

# Completing Contracts Ex Post: How Car Manufacturers Manage Car Dealers

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## Abstract

This article illustrates how contracts are completed ex post in practice and, in so doing, indirectly suggests what the real function of contracts may be. Our evidence comes from the contracts between automobile manufacturers and their dealers in 23 dealership networks in Spain. Franchising dominates automobile distribution because of the need to decentralize pricing and control of service decisions. It motivates local managers to undertake these activities at minimum cost for the manufacturer. However, it creates incentive conflicts, both between manufacturers and dealers and among dealers themselves, concerning the level of sales and service provided. It also holds potential for expropriation of specific investments. Contracts deal with these conflicts by restricting dealers' decision rights and granting manufacturers extensive completion, monitoring and enforcement powers. The main mechanism that may prevent abuse of these powers is the manufacturers' reputational capital.

Keywords: Franchising, incomplete contracts, self-enforcement, automobile

JEL: L14, L22, L62, L81, K12

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## 1. Introduction

A growing theoretical literature, starting with Grossman and Hart (1986) and Hart and Moore (1990), has studied the consequences of restricting the set of variables on which parties are allowed to contract. This approach (hereafter referred to as GHM) emphasizes that, when contingencies are unforeseen or indescribable, or the relevant information is observable but unverifiable, the allocation of property rights to the parties has implications for ex ante investment decisions. The assumption of ex post efficiency (conditional on investments) in this approach is problematic, however, when one considers the importance of voluntary compliance and enforcement costs, as Baker et al. (2003, 2004) have emphasized, following earlier work by Williamson (1985), Klein (1996), and Klein and Murphy (1988, 1997).

We illustrate the actual way in which automobile franchising contracts are incomplete and how the parties use the contract to define how they will deal with this incompleteness. We show that the contracts are indeed far from complete; parties cannot simply agree on a mapping from states of the world to actions. However, and unlike in the GHM approach, the issue that the contracts are attempting to deal with is the presence of unforeseen contingencies themselves and the need for ex post adaptation to these contingencies; not merely the motivation of efficient ex ante investment under costless ex post bargaining. Since the costs of ex post renegotiation to optimal decisions is high, and in many cases the decisions themselves are ex post uncontractible, the contract lists the decision rights allocated to each party and gives one of them (the manufacturer) the right of enforcing the contracts, applying if necessary the ultimate punishment of terminating the relationship and destroying the quasi rents of one of them.

Our perspective, which is also in the spirit of the literature on relational contracts and private legal orders,<sup>1</sup> holds important consequences. In contrast to what GHM would predict, when enforcement is costly, as Baker et al. (2004) have emphasized, the assignment of decision rights matters, even if investments are not specific. This is because the parties have different incentives with respect to actions (sales and service provision, pricing), and the existence of enforcement costs allows them to deviate from the ex post optimal action.

The paper fits within recent empirical literature (for example, Arruñada, 2000, Arruñada et al., 2001, Elfenbein and Lerner, 2003, Kaplan and Stromberg, 2003) that has emphasized the allocation of rights and other non-monetary aspects of contracts both between and within firms. The difference with our previous work is twofold. First, while in Arruñada et al. (2001) we focused on the allocation of decision rights ex ante, showing that the rights assigned to manufacturers increase when dealers' hazards are more prevalent and manufacturers are less prone to use these assigned rights opportunistically. The present paper concentrates on how these decision rights are exercised ex post. Second, while in Arruñada et al. we focused on

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<sup>1</sup> See, mainly, Macaulay (1963, 1985), Benson (1989), Ellickson (1991), Milgrom et al. (1990), Bernstein (1992, 1996, 2001), Greif et al. (1994), and Shavell (1995).

understanding the variation between the different contracts, here we focus on their common core and the nuanced interactions between contracts and legal institutions. As a result of this focus on commonalities, we do not undertake regression analysis to try to exploit and understand the between-brand variation. The interested reader is referred to Arruñada et al. for this analysis.

We rely on the dealership contracts of the 23 automobile distribution networks in operation in Spain (including all of the important multinational firms), and on extensive interviews with industry experts.<sup>2</sup> The aim of the interviews was to shed light on how typical contractual practices work. Instead of focusing on the economic content of contracts in a strict sense, we aim to analyze the economic contribution of all aspects of these contracts (assignment of decision rights, monitoring and incentives) to the solution of incentive conflicts. Franchisees have incentives to sell fewer automobiles and provide less than optimal services due to both vertical and horizontal externalities (Klein, 1995). On the other side of the equation, manufacturers may expropriate individual dealers by lowering the margins after the contract was negotiated or by selling new dealerships in the same local market. In principle, they may also expropriate the entire network by underperforming on their police role or by underinvesting in brand maintenance.

The contracts we study reduce the incidence of these conflicts through a complex set of vertical restraints monitoring and incentive mechanisms.<sup>3</sup> While some specifics of this contractual technology vary between contracts as a result of the different incidence and costs of moral hazard on both sides (see Arruñada et al., 2001), the structure and core content of the contracts, which is one of the focuses of the present article, are the same.

