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Executive Summaries

This section provides a concise, nontechnical summary of each article in the current issue of JR focusing on its strategic implications for management.

When the Music Stops Playing: Post-litigation Relationship Dissolution in Franchising

Marko Grünhagen, Xu (Vivian) Zheng, Jeff Jianfeng Wang

Franchise relationships engender franchisor-franchisee conflicts and are prone to premature dissolution. Building on agency theory and institutional theory, this study examines what specific reasons - from both franchisors' and franchisees' perspectives - may cause *post-litigation relationship dissolution* (PLRD) and how franchise regulations moderate these relationships. We propose a "dual agency" view: both franchisor and franchisee may misrepresent themselves before their relationship begins (adverse selection) and both may behave opportunistically after the contract is signed (moral hazard). The results from 20-year archival records of franchisor-franchisee relationship histories gleaned from multiple data sources largely support our hypotheses.

To prevent the problem of pre-contractual hidden information, agency theory suggests several safeguards including screening, signaling, and providing opportunities for self-selection. While traditionally the focus has been on the principal (franchisor), we argue that safeguards can be utilized by both sides. For instance, prospective franchisees can filter out franchisors by creating screening mechanisms, such as acquiring information through on-site visits, personal references, or public disclosure documents. Meanwhile, in order to make a franchise more attractive to prospective franchisees, the franchisor can be proactive to signal its desirable qualities, such as offering exclusive territorial rights or operating own units.

A number of data sources can be utilized for this purpose. The archival databases used in this research (FDDs, *Bond's Franchise Guide* and *Entrepreneur Magazine*) offer objective and longitudinal data about various franchise systems. For example, the litigation history in the FDDs shows alleged frauds, including exaggerated financial projections and false promises of "unique" and "proprietary" methods and systems. Information search and evaluation is especially important for first-time franchisees. With no experience and limited resources, they are often attracted to small- or medium-size franchises that offer more novel concepts and lower franchise fees than established systems, yet do not have strong trademarks and the concomitant financial resources.

This study also identifies challenges to control and monitor inappropriate post-contractual behaviors of both parties in franchisor-franchisee relationships. Our results suggest that, while contracts and rules exist, opportunistic behaviors by both parties abound, which is another major cause for premature relationship termination. Control and monitoring methods should be employed to prevent the occurrence of moral hazard in the first place. When moral hazard occurs, each party should understand the reasons behind misbehaviors of the other party.

Finally, franchisees should be aware of the influence of the regulatory environment on franchisors' termination decisions when selecting which system to join. In states with a registration law regime, franchisors may be more likely to terminate the dysfunctional relationship to ensure quality standards across the system. In states with a relationship law regime, franchisors may be less likely to terminate the relationship when franchisees are found to be engaged in passive moral hazard, but not when they are engaged in active moral hazard.

Compete in Price or Service? — A Study of Personalized Pricing and Money Back Guarantees

Bintong Chen, Jing Chen

In an intensely competitive market, retailers often choose multiple strategies to compete based on their strengths; pricing and customer service are two common strategies. While uniform pricing remains ubiquitous, the practice of personalized pricing has emerged in the wake of recent advances in information technology and consumer analytics. On the service side, with customer returns

being a common phenomenon in the retailing industry, post-sale services are critical to attract and keep loyal customers. More and more retailers choose to offer more lenient customer returns policies, offering Money-Back-Guarantees (MBG), for example, for most items. More interestingly, these retailers are simultaneously experimenting with personalized pricing strategy (PPS). This motivates us to study the newly-emerged PPS and commonly-adopted MBG together, to examine how retailers compete using both pricing and service strategies.

While it is well understood that both PPS and MBG benefit a *monopolistic* retailer's profit and demand, the impacts of these policies on retailers and customers in the more common *competitive* market are not yet as clear. Do both strategies enhance a retailer's competitiveness, and is one strategy more effective than the other in the short term or in the long term? How do the two strategies impact retailers' demands, profits, and prices, as well as customer surplus? Should a retailer faced with competition select one or both strategies? To bridge this gap in the literature, we use a game theoretic model to systematically analyze the combined impact of the two popular retailer strategies. We develop a duopoly model, in which the two retailers differ in customer satisfaction rates. Each retailer chooses a pricing strategy, PPS or uniform pricing, and a product return strategy, MBG or 'no returns.' We show that both PPS and MBG are dominant strategies, but their impact on retailers' prices and profits are different. While PPS intensifies price competition and may lead to a prisoner's dilemma, with both retailers losing profit in the switch from uniform pricing to PPS, MBG mitigates price competition and may result in a Pareto improvement in profit for the two retailers when they both switch from no-returns to MBG policies. Both PPS and MBG increase the size of the overall market, but not the total duopoly profit. The total customer surplus and social welfare may increase under either strategy. Furthermore, our numerical experiments indicate that PPS and MBG remain dominant strategies. Endogenous decisions seem to increase the likelihood of a "prisoner's dilemma" when the retailers switch to PPS (both retailers lose profit), and also increase the likelihood that the higher quality retailer will benefit from adopting an MBG.

This paper contributes to the literature in several ways. First, by extracting the key parameters of each retailer in the asymmetric duopoly structure, we are able to obtain simple conditions for the two retailers to co-exist under all pricing and service strategy combinations. Second, we show that no matter whether the two retailers co-exist or not, both PPS and MBG are dominant strategies. Their impact on the duopoly, however, is very different, and we delineate, for the first time, the precise conditions under which each is beneficial or deleterious. The implication is that even though a PPS pricing strategy may lead to short-term gain for some retailers, MBG is a more sustainable long-term strategy for the duopoly – incidentally offering another convincing explanation for the popularity of MBG. In addition, if the quality decision is exogenous, we show that the positive effects of MBG may overcome the negative effects of PPS and lead to a "win-win" for both retailers, when both strategies are chosen simultaneously. Furthermore, we are able to obtain a clean order relationship among retailers' prices, demands, and profits under various pricing and service strategy choice combinations. In particular, we show that both PPS and MBG may enhance customer surplus and social welfare for the duopoly, under certain conditions. Third, on the technical side, the introduction of several new terms enables uniform and clean representation of all results across all possible pricing and service strategy combinations for both retailers, which allows us to reveal more structural results and provide related new managerial insights. The conditions of co-existence of the two retailers, of the Pareto improvement from MBGs, and of the "prisoner's dilemma" due to PPS are identified based on the relative values of the two retailers that combine key parameters of each retailer, rather than a single factor (such as either the quality or a certain cost) in the literature. Finally, we provide new insights on how retailers should choose their quality levels endogenously to compete in both pricing and customer returns strategies.

Competitive Retailer Strategies for New Market Research, Entry and Positioning Decisions

Xiaodong Yang, Gangshu (George) Cai, Ying-Ju Chen, Shu-Jung Sunny Yang

It can be a rewarding retailing practice for competing retailers to enter a new market. However, the emergence of a new market is typically uncertain, because retailers often know little a priori about the nature or extent of the new demand. Although retailers may conduct market research to explore the new market, in practice, some retailers oftentimes neglect the new market, giving a leeway for their rivals to encroach on the new market. For example, despite the prevalence of big-box retail chains, such as Wal-Mart, over the last several decades, Whole Foods Market has enjoyed wild success selling organic groceries over much of the past 30 years.

This paper investigates competitive retailer strategies for new market research, entry and positioning decisions in

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