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Expanding the conceptual domain of governance in franchising

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ABSTRACT

We propose a model that expands the conceptualization of governance in franchising that acknowledges traditionally ignored stakeholders, including debt and equity holders. Though research has examined how equity holders benefit from the organizational form of franchising, it has not examined the specific role that equity or debt holders play in governing franchise organizations. Additionally, the unique ontology of franchising, which includes semi-internal members of the organization (i.e., franchisees) that invest their own assets and maintain their own balance sheets, provides a rich context for exploring such governance issues. Franchisees exist outside traditional firm boundaries and are not employees, but they are closely linked to the brand given their significant investments in firm-specific assets. Franchisee-based organizations also are growing their own corporate structures and investments in firm-specific assets, sometimes dwarfing those of their franchisor partners. By expanding the concept of governance in franchising, we open avenues for significant scholarship that can enrich both the governance and franchising literatures. We provide several preliminary propositions and constructs to help encourage new research in this emerging arena of franchising research.

1. Introduction

In the industrial marketing domain, channel governance (Paswan, Guzmán, & Blankson, 2012) and, more specifically, governance in a franchising context (Gorovaia & Windsperger, 2018) have emerged as important research topics. Decades earlier, an opinion piece in the second volume of Industrial Marketing Management (IMM) entitled “Franchising the ultimate in industrial marketing?” highlighted the importance of franchising by arguing it is a unique form of distribution. Since this publication, IMM has continued to publish a wide array of papers focused on franchising (Hajdini & Windsperger, 2019; Lawrence & Kaufmann, 2019; Panda, Paswan, & Mishra, 2019). In this paper, we provide an expanded framework for research examining governance in franchising, encouraging future scholarship in IMM and other outlets interested in understanding this prolific form of distribution.

A half-century has passed since Oxenfeldt and Kelly (1969) published their seminal article on the system-wide dynamics of ownership patterns in franchising. Arguing for a life-cycle model of system-wide dynamics, they began a long tradition in franchising research examining ownership patterns, defined as the choice to distribute via corporate or franchised outlets. Subsequent research has examined the costs and benefits of different distribution structures (e.g., franchised, corporate, plural form) (Bradach, 1997; Cannon, Achrol, & Gundlach, 2000), the forces driving outlet ownership changes (Dant & Kaufmann, 2003; Dant, Paswan, & Kaufmann, 1996; Windsperger & Dant, 2006), and the firm’s choice to franchise (Lafontaine & Kaufmann, 1994).

This focus on outlet-level ownership and control has helped define the field’s view of franchising governance (Yin & Zajac, 2004) as a retail distribution channel strategy (Argyres & Liebeskind, 1999; Brown, Dev, & Lee, 2000; Heide, 1994, 2003; Hendrikse & Jiang, 2011), neglecting ownership and governance structures at higher levels of the supra organization. In this view, the franchisor has sole autonomy to design and implement channel structure (Hsu, Kaufmann, & Srisivasan, 2017) in isolation of other factors that may influence strategy, such as financial structures and covenants. As a result, scholarly work in this realm has largely ignored the influence of external equity and debt holders on modern franchise systems. Given the financial crisis spurred by the coronavirus pandemic, we know that a narrow conceptualization of governance fails to acknowledge the enormous impact such entities can have on system structure, function, and survival.

The focus of system-wide dynamics research and its attendant debates have evolved (Kaufmann & Dant, 1996) to acknowledge the evolution of franchisees from single-unit, “mom-and-pop” entities into large enterprises such as publicly traded companies (Lawrence, Pietrafesa, & Kaufmann, 2017). Nonetheless, a dearth of research exists...
examining the growth and consolidation of ownership at both the franchisor and franchisee levels (Massimino & Lawrence, 2019), leaving many interesting avenues and topics for future research. For example, franchise organizations can be owned by cooperatives (e.g., Best Western, Ace Hardware, Coop), private equity firms (e.g., Roark Capital, Bain Capital), publicly traded companies (e.g., Domino’s Pizza, McDonald’s), families (e.g., Chick-fil-A, Enterprise Holdings Inc., H&M), or foundations (IKEA Interogo). These structural characteristics, in turn, influence the organizations’ debt and equity positions and their risk profiles. A private equity owner, for example, may leverage the debt of its investment portfolio. Chick-fil-A, a family-owned firm, mandates closure on Sundays, limits franchise partners’ unit growth, and has no significant debt obligations. Despite the impact of the franchisor on the network’s structural dynamics (Patel, Kim, Devaraj, & Li, 2018), including debt and equity levels, we are unaware of any literature that acknowledges this in the broader franchise governance framework. We contend these high-order ownership and governance characteristics warrant consideration given their implications for the unique ontology of franchising (Dant, Grünhagen, & Windsperger, 2011), one that includes ownership redirection, the stable plural forms thesis, and the growth of multi-unit franchising.

