

# Franchising in Germany: the Importance of Management and Psychological Contracts

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**Abstract:** Both controlled regulation and entrepreneurial autonomy are bound together in franchising. This bonding may result in the partners' collaboration or in dilemmas. There are limitations placed on the legal contract as an instrument to attain consent of the franchise partners and as such, of controlled regulation and entrepreneurial autonomy.

Additional insight is provided in this article as to the nature of franchising in order to identify the mechanisms or processes which influence a successful combination of regulation and autonomy in this business arrangement – despite potential imbalances in the allocation of power, rewards and resources in the franchisor-franchisee relationship.

## The Franchise Paradox

Franchising is a particular form of hybrid agreement which has become more popular over time (Pizanti and Lerner, 2003, with reference to Preble and Hoffman, 1995). It is defined as

*“... a business form essentially consisting of an organisation (the franchisor) with a market-tested business package centred on a product or service, entering into a contractual relationship with franchisees, typically self-financed and owner-managed small firms, operating under the franchisor's trade name to produce and / or market goods or services according to a format specified by the franchise. (Stanworth and Curran, 1999)”*

(Stanworth et al, 2004, p.541)

This complex business relationship has two facets: at first sight, franchising seems to be an easy and clearly defined business relationship: two business partners collaborate, one of them granting the right to exercise an experienced business concept to the other partner, earning a royalty in exchange. This approach reflects the description of franchising which is often used to praise the franchise arrangement in practice. Moreover, economic theoretical perspectives on franchising emphasise the opportunities given (possible opportunities of) by this arrangement as a potential relationship to resolve agency problems.

However, insights into the franchise relationship reveal a variety of potential dilemmas which may weaken the business collaboration. The franchisee, as the partner who is granted the right and the obligation from the franchisor to use the approved business concept, is both legally self-employed and the franchisor's operating partner.

*“Contrary to the rhetoric which so often accompanies the mention of franchising, this book argues that franchisees operate in businesses which are neither independent nor subsidiaries of another company. They can more aptly be considered to be ‘betwixt and between’ these two extremes (sic).”*

(Felstead, 1993, p. 192)

Therefore, the franchisee is bound by duties and regulations resulting from the system-membership. In parallel, he or she bears the entire risk of his or her business. Moreover, the franchisee has both to conduct his or her business according to given guidelines and to act autonomously according to his or her self-employment. Evidence is given of these personal and economic dilemmas faced by franchisees (Felstead, 1993; Jacobsen, 2003). The franchisor as counterpart has to ensure both brand management and the franchisees' entrepreneurial motivation and energies - the concept of franchising includes reliance on franchisees' self-motivation and engagement (see marketing and retail system scholars, for instance Tietz, 1987 or Stern 1997). Thus, the franchisor may also be faced with dilemmas. Franchisors and franchisees are likely to have congruent expectations of their relationship in terms of the brand image and the qualities inherent in the brand, such as the kind of business or the values transferred by the service or product delivered. Moreover, both partners must be interested in being part of a greater network of companies or even of a global corporation, and by agreeing to the franchise arrangement both parties accept the necessity of the local adaptation of this network. But there are also conflicting interests in the franchise relationship: franchisors usually charge the franchise fee in relation to the franchisees' turnover, whereas franchisees themselves live from the profits of their businesses. Thus, as franchisors are mainly interested in increasing an outlet's turnover, franchisees are concerned about the profits of their business, as these determine their income. Moreover, franchisors and franchisees may encounter conflict due to imbalances in power and other aspects of their relationship (Felstead, 1993).

These aspects raise the question of why the partners engage in this specific business arrangement. Whereas some common interests have already been explored as bonding elements in the franchisor-franchisee relationship, these do not constitute a sound explanation of the franchise phenomenon, particularly the understanding of the complexity of the franchise arrangement and how the partners cope with this complex relationship – key aspects which were addressed in the author's research on franchising in Germany.

