Provisions to Be Negotiated in Franchise Contracts: The Case of Spanish Chains

Vanesa Solís-Rodríguez[1] & Manuel González-Díaz[1]

[1] School of Economics and Business, University of Oviedo, Oviedo, Spain

Correspondence: Vanesa Solís-Rodríguez, School of Economics and Business, University of Oviedo, Oviedo, Spain. Tel: 34-98-510-3703.

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Abstract

This paper focuses on franchise contract design, identifying different provisions to be included in contracts and testing the contractual heterogeneity in the number of provisions across chains. Analyzing 74 Spanish franchise contracts, we identify 157 different provisions and document notable differences in contract design. Furthermore, we observe that franchise agreements are unbalanced: contracts cover franchisees' obligations more than franchisors' obligations. This asymmetry can be explained because franchise contract is the basic tool for the franchisor to attenuate franchisees' opportunism. However, franchisees may use alternative safeguards such as franchisor reputation. Finally, we also observe that there are provisions that modify others, changing their literal meaning. Given that such interactions have hardly been studied, more research is needed to measure how they modify parties' rights and obligations.

Keywords: Contract design, Provisions, Obligations, Asymmetry

1. Introduction

A franchise relationship can lead to conflicts between the franchisor and the franchisee because their mutual commitments are costly to monitor and opportunistic behavior may appear (Bercovitz, 2000; Brickley & Dark, 1987; Combs & Ketchen, 1999; Lafontaine, 1992; Shane, 1998). Furthermore, the franchisor seeks standardization and control of the franchisee's business so as to maintain the profitability of the whole network, whereas the franchisee strives to achieve managerial autonomy over its facility (Kidwell, Nygaard, & Silkoset, 2007). Consequently, a balance is created that is highly sensitive to the opportunistic behavior of the parties.

The franchise agreement is the basic tool that supports this balance. In this regard, the literature indicates that the formation of a contract between the franchisor and franchisee can avoid or at least reduce the opportunistic behavior of the parties because the contract is a critical mechanism for addressing control issues and other conflicts that may arise between two parties with divergent interests and incentives (Brickley & Dark, 1987; Shane, 1998). For this reason, we focus on how the contract can solve opportunism.

The details included in contracts depend on both the risk of opportunism (Williamson, 1985) and on parties' capabilities to design the contract (Argyres & Mayer, 2007). Transaction Cost Economics and Agency Theory scholars have explained how contracts have to change to address different contractual hazards (see for example Blair & Lafontaine, 2005). According to them, increases in transaction hazards lead to the introduction of a higher number of provisions in the franchise contract (Klein, Crawford, & Alchian, 1978; Williamson, 1985). On the other hand, literature on organizational learning (Argote, 1999) suggests that firms learn to contract over time, on the basis of their experience and past problems, therefore developing contract design capabilities (Argyres, Bercovitz, & Mayer, 2007; Vanneste & Puraman, 2010). In other words, they progressively improve their knowledge about relevant aspects and details which they then formalize in their contracts, introducing more provisions (Argyres et al., 2007). This means that not all companies are equally able to write contractual provisions to deal with potential opportunism (Argyres & Mayer, 2007): companies without these capabilities are not able to design such detailed contracts (Solís-Rodríguez & González-Díaz, 2015).

Extant literature on franchise agreements have extensively documented *specific* provisions and explained their economic rationality. Some examples are the financial conditions (Agrawal & Lal, 1995; Lafontaine, 1992; Lal, 1990), contract duration (Brickley, Misra, & Van Horn, 2006; Vázquez, 2007), sales prices (Lafontaine, 1999; Lafontaine & Slade, 2001; Muris, Scheffman, & Spiller, 1992; Shepard, 1993), contract termination and renewal (Arruñada, Garicano, & Vázquez, 2001; Brickley, Dark, & Weisbach, 1991), territorial exclusivity (Brickley, 1999) or tying (Shane, 2001).

However, hardly any attention has paid to the contract as a whole, when a general vision of its content is relevant. Only Udell's study (1972) analyzes the franchise contract in this way. As stated by Golberg and Erickson (1987) and Argyres et al. (2007), clauses included in a contract are chosen simultaneously and may interact, so empirical studies should analyze contractual provisions as a whole.

We address this gap in the literature by conducting a descriptive analysis of different provisions included in franchise agreements (Note 1). First, we identify the specific aspects of the franchise relationship that could be addressed in these contracts. Second, we examine variability in the number of provisions across franchise chains by elaborating a list of standard contractual provisions or stipulations and their percentage of use. Finally, we identify the interdependences among provisions, bringing into question part of extant empirical studies about the economic relevance of single provisions. This analysis is useful not only for researchers but also for entrepreneurs and practitioners without contract design capabilities who may want to have a benchmark for wording their contracts.

This chapter is organized as follows. First, we review the literature about the franchise contract, focusing on the contractual provisions that have been analyzed. Second, we describe sample features and provide a list of the provisions identified in our analysis of franchise contracts. Finally, we discuss implications of our findings.

2. Theoretical Review

A franchise is an agreement between two legally independent entities, the franchisor and the franchisee. The former is the owner of a business concept, brand or product that it has developed and agrees to give the franchisee temporary use of them. In exchange for this transfer, the franchisee pays a franchise fee and a royalty. In US, franchising directly contributes $674.3 billion in economic output, accounting for 2.5% of private sector GDP (International Franchise Association, 2016). The figures are smaller in Spain, but franchising is growing constantly, reaching 9 percent of Spanish retail sales and employing more than 250,000 people (Asociación Española de Franquiciadores, 2016).

Due to the increasing level of competition in different industries, many companies have started to expand their coverage (Ansari & Riasi, 2015; Welsh, Alon, & Falbe, 2006) by signing franchise agreements or starting long term partnerships with other business entities. Given the economic importance of these operations, the joint effort required and the difficulty of monitoring the behavior of both the outlet manager and the franchisor, it is possible that the parties, acting in their own self-interest, will decide not to pursue the efforts expected of them (Bercovitz, 2000). Thus, both the franchisee and the franchisor have the potential to engage in opportunistic behavior.