This expanded perspective on franchise ownership dynamics foregrounds corporate governance, which we define as the system of laws, rules, and factors that control operations at a company (Gillan & Starks, 1998). The literature on corporate governance formed from research examining boards of directors (Tricker, 2015) as the connection between those that supply capital and the managers utilizing it. Research in this area has evolved to conceptualize a governance system in which cooperating structures control the enterprise as a whole (Gillan & Starks, 1998; Shleifer & Vishny, 1997). Such a view has widened the scope of corporate governance to consider the role owners and equity market owners could play in firm governance (Aguilera & Cresspi-Cladera, 2012; Gillan, 2006). Franchising is a distinctive realm for studying corporate governance because its agreements are unique contractual arrangements between an independent, business-owning franchisee and a brand-owning franchisor. Franchisees also invest significant assets into the franchise system under term-limited contracts, though many have multi-generational brand commitments. Their significant financial investments in firm-specific assets tie them firmly to the brand despite their existence outside traditional firm boundaries. In other words, a franchisee may consider himself an independent contractor but he is one who “cloaks himself in the identity of the franchisable trademark” (Caves & Murphy, 1976, p. 572). These unique characteristics provide fertile ground for theorizing about corporate governance.

This conceptual paper seeks to expand the model of governance in franchising by integrating the impact of the franchisor’s and franchisee’s respective ownership and capital structures into their dyadic relationship. With this new conceptualization, we hope to open avenues for significant scholarship that can enrich the literatures of corporate governance, retailing, marketing channels, and franchising. We also aspire to reflect franchising as it exists today: a complex financial arrangement involving the franchisor, the franchisee, and outside entities that have significant influence and control over system-wide dynamics.

The rest of the article is structured as follows: We begin by reviewing the literature on both franchising and corporate governance. We then integrate these literatures into a conceptual model that accounts for the unique characteristics of the franchise relationship, offering several propositions. Due to the conceptual nature of our paper these propositions are meant to stimulate future scholarship. Propositions are purely conceptual in nature and as such should not be treated as empirical generalizations. Lastly, we provide guidance for future work that expands corporate governance and franchising scholarship, highlighting research questions and constructs of significant interest to an emerging view of franchising governance. To clarify the differing perspectives in corporate governance and in franchising, Table 1 highlights the traditional and emerging assumptions we adopt in our conceptualization.

2. Governance in franchising

When addressing governance in a franchising context, scholars are referring specifically to the decision to corporately own or franchise retail outlets (Brown et al., 2000; Cannon et al., 2000; Heide, 1994; Yin & Zajac, 2004). This narrow view of governance is partially due to assumptions in the literature about the role the franchisor plays as brand steward (Lawrence & Kaufmann, 2019), the locational focus of franchising in the retailing literature (Dant et al., 2011), and a research emphasis on the agency dyad (Lafontaine, 1992). See Fig. 1 below for a graphic representation of the traditional view of franchise governance.

In their commentary, Dant et al. (2011) identify the nested hierarchical structures and chains-within-chains structures in franchising as unique characteristics. They further claim that this conceptualization entails multiple agency relationships that present unique governance challenges and opportunities for future research exploring the ownership-control relationship. In practice, franchisors are increasingly reducing outlet ownership and consolidating operations among a smaller set of large, multi-unit operators (Lawrence et al., 2017). This has resulted in relationships more resembling strategic partnerships than the traditional franchisee-franchisor dyad. International expansion often leads to non-traditional structures, regularly involving partnerships with operators that manage a portfolio of multinational brands, under master franchise agreements with different parent companies.

A trend toward private equity ownership has only further complicated franchise governance (Lawrence et al., 2017). Following some of the world’s largest and best-known private equity, family offices, and alternative investment funds (e.g., Roark Capital, JAB Holding, Sun Capital Partners, Carlyle/CITIC, Triant Partners, Pershing Square, 3G Capital, NRD Partners etc.), savvy investor-owners have stepped in to govern franchise companies’ growth and management. Roark Capital Group, which has multiple franchise brands in its portfolio, states that the “best way to create value is to form a close partnership with outstanding operating executives and a value-added Board of Directors” (www.roarkcapital.com). Private equity also has become engaged in funding franchise growth and ownership, as seen with Carlyle and CITIC’s partnership with McDonald’s for expansion in mainland China and Hong Kong. In announcing the investment deal, McDonald’s CEO Steve Easterbrook stated that the fast-food retailer “will continue to play an active part in the China growth journey through our remaining interest and participation on the China Board” (Tsang & Wee, 2017). Current conceptualizations of franchising fail to acknowledge such increasingly common ownership and governance structures.

When examining the structure, internationalization, and performance of franchise organizations, the franchising literature departs from the traditional view of corporate governance (von Koch, Ludvigsson-Wattle, & Nilsson, 2020). Our efforts to broaden the view of franchising governance to include the perspectives of other stakeholders—franchisees, external debt and equity holders, and regulatory agencies—enrich a body of literature largely focused solely on the franchisor (Dant et al., 2011).

3. Traditional view of corporate governance

Corporate governance research defines governance as the mechanism through which suppliers of capital ensure themselves a return on their investments (Shleifer & Vishny, 1997). This definition comes closer to a holistic view of governance that envisions cooperating structures collectively controlling the enterprise. The primary unit of analysis for corporate governance historically has been boards of directors, seen as the connection between suppliers of capital and the managers that make use of it (Tricker, 2015). Many traditional corporate governance studies assume a separation between ownership and
control, explaining that corporate governance mechanisms help prevent the undesirable outcomes that agency problems can cause. This traditional view, exemplified by the work of Berle and Means (1932) and Jensen and Meckling (1976), characterizes organizations as having dispersed ownership, while control and accountability are guaranteed through straightforward hierarchical relationships.

