supplies.
Start-up	55	A maximum period is established as of signing the contract.
Duration	100	Duration of the contract and possibility of renewal.
Termination	97	Rights of the franchisor and franchisee to terminate the contract.
Other clauses	23	No right to indemnity for goodwill.
	40	Replaces any previous agreement.
	38	Modification of the contract.
	58	Communication between the parties.
	43	Nullity of the clauses.
Law applicable	37	Spanish and European Union law.

The same conclusion can be reached from analyzing the clauses relating to the termination of the contract and to the post-contractual obligations of the parties. Thus, in all the contracts analyzed, the franchisor has the right to terminate the contract, and the franchisee must state that he agrees that breach of any of the obligations contained in the contract gives grounds for terminating it. However, the franchisee does have some possibility of terminating the contract in 80% of the cases. After the contractual relationship has ended, the franchisee still has obligations to fulfill: he has to keep confidentiality, cannot engage in activities that compete with the franchisor, must refrain from using any item that might be misleading and notify all the third parties concerned of that fact, and, for his part, the franchisor has the option to re-purchase the outlet and/or the inventories.

Lastly, 95% of the contracts refer to the method the parties use to settle any disputes or litigation arising out of the franchise relationship, the options used being jurisdiction and/or arbitration.

### 3.2. Description of the model and variables

When analyzing the complexity of the contracts, an answer to two questions is sought:

- 1- Can groups of chains be differentiated according to the complexity of their contracts?
- 2- What factors have bearing on the greater or lesser complexity of franchise contracts?

To answer the first question, a cluster analysis technique is used and, more specifically, the analysis of conglomerates in two stages, which automatically determines the optimum number of conglomerates for a specific set of data, using the Bayesian Information Criterion (BIC) as a criterion. Since the aim is to determine whether or not groups of franchises exist according to the complexity of their contracts, three grouping variables were used: number of clauses, number of pages and the number of words in the contract<sup>14</sup>.

To analyze the factors that determine the complexity of the contracts, the empirical model used was a multiple regression, with the following structure:

$$\begin{aligned} \text{Contractual complexity} = & \beta_0 + \beta_1 \text{Specificity} + \beta_2 \text{Experience} + \\ & + \beta_3 \text{reputation} + \beta_4 \text{Effort} + \varepsilon \end{aligned}$$

The dependent variable used in this case is the number of clauses in the franchise contracts, as we feel that this is the most appropriate variable for measuring their complexity. Meanwhile the independent variables used to approximate the determinant factors of contractual complexity are as follows. First, for the purpose of assessing the specific nature of the assets, two variables were used: FEE, which is the franchise fee the franchisee has to pay in order to form part of the chain, and INVINI, which is the initial investment an individual has to make to be able to open an outlet of a particular chain and thus become a franchisee of that chain. Both variables can give us an idea of the relationship-specific investments made by the franchisee and franchisor, so the greater their value, the more complex the franchise contract will be<sup>15</sup>.

To estimate the chain's experience, the ANTG variable has been used, which sets out the number of years the different chains have been franchising in Spain. Foreseeably, the more experienced as franchisor is, the more he will have learnt from past mistakes, so the contracts will be more complex.

To assess the franchisor's reputation in the market, the variable EST was used, which is the total number of outlets that each chain possesses, both in Spain and abroad. We consider that the

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<sup>14</sup> The first of the variables has been used by authors such as Parkhe (1993), Poppo and Zenger (2002), Reuer and Ariño (2002) and Reuer and Ariño (2007), while the second has been used by Poppo and Zenger (2002).

<sup>15</sup> The franchise fee is a relationship-specific investment, although not the only one and, evidently, not all the investment that the franchisee makes is specific. Nevertheless, both measurements enable us to come close to the value of the intangible assets passed on by the franchisor.

greater the value of this variable, the less complex the contract drawn up by the franchisor will be, as the franchisees are aware that the franchisor is the party that would stand to lose most in the event of breach, as his reputation as a franchisor would deteriorate.