Franchisee's remuneration with the residual rights from its particular units generates high-powered incentives which may lead it to maximize its owned gains at the expense of the overarching franchise system by, for example, cutting costs by lowering product or service quality. This is because the cost of such behavior is borne primarily by the other franchise units, which lose customer patronage, and by the franchisor, which will have a less valuable trademark to franchise in the future. Franchisees can also hurt the franchise system by failing to make the efforts expected of them. As stated by Lal (1990, p. 312), "if the service level cannot be specified in the contract and accurately verified with certainty subsequently, the franchisee has incentives to shirk since it does not capture all the benefits from delivering the higher service level".

Problems can also arise due to opportunistic behavior by the franchisor (Lafontaine, 1992; Rubin, 1978). The success of a franchise chain mainly depends on the franchisor because he provides the brand image and ensures that its value persists or increases over time (Perales & Vázquez, 2003; Solís-Rodríguez & González-Díaz, 2012). To achieve this end, the franchisor will centralize the promotion of its products/services, update the know-how needed to manage the business, and train and assist franchisees to maintain chain uniformity. However, the franchisor does not receive the full benefit of its efforts. Because it has franchised a certain percentage of its establishments, the franchisor bears all the costs of these activities but only receives a fraction of the profit. This may lead the franchisor to neglect its obligations and to maximize its benefit in the short term by collecting royalties and fees from its franchisees while allowing the chain and its brand to lose value. Moreover, the franchisor may have incentives to terminate and/or fail to renew the contracts of successful franchisees in order to take back control of the most profitable franchise establishments (Dant, Kaufmann, & Paswan, 1992). From the perspective of the franchisee, all these types of behavior are important problems which may lead them to lose their specific investments.

The franchise agreement is the basic tool for solving or at least mitigating problems related to opportunism through appropriate provisions or safeguards. These provisions have three objectives: a) to encourage the effort and dedication of the franchisee to manage the establishment (Rubin, 1978); b) to limit the franchisee's ability to impose negative externalities on other franchisees or the franchise chain (i.e., to incentivize the franchisee to maintain the value of the brand and to act to benefit the entire chain) (Lafontaine & Raynaud, 2002); and c) to encourage the franchisor to perform activities necessary to maintain brand value (Bercovitz, 2000).

The literature and empirical evidence on franchise agreements have focused primarily on analyzing specific provisions. Some works are descriptive, aiming to explain the content of these stipulations, establish the percentage of franchises that use them, etc. Other studies have analyzed the evolution of different provisions over time or endeavored to explain how these stipulations contribute to the achievement of the three goals mentioned above. A review of the existing literature on franchise provisions is presented below.

2.1 Financial Conditions

Undoubtedly, the most studied franchise provisions are those relating to financial conditions (Agrawal & Lal, 1995; Lafontaine, 1992; Mathewson & Winter, 1985; Sen, 1993). Such stipulations usually include a franchise fee, which is a fixed amount paid at the beginning of the relationship, and regular commissions, which comprise royalties and advertising fees and are usually established as a percentage of the franchisee's sales (Caves & Murphy, 1976; Rubin, 1978). We are therefore discussing what is called a share contract.

The franchise fee is a sunk cost for the franchisee and thus acts as a guarantee for the franchisor in addition to compensating the latter for its specific investments made at the beginning of the relationship (e.g., advice on the selection and location of the establishment, training or assistance in the opening of franchised outlet) and the intangibles conveyed by the franchisor to the franchisee (e.g., know-how). Thus, the greater the specific investments and intangibles transmitted to the franchisee are, the greater the franchise fee (Dnes, 1992). In turn, the variable payments *a*) positively affect the investments required by the franchisor to maintain brand value, thereby avoiding possible problems with franchisor opportunism, but *b*) negatively affect the level of service provided by the franchisee and can thus cause opportunistic franchisee behavior, such as reductions in product quality or breaches of the franchise agreement. Therefore, the amount of the variable payment is determined based on the relative importance of the work done by the franchisor and the franchisee. The empirical evidence is consistent with the doubled-sized moral hazard model: the more (less) important the work done by the franchisor (franchisee) is, the higher (lower) the variable payments will be (Agrawal & Lal, 1995; Lafontaine, 1992; Rubin, 1978; Sen, 1993).

One closely analyzed issue related to financial conditions is the relationship between the franchise fee and royalties. The doubled-sized moral hazard models establish the existence of a negative relationship because they assume that the franchise fee and royalties are alternative means of extracting rent from the franchisees (Lafontaine & Slade, 2001). However, most studies of this issue have observed a positive relationship between them (Baucus, Baucus, & Human, 1993; Lafontaine, 1992; Mathewson & Winter, 1985). The explanation for this result is that the franchise fee and royalties are remuneration for two distinct concepts: the entry fee allows the franchisor to recover its initial costs, whereas royalties compensate the franchisor for granting the franchisee the right to use its brand and know-how and for the advisory services and support provided by the franchisor throughout the duration of the contract.

The advertising fee has generally been studied together with royalties because its incentivizing effect is similar (e.g., Lafontaine, 1992; Sen, 1993). In fact, many franchise agreements provide for the payment of a single royalty that encompasses both concepts. However, the royalty and advertising fee are discrete concepts: the royalty, similar to the entry fee, compensates the franchisor for a set of services provided to the franchisee, so it is a source of income for the franchisor, whereas the advertising fee is not because it is used to finance national advertising for the entire franchise chain (Sen, 1993; Desai, 1997).

Finally, with regard to the use and evolution of financial provisions over time, it is interesting to note that most theoretical models of contracting maintain that the principal should adapt the terms of the contract to fit the unique characteristics of each agent, establishment and market (Lafontaine & Slade, 2001). This proposition implies that the franchisor should write a different contract for each franchisee (Bhattacharyya & Lafontaine, 1995) and therefore calculate a different payment scheme for each franchisee. However, we find that the opposite occurs in practice, with most chains using a standard contract for all franchisees at their disposal at a particular point in time (Lafontaine & Kaufmann, 1994).

Empirically, this uniformity is observed in the establishment of financial conditions (Dnes, 1992; Lafontaine, 1992; Sen, 1993). It has also been observed that franchise agreements remain stable over time and that franchisors do not significantly change contractual terms, especially financial provisions (Lafontaine, 1992; Brickley et al., 2006).