This research explored the importance of intangible factors on the franchise partners' perception of fairness, partnership orientation and mutual contribution in franchising. The qualitative research approach centred on a cross-case analysis of three franchise

systems in Germany, including: Pet Food Store (original name covered), which was founded as a German company in 1990 and operated up to 650 franchise outlets in Europe during the time-frame of this research; Pirtek, a global franchise organisation which offers a specialist mobile hydraulic repair service with up to 30 franchisees in Germany, and the Yamaha music school system, offering music teaching programmes with up to 80 franchisees in Germany as part of the global Yamaha conglomerate. These numbers refer to the time the systems were investigated (2004-2006). Though changes in size and character of the systems can be noticed today, each of the systems in its existence at the time of research represent a specific type of franchising and are therefore valuable in explaining the franchise phenomenon. In general, these types can be distinguished in low, medium structured and fully structured systems, whereas the latter is close to systems like McDonald's or branches within a retail system (Bockel, 2007).

### **Control, Consent and Autonomy in Franchise Relationships in Germany**

In detail, this research addressed under-researched areas in the understanding of franchising and its inherent tensions. These areas included invisible human and psychological processes in franchise arrangements which were based on aspects of the understanding of the psychological contract (Schein, 1987)– a concept which has so far been applied to employer-employee relationships. To apply aspects of the psychological contract to franchise arrangements promised an understanding of why franchise partners engage and how they cope within the specific character of this arrangement. This and other questions guided this study and will be answered in the following sections.

#### **The nature and existence of franchising**

The franchise arrangement turned out to be a complex relationship with individual aspects as well as a business configuration in which a major input of managerial and social capital can lead to collaboration for/with the franchise partners.

*“The popular view, one widely supported by the literature, is that franchisors tend to be entrepreneurial through the creation and growth of their concept. Conversely, franchisees are restricted and constrained by contractual obligations, thereby subordinated to their franchisor and unlikely to emerge as an entrepreneur within the system. Although there is little evidence to suggest that the world of a franchisee remains constrained, in practice the environment is much more flexible, complex, diverse and dynamic than appears on the surface.”*

(Clarkin and Rosa, 2005, pp. 327-328)

The analysis and discussion of Pet Food Store, Pirtek and Yamaha revealed significant differences within the companies: in terms of the degree of detail of formal regulation, in terms of the motivation for the franchisees to engage in the relationship, in terms of business growth, and other factors of the business.

With these differences, each company has existed for a number of years and the majority of franchisees interviewed stated that they were generally satisfied with the franchise arrangement. The analysis revealed that some elements of the cases were of particular value for the company. For instance, Pet Food Store distinguishes itself from the other cases by an explicit business concept. This concept appears as being 'thought through' and therefore, generates high security of business success for those entering a franchise. The further analysis and comparison of the other cases puts this distinguishing character of Pet Food Store into context and as such, demonstrated the limitations of a high degree of regulation. Pirtek and Yamaha, as businesses which include services, strongly rely on the flexibility and individual style of their franchisees. As such, the franchisees are in a higher position in the businesses' value chain than Pet Food Store franchisees. Therefore, providing these franchisees with more autonomy for individual amendments than those franchisees acting solely as retailers seemed to be appropriate for these businesses.

The degree of formal regulation is just one of the franchise factors which appears as being a double-edged sword. Hence, the research suggests that there is no 'one best way' for the use of controlled regulation, entrepreneurial autonomy and management in franchising. These key ingredients of franchising have to be created and evaluated in the specific context of the individual franchise arrangement. As such, the notion of individuality in franchise arrangements can be underlined. Differences in the key elements of the case studies came to make sense by regarding the companies as an entity – a finding which supplements earlier research (Clarkin and Rosa, 2005). As indicated before, the findings also stress that the nature of franchising is complex, and the combination of controlled regulation and entrepreneurial autonomy bears both significant risks and advantages for stakeholders of franchising.

### **Why franchising?**

Despite the complexity and the risks inherent in franchise arrangements, franchising is a popular form of business alliances and has achieved widespread importance during recent decades. The franchise partners who took part in the study partly agreed with the commonly held rationale for franchising. Thus, the common use of a brand and economies of scale results in economic benefits for the franchise partners. Moreover, the majority of franchisees appreciated their entrepreneurial freedom, which had different meanings.

