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

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Abstract

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 argue that both franchisor and franchisee may misrepresent themselves before their relationship begins (adverse selection) and behave opportunistically after the contract is signed (moral hazard), that is, 'dual agency'. Based on 20-year archival records of franchisor–franchisee relationship histories gleaned from multiple data sources, we found that PLRD is likely to be caused by franchisors' passive moral hazard and by franchisees' active moral hazard. In addition, franchisor adverse selection has a greater impact on PLRD than franchisee adverse selection. With regards to regulatory influences, the presence of relationship law weakens the impact of franchisees' passive moral hazard, but not their active moral hazard, on PLRD. Contrary to what we hypothesize, the presence of registration law amplifies the impact of franchisee adverse selection on PLRD. Ultimately, this study creates a better understanding of the antecedents and curbing mechanisms of PLRD in franchising.
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Keywords: Post-litigation relationship dissolution; Dual agency; Moral hazard; Adverse selection; Regulation; Franchising

"Parting is all we know of heaven, and all we need of hell."

Introduction

Business format franchising has become the most popular form of franchising in the past decade (Beshel 2010). It covers a diverse spectrum of industries and entices millions of entrepreneurs globally to own a business. Franchisor–franchisee relationships, however, are characterized by conflict—". . .a situation in which one channel member perceives another channel member to be engaged in behavior that is preventing or impeding him from achieving his goals" (Gaski 1984, p. 11). Territory arrangements (Gibson 2001), price setting disagreements (Gibson 2010), franchisors' lack of support (Gibson 2008), and a myriad of other reasons can spiral up to serious conflicts calling for the involvement of a third party, for example, a judicial court. As a matter of fact, legal actions between franchisors and franchisees have been common over the past three decades (e.g., Creswell 2007; Daley 2015; Drahozal and Hylton 2003; Emerson 1998; Winsor et al. 2012; Zeidman 1981). Shane (2015) notes "the relatively high level of litigation in franchising", and estimates of legal disputes in franchise systems range from an average of 27% (Siebert 2009) to 35% (Giddings et al. 2011) across all industries.

Although demarcating serious conflict, the filing of litigation is not equivalent to relationship dissolution. Many lawsuits by franchisors or franchisees are not intended to dissolve the relationships, but rather to recover damages, obtain repayment of lost earnings, or compel contract compliance by either franchisee or franchisor (e.g., Dance, Powers, and Rosen 2013; Dunham 2003). For less critical issues, disputants may choose to ratchet down the conflict by adopting a compromising approach through which relationship continuity is possible. By contrast, non-conciliatory disagreements between the franchisor and the franchisee pursuant to the filing of litigation may lead

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to relationship dissolution. With a whopping 122% turnover rate from 2010 to 2013 (FranchiseGrade.com 2013), many franchisor–franchisee relationships fail to reach their contract maturity date, let alone have their franchise renewed.

In this study, we define relationship dissolution that occurs after the filing of litigation as *post-litigation relationship dissolution* (PLRD).[1] Despite growing interest in relationship dissolution (Payan et al. 2010), scant research has examined the dynamics involved in relationship dissolution, and three major limitations remain. First, accurate and objective accounts of reasons for relationship dissolution are unknown. Prior studies have mainly focused on factors at the firm-level, such as resource provisions (Seabright, Levinthal, and Fichman 1992), alternative attractiveness (Ping 1994), level of commitment (Ganesan et al. 2010), and managerial and functional capabilities (Fortune and Mitchell 2012), while an understanding of specific reasons at the conflict level that may cause relationship dissolution remains limited. Efforts have also been made over time to identify proxies to assert the existence of conflict, ranging from distance between reciprocal channel members' perceptions (Rosenberg and Stern 1974) to preference incongruity (Brown and Frazier 1978; Eliashberg and Michie 1984) and intensity (Brown, Johnson, and Koenig 1995; Zhou, Zhuang, and Yip 2007) or frequency of disagreements (Lusch 1976; Wilkinson 1981; Zhuang, Xi, and Tsang 2007). However, most studies have relied on cross-sectional, survey-based assessments, and an objective account of what reasons may lead to relationship dissolution has remained unexplored.