The first element of the contractual technology is the assignment of decision rights to dealers and manufacturers. Contracts assign substantially similar decision rights to dealers and manufacturers of different brands. In particular, contracts consist, to a large extent, of a system of restraints that aims to limit the decision rights of dealers in order to increase the quantity of cars sold and to ensure a minimum quality of service. Dealers must attain sales targets set by manufacturers, they must provide predetermined levels of information and publicity, and they must attain certain levels of sales and after-sale services. Contracts also authorize manufacturers to decide the quantity and quality of the facilities, and the machinery and labor resources to be used by the dealer. In addition, they grant a wide range of decision rights. In particular, manufacturers hold extensive interpretation, implementation and enforcement powers. For

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<sup>2</sup> Fieldwork included 48 in-depth interviews with experts: the managers of the two trade associations, ANFAC and FACONAUTO, 23 franchisees of different brands and 23 managers of distribution networks. Manufacturers which participated in the study in Spain represent the following brands: Alfa Romeo, Audi, BMW, Chrysler, Citroën, Daewoo, Fiat, Ford, Honda, Hyundai, Jaguar, Lancia, Mazda, Mercedes, Mitsubishi, Nissan, Opel, Peugeot, Renault, Rover, Seat, Skoda, Suzuki, Toyota, Volkswagen and Volvo. In 1994, these manufacturers produced 99.3% of the total number of automobiles sold in Spain. (Ministerio de Justicia e Interior, 1995).

<sup>3</sup> In analyzing the contractual technology as being composed of the assignment of decision rights, monitoring and evaluation mechanisms, and compensation incentives, we use categories developed by Jensen (1983) and Jensen and Meckling (1995).

example, the contracts studied allow manufacturers to produce the demand forecast on which sales targets are based and to determine sanctions for non-performing dealers.

A second component of the contractual technology is a monitoring and evaluation mechanism that allows manufacturers both to assess dealers' performance and to ensure their compliance with these vertical restraints. Manufacturers are authorized in all 23 contracts to inspect crucial dimensions of inputs (machinery, personnel, etc.). They are also allowed to set output targets that dealers must attain, both in terms of sales and in customer satisfaction (as measured by polls). Finally, manufacturers may monitor dealers' overall performance by regularly auditing dealers' financial statements to assess their profitability. The aim of this assessment is to avoid the conflict posed by the debasement of long term incentives when dealers' profits are too low. The whole monitoring and evaluation mechanism is used by the manufacturer to implement corrective policies and as an input into the reward and sanctioning mechanism established by the contracts.

The third element of the contracts is two sets of monetary incentives, which ensure that the parties act so as to maximize joint value. These take the form of price discounts related to sales, customer satisfaction and termination rights. The contracts hardly seem concerned with the possibility of moral hazard on the manufacturer side. In particular, apart from the reputation of the manufacturer and the legal system, no contractual provision exists that may prevent abuses by the manufacturers of the decision rights the contracts grant them. We therefore expect reputation to matter a lot here, since manufacturers interact repeatedly with a large number of dealers. Opportunistic behavior towards them not only decreases the possibility of finding franchisees in the future, but also induces existing dealers to run down their level of service, damaging the brand's value.

The rest of the paper is structured as follows. Section 2 analyzes the reasons why franchising is the preferred organizational design and discusses the incentive incompatibility problems that it may create, which need to be dealt with by contracts. Sections 3 and 4 analyze different aspects of the contractual technology we observe: assignment of decision rights, monitoring and evaluation mechanisms and incentive mechanisms. Section 5 concludes.

## 2. Franchising and double-sided moral hazard

### 2.1. Organizational Design: The Choice of Franchising

Dealers use two methods to organize their distribution network: (1) direct management of company-owned outlets and (2) franchising. They mostly rely on franchising, with only a small minority of outlets being directly owned and managed by manufacturers.<sup>4</sup>

The power of the incentives provided by each of these two arrangements is different. Franchising generates substantially stronger incentives, since franchisees receive the residual rent of their business. The incentives for managers of manufacturer-owned outlets are usually weaker, since they neither fully bear the costs nor fully enjoy the benefits of their decisions. For example, in the manufacturer-owned dealerships which were studied, between 70 and 80% of the total compensation of managers was unrelated to performance.<sup>5</sup>

These powerful incentives are necessary in the distribution of automobiles, likely because pricing decisions and the provision of (largely unobservable) sales and after-sale services must be decentralized, creating a large scope for moral hazard.

First, the sale of automobiles frequently involves bargaining over price, this allows price discrimination to take place among buyers.<sup>6</sup> Part of the payment for a new car is often the trade-in of a used vehicle. Reaching optimal decisions in both of these areas requires substantial decentralization of the pricing decision, which involves delegating essential decision rights to sellers. This may create a large scope for opportunistic behavior, due to the unobservability of the conditions motivating the individual pricing decisions. Thus, making the dealer a residual claimant saves on monitoring costs (while increasing other costs, more on this below). In most cases, the franchisee himself or the head of his sales department is in charge of the final pricing decision in negotiations that involve intense bargaining. Alfred Sloan (1964:282), among others, claimed that the generalization of the trade-in was *the* reason for the transition towards franchising in the 1920s.