2.2 Contract Duration

Another provision that has been widely studied is the provision that defines the duration of the contract, which is considered by both franchisee and franchisor to be one of the most important stipulations contained in the franchise agreement (Dant et al., 1992). However, the interests of the parties diverge as to the optimal duration. On the one hand, franchisees prefer long-term contracts because this provides sufficient time to recoup their investments, many of which are specific to the relationship and would therefore generate hold-up problems (Klein et al., 1978; Williamson, 1985). On the other hand, long-term contracts limit the ability of the franchisor to implement necessary changes in the franchise system and to rescind contracts with inferior franchisees without engaging in costly litigation (Brickley et al., 2006; Crocker & Masten, 1988) (Note 2). Thus, the optimal duration of the contract must reflect a balance between the cost of negotiating the terms of the contract and the risk of being tied to an inflexible agreement for a lengthy period of time (Crocker & Masten, 1988). It is therefore necessary to consider what factors determine the duration of the franchise agreement.

Although few studies have explored this issue, either in the franchising field or in other contexts (Brickley et al., 2006; Crocker & Masten, 1988; Joskow, 1987; Vázquez, 2007), we can clearly distinguish three major factors that affect the duration of the franchise contract: asset-specific investments, experience and the likelihood of opportunistic behavior by the franchisee. First, it is believed that the greater the investment by the franchisee in franchise-specific assets to launch the business is, the longer the contract duration should be; in this way, the franchisee is protected from the opportunistic behavior by the franchisor to expropriate the quasi rents generated by these assets. In addition, long-term contracts provide adequate time for the franchisee to recoup its investments (Joskow, 1987; Brickley et al., 2006). It has also been observed that there is a positive relationship between the franchisor's experience in franchising and the duration of the contract (Brickley et al., 2006). Because younger chains face greater uncertainty when designing the contract, the parties prefer to establish short-term contracts, which give them greater flexibility to modify the contract if needed. Finally, it is believed that the greater the likelihood of opportunistic behavior by the franchisee is, the shorter the contract duration will be because a limited duration gives the franchisor more power to control such opportunistic behavior (Vázquez, 2007).

In short, the duration of the contract affects the expected rents of the franchisee and thus incentivizes the franchisee to comply with contractual provisions. Contract duration thus acts as a self-enforcement mechanism. Long-term contracts *a*) increase the level of rents obtained by the franchisee and *b*) provide sufficient time for the franchisee to recover the investment made to acquire the franchise. The franchisee therefore has a greater incentive to make franchise-specific investments because it has greater protection from opportunistic franchisor behavior (Brickley et al., 2006; Vázquez, 2007).

2.3 Contract Termination and Renewal

Other provisions that affect the expected rents of the franchisee are those related to contract termination and renewal. On the one hand, the possibility of contract termination is crucial in managing the franchise relationship (Arruñada et al., 2001) because the efficacy of a self-enforcement mechanism depends on the franchisor's ability to terminate the contract if opportunistic franchisee behavior is detected (Brickley et al., 1991). For the franchisee, early termination of the franchise contract signifies *a*) lost rents and *b*) lost investment. Thus, the franchisee has an incentive to behave appropriately to avoid early contract termination.

On the other hand, the existence of termination provisions can induce opportunistic behavior by the franchisor because they can be used to appropriate the most profitable franchise establishments (Brickley et al., 1991). To protect franchisees from this type of behavior, courts often require the franchisor to show just cause for contract termination, which in turn limits the franchisor’s ability to control opportunistic franchisee behavior. Together with a lengthy contract duration, the requirement of just cause for termination increases the franchisee’s incentive to breach the provisions of the contract, which in turn reduces the effectiveness of such terms as self-enforcement mechanisms (Brickley et al., 1991).

In contrast, contract renewal is subject to less regulation, meaning that franchisees that behave opportunistically can be sanctioned through non-renewal of the contract. Non-renewal therefore acts as a substitute for rescission prior to contract expiration. Contract renewal implies that the franchisee will continue to receive rents beyond contract expiration. The higher the probability of contract renewal is, the higher the amount of rents associated with maintaining the relationship, which means that the franchisee has a greater incentive to comply with franchisor directives (Lafontaine & Raynaud, 2002).

2.4 Sales Prices

Provisions pertaining to prices have also been analyzed. One drawback associated with franchising from the franchisor's perspective is the loss of control in favor of the franchisee, including the loss of control over the final prices paid by consumers. From the theory, a company experiences higher price dispersion under a franchise system for two main reasons (Lafontaine, 1999). First, although the franchisor values price uniformity within the franchise chain for efficiency reasons, the franchisee wants to adapt its prices to the characteristics of its particular market. Because the franchisor has no direct control over prices, the franchisee will establish the prices that it deems optimal for that particular establishment, causing price dispersion within the franchise chain. Second, even if the conditions are the same for all franchise establishments, price dispersion will nonetheless exist because the franchisor and franchisee disagree on the price charged to the final consumer. The empirical evidence is in line with theory in this regard, and we find that prices are systematically different in owned and franchised establishments, with higher prices being found in the latter (Muris et al., 1992; Shepard, 1993).

Franchisors often believe that the prices set by the franchisees are too high and thus try to reduce them. Consequently, franchise contracts often obligate the franchisee to follow the franchisor's price recommendations. In this way, the franchisor limits the ability of the franchisee to behave opportunistically and therefore reduces the benefits the franchisee might earn from such behavior (Klein, 1980), which could affect the image of the entire franchise chain. In short, price control provides the franchisor an advantage in disputes with the franchisee and limits price dispersion within the chain (Blair & Lafontaine, 2005).

2.5 Territorial Exclusivity

Granting territorial exclusivity allows the franchisee to have a certain level of market power in a specific geographical area, which ensures that the franchisee will not have the incentive to behave opportunistically (Brickley, 1999; Klein & Murphy, 1988; Mathewson & Winter, 1994). In the absence of any other chain establishment, either owned or franchised, in the area in which the franchisee is located, the franchisee benefits from all sales generated by the chain in this area and is assured that all efforts to develop the business will directly benefit himself. In short, a grant of exclusivity increases the potential rents of the franchisee, thereby acting as a self-enforcement mechanism.

In addition, territorial exclusivity decreases the risk of encroachment, which is the establishment by the franchisor of new outlets within a given exclusive territory, which cannibalizes the sales of the franchisee to which said territory had been granted (Sass & Saurman, 1993). In this sense, Azoulay and Shane (2001) observe that a grant of territorial exclusivity increases the probability that a franchised outlet will survive, which they interpret as an indication that a grant of exclusivity is so important to franchisees that the failure to offer such a grant will make it extremely difficult for a franchisor to attract new franchisees.