Yet despite these common aspects in the choice of franchising as organisational form, there were different factors in the franchisees' preference for a particular arrangement. When asked why the franchisees chose their franchise system, they usually mentioned the kind of business and particular features of a system as key criteria for their decision. Therefore, Pet Food Store franchisees would not choose Pirtek or Yamaha and vice versa. Consequently, brand management, economies of scale and entrepreneurial

autonomy cannot solely be given as reasons for the choice of franchising. It appeared that the franchisees really wanted to belong to a particular franchise system – because of economic success, growth and fun at work (Pet Food Store), because of being part of a business family and working in a ‘real’, tangible business field (Pirtek) or because of using sophisticated music teaching programmes and following the aim of music teaching as a societal contribution (Yamaha).

These issues were those aspects which were stressed by the franchisees when they were asked about their motivation to engage in their franchise system. These issues go beyond contractual mechanisms and the consideration of advantages and disadvantages. Moreover, these features in the rationale for franchising seem to be under-acknowledged so far. Therefore, it is suggested that both economic-administrative benefits and a common business aim may be considered in the rationale for franchising.

### **The partners’ perception**

The research further revealed that franchisees who perceive their relationship as fair and partnership-orientated are not the exception. It turned out that both controlled regulation and entrepreneurial autonomy may co-exist in a manner which the partners perceive as collaborative and as being advantageous for both sides. There were a few statements by franchisees which addressed imbalances in the relationship. These statements lead to the conclusion that franchising is still a challenging business arrangement which requires attention to the mutual benefits of franchisors and franchisees. For instance, it may be recommended that both the German Association of Franchisors and the Association of German Franchisees develop quality checks for franchise systems jointly rather than – as currently given – as separate concepts. Such joint quality award for franchise systems may lead to a closer communication of franchisors and franchisees and, as such, support the balance of mutual understanding and contribution in franchise arrangements.

Despite this demand, the case studies in this research revealed a situation of franchising in Germany in which – as indicated - a number of satisfied, successful franchisees could be identified. These franchisees reflected a notion of partnership orientation which was consciously transferred into the system by the franchisors. Each of the franchisor’s representatives stressed the importance of partnership orientation and mutual benefits to the success of a franchise system.

### **Coping with franchising**

Despite the notion of partnership orientation and mutual contribution and benefits, weaknesses could be noted in the franchise arrangements under investigation. Franchisees suffered from weaknesses in the business concept, they felt limited in their personal autonomy by the system’s regulations, or they felt insufficiently supported by the franchisor. Franchisors remarked on the difficulty of steering a franchise system within legal boundaries which limit the freedom to issue directives and which may provoke difficulties in finding a common agreement among the group of franchisees.

Moreover, the franchisors are faced with the challenge of protecting the brand even if franchisees deviate from the business concept. The franchisors also have to find efficient ways to manage the franchise organisation, and they may have to manage their dependence on franchisees if they are in the start up stage of their franchise system.

Both franchisors and franchisees have a variety of methods to cope with these weaknesses. The franchisees approach the tensions they are confronted with by either regarding their situation as a trade off, in which certain disadvantages are overridden by the benefits from being a franchisee in the system of choice. Other franchisees ignore disadvantages and appear as being caught up in the system and its philosophy. Moreover, franchisees have the opportunity to get in contact with the franchisor if there are issues of disagreement – a franchise characteristic which appeared to be supported by the franchisor and the headquarters' management. Therefore, franchise systems use a number of methods which facilitate ongoing communication between franchisor and franchisees. Even in large systems, franchisors have personal contact with the franchisees and the regional advisors are the link between franchisor and franchisee, which provides individual contact. Therefore, potential tensions inherent in the co-existence of controlled regulation and entrepreneurial autonomy are alleviated by personal and close contact between franchisor and franchisees. This contact supports the mutual understanding of the measures derived from controlled regulation. Open communication provides scope for entrepreneurial autonomy, since franchisees feed their impressions, concerns and innovative ideas back to the franchisor. Overall, the partners are aware of disadvantages inherent in the nature of franchise arrangements. The franchise partners stated that they accepted these disadvantages for the sake of an overall satisfactory business. Moreover, franchise partners use openness and personal contact to find individual compatibility despite standardisation in their arrangements. Finally, the franchisor also uses a variety of management tools in order to facilitate ongoing communication and an atmosphere of openness, which will be further described in the following section.