Second, the sale of automobiles requires the provision of information and other sale services to consumers. Again, this supply of information is hard to monitor, and setting the right

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<sup>4</sup> According to Rafer and Guest (1996:7, 46), the share of franchised dealerships in 1995 was 99.27% in the UK, 95.92% in France, 98.94% in Germany, and 99.33% in Italy. In Spain, only 71 of the 3,031 dealers existing at the end of 1995 were owned by manufacturers, and only five manufacturers owned at least a dealership. Moreover, in none of these cases was the percentage of manufacturer-owned dealerships larger than 13% of the total number of dealerships.

<sup>5</sup> Franchisees in the same industry and country have been found to be 35% more profitable than company-owned outlets (Arruñada and Vázquez, 2003). Part of the reason is that while worker's productivity is 6% lower, average labor costs are 11% higher in owned outlets.

<sup>6</sup> See, for example, Jung (1959, 1960) and Goldberg (1996).

incentives implies a close dependency of the income of the seller on the conclusion of the transaction.

Finally, cars are durable goods—that is, they are deposits of future transport services. In order for manufacturers to guarantee the homogeneous quality of automobiles, it is necessary that dealers deliver standard after-sale services. Since these after-sale services are credence goods, whose quality is only known in the long term, if ever (Darby and Karni, 1973), monitoring their quality is costly. A contract that makes dealers responsible for after-sale services, and makes them bear most of the cost of low quality of after-sale services, reduces the potential for moral hazard in this respect.<sup>7</sup>

The prevalence of franchising as an organizational form for this industry supports the view that, if managers are to be allowed such a large degree of control over pricing, service provision and the purchase of used cars, they must also be provided with high-powered incentives. Transferring the ownership of the dealership to them, transforming them into “dealers,” achieves precisely this aim, by making the manager claimant to the residual income.

## 2.2. Double-sided moral hazard and incentive conflicts in franchising

By creating stronger incentives, franchising goes a long way towards motivating managers to deliver high levels of promotional and other services, and to make careful pricing decisions. However, given the strength of the incentives, it also has the potential to motivate gaming behavior. In particular, dealers have incentives to undertake suboptimal decisions concerning both pricing and services provided, decisions which would harm not only the manufacturer, but also other dealers in the network. There is also a large scope for opportunism on the side of the manufacturer, rooted both in its police role and in its ability to reduce dealers’ quasi-rents through the sale of new dealerships or through increases in sales targets.

Suboptimal pricing may arise because dealers are in a position to practice double marginalization. Since they enjoy territorial protection, they also benefit from manufacturers’ market power. If they can set their prices freely, they will add their own price-cost margin on top of the manufacturer’s price-cost margin, so that a smaller quantity of automobiles is sold than that which would maximize the value of a vertically integrated manufacturer-dealer. Another consequence of this market power is that dealers have an incentive to provide less promotional and sales services than optimal, since the marginal return they obtain from these services is only a part of the total return on an extra sale (the sum of both mark-ups). In fact, this distortion on the level of promotional and sales service provided by dealers remains even when dealers have no market power, as long as cars are sold to them at a price higher than marginal production cost (Klein and Murphy, 1988).

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<sup>7</sup> Evidence on the same services points to the importance of this argument. Brickley and Dark (1987:411) found that networks specializing in automobile repairs were the least likely to directly manage an outlet (they did so in only 4% of the cases). Shepard (1993:65) found that the probability that a gas station was owned by a franchisor was four times larger when no repair services were offered than when they were.

Horizontal externalities aggravate the underprovision of informational and promotional services.<sup>8</sup> Dealers generate information by investing in publicity and providing certain services. Consumers have incentives to obtain information from the dealers who provide it and then acquire their car from other dealers, who may sell at lower prices but do not provide this information. This free riding by dealers reduces the total supply of publicity and information, which decreases the final demand for cars.<sup>9</sup>

On the other side of the relationship, manufacturers may expropriate individual dealers by lowering their margins under threat of termination. This is particularly credible when directed against marginally performing dealers, or when technological changes require changes in the structure or operation of the dealerships. In both of these cases, it will be difficult for third party enforcers to distinguish opportunistic from disciplinary cancellation.<sup>10</sup> Manufacturers may also increase the number of dealerships sold in the same local market. Finally, manufacturers can raise opportunistically the sales targets that dealers must attain, producing a “ratchet” effect (Freixas et al., 1985).

Rather than expropriating the future rents of an individual dealer, some actions by manufacturers may expropriate the rents of all of them. This is typically the case when manufacturers underperform in their police role. Less policing increases the extent of opportunistic behavior by dealers, decreasing the value of the brand and the dealers’ brand-specific assets. More generally, manufacturers may underinvest in brand maintenance, for example, by following a downmarket strategy and lowering their investments in new products, advertising, training and promotion.

To sum up, governance structure in this industry must tackle potential conflicts between the dealer and manufacturer. On the dealer side, it must deal with the possibility of suboptimal pricing and service decisions, and it must protect the manufacturer’s quasi-rents. On the manufacturer side, it must reduce the potential for opportunistic expropriation of the dealer’s quasi-rents by the manufacturer and it must ensure that manufacturers undertake the optimal level of training, advertising, promotion and quality control.

The following three sections examine the way automobile franchise contracts deal with these problems. They do so by analyzing three aspects of the contractual technology: the assignment of decision rights, the performance evaluation systems, and the incentive mechanisms used to align the objectives of the parties.