2.6 Supply

The franchisor commonly requires the franchisee to purchase certain products directly through the chain or from suppliers authorized by the chain. This obligation is known as a tying agreement (Note 3).

The establishment of this provision serves a dual purpose for the franchisor. First, it controls the behavior of the franchisee (Klein & Saft, 1985) and thus reduces the franchisee's incentive to behave opportunistically (Shane, 2001). The franchisor thereby ensures that all franchised outlets maintain a minimum standard of quality (Shane, 2001). Second, the franchisor will earn supplemental rents from these franchisees, in addition to the monthly royalties. This supplemental rent is important because it allows the franchisor to decrease its franchise fee, which in turn makes the franchisor more attractive to potential franchisees (Blair & Lafontaine, 2005).

2.7 Other Provisions

Other provisions that mitigate the opportunistic behavior of the franchise parties have been studied, albeit in less depth than those discussed above. For example, Dnes (1993) focuses on provisions relating to non-competition and to the transfer of the franchisee's assets upon contract termination, concluding that these provisions protect both the franchisor and franchisee from the potential opportunistic behavior by the other party. Brickley (1999) examines stipulations regarding the franchisee's management of and dedication to the business, relating such provisions to the risk of opportunism (free-riding) by the franchisee. The author claims that they are more likely to be included in the franchise agreement in the presence of externalities that motivate opportunistic behavior by the franchisee. Lafontaine and Raynaud (2002) analyze various contractual provisions that are used to encourage the franchisee to properly manage the establishment and to avoid jeopardizing the image of the chain. Stipulations relating to proper management of the franchise establishment include those that require the franchisee to provide accounting and sales information to the franchisor; specify the manner and frequency with which such information should be transmitted; entitle the franchisor to conduct inspections of the franchisee's establishment; and govern the franchisee's ability to transfer its rights and obligations under the franchise agreement. Provisions designed to protect the image of the chain include those relating to suppliers, compliance with franchise guidelines and the potential to open new chain outlets (multi-franchising) (Note 4).

3. Methodology

3.1 Data Collection

Between March 2006 and December 2007, we contacted 805 Spanish franchise chains by telephone and e-mail, aiming to ask the franchisors about various aspects of their franchise experience, including the franchise agreement. We received responses from 293 franchisors (in many cases after multiple contacts), 74 of which sent us the franchise contract. All such contracts belong to franchisors that currently operate in Spain in the service or retail industry. The former category includes real estate agencies, hairdressers, travel agencies or consultancies, and the latter category includes catering and clothing establishments or vending operations.

Using the 74 contracts provided by respondents, we began to develop a database of the provisions included in each contract. With this aim, we had to code all provisions included in our sample. The first step was to carefully read the 74 contracts to obtain a first draft of the list of provisions or contractual problems included in all of them. Certain provisions were already known to the authors because, as mentioned above, the literature and empirical evidence on franchise contracts have analyzed specific provisions (such as those relating to payment structure, contract duration, selling prices, territorial exclusivity or tying). However, other provisions were completely new to us because they address issues that are not publicized by franchise chains.

Once we had a draft list of provisions, the next step was to process all the literal clauses included in the contracts to identify which provisions (Note 5) were included in each contract at least once (Note 6). For this purpose, the authors separately classified the provisions and agreed on any differences. Where there were discrepancies, a third-party opinion was sought. The authors ultimately identified 157 potential provisions in the contracts (Note 7). Obviously, there were differences among the contracts in terms of the number and types of provisions addressed therein. Therefore, the review of the contracts involved a learning process during which we progressively adjusted the number of provisions by a) creating a new provision for aspects that were initially included under another provision; b) combining two or more provisions into a single provision; and c) moving aspects from one provision to another.

3.2 Description and Discussion of Main Provisions in the Sample

Table 1 presents a description of the main provisions included in the analyzed franchise agreements. Certain issues relating to the design of such contracts are highlighted below.

Table 1. Provisions covered in contracts

PROVISIONS	% CONTRACTS	COMMENTS
Purpose of the contract	90.54	Purpose of the franchise agreement; 5.97% include a definition of franchise
Legal independence from the franchisor	85.14	No employment relationship exists between the franchisor and franchisee. The franchisee is solely responsible for the business.
	58.11	The franchisee is an independent company.
Management of the outlet by the franchisee	10.81	50% require the franchisee to personally direct the business; 25% provide for the possibility of a different manager.
Fee	75.68	Compensation for the license granted, use of logos, transfer of technology, know-how, etc.
Initial investment	17.57	Initial investment required to open a franchise establishment.
Royalty	67.57	58% require a monthly royalty as a % of sales; 28% specify a fixed royalty; 4% provide for a mixed royalty; and 10% establish an annual royalty.
Advertising fee	40.54	A monthly % of sales for 43.3%; a fixed monthly rate for 40%; and an annual fee for 6.7%.
Contract duration	100	Establishes a specific contract duration; 87.84% specify the possibility of renewal if there are no defaults and/or express termination by any party.
Transfer of the business	94.59	Franchisor consent is required. In 37.14% of cases, the franchisor has a right of first refusal.
	32.43	In cases of assignment by the franchisor, 79.17% require that the franchisee be informed.
Training and assistance	82.43	Franchisor provides initial training; 52.46% of cases also mention continuing education.
	56.76	Franchisee is obligated to accept the training provided by the franchisor.
	79.73	Assistance; 20.34% require the franchisor to provide support personnel during the first days of franchise activity.
Inspections	87.84	90.77% obligate the franchisee to allow entry by the franchisor; 29.23% obligate the franchisor to conduct regular monitoring visits.
Mandatory accounting records	75.68	82.14% grant the franchisor the right to inspect the data; 69.64% require periodic delivery of documentation; and 10.71% impose penalties if the statement is inconsistent with reality.
Non-competition against the franchisor	72.97	During the contract period, the franchisee may not engage in competitive activities or acquire shares in competing companies.
	52.7	Post-contractual obligations; 92.31% specify duration; 30.77% specify the covered territory; and 48.72% require compensation for breach.