### **Approaching consent in franchise practice: Management**

#### **Management and the psychological contract**

*“... only a small amount of research has been published which addresses the operational details of a franchise system.”*

(Forward and Fulop, 1993 / 1, p. 176)

While the body of knowledge about franchise management has been enhanced by recent research (for instance, Ahlert, 2001; Sydow and Kloyer, 1995), the impact of franchise management on the alleviation of franchise tensions seems to be unexplored so far.

In the research, the role of management in franchising appeared to include two major tasks: first – as described above –, to provide scope for communication with the franchisees and to create an atmosphere of openness in which mutual feedback can be

given; second, to support the notion of partnership orientation, of being behind the franchisees, and of the attempt to achieve mutuality in benefits.

Therefore, a variety of tools, methods and mechanisms are part of franchise management. These include bonus-payments, which consider the franchisees' performance, diverse committees and meetings for informal and formal communication, different support mechanisms, to name but a few management tools. These tools appeared to play a valuable part in the management of franchise tensions. When franchisees were asked about the limitations in their autonomy, they often referred to the potential to integrate into the system's development with feedback, being a member of a committee, or by asking the franchisor about explanations for certain regulations. Therefore, the role of management and the tools of this management appeared to be significant in the alleviation of franchise tensions. Management can assist the franchisees' understanding of controlled regulation (e.g. using communication platforms), the identification with the franchise system (e.g., by award systems), and the constructive and active implementation of franchisees' entrepreneurial qualities into the entire system (e.g. by feedback systems and committees).

The management methods turned out to be a prerequisite for the fulfilment of mutual expectations. Close communication facilitates the clarification of expectations and moreover, it is a method for the franchisor to measure the franchisees' satisfaction and to identify any rumours which may indicate franchisees' dissatisfaction. Moreover, the close relationship between the franchisor or his representatives and the franchisees facilitates the continual renegotiation of the relationship – a necessity which results from the incompleteness of the legal contract. Within the renegotiation process, the partners' contribution and commitment to the system is influenced. In order to gain franchisees' contribution and adherence to the business concept beyond contractual powers, the franchisor and the headquarters demonstrate their commitment and reward the franchisees' contribution. This may be done by the franchisor's presence in the system and at the franchise outlets, even though this may require significant effort because of the number of franchisees. Franchisees' contribution may also be based on the reward for and acknowledgement of their achievements. It appeared that the personal relationship between the franchisor, his representatives and the franchisees plays a major role in the franchisees' commitment to the system. It was one of the factors which formed the franchisees' perception of the franchisor's commitment to the franchise system. This commitment was highly appreciated by the franchisees and it appeared to create a reciprocal commitment by the franchisees –one of the major issues in the understanding of the psychological contract in this study.

Moreover, the franchisees in the case studies did not see a dilemma in following the system regulations if they perceived the implementation of controlled regulation as fair, and if they felt acknowledged and their contribution appreciated by the franchisor. Finally, communication and feedback in the system appeared to be a source of awareness and negotiation of mutual expectations. These processes facilitate the franchisors implementing controlled regulation without losing the franchisees' commitment and contribution. Therefore, psychological contracts in franchise arrangements can be said to support consent in franchise arrangements.