Lastly, to estimate the importance of the effort of the person in charge of the establishment, the variable PMIN has been used, which is the minimum population required by the chain which would have a specific city center for a franchisee to establish his outlet in that area. The argument is that chains that offer more specialized products or services will be the ones that will require a larger minimum population, as there is less demand for them so they have to amortize the investment made. So, as only a small percentage of the population is interested in the product, each customer is very important for the business and the person in charge of the establishment has to make a great effort to look for, attract and keep that customer. In this case, the greater the value of this variable, the more complex the franchise contract. Statistics describing all these variables are given in Table 3.

**Table 3: Descriptive statistics**

Variable	Average	Std. Dev.	Min.	Max.	N
CLAUSES	60.484	19.933	13.000	103.000	64
FEE	10492.070	9031.827	0.000	31250.000	63
INVINI	80384.050	86782.300	3000.000	450000.000	64
ANTG	8.531	6.115	1.000	26.000	64
EST	89.297	110.975	4.000	464.000	64
PMIN	31701.750	25613.870	0.000	100000.000	57

**4. RESULTS**

**4.1. Identification of groups according to complexity**

The results obtained from the analysis of conglomerates in two phases, using the statistics program SPSS, are given in Table 4, while Table 5 gives the profiles of the groups obtained.

**Table 4: Distribution of conglomerates**

		N	% combined
<b>Conglomerate</b>	1	31	48.4%
	2	33	51.6%
	Combined	64	100.0%
<b>Total</b>		64	

**Table 5: Profiles of the conglomerates**

		Conglomerate		
		1	2	Combined
<b>Pages</b>	Average	9.23	26.61	18.19
	Typical dev.	4.096	9.698	11.507
<b>Words</b>	Average	2932.87	9199.48	6164.09
	Typical dev.	1359.000	3247.740	4025.021
<b>Clauses</b>	Average	44.77	75.24	60.48
	Typical dev.	14.534	10.977	19.933

As can be seen, the analyses conducted enable us to identify the existence of two groups of franchise chains, which we have called “Chains with simple contracts (implicit or open)” (conglomerate 1) and “Chains with complex contracts (explicit or formalized)” (conglomerate 2). The contract in the first group is characterized by the fact that it has on average nine pages, 2,900 words and 45 clauses, whereas the one in the second group has an average of 27 pages, 9,200 words and 75 clauses. So there are considerable differences between the groups, taking into account any of the three variables<sup>16</sup>.

If we analyze the two groups identified in greater depth, major differences between them can be found. So, in the first place, if we focus on financial conditions, the chains that belong to the first cluster ask for an average of 6,300 euros as a franchise fee and an initial investment of 51,500 euros, while those in the second cluster ask for higher amounts, 9,000 and 99,000 euros, respectively. So chains that draw up more complex contracts are the ones that ask for a larger disbursement, which would fit in with the idea of the specific nature of the assets.

Differences also exist as regards experience. The chains that belong to the second of the conglomerates are the ones that have been franchising their business for more years, 9.64 years compared to 7.35 years, which indicates that the greater the franchisor’s experience, the more complex the franchise contract. This is logical because, as was indicated earlier, experience enables the franchisor to build up more knowledge of his business and, as a result, to gradually introduce new clauses that enable problems not considered in the past to be solved.

Another variable that makes it possible to establish differences between the clusters is the size of the chains. The companies in the first group have an average size of 97 outlets, while those in the second group have an average of 92 outlets. As we are considering this variable as a measure of the company’s reputation, again, the theoretical approach that companies with a better reputation in the market are the ones that draw up less complex contracts would seem to be confirmed, as they do not

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<sup>16</sup> What is more, this analysis enables us to identify which of the variables used are really important when it comes to forming each of the conglomerates. In our case, the three variables used are important for the formation of the clusters. See Appendix II.

need to do so. Potential franchisees know that, in the event of opportunistic behavior on the part of the franchisor, the latter stands to lose, so they will not have misgivings about signing a contract that is not very detailed.