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<sup>8</sup> This free rider problem is dealt with by Telser (1960), Rubin (1978), Klein (1980, 1995), and Klein and Leffler (1981).

<sup>9</sup> During the 60s, manufacturers and dealers who provided a high level of service engaged in frequent trials in the U.S. against those who free rode on them by having a small labor force and no autos in exhibition (Klein, 1995:13).

<sup>10</sup> Williams (1999) shows, however, that terminations by franchisors are infrequent (fewer than 4% annually), and that the conditional probability of termination decreases significantly as outlet performance increases, the opposite of the relationship predicted if franchisors were primarily motivated by opportunism.

### 3. Ex ante assignment of decision rights

The core content of all contracts limits the decision rights of dealers, and in parallel grants to manufacturers a general decision right to fill in or complete the contract in several crucial dimensions ex post.

All contracts limit dealers' decision rights through clauses aiming to prevent double marginalization, to ensure that dealers provide an adequate level of sales and service, and to protect the quasi-rents generated by specific investments undertaken by manufacturers and other dealers. Table 1 summarizes the frequency with which these clauses are used in our sample.

*Sales targets and double marginalization.* In order to deal with the inclination of dealers to charge prices which are too high and sell too few units, all contracts authorize manufacturers to impose sales targets on dealers. These targets are defined in terms of the market share that the dealer must achieve in the relevant local market, and then communicated to dealers in the form of the sales volume they must achieve. They are then used to compensate dealers through substantial discounts in the wholesale price of the cars they buy from the manufacturer. Targets are set every year in January, relying on forecasts elaborated by manufacturers based on historical sales data in the dealer's market and at the national level. Of 23 manufacturers, 16 do not desegregate these targets by model—that is, they specify only the total number of cars to be sold in a particular market. Conflicts about product mix are unlikely to arise, however, since both manufacturer and dealer prefer to sell higher margin (often luxury or larger) cars. The extent to which targets are achieved is provisionally calculated using official data desegregated by model and municipality. Every month dealers receive the estimated discount for the previous month. At the end of the year the annual figure is calculated and the final discount settled.

These numerical targets are revised whenever either the sales of automobiles in the whole national market or the market share of the brand in the national market are lower than forecasted. In the latter case, when revisions are caused by a drop in the brand's share, the market share target of the dealer is also revised accordingly. The dealer is therefore partly insured against the risk derived from both poor aggregate car market performance (the dealer's market share target is kept constant in this case) and from relatively poor brand performance (both the share and volume targets are revised).<sup>11</sup> This system is therefore in accordance with the informativeness principle (Holmstrom, 1979), which says that all information that illuminates the effort provided by the agent should be used if it can be obtained at low cost.

Decision rights on the performance benchmarks are left entirely in the hands of the manufacturer. Little exists in the contracts to constrain the ability of manufacturers to cheat when setting or revising objectives. The extent to which these targets are met is the crucial variable determining dealers' compensation, as we shall show below. By manipulating sales targets, manufacturers could lower dealers' profits below ex ante expectations. Moreover, the fact that different targets are set every year might generate a ratchet effect, which would limit the

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<sup>11</sup> The dealer is only partly insured against low brand penetration or low aggregate sales, since his income falls when he achieves the same percent discount on a lower sales volume.



effectiveness of the incentives used in the contract. However, contracts only contain a vague mechanism to limit the possibility of opportunistic behavior in this dimension, namely the dealer's right to have the sales target revised during the year when aggregate sales are too low.

*Restrictions on sale services.* Contracts have clauses aiming to avoid dealers delivering a service level inferior to the one that maximizes the value of a vertically integrated manufacturer-dealer. They all establish limits on the quantity of inputs that dealers must use to deliver these services, such as showrooms, advertisement, inventory, and personnel; impose obligations on dealers concerning the size and decor of showrooms; and oblige dealers to invest in local advertising. Furthermore, 15 of 23 contracts allow manufacturers to decide dealers' promotional and advertising expenses and contents, while the rest establish that these expenses must be a fixed proportion (between 0.75% and 1%) of gross revenue. In addition, all contracts require dealers to maintain automobile inventory at levels determined by manufacturers, usually equivalent to 45 days of sales.<sup>12</sup> Finally, contracts oblige dealers to hire enough sales personnel and with sufficient training, usually acquired through mandatory courses organized by the manufacturer and paid for by the dealers.

*Restrictions on after-sale services.* These clauses aim to control the quality of after-sale services provided by dealers and show little variation, as all contracts focus on the inputs used. First, dealers are subject to manufacturers' directions concerning the machines and tools necessary to provide maintenance and repair services. They must hire enough well-trained personnel to deliver the after-sale services and must send their own employees to training workshops organized by the manufacturer. Moreover, manufacturers determine the organization and dimension of the garage where this service is delivered. Dealers were also obliged in all contracts to use original spare parts in repairs covered by warranty (whose cost is borne by the manufacturer), and to use quality spare parts in non-warranty repairs. Finally, in all contracts, dealers undertake the obligation to keep a minimum stock of spare parts, in order to avoid delays in after-sale services. Most manufacturers (18 of 23) retain discretion in determining this stock.