More recent research has broadened its view of corporate governance to include external stakeholders. Gillan (2006) argues that the definition of corporate governance differs depending on one’s worldview, Shleifer and Vishny (1997) view corporate governance in more financial terms, defining it as the ways in which suppliers of financing to corporations ensure a return on their investment. In line with this research, we take a broad perspective on franchise governance issues, defining corporate governance as the system of laws, rules, and factors that control operations at a company (Gillan & Starks, 1998). This expanded view, however, goes beyond the constraints of the traditional, hierarchical model of one-company governance (Gillan, 2006).

A model adapted from Gillan’s (2006) conceptualization, which was inspired by Jensen and Meckling (1976), seeks to capture this increasing complexity by presenting a nexus of contracts related to the corporate governance of a single organization. While similar to the nexus-of-contracts view that Jensen and Meckling (1976) advance, this even broader perspective encompasses the community, the political environment, laws and regulations, culture, and the markets, reflecting a stakeholder view of the firm (Jensen, 2010). This perspective has been embraced in research (Gillan & Starks, 1998) and in some U.S. stakeholder laws, which permit companies to reject takeover bids if the acquisitions adversely affect the targeted firm’s community. Laws and politics in general can heavily influence corporate governance and its operationalization, as evidenced by the Securities Act of 1933 and the Sarbanes-Oxley Act of 2002. Research, moreover, has shown that certain corporate governance levels can lead to lower capital costs, increased access to external financing, and higher firm valuation (Bebchuk 2004, Brown and Caylor 2006, Gompers et al. 2003).

The articles outlined in Table 2 represent research in the field of franchising and corporate governance in corresponding areas A through E. Labels A through E correspond to areas in Fig. 2 that show an expanded “Conceptual model of governance in franchise systems.”

### Table 1

| View of Principal and Agent | Traditional assumptions in corporate governance | Traditional assumptions in franchising | Emerging assumptions |
|----------------------------|-----------------------------------------------|--------------------------------------|----------------------|
| The principal is the owner of the firm’s assets and the agent is the manager of those assets. | The principal is the owner of the brand (franchisor) and the agent (franchisee) follows brand standards. | The franchisor acts as both agent and principal. Multiple principal-agent relationships are embedded in the franchise network. Dual layers of ownership (franchisee owns physical assets and franchisor owns intangible assets) and multiple firm relationships. |
| Primary Relationship of Focus | A single firm that owns its assets and hires managers to work in their interest. | A single franchisor that owns the brand and licenses brand rights to a franchisee. | Considers multiple residual claimants and how these parties influence performance and risk/return |
| View of the Residual | The residual claimant refers to the owner who has remaining claim on the organization’s net cash flows | The residual claimant refers to the franchisee owner who has claim on their franchise outlets net cash flows. | Integrate franchisees, whom exist outside the traditional boundaries as quasi-employee stakeholders |
| The View of Organizational Members | Classified as employee | Classified as employee (corporate store & mgmt) and non-employee (franchisee) | |

**Fig. 1.** Traditional conceptual model of channel governance.

4. Applying corporate governance in franchising

To address the unique organizational relationships (e.g., horizontal relationships) inherent in partnerships (Child & Rodrigues, 2003), some corporate governance scholars have turned to non-traditional organizational models (Aguilera & Crespi-Cladera, 2012). Franchising, with its uniquely disaggregated ownership structure, provides a unique and potentially theoretically rich context for this work. In traditional governance models, suppliers of capital are defined as the principal while board members or managers represent their interests as agents. A traditional conceptual model of franchising positions the franchisor as the principal and franchisees as agents of the brand (Brickley, Dark, & Weisbach, 1991). Despite the franchisor’s ownership of the brand and its related intangible assets, it does not however supply the capital needed to grow and sustain the system—franchisees do. Franchisees also own and operate independent outlets despite being viewed as agents of the franchisor. As a result, franchisees often have more personally invested in the brand than their corporate counterparts (Lawrence & Kaufmann, 2019). Complicating franchise relationships are organizations such as private equity groups, which may own significant portions of a franchise brand portfolio but no physical assets. Private equity groups also may be highly leveraged, taking on debt to fund future acquisitions. The unique ontology of franchising confronts traditional views of corporate governance and introduces new stakeholder relationships to consider.
Table 2

| Related articles in the field of franchising and corporate governance. |
|---------------------------------------------------------------|
| **A**: Internal Governance of the Firm/Franchisor              |
| Agrawal, A., & Chadha, S. (2005). The impact of board structure | |
| and compensation on firm performance.                         |
| Baysinger, B. D., & Butler, H. N. (1985). Journal of          |
| Marketing                                                   |
| Bradach, J. L. (1997). Administrative Science Quarterly      |
| Cannon, J. P., Achrol, R. S., & Gundersen, G. T. (2000).      |
| Journal of Marketing                                         |
| Daily, C. M., Dalton, D. R., & Cannella Jr., A. A. (2000).    |
| Journal of the Academy of Management                        |
| Dant, R. P., Paswan, A. K., & Kafkaloudis, P. J. (1996).      |
| Journal of Retailing                                          |
| Hendriks, G. & Jiang, T. (2011). Journal of Retailing        |
| Johnson, L. J., Dally, C. M., & Elfrandt, A. E. (1990).      |
| Journal of Financial Management                               |
| Rosenbloom, S. & Wynter, H. G. (1990). Journal of Retailing  |
| Witte, W. M., S. (1990). Journal of Financial Economics      |
| **B**: Internal Governance of the Franchisee                  |
| The left-hand side of Fig. 2 includes both of the traditional areas of corporate governance (A) and franchise governance (B) research. In relationship (A), the board of directors oversees executive management; this remains a primary unit of analysis for traditional governance research. Most franchising companies, however, have dual (plural) ownership structures: a mix of corporate owned units that exist internally and franchised units that exist outside traditional firm boundaries (see Fig. 1). The relationship between the franchisor and the managers of company-owned units is regulated by employment contracts and is, therefore, internal to the franchisor firm. The franchisor can offer single-unit, multi-unit, or master franchisee ownership rights and regulate the franchisee's residual income rights (royalties), decision rights, and ownership provisions, as represented by relationship (B). The option to franchise decreases the business's need to access capital through traditional equity markets. |