Finally, if we focus on the analysis of the type of clauses used by each of these groups, the clauses dealing with the franchisee’s obligations are the ones that mark the difference (Tables 6 and 7). So, the contracts of the chains in the first group have an average of 6.68 clauses dealing with the franchisor’s obligations and 14.71 clauses dealing with the franchisee’s obligations, whereas the contracts of the chains in the second group have averages of 9.15 and 23.03 clauses, respectively. To be more specific, particularly big differences can be seen with regard to the obligations of the franchisee that are considered to be important in the franchise relationship. So, on the one hand, obligations such as those that refer to compliance with the method, use of the brand or to the offering can be found in approximately 75% of the contracts of chains that belong to the first conglomerate, while these same clauses can be seen in 100% of the contracts drawn up by chains that belong to the second conglomerate. Meanwhile, clauses dealing with the confidentiality obligation and that of non-competition are included in 55% and 45%, respectively, of the “less complex” contracts, and are present again in most of the “complex contracts”. However, the greatest differences can be seen in relation to clauses that have hardly been studied at all, such as those dealing with advertising, the start-up of business, the independent-entrepreneur indication, the opening hours or taking advantage of the training provided by the franchisor.

**Table 6: Franchisee’s obligations: comparison of conglomerates**

<b>CLAUSES</b>	<b>CLUSTER 1</b>	<b>CLUSTER 2</b>
Fitting out the establishment	87%	100%
Compliance with the method	74%	100%
Use of the trademark	77%	100%
Geographical exclusiveness	83%	97%
Pricing	45%	55%
Advertising	48%	91%
Confidentiality	55%	97%
Non competition	45%	97%
Supply	77%	82%
Offering	74%	100%
Accounting books	55%	88%
Policies and insurance	55%	75%
Transfer of the contract	90%	100%
Start-up	32%	79%
Independent-entrepreneur indication	26%	88%
Inspection	74%	97%
Opening hours	23%	67%
Making use of training	26%	79%
Recruitment	39%	70%

As regards clauses dealing with the franchisor’s obligations, the biggest differences between the two groups can be seen in connection with providing advice on the selection and location of the franchisee’s outlet, the training to be given, both initial training and for updating skills, and the promotion of the chain as a whole.

In short, it seems logical to conclude that the main difference between both groups of contracts is that the “complex contracts” include a wider range of obligations to be fulfilled by the franchisee, the aim being to try to avoid, as far as possible, opportunistic behavior on the part of the latter that puts the chain’s image at risk.

**Table 7: The franchisor’s obligations: comparison of conglomerates**

CLAUSES	CLUSTER 1	CLUSTER 2
Making items available	81%	100%
Advice on outlet	32%	64%
Training	65%	97%
Technical assistance	71%	87%
Exclusivity	74%	85%
Franchise transfer	23%	42%
Advertising	45%	82%

**4.2. Factors that determine the complexity of the contracts**

Table 8 shows the results of the econometric model, obtained with the Stata 8.0 program. As can be seen, in the first column we have considered the franchise fee, the age of the chain and its size as a measurement of the complexity of the contracts. In the second column, we have considered the initial investment, instead of the franchise fee, because of the high correlation between them. And in the third column, we have considered the minimum population for the same reason.

Firstly, it should be noted that both the parameters of the franchise fee, in the first column, and of the initial investment, in the second, are significant and have the sign expected. As these variables approximate the investment in specific assets that the franchisor and franchisee have to make in order to be able to sign the franchise agreement, this supports the first of the hypothesis put forward, i.e. the greater the value of the assets specific to the relationship, the more complex the franchise contract drawn up by the franchisor will be.

In the second place, the variable responsible for measuring the chain’s experience, ANTG, presents the expected sign in all the models and is, moreover, significant. This supports hypothesis H2, so the more years the chain has been using the franchise formula as a means of expanding the business, the more complex the franchise will be, as well.

For its part, although the EST variable, responsible for measuring the size of the chain, and ultimately its reputation, presents the expected sign in all the models, is not significant. So, the



conclusion can be reached that it is not a particularly important factor when determining the complexity of the contracts.

Lastly, the PMIN variable is significant and presents the expected sign. Inasmuch that this variable can measure the importance of each customer, this result supports our hypothesis H4, on the importance of the effort made by the person in charge of the establishment. In short, it can be seen that these results ratify the results obtained from the cluster analysis set out in the previous section.