Table 1. Provisions covered in contracts (Continued)

PROVISIONS	% CONTRACT	COMMENTS
Business confidentiality	78.38	Franchisee, for the duration of the contract.
	47.3	Franchisee, indefinitely after termination of the contract.
	6.76	Franchisor, for the duration of the contract.
Inheritance	40.54	Transfer of the franchise in case of the death of the franchisee.
Regulation of brand use	90.54	Franchisee: 50.75% require immediate notification of any violation of industrial property rights; 53.73% require the exclusive use of the franchisor's brands in the establishment; and 26.86% provide no rights to brands.
	72.97	Franchisor: authorizes the use of the brand by the franchisee; 25.93% include an obligation to protect the brand.
Advertising	70.27	Franchisee: 75% require franchisor approval of any campaigns.
	62.16	Franchisor: 43.48% obligate the franchisor to conduct regular promotions for the chain.
Control of selling prices	50	Franchisee: 78.38% require the franchisee to adopt the prices established by the franchisor.
	55.4	Franchisor's obligation to provide the selling prices
Territory	45.95	The franchisee cannot conduct selling activities outside its exclusive territory.
	79.73	The franchisor must respect the exclusive territory of the franchisee.
Adaptation of premises/establishments	94.59	The franchisee must set up and decorate the establishment in compliance with the franchisor's requirements; 20% require a "Certificate of Conformity" to start franchise activity.
	87.84	Exclusive scope of performance; 72.31% require franchisor consent to change location and/or open new establishments.
	47.3	Franchisor is obligated to provide advice regarding selection and location of the establishment.
Compliance with franchise methods	91.89	Franchisee must comply with the franchisor's method; 58.82% require the use of a computer system connected to the franchisor; 30.88% prohibit the use of the method for any other purpose; 10.29% require the use of uniforms; and 22% define know-how.
	90.54	Franchisor must provide the elements necessary to conduct the activity.
Control of suppliers	83.78	Franchisee: 64.52% provide for exclusive supply through the franchisor and/or authorized suppliers; 22.58% provide for the possibility of engaging with other suppliers.
	10.81	Franchisee must meet a minimum level of purchases through the central branch.

Table 1. Provisions covered in contracts (Continued)

PROVISIONS	% CONTRACTS	COMMENTS
Control of product range	89.19	78.79% require the exclusive use of the franchisor's products/services; 7.6% provide for the possibility of offering other products/services with franchisor consent; and 24.24% require the franchisee to provide the full range of products/services to customers.
	14.86	Reach commercial objectives.
	14.86	Transfer of customers between franchisees.
Hours of operation	41.89	The franchisee shall comply with the established hours of operation.
Start of the business	56.76	Deadline is established after the contract is signed.
Labor regulations/hiring	50	Franchisee: 59.46% require compliance with legal requirements and/or specify required degrees/qualifications; 43.24% require a sufficient number of employees; and 24.32% must comply with the directives of the franchisor and/or are required to obtain franchisor consent.
	18.92	Franchisor: 64.29% require the franchisor to provide advice on personnel selection.
Prompt payment to franchisor and/or third parties	83.78	Payments to the franchisor and/or third parties; 38.71% require bank guarantee of obligation.
Data protection	19	Franchisee: Compliance with data protection regulations.
	12.57	Franchisor shall comply with data protection regulations
Resolution of causes	97.3	100% grant the franchisor a right to terminate the contract; 81.94% grant the franchisee a right to terminate the contract.
Post-contractual obligations	87.84	Prohibition on the use of the franchisor's system and obligation to eliminate elements referring to the franchisor.
	72.97	Elements related to the franchise must be returned.
	31.08	Franchisor's preference over the stocks.
	37.84	Immediate cessation of operations/notification to anyone who might be affected by the termination of franchise activity.
	55.4	Payment of any amounts due.
	27.03	Elimination of any advertising activity performed as a franchisee and listings in telephone directories under the chain's identity.
Other provisions	21.62	No right to compensation from the business.
	39.19	Supersedes any previous agreement.
	36.49	Contract modification.
	58.11	Communication between the parties.
	39.19	Nullity of clauses.
	14.86	Notarization of the contract/expenses.
Arbitration/Forum	95.95	78.87% specify a forum; 11.27% mandate arbitration; and 9.86% use both.
Applicable law	39.19	Spanish and European Union law.

1. Contract duration

The only provision that appears in every contract addresses contract duration. Furthermore, 88 percent of the contracts specify the possibility of contract renewal by the franchisor provided that there are no breaches and/or express notice of termination is given by one of the parties. This renewal option provides an incentive to the franchisee because it affords him more time to recover its investment (Note 8). In Udell's study (1972) for the US these percentages are smaller: only 78 percent of the contracts indicated the length of contract (usually between 10 and 20 years) and only 54.2 percent specify the option to renew the agreement (in this case, the franchisee's right to renew). The initial term of the contracts varies between 1 and 10 years, as does the renewal period; the most common formula is a term of 5 years with an option to renew for another 5 years (Note 9). Finally, the wording of this provision is quite similar in all contracts analyzed, typically stating the following:

> "This contract takes effect on the date specified in the header thereof and, unless there is an anticipatory termination for any of the causes contemplated herein, will last for [...] years. This contractual relationship may be renewed for successive [..] periods [...], provided that there is no written and credible cancellation of the contract before [...] months before its expiry date in which either party reveals the intention to not continue the relationship to maturity […]. The renewal will include new elements and conditions of the franchise that have been incorporated [...], thus the new contract will be in agreement with the proposal for new franchisees. [...] in any case, at the end of the agreed time, the franchisee is required to make the investment needed for the renewal and adaptation of furniture and existing decor [...] in the premises in which the provision of services of this franchise occurs."

The above example includes two conditions that are commonly required by the franchisor for contract renewal. Specifically, a) the franchisee must accept the terms offered to new franchisees at the time of renewal and b) the franchisee must undertake all necessary investments to adapt its business to changes implemented by the chain. Therefore, the franchisee must comply with certain conditions imposed by the chain to continue operating as a franchisee. This is a clear example of how different provisions (contract duration, renewal and adaptation) are interdependent and therefore must be jointly analyzed.