Contracts also avoid a low quality of sale and after-sale services by imposing on dealers the obligation to provide "customer satisfaction" as measured by customer surveys. Even though fulfillment of this obligation is difficult to verify by third parties, clauses to this effect are present in 13 of the 23 contracts, constructing monetary incentives which link price discounts to the level of service.

*Protection of investments of manufacturers.* Manufacturers must make specific investments in order to create their reputational capital and develop their commercial networks. Dealers may take advantage of these investments by distributing the cars of other firms or providing after-sale services for them. Contracts protect the property rights of manufacturers over these investments with several clauses that affect the possibility of competition during and after their contractual

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<sup>12</sup> Most contracts grant discretion on this issue to manufacturers, while only 5 mandate the 45-day stock in the contract. Manufacturers have little incentive to abuse this discretion, since these stocks are usually co-financed by them through the delay of payments for 20 to 30 days.

relation. All contracts thus require dealers who sell automobiles of different manufacturers to maintain differentiated dealerships and management during the duration of the contract. In addition, dealers are not allowed to use the brand of the manufacturer after the contract terminates. Moreover, 20 of the 23 networks reserve for manufacturers the right to acquire from their dealers any new cars that remain unsold at termination. Similarly, eight contracts grant manufacturers the right to buy back unused original spare parts, signs and specialized tools at the time of expiration.

*Protection of dealers' investments.* Dealers' specific investments also enjoy some protection against expropriation by the manufacturer and other dealers. The most important of these protections is probably the implicit safeguard supplied by the manufacturer's reputation, given that it must deal repeatedly with a large number of dealers. Some explicit protection against expropriation is also provided by European law, mainly Regulation (EU) 1475/95, the rule in force at the time of our sample, which included: minimum notification requirements before termination (art. 5.2.), a general ban on discrimination among dealers (art. 5.1.2.b.), and a restriction on the possibility of reducing the exclusive area of dealers by granting new concessions in it (art. 6.1.5.). In addition, these contracts define territorial limits for dealerships, forbidding each of them to market actively outside their assigned territories. This should protect dealer-specific assets against competition by other dealers of the same brand.<sup>13</sup>

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<sup>13</sup> On the other hand, contracts allow manufacturers to close down allegedly underperforming dealers or even to sell new dealerships in the exclusive areas. Thus, dealers' territories are not protected by contract against manufacturer opportunism. Moreover, for the contractual protection against other dealers to be effective, the manufacturer has to perform in his role of network policing. The ultimate safeguard then becomes, again, his reputation. For these reasons, territorial protection should be understood as a way of preserving the decision rights of the manufacturer.

Table 1. Share of contracts that include the clauses analyzed

<i>Double marginalization clauses</i>	
Sales targets	100.0%
<i>Sale services clauses</i>	
Minimum publicity investment	100.0%
Signs	100.0%
Design and size of showroom	100.0%
Minimum stock of new vehicles	100.0%
Minimum size of sales force	100.0%
Compulsory sales-force training	65.2%
Trial vehicles	52.1%
<i>After-sale services clauses</i>	
Machinery and Tools	100.0%
Organization and size of workshop	100.0%
Minimum number of after-sale personnel	100.0%
Compulsory training of after-sale personnel	100.0%
Minimum quality of spare parts	100.0%
Minimum stock of spare parts	100.0%
<i>Protection of investments of manufacturers (non competing clauses)</i>	
Exclusive distribution of own manufacturer's automobiles	100.0%
Right to buy unsold new vehicles at the time of expiration	87.0%
Right to buy unused original spare parts, signs and tools at the time of termination	34.8%
<i>Protection of investments of dealers</i>	
Territorial protection	100.0%
Right of manufacturer to sell directly in exclusive territory of dealer	47.8%
Right to sell unused original spare parts, signaling elements and specialized tools	8.7%
<i>Monitoring clauses</i>	
Manufacturer right to undertake direct inspections of dealership	100.0%
Dealer duty to provide accounting data.	87.0%
Manufacturer right to authorize management changes	87.0%
Manufacturer right to audit dealer accounting	52.2%
Manufacturer right to establish minimum operating capital and net worth	52.2%
<i>Non-cure clauses</i>	
Repeated breach of sales and service targets	100.0%
Change of management or death or disability of dealer	82.6%
Disagreement among partners or managers	60.9%
Change of location	60.9%
Appointment of liquidator	56.5%
Court verdict against dealer, partner or manager of dealership	43.5%
False information provided to manufacturer	34.8%
Loss of control of the premises	8.7%
Dealership closed for a holiday period longer than normal	8.7%

Source: Dealership contracts of 23 dealership networks.

## 4. Exercising decision rights ex post

### 4.1. Contract Completion

Decision rights granted by contract allow manufacturers to interpret and fill in the contract and to act as enforcers. Manufacturers thus build the demand forecasts on which sales objectives are based. They alone decide, within the broad limits defined by law,<sup>14</sup> what constitutes underperformance on the part of a particular dealer, and which specific sanctions are applicable to punish underperformance. Moreover, they may adapt the contract to new technological circumstances by deciding, for example, to reorganize the network.<sup>15</sup>

The relationship therefore features a large degree of asymmetry. While contracts describe the duties of dealers in detail, those of manufacturers are described vaguely, so that they enjoy substantial discretion. Furthermore, no incentive mechanism is provided by contract to ensure manufacturers compliance. This apparent lack of balance seems to expose dealers to a large risk of expropriation by manufacturers.