5. Internal governance (A&B)

One benefit of studying corporate governance in franchising is that the separation of ownership and control exists at more than one level of the firm. This dynamic creates opportunities to explore various governance formats, including nested hierarchical structures and chains within chains (Dant et al., 2011). In the holistic corporate governance system view, for example, monitoring and controlling collectively create the governance of the corporation as a whole. Shleifer and Vishny (1997) view external governance as stemming from the firm’s need to raise capital at different times. They also emphasize that in a publicly traded company, separation exists between the capital provided to the firm and those who manage it.

In Fig. 2, we introduce an expanded conceptual model of governance in franchise systems that includes a multi-layered model of governance. This model captures both the higher-order external governance of ownership and the downstream relationships of the semi-internal “company-within-the-company” relationships as they exist today in franchise organizations. For the sake of parsimony, our conceptualization of the governance of the franchisee does not explicitly include a board of directors. This does not, however, preclude the existence of such an entity.

6. Internal governance of the franchisor (A): The board and executive management

Within the context of traditional governance scholarship (Daly, Dalton, & Cannella Jr., 2003; Hambrick, Misangyi, & Park, 2015; Hillman & Dalziel, 2003; Pettigrew, 2008), extensive research exists examining the relationships between the board and executive management (Baysinger & Butler, 1985; Johnson, Daily, & Ellstrand, 1996; Rediker & Seth, 1995; Shleifer & Vishny, 1997). Scholars have explored the complexity of board of directors’ team dynamics to understand what makes these teams effective and how closely held firms can achieve strategic change (Brouning, Nordqvist, & Wiklund, 2007). Findings related to boards and governance (Hillman & Dalziel, 2003) show that board capital affects board monitoring, while resource provisions mitigate these relationships. To our knowledge, no published work has examined the franchisor's internal governance and the impact of board makeup on franchise system performance.

Franchising has distinct characteristics that make the relationship between the board and senior management particularly interesting to study. First, capital allocation and reinvestment in the system remains a primary board concern, namely decisions on cash distributions to shareholders and stakeholders such as franchisees. In franchise systems with limited or no corporate owned outlets the decision to invest capital at the outlet level for remodelling and expansion remains a franchisee decision but often regulated by contractual arrangements for remodeling or growth. One important board decision is the corporate- and franchise-owned mix, which can have implications for both returns and risk.
Though some have argued that plural-form structures provide a strategic benefit (Bradach, 1998), leading industry firms are rapidly shifting toward a greater percentage of franchised outlets (Lawrence et al., 2017). Second, incentive incompatibility (Blair & Kaserman, 1994) remains an important decision-making factor because system-wide sales motivate franchisors while unit-level profitability motivates franchisees. A board, therefore, may focus on system growth instead of unit-level profitability, which could spark tensions with franchisees investing capital at the outlet level. Examining such tensions in the context of franchise-based organizations, as well as the representation of key stakeholders (e.g., franchisees) on boards, would contribute to a greater understanding of franchise governance. Given the number of private equity investors that own multiple brands (e.g., Roark Capital), board composition remains an important avenue of future inquiry. Third, franchisees remain small-business owners primarily interested in unit-level performance, not corporate-level metrics such as stock price. Unlike most corporate structures where employees may be rewarded through stock options, franchisees that invest significant amounts of their own equity have little interest in corporate profits or rising stock prices. This unique organizational structure creates significant scholarship opportunities for exploring board governance.

Given the importance of the franchise system’s structural characteristics, future work should examine the role the board and senior management have in these changes. Boards play a critical role in mitigating management opportunism and working to protect stakeholder interests (Fama & Jensen, 1983). Studies also have demonstrated the important role outside directors play in the governance of corporations (Rosenstein & Wyatt, 1990; Weisbach, 1988). Board diversity, moreover, leads to better management decisions and higher levels of performance (Baysinger & Butler, 1985; Bommaraju, Ahearne, Krause, & Tirunillai, 2019; Carter, Simkins, & Simpson, 2003). Franchisees are neither outsiders nor insiders (Lawrence & Kaufmann, 2019) but have extensive institutional knowledge about the firm (Lawrence & Kaufmann, 2011). Including them in decision making, therefore, may help reduce system-wide conflict (Lawrence & Kaufmann, 2011), introduce alternative viewpoints, and increase organizational commitment (Mathieu & Zajac, 1990). From the franchising literature (Leblebici & Shalley, 1996; Stephen Spinelli, Birley, & Leleux, 2003; Steve Spinelli & Birley, 1996) we have learned that conflict solutions and relational contracts lead to better relationships. We therefore propose:

**Proposition A.** Corporate boards that include franchisee representation will have lower levels of system-wide conflict and higher levels of system-wide performance.