2. Obligations of the franchisee

A second set of provisions included in a significant share of the analyzed contracts are those that establish the obligations of the franchisee. One of these provisions is related to the transfer of the business. In 94.59 percent of the cases analyzed, the franchisee must receive express authorization from the franchisor for transferring the franchise (74.1 percent in Udell's study), and nearly 40 percent of these contracts grant the franchisor the right of first refusal if such authorization is granted (this figure is similar in Udell's study: 32.4 percent). The latter condition gives the franchisor full control over the establishment because it allows the franchisor to match any offer made by a third party (Dnes, 1993).

> "In the event the franchisee wishes to sell or transfer the business, the franchisee must first offer it to the franchisor [...]. The franchisee will not reduce the price or give another person conditions more favorable than those being offered to the franchisor without previously having offered this to the franchisor mentioned [...]. The franchisee may not burden, mortgage, pledge or dispose of the interests or rights in the franchise agreement without the prior written consent of the franchisor […]."

Thus, the franchisor seeks to protect its interests in the sense of maintaining the brand image and quality offered by the chain and to prevent the franchisee from expropriating the rents generated by intangible assets (Windsperger, 2002). Clearly, if the franchisor grants the franchisee the authorization to transfer the business, the franchisee must meet certain conditions. For example, as set forth in one sample contract:

> "The transfer of rights of this property will be subject to the following conditions: *a*) there is notice at least 60 days before the date of the proposed transfer; *b*) the acquirer successfully passes the selection process that the franchisor has established at that time; *c*) the franchisee is up-to-date with all payments to the franchisor; *d*) the acquirer formalizes a new franchise agreement with terms that the franchisor has determined to join the network at that time; [and] *e*) the franchisee pays the franchisor 15 percent of the transfer price."

This example clearly shows again that provisions in the contract are interdependent. In this case, the transfer of the business provision should be jointly analyzed with "selection process" (point *b*), "franchisees' payments" (point *c*) and "renewal" (point *d*) provisions.

When we shift our focus from the transfer of the business by the franchisee to the sale of the chain by the franchisor, the situation changes dramatically. In particular, only 32 percent of the analyzed contracts refer to this provision, indicating that the franchisor is free to assign the business without seeking the consent of the franchisees. Moreover, in the contracts that do refer to this provision, the only requirement is that the franchisor communicates this decision to the franchisees.

Other notable provisions within the group of franchisee obligations are the following:

➢ Adaptation of the establishment:

This provision is present in 94.59 percent of the contracts analyzed and essentially establishes that the franchisee must follow the instructions of the chain regarding the layout and decoration of the establishment. Thus, as set forth in the following example:

> "The establishment will be built [...] by faithfully complying with the instructions received from the franchisor. The appearance [...] will not be altered during the term of this agreement, [...] except with the prior written consent of the franchisor. The decoration and adaption plan of the establishment [...] will be conducted by the franchisee at the franchisee's expense [...] the franchisor has the right to inspect the property after the signing of this contract and to demand the necessary corrections [...] the franchisee will make the improvements and changes that the franchisor deems necessary at the franchisee's expense […]. The franchisee must have the establishment as property or other legally appropriate means [...]. The obtaining of licenses and administrative permissions necessary for the operation of the establishment will be the exclusive duty and expense of the franchisee."

➢ Use of the franchisor's brand:

This provision stipulates that the franchisee does not acquire any rights to the transferred brand and must use the brand only in the franchised establishment and for the development of franchise activity. This obligation is included in 90.54 percent of the sample contracts. The following is an example of such a provision:

> "[…] the franchisee has the right and obligation to use the name, brand, signs, labels, formulas and methods of the franchise solely and exclusively in the establishment indicated in the contract [...] and will use them only in the manner authorized and permitted by the franchisor. [...] Any unauthorized use will constitute an infringement of the rights of the franchisor, which will lead to compensation for harm and damages. [...] The franchisee will not use the brand to incur any obligation or liability on behalf of the franchisor. [...] The franchisee will notify [...] of any unauthorized use of trademarks […]."

➢ Compliance with the franchise method:

This refers to the franchisee's obligation to strictly comply with all guidelines established by the chain in Operating Manuals and in the contract itself. Furthermore, the franchisee may use the know-how provided by the franchisor only for the activity specified in the contract. This provision is observed in 91.89 percent of the contracts. The following is a sample:

> "The Manual refers to the book containing information on the operation, training and continuing operation instructions [...] that the franchisor provides to the effect that they are followed by the franchisee in the operation of the establishment [...]. The franchisee [...] will manage the establishment in accordance with the obligations of the contract and in compliance with the guidelines and standards set in the manual [...]. The franchisee will not exploit or use the System except for the operation of the establishment and in the establishment itself, always in accordance with the terms and conditions of this agreement. […]."

➢ Supply:

This provision appears in 89.19 percent of the contracts in our sample and provides that the franchisee may only sell products authorized by the chain at the franchise facility. However, a portion of these contracts provide for the possibility that the franchisee can offer products other than those described above with the express consent of the franchisor (7.6 percent of the contracts with supply provisions). An example of a supply provision is presented below:

> "The franchisee must refrain from marketing products branded by third parties in the business [...] and undertakes not to market products competing with the business [...] agrees not to market products or services that could damage the corporate image, the common identity and/or prestige of the

> network [...] will not make any statement and will not make guarantees to any customer regarding the products, except those required by law or specifically authorized by the franchisor [...].”

- Sourcing:

A sourcing provision requires that the franchisee be supplied solely through the franchisor and/or suppliers approved by the franchisor and is contained in 83.78 percent of the contracts analyzed. Additionally, similar to the supply provision, a portion of the analyzed contracts provide for the ability to source from other suppliers with consent by the franchisor (although the percentage is higher in this case, 22.6 percent). The purpose of this exception is to allow the franchisee to purchase products that neither the franchisor nor its suppliers can supply. The following is an example:

> “[…] it is understood that products XXX are the products of exclusive supply by the franchisor and therefore may not be obtained by the franchisee from a source other than those indicated by such franchisor [...] With respect to products other than those specified [...] that the franchisor could not supply directly to the franchisee, the franchisor will appoint one or more suppliers of his choice [...]. Only through express prior written consent of the franchisor [...] may the franchisee contract with alternative suppliers [...] the franchisee will keep the franchisor regularly informed on the quantities of items delivered by this alternative source. […].”