**Table 8: Factors that determine complexity**

Variable	Model 1	Model 2	Model 3
FEE	0.001*** (3.48)		
INVINI		0.000*** (2.83)	
ANTG	1.268*** (3.18)	0.949** (2.22)	0.878* (1.95)
EST	-0.021 (-0.96)	-0.034 (-1.52)	-0.024 (-0.92)
PMIN			0.000** (2.60)
N	63	64	57
R <sup>2</sup> adjusted	0.248	0.207	0.195
F	7.82***	6.47***	5.52***

Note: Statistic *t* between brackets \*\*\*' \*\*' \* = Significance of 99%, 95% and 90% respectively.

## 5. CONCLUSIONS

This paper sets out to analyze the complexity of franchise contracts. More specifically, the aim is to establish, in the first place, whether there are differences between the contracts designed by the different chains and, in the second place, what factors influence the greater or lesser degree of complexity of those contracts. Although this has been examined before in other kinds of partnership agreements or alliances, it has not been examined in the specific case of franchise agreements. For that purpose, 64 contracts held by different franchise chains currently operating in Spain have been used as a sample.

The results obtained show, on the one hand, the existence of two groups of chains according to the complexity of their contracts, which we have called “chains with simple contracts” and “chains with complex contracts”, the main difference between them being that the second ones include a wider range of obligations for the franchisee, in order to try to avoid opportunistic behavior on the part of the latter that put the chain’s image at risk. On the other hand, it can be seen that *i*) the larger the relationship-specific investments, *ii*) the broader the chain’s experience in the market and *iii*) the more important the effort of the person in charge of the establishment is to the success of the business, the

more complex the contracts drawn up by the franchisors will be. The franchisor's reputation, however, does not appear to influence the degree of detail with which the contract is designed.

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## APPENDIX I: CLAUSES IDENTIFIED IN THE FRANCHISE CONTRACTS

<b>THE FRANCHISOR'S OBLIGATIONS</b>	
Confidentiality	Customers
Data protection	Hiring staff
Make available the items necessary	Transfer of rights and obligations
Advice about the outlet	Start-up of the business
Use of the trademark	Policies and insurance
Supply	Perform tasks that the franchisee cannot do
Pricing	Process documents
Training	Carry out promotion activities
Technical assistance	Preserve image / way business is operated
Geographical exclusiveness	Conduct inspections
<b>THE FRANCHISEE'S OBLIGATIONS</b>	
Running the business / Dedication to it	Provide the franchisor with documentation about his set up / personal documents
Achieve business objectives	Minimum level of purchases from the headquarters
Authorize the franchisor to engage in dealings	Fit-out the outlet
Comply with the method	Accounting books
Use of the trademark	Policies and insurance
Transfer of rights and obligations	Confidentiality
Payments / Bank guarantees	Offering
Customers	Installing recreational machines and others
Business start-up	Independent entrepreneur indication
Providing the franchisor with information	Franchise fee
Initial investment	Royalty
Advertising fee	Initial advertising expenses
Carry out promotion activities	Opening hours
Compliance with regulations	Data protection
Pricing	Making use of the training provided by the franchisor / Training his employees
Hiring employees / Uniformity	Not to enter into other franchise agreements
Supply	Non-competition
Diligence in operating the business	Inspection of the outlet
Geographical exclusiveness	

**APPENDIX I: CLAUSES IDENTIFIED IN THE FRANCHISE CONTRACTS  
(CONTINUED)**

<b> GROUNDS FOR TERMINATION ON THE PART OF THE FRANCHISOR</b>	
Infringement of obligations under other contracts	Misleading to secure the contract
Failure to allow the franchisor to engage in dealings	Carrying out promotions
Compliance with regulations	Hiring employees / Uniformity
Outlet	Payments / Bank guarantees
Offering	Use of the trademark and method
Customers	Conducting inspections
Non-competition	Engaging in activities that might destabilize the chain
Confidentiality	Transfer of rights and obligations
Insolvency / Court proceedings	Accounting books
Policies and insurance	Geographical exclusiveness
Opening hours	Providing the franchisor with information
Independent-entrepreneur indication	Start-up of the business
Data protection	Supply
Diligence / Way business is operated	Unilateral termination by the franchisee
Making use of the training provided by the franchisor / Training his employees	Installing recreational machines and others
Pricing	Achieve business objectives
Information from the franchisee about its set-up / personal details	Running the business / Dedication to it
<b> GROUNDS FOR TERMINATION ON THE PART OF THE FRANCHISEE</b>	
Processing of documentation	Conduct inspections
Passing on the method, brand and other items necessary	Supply
Geographical exclusiveness	Insolvency
Training	Technical assistance
Pricing	Conduct promotions
Preserve the image / Way business is operated	Transfer of rights and obligations
Guidance and advice about the outlet	Unilateral severance by the franchisor
Customers	Hiring staff
Performing tasks that the franchisee does not do	Data protection
Concealment / Distortion	Confidentiality