Though we provide one potential proposition involving franchise board composition and its effect on performance, many more remain. For example, how does one ensure appropriate board governance and incentives amid the incentive incompatibility between a publicly traded organization’s stock price and a franchisee’s unit-level profitability? Corporate governance research should broaden in scope to examine how owners and equity market owners could govern firms. As franchising is a unique contractual arrangement, should board members have franchise experience or does general industry experience suffice? What constraints does the board have in times of crisis like the coronavirus pandemic, when federal financial aid legislation has limited the ability to manage the firm with stock buybacks?

7. Internal governance of the franchisee (B): Franchisor-franchisee relations

Franchising scholarship has focused primarily on the franchisor’s governance of both corporately owned and franchised outlets (B). Meanwhile, governance researchers have focused largely on boards (A), paying little attention to the implications of different organizational forms (Krause, Semadeni, & Cannella Jr, 2014). Significant contributions could be made to this field by exploring how debt and equity partners work to govern a franchise system. Property rights, for example, are sanctioned behavioral relations among decision makers for
the use of valuable resources within a given parameter. This definition stresses both the legal and social components of property rights and characteristics that govern behavior—among them, corporate culture and reputation (Ostrom, 1990).

Research by Konigsberg (1991) and Jell-Ojobo and Windsperger (2014) examines franchising-specific structures and how they differ with regard to control and governance. Among the four structures examined, the studies contend that joint ventures have lower control than a wholly owned subsidiary but higher control than area development franchising and master franchise agreements. Previous work has found that franchising firms' governance structures are seen as working together usefully for decision rights and ownership rights, while the dual distribution does not depend on heterogeneous downstream outlets (Hendriksen & Jiang, 2011; Windsperger & Yurdakul, 2007). The relationship between ownership rights and residual decisions in franchising companies, however, remains under-researched. According to Baker, Gibbons, and Murphy (2008), a firm's governance structure refers to decision and ownership rights. In franchising, decision rights encompass the assignment of rights for use of system- and outlet-specific assets in contracts. In other words, ownership rights in franchising are seen in the ratio of company-owned to franchisee-owned stores and residual income rights, as traditionally conceptualized in Fig. 1. Private equity ownership in franchising continues to grow (Mazerov, 2019) as investors are attracted to acquisitions with low asset requirements and a steady stream of royalty payments.

A focus on how franchisor strategy impacts the mix of corporately owned and franchise outlets has a long history of scholarship in marketing (Dant et al., 1996; Oxenfeldt & Kelly, 1969; Windsperger & Dant, 2006). However, these lifecycle shifts have been predicated on a strategy to acquire profitable assets rather than higher-order ownership shifts that have implications for how systems will allocate resources and grow. Unlike publicly traded or family-owned franchise chains, private equity groups operate on limited time horizons and under pressure to realize returns from their investments. One short-term route to improving private equity groups' returns on assets is to sell existing company-owned units to new or existing franchisees, otherwise known as refranchising. Returns from franchising through royalties are significantly higher than company-owned store margins (Siebert & Leonesio, 2015). Although there may exist long-term synergistic benefits to plural-form franchising (Baker & Dant, 2008; Bradach, 1997), we suspect the trend toward wholly owned franchise units in private equity firms will accelerate, contradicting Oxenfeldt and Kelly's (1969) original hypothesis. We therefore propose:

**Proposition B.** Private equity-owned franchisors eventually will become wholly franchised firms.

From the relationship between ownership and channel governance, could spring many more propositions. For example, which ownership model and control modes do private equity investors favor? How are these control modes decided and at what level of the organization? When, compared to other types of owners, will private equity owners have a higher proportion of multi-unit franchisees and international master franchise agreements? Is effective corporate governance more important in franchising and abroad, where information is less reliable and franchisees are far away?

8. **External governance (C&D)**

Though previous work has studied returns to franchise organizations' equity holders (Hsu et al., 2017; Madanoglu, Lee, & Castrogiovanni, 2011; Stephen Spinelli et al., 2003; Srinivasan, 2006), remarkably little research has focused on the influence of external governance in franchising. Corporate governance structures in a franchising context are complex, considering the external financing dynamics involved. As illustrated on the right-hand side of Fig. 2, franchising involves two distinct but related entities—the franchisee and franchisor—that both may be governed by external financing sources. This part of Fig. 2 shows how a company's “owners” (i.e., equity investors) govern through the board of directors while “debt holders” (i.e., banks, lenders) govern by applying different loan restrictions or covenants.

9. **External governance of the franchisor (C): equity holders/owners and debt holders**

Franchise-based organizations' ownership structures are changing (Lawrence et al., 2017) as established brands are sold to private equity firms amassing diverse portfolios of franchise investments (Lawrence & Kauffman, 2011, 2019). Limited research exists, however, examining the impact of such ownership changes on governance and system performance (see Bernstein, Lerner, Sorenson, & Strömberg, 2010; Bernstein & Sheen, 2016). As these owners actively seek to improve corporate governance within their portfolio companies (Aggarwal, Erel, Ferreira, & Matos, 2011), they wield considerable influence on the firms’ strategic direction. But these active institutional investors—among them, hedge funds and large investment offices—appear to focus more on short-term speculation (Coffee Jr & Paia, 2016) that could conflict with franchisees' decades-long commitments (Lawrence & Kauffman, 2011).