Assigning residual decision rights to one party may be efficient in long term relations characterized by a large degree of uncertainty, in order to decrease bargaining costs. It is only natural to grant this authority to the party that contracts more often and who has the largest reputational capital. The large investments made by manufacturers to create a brand name provide an implicit guarantee of their honest behavior. Manufacturers are involved in repeated transactions with a large number of dealers all over the country. A strategy of expropriation of dealers' quasi-rents would therefore be costly to them: not only because the possibility of finding good dealers would decrease, but also because current dealers would reduce their quality of service in order to recover the quasi-rents associated with their specific investments as soon as possible.

### 4.2. Monitoring

In order to ensure compliance with the vertical restraints discussed above, and to determine the application of monetary incentive mechanisms (sales and discounts) discussed in the next section, contracts allow manufacturers to evaluate the performance of dealers. In agreement with the informativeness principle, all of the low cost information available is used in these contracts: information on outputs of sales and services, information on the observable inputs, and information on dealership finances.

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<sup>14</sup> Two limits to the manufacturer's discretion established by legislation and judicial precedent in Spain are the "good faith" exception (art. 7.1. of the Spanish Civil Code) and the need to respect the implicit will of the parties to the contract (art. 1258). We discuss more extensively below the legal framework in relation to the right of the manufacturer to terminate the contract.

<sup>15</sup> For example, art 5.3 of Regulation (EU) 1,475/95 authorizes manufacturers to terminate a contract (with a one-year notice) whenever they need to reorganize substantially a part of or the entire network.

Manufacturers spend resources on acquiring information about two outputs of dealers—sales and customer satisfaction. They use this information to build two performance measures. First, manufacturers set and follow up yearly sales targets. Second, 17 of 23 manufacturers poll their clients to measure customer satisfaction along several dimensions such as cleanness of showroom, helpfulness and effectiveness in solving problems, satisfaction with the sales staff, etc. These two sets of observable outputs are then linked with dealer compensation through price discounts.

Contracts also allow manufacturers to directly monitor some of the dealers' inputs, by providing for inspections. Inspectors visit dealerships randomly at their discretion to ensure compliance with input obligations related to the provision of an adequate service level. The information obtained through these inspections is used only in the termination decision, apparently having no direct impact on the monetary incentive system.

Finally, manufacturers closely monitor the financial condition of dealers, since the incentives for dealers to fulfill their obligations decrease as their profitability decreases. Heavily indebted dealers are more likely to have short-term objectives, thus reducing the level of services delivered and potentially damaging the brand reputation.<sup>16</sup> This monitoring is implemented in 20 out of 23 networks through the dealers' obligation to periodically present their financial statements. Some manufacturers go further, by having their own staff audit the accounts of dealers (12 out of 23) or even, in two cases, integrating the entire accounting system of the dealers with their own. The financial health of dealers is also ensured in most networks (12) by granting to the manufacturer a right to set minimum solvency ratios for dealers.

Dealers also undertake some monitoring of manufacturers. Since for individual dealers it would hardly ever be profitable to undertake this function, monitoring of manufacturers is undertaken by dealers' associations at both brand and inter-brand level. Interestingly, manufacturers are closely involved in creating and financing these monitoring organizations, probably in order to increase their commitment to behave honestly towards dealers.

Two institutional arrangements facilitate monitoring by dealers of the manufacturer conduct. First, all networks have dealer councils, usually partially financed by manufacturers. Their functions are: (a) to represent networks in front of the manufacturer when discussing future strategies and problems; (b) to ensure that manufacturers apply control mechanisms in a fair, non-discriminating way; (c) to provide legal assistance to dealers in their conflicts; and (d) to attain scale economies in the acquisition of some inputs, such as office supplies.

Second, all dealer associations belong to the national dealer association (FACONAUTO) which, apart from lobbying in the political arena and negotiating with manufacturers, has also been involved in determining whether a manufacturer is unfairly expropriating from all of the members of the dealer network. In at least one case, the association found that the dealers of a particular network (Daihatsu) were being expropriated by the manufacturer when the

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<sup>16</sup> Rubin (1978:228) pointed out that one of the functions of franchisors is precisely to force the closure of unprofitable franchisees.

manufacturer reduced the promotional investments below what had been agreed, stopped subsidizing the stock of dealers and did not fulfill the deadlines for automobile delivery.

### 4.3. Termination

In the presence of quasi-rents, the prospect of termination promotes compliance. Indeed, the contracts we analyze do not rely exclusively on targets and discounts to provide performance incentives to dealers, but provide for three types of termination: at will, automatic and due to breach of contract.