- Financial conditions:

Finally, the obligations of the franchisee include certain financial conditions. As noted previously, these provisions seem to receive the most attention in the literature, but Table 3.1 shows that they are not as employed as often as the provisions described above. In particular, only 75.68 percent of the analyzed contracts establish the franchisee's obligation to pay a franchise fee (Udell’s study; 78.8 percent); 67.57 percent establishes the franchisee’s obligation to pay royalties (Udell’s study: 76 percent); and 40.54 percent establishes the franchisee’s obligation to pay advertising fees (Note 10).

Franchise fees range from a minimum of 0 euros to a maximum of 35,000 euros, with the average of approximately 11,000 euros. The franchise fee provision typically establishes that the payment of this amount compensates the franchisor for the transfer of the business model and for providing the franchisee with a set of services needed to start the business. As stated in the contract of one of the chains in the sample:

> “[…] The payment of this fee includes the provision by the franchisor of the following services: *a*) the right to use trademarks, service marks, standards and procedures; *b*) support and advice for installation, commissioning and operation of the outlet; *c*) review of the lease contract for business premises; *d*) any initial training needed to develop real estate and financial management with the utmost diligence; *e*) provision of agendas, calculators, desk and wall calendars, lighters, pens, etc.; [and] *f*) decoration of the outlet with pictures and stickers of XXX […].”

In this case, it is important not only that the franchise contract includes provisions regarding these items but also what those provisions establish with them. So in this case, the franchise fee provision is clearly interrelated with some franchisor’s obligations.

In contrast, royalties and advertising fees are usually established as a monthly percentage of the franchisee’s sales (as in 58 and 43.3 percent of the sample contracts, respectively), although certain contracts establish royalties and advertising fees either as a fixed monthly percentage (28 and 40 percent, respectively) or an annual amount (10 and 6.7 percent, respectively). Moreover, certain chains that require the payment of a monthly percentage specify a minimum monthly payment by the franchisees and/or establish a percentage scale based on the level of sales. An example of a provision addressing royalties and advertising fees is provided below:

> “A royalty is established based on gross monthly sales (total sales of the franchise), based on the following parameters: *a*) for sales of 0-5000 euros, 150 euros (this amount is a monthly minimum); *b*) for sales between 5,001 and 7,500 euros, 3 percent of gross sales; *c*) for sales between 7,501 and 10,500 euros, 4 percent; *d*) for sales between 10,501 and 14,000 euros, 5 percent; *e*) for sales between 14,001 and 18,000 euros, 6 percent; [and] *f*) for sales exceeding 18,001 euros, 7 percent […].”

3. Obligations of the franchisor

The number and use of provisions that establish franchisor obligations are much lower than those establishing franchisee obligations. In fact, franchisor obligations are in many cases limited to the provision of the necessary elements for the franchisee to develop the activity (90.54 percent), training (82.43 percent), support (79.73 percent) and an exclusive territory (79.73 percent).

Among franchisor obligations, training and assistance are perceived as one of the major benefits of the franchise system (Mendelsohn, 1985) because they contribute to improvements in franchisee performance and thus enhance the profitability of both parties (Davey-Rafer, 1998). Therefore, chains generally provide training and assistance both initially and throughout the duration of the contractual relationship. Initial services include advice from the franchisor regarding the selection and location of the establishment, staffing, sales techniques, etc., as well as training of both the franchisee and its employees. Later, throughout the term of the contract, the franchisor provides ongoing training and support to facilitate the implementation by the franchisee of any system-wide changes, which in turn facilitates the fulfillment of franchisee obligations. Furthermore, a portion of the analyzed contracts obligates the franchisor to provide the franchisee with personnel to assist during the first days of franchise activity, as in the following example:

> "[…] the franchisor will work with the franchisee during the process of opening and launching the business. To that end, [...] the franchisor will make available to the franchisee a professional structure to perform this assistance during a period of 10 days. If the franchisee specifically requests, the franchisor will extend the period of this professional assistance […]."

Although not as common as the previous provision, another key obligation of the franchisor is to promote the image of the chain. Among the sample contracts, 62 percent include a reference to this concept, although only 43 percent expressly states the franchisor's obligation to conduct regular campaigns. This percentage is remarkably low, given the importance of maintaining the brand to the success of any franchise (Blair & Lafontaine, 2005).

The chain obtains the resources to spend on brand promotion through the advertising fees paid by franchisees. However, the franchisor is free to use these funds as it deems fit, which can cause conflicts between the franchisor and its franchisees if franchisees believe that the advertising fee is excessive, that advertising at the national, regional or local level is inadequate, or simply that the chain is not properly using the resources available for this purpose (Blair & Lafontaine, 2005). Franchise contracts often include a phrase along the lines of "the franchisor will conduct the advertising actions it deems appropriate to support and promote sales for the benefit of all franchisees in the chain." However, very few of the analyzed contracts specify an obligation of the franchisor to be accountable to the franchisees regarding the use of these funds.

In short, we can conclude that most of the provisions in franchise agreements establish the obligations of the franchisee, which is not surprising given that the franchisor drafts the contract and aims to ensure to the greatest extent possible that the franchisee will properly manage the facilities and comply with the rules and methods imposed by the franchisor.

The same conclusion can be reached with respect to provisions related to contract termination and the post-contractual obligations of the parties. Specifically, all analyzed contracts that establish grounds for termination provide at least one basis for the franchisor to terminate the contract. However, only 81.94 percent provide such a basis to the franchisee. Moreover, certain franchisee obligations survive contract termination. In particular, the franchisee must continue to comply with confidentiality requirements, cannot conduct activities in competition with the franchisor, must cease the use of any item that may lead to confusion, must notify affected third parties of the termination of the franchise relationship, and must satisfy all payment obligations arising from the contract.

4. Conclusions

We have analyzed the design of franchise contracts. More specifically, we have identified and quantified which provisions or contractual problems franchisor and franchisee formalize in their contracts. We have also offered examples of the wording of related clauses. Contractual design is a key element in franchise relationships because parties introduce provisions and safeguards in order to regulate and structure their conflict of interest, enabling them therefore to reduce their mutual opportunistic behavior (Brickley & Dark, 1987; Shane, 1998).