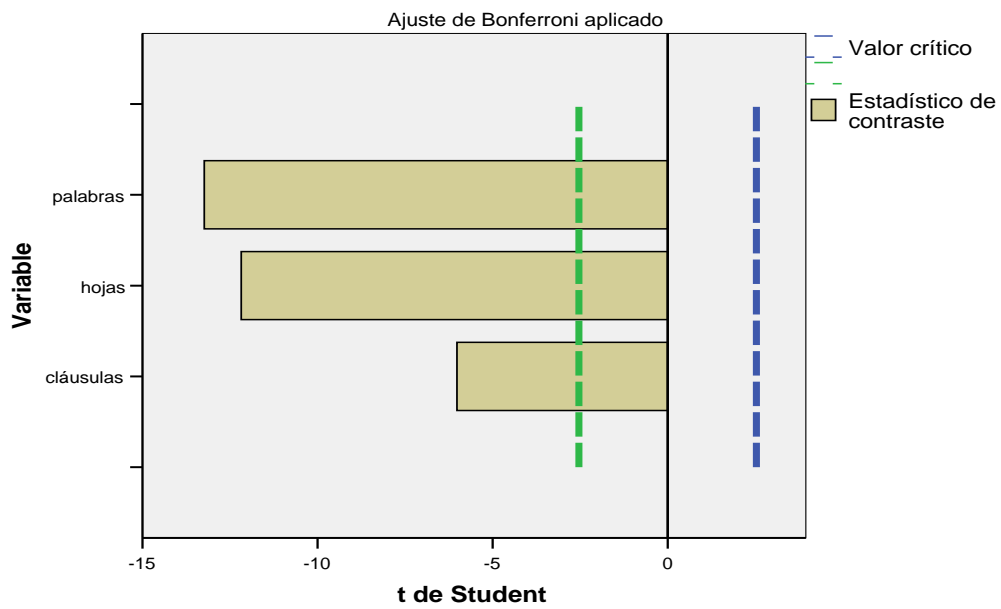
**APPENDIX I: CLAUSES IDENTIFIED IN THE FRANCHISE CONTRACTS  
(CONTINUED)**

<b>OTHER GROUNDS FOR TERMINATION</b>	
End of the term of the contract	Modifications that affect the contract
<b>POST-CONTRACTUAL OBLIGATIONS</b>	
Franchisor: personal details	Franchisee: Must not use the method / Must remove misleading items
Franchisee: Give materials back to the franchisor	Franchisee: Option right of the franchisor over outlet and/or inventories
Franchisee: Stop business / Communication	Franchisee: Payment of sums owed
Franchisee: Telephone lines / Advertising	Franchisee: Confidentiality
Franchisee: Non-competition	Franchisee: Vacate the outlet
<b>OTHER CLAUSES</b>	
Independence of the parties	Purpose of the contract
Obligations stay in force until they expire	Registration of franchisors
No action whatever allowed	No right to compensation for goodwill
Documents attached / Additional documents	Headings and epigraphs / Contradictions
Free acceptance of the contract / It replaces any preceding agreement	Modification of the contract
Loyalty of the parties	Method of communication between the parties
Charges attributable to the parties	Refrain from seeking compliance by the other party
Legal interpretation of the contract and nullity of the clauses	If the franchisee is several persons or a company
Liability of the franchisee for actions of third parties	Jurisdiction: the place where the litigation takes place
Personal guarantees	Prior information
Independent advice	Placement of contract on public record / Costs
Law applicable	



## APPENDIX II: IMPORTANCE OF GROUPING VARIABLES

### Número de conglomerados en dos fases = 1



### Número de conglomerados en dos fases = 2