One consequence of these ownership changes may be refranchising, as demonstrated by The Carlyle Group's restructuring of McDonald's in the Chinese market (Tsang & Wee, 2017). While refranchising reduces the franchisor's balance sheet and capital requirements while improving return on assets, it may have governance implications beyond financial ones (Williamson, 1988). The offloading of assets achieved through refranchising, for example, may lead companies to make decisions that increase the system's risk profile, putting franchisees investments at greater liability. Such decisions are emblematic of a disconnect that exists between stakeholders—among them, franchisees—and increasingly prominent private equity investors, which wield power as key minority owners in equity markets. These investors utilize shareholder-oriented governance systems, which grant wide rights and responsibilities to shareholders and are designed for majority ownership spheres governing and controlling listed firms (Henrekson & Jacobsson, 2012). Research examining ownership structures (Lemmon & Lins, 2003) has linked changes in performance to greater management control. In addition, research examining different forms of ownership, including family-owned firms (Carney, 2005), private firms (Uhlman, Wright, & Huse, 2007), foundations (Thomsen & Rose, 2004), and cooperatives (Hansmann, 1988), has demonstrated their influence on the use of equity and debt.

In the marketing domain has documented a positive and significant relationship between franchisee and franchisor bankruptcy (Antia, Mani, & Wathne, 2017). Antia et al. (2017) also find effects of franchisor-deployed governance mechanisms on likelihood of franchisee bankruptcy. During times of market growth, the relationship between debt and ownership dispersion can be graphed in a nonlinear fashion (Schulze, Lubatkin, & Dino, 2003) that indicates a firm's vulnerability in times of crisis. The risk assumed is a function of how the firm perceives the influence of ownership dispersion on debt use. Research also has demonstrated that private equity ownership can improve the system-wide operation of a chain of outlets (Bernstein & Sheen, 2016) and improve performance after a financial crisis (Bernstein, Lerner, & Mezzanotti, 2019). Bernstein et al. (2019) found that private equity-backed firms were less financially constrained during a financial crisis, experienced higher post-crisis performance in assets and market share positions, and were not more likely to go bankrupt. These results point to private equity-backed firms' ability to better utilize and access financing to improving post-crisis performance. We therefore propose:

**Proposition C.** When compared to other ownership forms, private
equity ownership of franchise-based firms will result in lower levels of franchisor bankruptcy following a financial crisis.

Given the current coronavirus pandemic and its threats to firms’ liquidity, significant potential exists in franchising scholarship to examine questions related to external funding and risk. The economic fallout of the pandemic has highlighted balance sheets as a key vulnerability for many firms. Franchise-based companies, however, are uniquely positioned to outperform the market during the pandemic because of certain structural characteristics. First, most franchisees are small businesses that can qualify for government loans and assistance. Second, franchisees and business owners may be more innovative than corporate store managers, leading to higher outlet performance. Third, franchisees with few corporate-owned outlets will have lower debt levels, reducing their risk profiles and increasing access to capital.

10. External governance of the franchisee (D): equity holders/owners and debt holders

Just as franchisors’ external governance has evolved, so too has franchisee ownership. We often conceptualize franchisees as small mom-and-pop operators but they have steadily grown in size (e.g., Carrols Restaurant Group, owner of over 1000 restaurants under the Burger King and Popeyes brands; NPC International, owner of more than 1100 Pizza Hut units in 27 states) to challenge these longstanding assumptions. Private equity firms also are buying multi-unit operators and partnering with operating partners to run outlets. Franchisee organizations today can encompass hundreds of outlets with their own balance sheets and ownership structures. The evolution of franchisees’ relationship to debt and equity holders as family-owned firms or private equity ownership grows provides a unique context for governance research. The current literature on franchising neglects to acknowledge the existence of these organizations or the governance relationships they embody.

In our conceptual model, (D) includes the franchisee, classified as a semi-internal actor, with its own external ownership structures. In some cases, franchisees can be large enough to become publicly traded companies (e.g., Arcos Dorados Holdings, Diversified Restaurant Holdings) or are owned by private equity investors (e.g., Sun Capital owns Heartland Automotive Services, Inc., the largest Jiffy Lube franchisee; Sentinel Capital owns Border Foods, a Taco Bell franchisee). Some brands, by contrast, construct their franchise agreements to reduce the threat of private equity ownership. For example, Domino’s Pizza requires franchisees to be operating owners, reducing the ability of private equity ownership or other passive investment strategies (Bell & Shelman, 2017). The strategic decision to attract multi-unit investor franchisees versus owner-operators remains an important and under-studied topic in franchising. Multi-unit operators often are more sophisticated operators, with the potential to invest significant assets to grow and sustain the brand. As absentee owners, however, they must hire managers to run their business, threatening the agency arguments often credited to the success of franchising as a distribution mode (Jindal, 2011; Lawrence et al., 2017).

The selection of an appropriate exchange partner has been one focus of the marketing channels literature (Wynts & Geyskens, 2005) and more specifically the literature on franchisee selection (Jambulingam & Nevin, 1999). The success of a franchise system is dependent to a great extent on the selection of appropriate franchisees. Selecting larger franchisee partners (e.g., private equity) may accelerate expansion but this strategy has a caveat: Private equity firms have financial skills but often lack operational capabilities. In times of crisis, (Bernstein et al., 2019) we know that private equity investors may have access to financial resources and ability to invest and capture market share. Though this may benefit the system, larger multi-unit franchisees with more resources also may deploy those resources by challenging the franchisor or ignoring top-down directives (Massimino & Lawrence, 2019). Mature legacy franchisors may value control over system growth, moving to limit the number of private equity-owned franchisees. We therefore propose:

Proposition D. Mature franchise systems will have more restrictive contracts, limiting the number of private equity-owned franchisees.