Although several authors have analyzed specific provisions such as financial conditions, contract duration, selling prices, termination and renewal, geographical exclusivity or tying (Brickley et al., 2006; Lafontaine, 1992; or Shane, 2001 are some examples), few empirical papers have studied the contract as a whole, using primary information about contracts. Conversely, most previous studies are based on analyzing some particular provision and using secondary information (namely results have not been directly obtained from franchise contracts). Even when primary information is used, they rely frequently on surveys so that researchers cannot read the contract. As stated by Golberg and Erickson (1987) and Argyres et al. (2007), a general vision of its content is relevant because clauses included in a contract are chosen simultaneously and may interact. Consequently, empirical studies should analyse contractual provisions as a whole.

We address this gap in the literature by analyzing 74 Spanish franchise contracts, directly identifying all potential provisions that parties included in their contracts. We have differentiated 157 potential provisions (Table 1 shows most relevant ones), ranging from very well-known provisions (such as contract length) to others that are much less frequently studied in the literature (such as the business transfer). We also document important differences across chains because neither the frequencies of occurrence of well-known provisions are always around 100% nor less common stipulations frequencies are around 0%. We believe that this heterogeneity is because parties, mostly the franchisor, differ in terms of capabilities to design a franchise contract. More research is needed to clarify this point.

The results allow us to draw two additional conclusions. First, contracts are not balanced in terms of franchisor and franchisee obligations. Conversely, franchisees' obligations are larger both as an amount and as a percentage of use. This different treatment of parties' obligations has been already noted in the literature (Al-Najjar, 1995; Arruñada et al., 2001; Klein, 1980; Spencer, 2008). This asymmetry suggests that the contract is the key tool to moderating franchisee's opportunism but it is not so relevant for controlling franchisor's misbehavior (Solís-Rodríguez & González-Díaz, 2015). This is because the threat of enforcing formal contracts in courts is more relevant for the franchisee than for the franchisor. The latter's opportunistic behavior can also be controlled by other safeguards, such as reputation or other relational governance mechanisms, which reduce the need of detailing their obligations in the contract (Klein, 1996). As stated by Klein (1980, p. 360), "when both parties can cheat, explicit contractual restraints are often placed on the smaller, less well-established party (the franchisee), while an implicit brand name contract-enforcement (self-enforcing) mechanism is relied on to prevent cheating by the larger, more well-established party (the franchisor)".

Second, although numerous contractual provisions have been studied in previous works, there are others that have been neglected in the literature. In fact, there are some, for example the transfer of the business by the franchisee, that are present in a higher percentage of the analyzed contracts than some of the traditional ones (for instance, the financial conditions). These less studied provisions also address problems related to opportunistic behavior by both the franchisor and the franchisee, but they are not as easily observable as the traditional ones. This is because, as we mention previously, most of previous studies have not used primary information, so they have not read the contract. Furthermore, we detect that some contractual provisions are interdependent and influence each other, such as the duration and the renewal or the transfer of the business and the renewal. These interactions may change the literal sense of some clauses and articles, suggesting, as already stated by Goldberg and Erickson (1987) and Argyres et al. (2007), that all contractual terms should be integrated to give a full picture of the provision that parties try to introduce in their relationship. Much more contract research is needed in this area because most of the extant research about contracts in business and economics literature has not taken these interactions into account. This constitutes an important item in our future research agenda.

Although our data are from Spain, our findings could be applicable to other countries. Most of the provisions negotiated by the parties and include in the franchise contract, for example in other EU members or US, should not be different than the ones negotiated in Spain. This is because they refer to aspects and details that parties consider relevant in their relationship, which depend mainly on the type of the business. A good indicator is the comparison of this study with Udell's one: despite that both the country (Spain vs US) and the time period (2006-2007 vs 1972) are different most of the provisions identified are similar. However, it is true that national regulation may affect contract design in terms of the degree of contractual completeness: contracts from countries with strong regulations capturing many aspects being relevant for franchising will tend to be shorter than those designed in countries where no or scarce regulation is available.

This study is not without limitations. As mentioned above, our data are from 2006-2007, so some changes both in the list of standard contractual provisions and their percentage of use may have occurred. For instance, aspects like data protection or e-commerce have become increasingly important in recent years. In our data, the first provision is present as a franchisee obligation in only 19 percent of the contracts analyzed and 12.57% as a franchisor obligation. The second one appears in less than 5 percent of the contracts. Therefore, it would be interesting the replication of this study nowadays and check new provisions included.

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Notes

Note 1. We follow Merriam-Webster definitions taking provisions or stipulations as synonymous. Provisions are different measures agreed by parties and taken beforehand to deal with a need or contingency. They can be written in one or several articles or clauses of the document.

Note 2. While this is true, franchisors are also interested in maintaining long-term relationships with good franchisees (Brickley et al., 2006).

Note 3. See generally Blair and Lafontaine (2005).

Note 4. See also Windsperger (2002), who analyzes the relationship between property rights and investments in intangible assets through the lens of certain contractual provisions; Davey-Rafer (1998), who focuses on the extent to which the franchisor uses the training and assistance provided to franchisees as a mechanism of power and control; and Drahozal and Hylton (2003), who analyze the circumstances under which the parties choose to resolve disputes through arbitration or litigation.

Note 5. For instance, one provision refers to the franchisee’s obligations related to the franchisor’s methods and know-how, another provision addresses the franchisor’s obligation to promote the chain, etc.

Note 6. Provisions addressed in only a single contract were considered because a) the number of such provisions was small and b) the presence of a provision in a single contract does not mean that such provision is limited to that particular contract; rather, it is possible that chains not included in our sample also cover this provision.

Note 7. Udell (1972) examined 172 franchise contracts in the US and identified 167 provisions. Because the provisions he identifies are generally much more specific than ours, we cannot make comparisons for all of them.

Note 8. FRANDATA Corporation (2000) and Brickley et al. (2006) establish that 91% of franchise agreements in the US include the possibility of renewal, a similar percentage to that obtained for Spain.

Note 9. In Europe, contracts have a duration between 5 and 10 years, whereas in the US, the average contract length is 10 years (Blair and Lafontaine, 2005).

Note 10. These percentages are well below those seen in the US. Specifically, in 2001, 99.2 percent of U.S. networks had established franchise fees (Blair and Lafontaine, 2005). In 2000, 95 percent had some form of royalty and 72 percent had advertising fees (FRANDATA Corporation, 2000).