The findings of the data analysis indicate that the partners' perception of fairness is strongly influenced by measures going beyond the legal contract. Whereas earlier research already provided insight into the management of franchise arrangements

(Ahlert, 2001), the meaning of this management in terms of achieving the franchisees' commitment and contribution to the partnership has not been clearly spelled out. Indications have been given by social theories that the partners' satisfaction with the relationship results in commitment (Decker, 1998). Moreover, social theories identified the reliance on entrepreneurial autonomy and of finding an agreement on the basis of a common aim (Maas, 1990). These theories have pointed to the value of support and promotion of the franchisor in obtaining the franchisees' commitment and contribution to the system (Sydow and Kloyer, 1995). Moreover, the influence on their solidarity of both organisational climate and recognition of fairness perceived by the franchisees has been indicated (Strutton et al, 1995). This research underlines this perspective on franchising and its impact on the existence of consent in franchise arrangements. The depth and intensity with which the partners talked about the different ways in which they ensured close contact with each other (franchisors) and how they perceived themselves as integrated into the franchise system (franchisees) went beyond their explanations of their legal bond.

Therefore, both franchisor and franchisees complement the franchise contract and the explicit or implicit elements of this contract by processes which are, according to the findings of this study, helpful in supporting mutual exchange of expectations and in finding consent. It can be inferred from the three cases under investigation that the way in which resistance is addressed in franchise arrangements impacts on the partners' satisfaction with the relationship. Thus, an open atmosphere in which criticism can be expressed supports the reduction of resistance or its change into a new status of consent.

These insights are based on the current social perspective on franchising. The school of thought adopting this perspective goes beyond contractual mechanisms and their implications. Theorists from this area focus on the existence and management of consent and resistance in franchise arrangements by human processes (e.g., Decker, 1998; Küster, 2000; Pizanti and Lerner, 2003) and in acceptance of potential imbalances of power and resources in franchising. This perspective includes the assumption that tight and limiting regulations may depress the franchisees' entrepreneurial powers and therefore, economic theories explaining franchising provide limited insights in the nature of franchising (Sydow and Kloyer, 1995).

Moreover, these theories stress that it is impossible to regard and evaluate the franchisor-franchisee relationship and the partners' engagement in this relationship in isolation (Sydow and Kloyer, 1995; Giddens, 1979). Rather, a number of factors shape the franchisor-franchisee arrangement and the fact that this is at times dominated by consent or by resistance.

### **Approaching consent: dynamic franchise arrangements**

As such, consent is likely if the franchise system is a financial success and if franchisees can agree with the brand and therefore, the type of business and philosophy given by the brand. Moreover, consent is supported if the franchisees can agree to the degree and measures of control by the franchisor. Finally, franchisees are likely to collaborate with and show commitment to the franchisor if they perceive the relationship as being fair and



if they feel that their expectations and ambitions have been and continue to be met. In contrast, to lose franchisees' consent may result in resistance in different ways. For instance, franchisees are likely to alter the system in various ways, for instance by raising their profit margins, in lower ambitions to meet profit margins, or in lobbying against the franchisor (Felstead, 1993; Royle, 2000). If resistance cumulates in conflicts and these are not resolved the franchise may end up being terminated. In order to avoid termination of the franchise contract, franchise arrangements may be understood and treated as dynamic systems with the concepts of control, consent, resistance and autonomy. These concepts may appear at different times in franchise arrangements, depending on a variety of factors, such as:

(1) The nature of the contract: as indicated above, franchise arrangements can be positioned on a scale from soft format franchises to strong format franchises. The typology indicates the degree of regulation within a franchise and as such, influences how far resistance may be caused by limitations in the franchisees' freedom. Alternatively, resistance in less standardised systems may arise because of limited support and, as such, reduced assurance of financial success in soft format or trade mark franchising.

(2) The nature of control and sanctions used: as indicated, control and sanctions can lead to consent or resistance, depending on the way in which these issues are practiced by the franchisor and perceived by the franchisees.

(3) Issues of successful brand management and brand positioning in the market, since the brand positioning influences the franchisor's power and the franchisees' financial success. A strong franchisor is likely to be able to use more coercive powers than a franchisor being in a weaker market position, as in the case of Pet Food Store compared to Pirtek. In addition, franchisees achieving relative financial success may be able to agree more easily with the franchisor's measures than those with less financial reward from their businesses.