Termination at will, through the introduction in the contracts of the so-called *ad nutum* clause, allows the parties to terminate the contract at any time when the contract is for unlimited duration, or not to renew it if it is for a limited duration (Paz-Ares, 1997:8). However, both European legislation and the general rules of Spanish contract law substantially limit this discretion. As we discussed in section 3, EU legislation at the time of our sample required a two-year notice (art. 5.2.2. of Regulation (EU) 1,475/95), unless the contract was of limited duration (in which case termination only required a 6-month notice) and it forbid discrimination among dealers (art. 5.1.2.b). Moreover, Spanish law further restricts manufacturer's ability to terminate by imposing obligations of good faith (Civil Code, art. 7) and respect to the implicit will of the parties. The most restrictive interpretation of these clauses reads them to imply several duties: a duty of trust (*deber de confianza*) which obliges the principal to allow the dealer enough time to recover the investment made, a duty of previous notification, and a duty of cooperating in the liquidation of the dealership. Other more expansive interpretations of these rules take them to forbid any "arbitrary" behavior by the manufacturer (Paz-Ares, 1997:46-8). Clearly, all these restrictions decrease the desirability of using termination at will to punish non-performing dealers, particularly since, according to some authors, they allow for considerations of fairness to be introduced by the court.

The contracts also determine several nonperformance conditions which lead to automatic termination.<sup>17</sup> In particular, these contracts punish repeated non-fulfillment of the sales and service targets with automatic termination. While most brands do not specify the thresholds they use to define these criteria, seven of them have made available to the authors the specific non-performance criteria that lead to automatic termination. As Table 2 shows, these criteria usually involved missing a percentage of the sales targets (around 80%) during several consecutive years or during a given number of years in a five-year period. The other circumstances leading to automatic termination are connected to changes in the ownership or financial condition of the dealership, as shown in Table 1.<sup>18</sup>

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<sup>17</sup> The Spanish court system has repeatedly upheld this type of termination. The Supreme Court, in Sentence 990/1995, agreed with the termination without compensation of a dealer who did not attain his sales objectives during three consecutive months. Several lower court decisions also coincide on the permissibility of this measure.

<sup>18</sup> In particular, all contracts punish with automatic termination a change in the ownership of the dealer, bankruptcy, or non-payment. Most of them provide for termination after the demise of the owner (19 contracts),

Table 2. Thresholds for automatic contract termination

<i>Manu- facturer</i>	<i>Termination if sales lower than (as a percentage of sales objective)</i>	<i>Termination if service lower than (as percent of satisfaction objective)</i>
2	2 consecutive years or 3 alternating years 80%	2 consecutive years or 3 alternating years 80%
5	3 consecutive years 85%	3 consecutive years 85%
8	3 consecutive years 80%	3 consecutive years 85%
12	2 consecutive years 75%	2 consecutive years 85%
15	2 consecutive years 80%	2 consecutive years 85%
18	2 consecutive years 85%	2 consecutive years 85%
22	3 consecutive years 80%	2 consecutive years 95%

Source: Dealership contracts. Manufacturers assigned a number in order to safeguard their anonymity.  
Note: Only the manufacturers listed in this table specify the criteria for termination for repeated breach.

Finally, termination for breach of contract is caused by the failure to perform contractual obligations which are not established in the contract as causes of automatic termination. Contracts require a 90 to 180 days notice for this type of termination. During this time, dealers are allowed to make an attempt to “cure” their non-performance.

#### 4.4. Monetary Incentives

Dealers produce two valuable outputs: sales and customer satisfaction with the service received. Contracts create monetary instruments to affect these two outputs, by linking discounts in the price that manufacturers charge to dealers with the dealers’ sales and service performance. In 20 out of the 23 networks studied, dealers can obtain discounts as a function of the degree to which they achieve their sales targets<sup>19</sup>. Table 3 shows the discounts applied to the prices of all vehicles acquired by dealers between 1993 and 1995. For example, dealers who met their annual sales targets received a mean discount of 2.11% of the price of all the automobiles they had acquired from the manufacturer in that year. The importance of these discounts is such that most dealers would be unable to obtain any profits if they were not receiving them.<sup>20</sup>

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when there is disagreement among partners (14 contracts), when the management or location of the dealership is changed without the manufacturer’s approval (14 contracts), or when a court rules against the dealer in a way that, according to the manufacturer, might damage the brand name (10 contracts).

<sup>19</sup> The three networks that did not use discounts declared in interviews that they do set and follow up sales targets, however, these targets are used only to impose disciplinary termination and to justify it before third party enforcers. Thus these three networks rely exclusively on termination to provide incentives to their dealers.

<sup>20</sup> Compare these discounts with the average return on sales in a random sample of 179 Spanish dealers, which was 0.783% in 1994 (Arruñada and Vázquez, 2003).

Table 3. Discount on automobile price charged by manufacturers to dealers, as a function of dealers' achievement of sales targets set by manufacturers