Second, relationship dissolution can be caused by either franchisor or franchisee, but prior research has mainly taken a single-party perspective (Tähtinen and Halinen 2002). Franchising has long been touted as an exemplar of the principal–agent relationship and, hence, convention has been to treat the franchisor as the principal whose interest depends on the proper behavior of its agents (i.e., franchisees). Despite its conciseness, this model fails to embrace the inherent interdependence in franchisor–franchisee dyads. In fact, both franchisors and franchisees may misrepresent themselves before the relationship begins (i.e., adverse selection) and behave opportunistically during the course of the relationship (i.e., moral hazard) (Antia, Zheng, and Frazier 2013). In other words, a 'dual agency' relationship exists. Yet, there is a lack of empirical examination of the antecedents of PLRD from both the franchisor's and franchisees' sides.

A third limitation pertains to the understanding of regulatory forces that curb the incidents of PLRD. Due to the high costs incurred by PLRD, regulators have enacted legislation to create greater balance in franchise relationships. Specifically, in the United States individual states have adopted statutes in regards to franchising, including most notably registration laws and relationship laws (Antia, Zheng, and Frazier 2013; Ayal and Benoliel 2015; Emerson and Benoliel 2013). Notwithstanding good intentions of protecting the interests of individual franchisees – presumably the weaker party (Keup and Keup 2012) – such regulations also result in high costs of compliance and the additional burden they impose on the franchisor's task of quality assurance (Antia, Zheng, and Frazier 2013; Brickley, Dark, and Weisbach 1991). A better understanding of whether these regulations serve the intended purpose of curbing the occurrence of PLRD is needed.

The present study seeks to address these research gaps and inform our understanding of actual reasons for PLRD in franchising and the moderating effects of regulatory influences on relationship dissolution. We undertake a rigorous examination of 505 litigation cases that occurred between 130 franchisors and their franchisees over a 20-year period from 1994 to 2013. We examine actual incidents of PLRD and their causes as recorded in franchise disclosure documents (FDDs). In addition, we acquired supplementary data from multiple franchise industry-specific trade publications, namely *Bond's Franchise Guide* and *Entrepreneur Magazine*. These historical records of actual occurrences of PLRD minimize possible social-desirability and memory biases, as well as other well-known survey data issues (Grünhagen, Dorsch, and Wollan 2008; Rindfleisch et al. 2008).

Hence, this study makes three contributions to the relationship marketing and franchise literature. First, we collect and categorize longitudinal legal documents that record litigation in franchisor–franchisee relationships. To the best of our knowledge, this represents the first effort to systematically examine objective accounts that precede PLRD. Building on the conceptual distinction between active and passive opportunism (Seggie, Griffith, and Jap 2013; Wathne and Heide 2000), we distinguish between active and passive moral hazard and compare their effects on PLRD. Second, by taking a dual-agency perspective, we examine the drivers of PLRD from both parties' sides. It complements the dominant view in the literature that treats the franchisor as the only principal and shows that principal–agent dyads are interdependent rather than one-way. Third, we provide a better understanding of the regulatory forces on PLRD and shed light on franchise laws' impact on franchisor–franchisee relationships.

Dual-Agency and Relationship Dissolution

An agency relationship is present when one party (the principal) depends on another party (the agent) to undertake actions on the principal's behalf. Two problems that a principal faces are pre-contractual *adverse selection* (hidden information) and post-contractual *moral hazard* (hidden actions). In prior marketing channel research, franchising has been touted as an exemplar of the principal–agent relationship, with the franchisor as the principal and the franchisee as the agent (Bergen, Dutta, and Walker 1992). To capture the interdependence between franchisor and franchisee, some studies have documented the problem of double-sided moral hazard (e.g., Bhattacharyya and Lafontaine 1995; Rubin 1978; Scott 1995; Sen 1993) and double-sided adverse selection (e.g., Desai and Srinivasan 1995). Building on these studies, we propose that both franchisor and franchisee may act in the roles of principal and agent simultaneously, that is 'dual-agency', for the following reasons.

[1] We do not argue that legal filing causes relationship dissolution; rather, we use litigation instances as credible evidence of existing conflict.