Once again, the coronavirus pandemic provides fertile ground for investigating questions surrounding governance in area D. Whether private equity-owned/operated franchisees are better positioned to weather the current crisis is one area of potential research. Larger multi-unit franchisee organizations, for example, can leverage financial know-how to arrange financing and apply for government assistance, positioning them to outperform smaller operators. Private equity-owned franchisees also may be better positioned to lobby the franchisor to provide relief in the form of royalty forgiveness. Smaller owner operators, however, may be quicker to react to market conditions and better suited to deal with pandemic-era operational challenges, particularly in being less leveraged.

11. Other external governance (E): External stakeholders of the franchisor/franchisee

External stakeholders in area E include franchisee associations, suppliers, customers, media, auditors, communities, politics, laws and regulations, culture, and the markets. These stakeholders need not engage directly in an economic exchange with the focal franchise firm but can affect, or be or affected by, its actions. Laws and regulations, along with the organizations that enforce them, are prominent external stakeholders of concern for franchise organizations, especially those that are listed companies. The Securities and Exchange Commission, for example, has exerted strong federal oversight of listed companies since 1933. The U.S. Federal Trade Commission, meanwhile, requires franchisors to complete a Franchise Disclosure Document for franchisees prior to sale. Given the narrow nature of federal regulations, many states have enacted stricter laws governing the franchisor-franchisee relationship. Wide variance in state regulations and statutes, coupled with the complexity of the Franchise Disclosure Document (Beniol et al. & Zheng, 2018), remain a significant governance barrier.

Some of these external stakeholders took on new prominence in the 1990s following several high-profile financial scandals that lost billions for investors. In response, several large institutional investors intervened, formulating so-called corporate governance guidelines for how corporations, mainly those listed on NYSE and NASDAQ, would be controlled. This led to the gradual expansion of corporate governance legislation (Tricker, 2015) and a proactive approach to corporate governance from institutional investors (Drucker, 1991). In the early 2000s, new U.S. legislation enforced strict corporate governance law with the Sarbanes-Oxley Act. Researchers have included the impact of such external stakeholders on governance to include management turnover (Agrawal & Chadha, 2005) and CEO dismissal (Bednar, 2012), while the franchising literature has highlighted the impact of external entities such as franchisee associations (Argyres & Bercovitz, 2015; Lawrence & Kaufmann, 2011). The role of external stakeholders in the governance of franchise-based organizations remains an area of particular importance given U.S. law regarding joint employers (Griffith, 2019). One promising area of research is the impact of such legislation and the differences among state laws on franchise system performance (Wang, Grünhagen, Ji, & Zheng, 2020).

In addition to these external factors, investors are growing increasingly interested in measures of corporate activities that go beyond shareholder maximization to include environmental stewardship, social involvement, and governance (ESG) activities. Research on corporate governance of stakeholder orientation issues shows institutional investors already interested in incorporating ESG variables into their financial investment decisions (Ho, 2010). In franchising, however, such decisions involve franchisees that simultaneously exist outside
traditional firm boundaries and have the autonomy to engage with local communities. Franchisees as independent business owners can establish wages, set prices, and participate in corporate social responsibility initiatives (Massimino & Lawrence, 2019). To successfully implement ESG principals throughout the franchise system, we argue that franchisees must gain buy-in from franchisees who have authority related to unit-level operations. We therefore propose:

Proposition E. Franchisors that include franchisees/franchisee associations in governance decisions will have higher corporate ESG scores and systemwide performance.

12. Implications for established theories, new constructs and avenues for future research

12.1. Ownership redirection to capital redirection

Oxenfeldt and Kelly’s (1969) seminal article on structural changes to franchising over time encouraged extensive scholarship in the domain of outlet ownership changes, referred to as ownership redirection (Dant et al., 1996; Dant, Kaufmann, & Paswan, 1992; Windsperger & Dant, 2006). Though franchise scholarship has focused on this trend, few studies have examined higher-order changes in capital distribution amid the rise of private equity ownership of large brand portfolios. We term these changes in ownership, from brand founders to external finance-based organizations such as private equity firms, capital redirection. Measuring such changes involves capturing the degree of movement of a firm’s resources (income statement and balance sheet activities) and its ownership over time. We can use financial metrics to better understand how these alternative sources of debt and equity affect firm strategy and performance.

One movement of resources that could create conflict between franchisor investors and franchisees is the use of cash flow for dividends. A possible metric for this strategy is a ratio borrowed from the finance literature that measures how much of total earnings flows to investors versus back into the system. The franchise firm dividend payout ratio—franchisor dividends paid, divided by net income—is important to franchisees as they make substantial long-term investments in firm-specific assets. Firms have other ways to return value to shareholders, including stock buybacks. Such distributions can be measured by an adjusted dividend payout ratio incorporating share buybacks (calculated by taking the sum of dividends plus buybacks, divided by net income). A high ratio may suggest an emphasis on short-term goals to increase share prices at the cost of long-term reinvestment.