(4) The skills requirement and the level of entrepreneurial input of the franchisees: franchisees with a high level of entrepreneurial input, such as in Pirtek, may become resistant because they have less guarantee of economic success in their businesses compared to franchisees in systems such as Pet Food Store, where franchisees' entrepreneurial input is limited due to the system's degree of standardisation. In contrast, entrepreneurial input can motivate franchisees and as such, lead to consent between franchisor and franchisees.

(5) The personality of the franchisees themselves and their personal circumstances: The franchisees' characteristics, motivations and ambitions influence how they perceive their relationship with the franchisor, the degree of regulation and the measures of control. This phenomenon became most obvious in the comparison of Yamaha- and Pet Food Store-franchisees. While some of the former were concerned with their individual freedom and the increasing standardisation of the system, the latter did not express any concern with regard to standardisation and moreover, they mainly focused on their financial benefits from the system. The question arises, if Yamaha franchisees had similar financial rewards as Pet Food Store franchisees would they still be concerned about issues of personal freedom and individuality of their businesses. Considerations of this kind underpin the complexity of franchising and the notion of interrelationships between different factors.

Referring to the complexity of franchising, this study suggests that the nature of franchising may be explained by the concepts of control versus autonomy and consent versus resistance – status' which appear in dynamic franchise arrangements, and which are determined by different factors. As such, the nature of franchising can be depicted as follows:

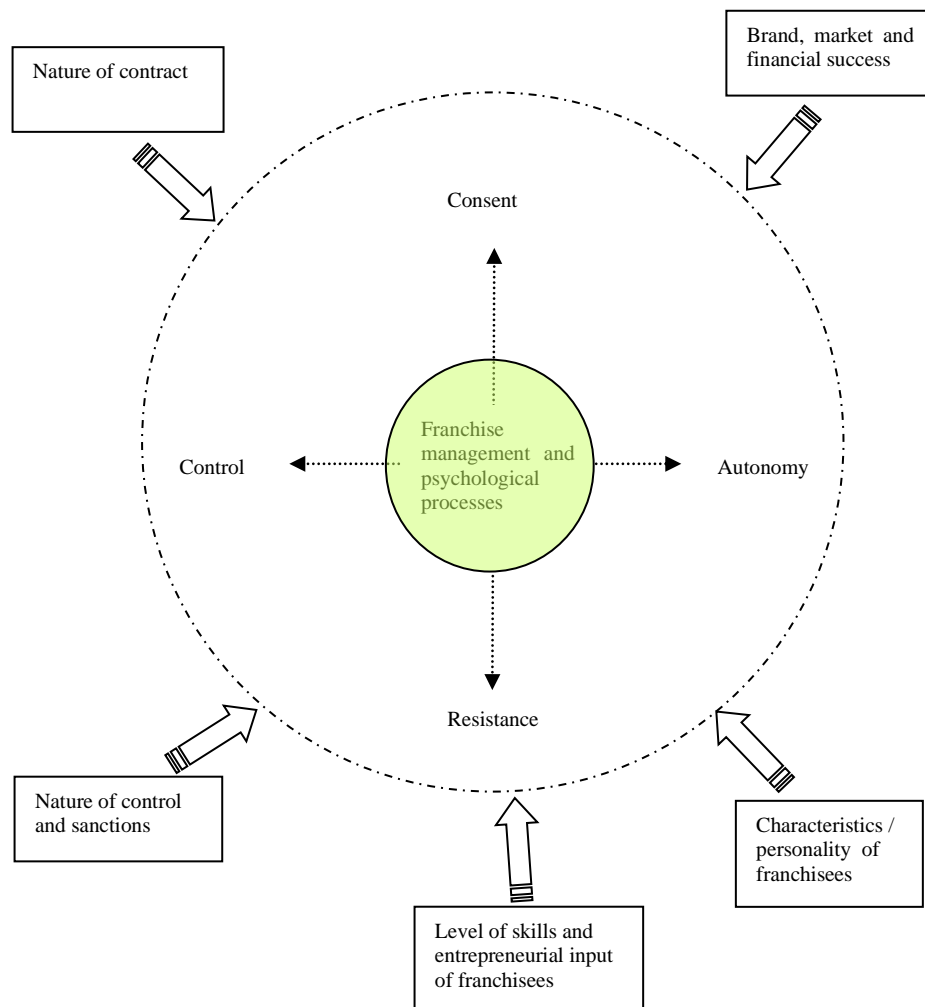


Figure 1: Franchise status and modifying factors

In summary, it is suggested that franchise organisations are understood as dynamic systems rather than as static definitions of trade mark or business format franchising. As the factors impacting on franchise arrangements vary over time, so will situations in the franchisor-franchisee relationships change. Franchise systems may go through a status of resistance in order to renew the arrangement to move back to a status of consent. To achieve consent different mechanisms are used by the franchisors. Despite the fact that these mechanisms can also be evaluated as instruments of monitoring and control, the franchise partners interviewed expressed acknowledgement of these efforts to achieve consent and the fact that the franchisees felt motivated to contribute and commit to the system through these measures. As described, the importance of consent varies with different factors, for instance the power of the franchise brand, which may if it is in a strong position allow more coercive measures and be able to sustain more franchisees' resistance than a weaker brand. It can also be argued from the findings in the study, that franchises have to find the right balance of consent and resistance in order to be sustained and as such, to be competitive in the market place.

### **Summary: towards a complete understanding of franchising**

The research not only contributes to the body of knowledge by demonstrating that consent is more often perceived – or at least expressed by the franchise partners as being perceived – than commonly suspected. Moreover, it has been revealed that and in which way franchise management and human and psychological processes in the franchisor-franchisee relationship strongly influence this perception. Therefore, it is suggested that this aspect of franchise systems is balanced against the economic understanding of franchising.

In considering both psychological relations and legal aspects of franchise arrangements on the basis of a variety of theories, it was intended to overcome the fragmentation in franchising research (Elango and Fried, 1997).

*“The complete understanding of franchising practice may require an explanation involving more than one theory.”*

(Inma, 2005, p. 27)

The findings suggest that both economic and social aspects determine franchise arrangements in different ways and thus, both have to be considered in the understanding of franchising. Moreover, a more dynamic evaluation and interpretation of franchising than currently given can be suggested. As such, the types of franchising from 1<sup>st</sup> generation to strong business format franchising may be seen as different positions on a scale from one end of a continuum to another. In addition, franchise arrangements may vary in their degree of collaboration of the franchise partners over time. As explained, changes in the market place, the system itself and the personality of those involved in the franchise arrangement affect the franchisor-franchisee relationship. Whether this is done

in the direction of consent or resistance can be influenced by the partners to a certain degree, as demonstrated by the in-depth investigation of franchise management, human processes and aspects of the psychological contract in franchise organisations in this study. The analysis of control, consent and autonomy of franchise arrangements in Germany against the theoretical understanding of franchising suggests that franchise partners may perceive and achieve (a certain degree of) consent despite imbalances in the allocation of power, rewards and resources. Moreover, it is suggested that franchisors and franchisees are not only bound by legal and economic considerations, but also by individual ambitions and motivations which address particular franchise systems and their branding.

*“The franchise way of organising has captured large parts of the service industry, yet we know very little about why these organizations function so well. The present and other studies point out that the franchisee incentive might embrace more of people’s lives than ‘making money’. To be or not to be a franchisee – it seems also to be a choice of a way of life.”*

(Marnburg et al, 2004, p.127)

Franchisees’ and franchisors’ choice ‘of a way of life’ includes the dynamics and complexity of franchising – aspects which should have much more consideration in the academic understanding and explanation of franchising. It has to be acknowledged that franchise relationships require the management of human and psychological processes because of their specific nature. These processes influence whether franchisors and franchisees act in a situation of consent or resistance.

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