In utilizing capital, the board of directors faces governance constraints that include creditor covenants and equity holders’ expectations of dividend returns. These constraints may, for example, complicate a move to reinvest in the future of the business, which benefits franchisees. This potential competing interest over capital allocation has important implications for franchise system management but has not been discussed in the literature. Instead, research historically has framed the conflict in franchising as one between sales and profits, even when capital allocation and reinvestment potentially may be primary drivers of system performance. When the owner of a company is establishing or governing a franchise system, the owner must make governance decisions on the optimal ownership and effect of capital structure—for example, redirecting capital from outlet ownership. A gap exists today in the corporate governance and franchising literatures surrounding the understanding of how such governance decisions affect performance. Addressing this gap could spur interesting research questions such as: 1) How does franchise system ownership affect long- and short-term strategic and capital plans? 2) How does capital allocation when reinvesting in the future of a franchised business differ from that of a non-franchise brand? 3) How does ownership concentration affect system-wide performance?

12.2. Plural form to portfolio form

Stable plural form theory (Bradach, 1997) argues that both company-owned and franchised outlets existing in singular systems accrue certain system-wide benefits. This theory, however, emerged in an environment when brands were often owned in isolation, quite unlike today’s ubiquitous portfolio brand model. How does this theory, one that seems to work for companies like McDonald’s, evolve as we see the growth of private equity ownership and other models?

In the current franchise landscape, we need constructs to help better understand the nature of franchisor brand portfolios, including the relationship between the number of brands a single owner (e.g., Roark Capital) may have and resource allocation among them. For example, dividing marketing or infrastructure investments in a single portfolio brand by total investments across the portfolio could provide one measure of that brand’s importance to its owner. This measure also may provide insight into how that singular brand is governed. Alternative measures may include comparing the book value of the intangible brand asset or the owner’s real estate investment in any singular brand to portfolio value. Franchisees or other external investors considering an investment in an individual brand may be interested in this measure to assess the organization’s commitment to individual brands.

Given the trend toward private equity ownership in franchising, greater focus should perhaps be given to the nature of these deals, including debt financing, and their impact on performance. Future research could examine how the increasingly common brand portfolio strategy affects market risk and returns. Other research questions to consider: Which franchise brand portfolio strategy (house of brands, branded house) engenders greater growth potential or risk mitigation? What is the role of relational governance mechanisms (e.g., information disclosure, informational asymmetry, signalling, social ties) in different franchise structures’ performance?

12.3. Franchisor perspective to multiple stakeholder perspective

Franchising research has focused almost exclusively on the central dyadic relationship, even though multiple other stakeholders influence the franchise system. Take, for example, franchise associations (Lawrence & Kaufmann, 2010, 2011) or advisory councils that advocate for franchisee interests (Argyres & Bercovitz, 2015). The impact of these structures in franchising warrants their recognition and examination. Though the literature has promoted an agency relationship that places the franchisor as the principal protector of the brand, recent work in franchising has highlighted the importance of a multi-stakeholder approach to brand management (Lawrence & Kaufmann, 2019). The corporation can, in some instances, lose legitimacy as the keeper of the brand. Take, for example, KFC’s attempt to distance itself from founder Colonel Sanders and its original fried chicken recipe (Sparks, 2010). These actions angered franchisees, which sued the corporation and demanded a return to the original classic recipe. This led to a “Re-Colonization” effort from owner YUM! Brands to reinvigorate the brand with the original Sanders ethos (Addady, 2016).

We need new constructs to evaluate the degree of such stakeholder engagement and diversity. For example, a measure of stakeholder inclusivity measuring the distinct number of stakeholders (e.g., franchisees, associations, community) that hold positions within the broad view of corporate governance structures. This measure could capture the percentage of board members that represent these diverse interests and provide insight into how and to what degree a company manages its operations to accommodate varied stakeholders.

A focus on collaborative governance generates several interesting research questions to include: 1) How can franchisors best incorporate such entities in joint/collaborative governance? 2) Do these efforts help improve franchisee-franchisor relations? 3) Does including franchisees as board members lead to stronger system performance? 4) Do franchisee associations hinder or promote growth?
13. Conclusion

Given the recent economic fallout from the coronavirus pandemic, it is apparent that many variables not often viewed in franchising govern-
ance models can influence operations. Take, for example, three U.S. franchisors: Chick-fil-A, InterContinental Hotel Group (IHG), and Roark Capital. Chick-fil-A is family owned, has a strong balance sheet, and
is generally risk averse. Its franchisees put up little capital ($10,000) and
are limited in their growth, typically to two franchise-financed stores.
IHG, a publicly traded global hotel franchising company, has a large
portfolio of brands with exposure in many international markets.
Owning very few assets, IHG relies on management contracts and
royalty fees for revenue. Roark Capital, meanwhile, is a private equity
company with an extensive portfolio that includes Anytime Fitness, Cinnabon, Auntie Anne’s brands, Buffalo Wild Wings, Arby’s, Sonic
Drive-In, and Jimmy John’s. Through aggressive growth, including
international master franchise agreements, Roark has raised over $12
billion in equity capital. How these three companies address the chal-
lenge and economic risks associated with the coronavirus depends a
great deal on who owns their debt and equity.

A firm’s ownership structure, financing, and external environment
all may have a dramatic influence on the functioning of modern fran-
chise systems. We must, therefore, expand the view of governance in
franchising to appreciate and investigate this influence. We argue that
the unique ontology of franchising also offers corporate governance
researchers significant avenues for scholarship. The semi-internal
identity of the franchisee, the existence of plural form ownership, and
the sizable capital investments that franchisees often make, collectively
offer a unique set of relationships that could enrich theories of gov-
ernance. Though research exploring a broader view of governance in
the franchising literature is in its nascent stages, we offer this initial
conceptual model to help move toward a greater appreciation of the
potential such research has.

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