<i>Manufacturer</i>	<i>Percent of sales objective achieved</i>							<i>Mean discount received</i>		
	$\geq 80\%$	$\geq 85\%$	$\geq 90\%$	$\geq 95\%$	$\geq 100\%$	$\geq 105\%$	$\geq 110\%$	1993	1994	1995
1	-	-	1%	1%	2%	2%	2%	0.97%	1.06%	1.14%
2*	-	-	20,000	20,000	30,000	30,000	30,000	1.08%	1.22%	1.38%
3	-	1%	1.5%	2%	2.5%	2.5%	2.5%	1.70%	1.89%	1.71%
4	1%	1%	2%	2%	3%	3%	3%	1.85%	2.06%	2.34%
5	-	0.5%	1%	1.5%	2%	2%	2%	1.67%	1.94%	n.a.
6	1%	1%	2%	2%	2.5%	2.5%	2.5%	n.a.	n.a.	n.a.
7	-	-	1.5%	1.5%	2.5%	2.5%	2.5%	1.58%	1.72%	1.65%
8*	10,000	10,000	20,000	20,000	30,000	30,000	30,000	1.2%	1.7%	1.9%
10	1.5%	2%	2.5%	3%	3.5%	3.5%	3.5%	2.7%	3.3%	3.2%
12	-	0.5%	1%	1.5%	2%	2.5%	3%	n.a.	n.a.	n.a.
13	1%	1%	2%	2%	3%	3%	3%	1.6%	1.9%	2.1%
14*	10,000	10,000	20,000	20,000	25,000	25,000	25,000	1.02%	1.12%	1.27%
15	-	-	1%	1%	2%	2%	2%	0.92%	0.99%	1.07%
16	-	0.5%	1%	1.5%	2%	2%	2%	n.a.	n.a.	n.a.
17	1%	1%	1.5%	1.5%	2%	2%	2%	1.14%	1.46%	1.64%
18	0.5%	0.5%	1.5%	1.5%	3%	3%	3%	n.a.	n.a.	n.a.
19	-	-	1.5%	1.5%	2%	2%	2%	1.21%	1.56%	1.48%
20*	5,000	5,000	10,000	10,000	15,000	15,000	15,000	0.85%	0.98%	1.14%
21	1.5%	1.5%	2%	2%	2.5%	2.5%	2.5%	1.35%	1.61%	1.72%
22	-	-	1.5%	1.5%	3%	3%	3%	n.a.	n.a.	n.a.
Mean	0.43%	0.56%	1.28%	1.39%	2.11%	2.13%	2.15%	1.39%	1.63%	1.70%

Source: Interviews with manufacturers. Manufacturers have been assigned a number in order to safeguard their anonymity. We transform numerical discounts into percentages by using the ratio of the absolute cash discounts to the average price of a car charged by each manufacturer to his dealers. Notes: n.a.: not available. \* In pesetas per automobile sold.

Sales-related price discounts may achieve two aims: they motivate a higher effort level by dealers and they reduce the price charged to the final consumer. Both of these results will lead to an increase in the number of cars sold and the second also to a higher brand value.



Table 4. Discounts in automobile price obtained by dealers as a function of consumers' evaluation of dealers in polls

<i>Manu- fac- turer</i>	<i>Percent of service objective achieved</i>							<i>Mean discount received</i>		
	70%	75%	80%	85%	90%	95%	100%	1993	1994	1995
1	-	0.5625%	0.6%	0.6375%	0.675%	0.712%	0.75%	0.68%	0.61%	0.63%
2	0.7%	0.75%	0.8%	0.85%	0.9%	0.95%	1%	0.91%	0.84%	0.87%
3	-	0.9375%	1%	1.0625%	1.125%	1.185%	1.25%	1.13%	1.09%	1.16%
5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.75%	0.56%	0.61%	n.a.
6	-	0.45%	0.48%	0.51%	0.54%	0.57%	0.6%	0.54%	0.55%	0.54%
8	0.64%	0.7%	0.76%	0.82%	0.88%	0.94%	1%	0.96%	0.96%	0.97%
12	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	1%	n.a.	n.a.	n.a.
14	0.42%	0.45%	0.48%	0.51%	0.54%	0.57%	0.6%	0.52%	0.48%	0.46%
15	-	0.35%	0.38%	0.41%	0.44%	0.47%	0.5%	0.38%	0.43%	0.42%
16	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.6%	n.a.	n.a.	n.a.
17	0.35%	0.375%	0.4%	0.425%	0.45%	0.475%	0.5%	0.40%	0.38%	0.44%
18	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.4%	n.a.	n.a.	n.a.
19	-	0.375%	0.4%	0.425%	0.45%	0.475%	0.5%	0.34%	0.39%	0.39%
Mean	0.23%	0.55%	.589%	0.627%	0.667%	0.705%	0.727%	0.64%	0.63%	0.65%

Source: Interviews with manufacturers. Manufacturers have been assigned a number in order to safeguard their anonymity.  
Note: n.a.: not available.

The effort vector is, in fact, multidimensional, and an increase in the sales effort does not necessarily lead to higher customer satisfaction. The price discount system we observe aims to solve this problem by complementing the quantity related price discounts with a quality related system. In 13 out of the 23 networks, dealers can obtain discounts as a function of the evaluation made by the clients of their services, as Table 4 shows. When customer satisfaction is highest, the mean discount that dealers could obtain annually was 0.73% of the price of all automobiles they acquired from the manufacturers. This number is large compared, for example, with average dealer profitability (see note 20).<sup>21</sup>

#### 4.5. Use Of Termination And Discounts

Termination is used to deal with serious or repeated non-performance as observed through the outputs, inputs and financial statements of the dealer. Price discounts are relied upon to provide incentives on both the "effort" and pricing dimensions of dealer behavior on a continuous, modulated basis. Sales and service targets play a dual role in this system: they directly determine yearly dealer compensation, and they provide an important input in the termination process, since, should litigation be necessary, they are court-verifiable variables.

<sup>21</sup> See Arruñada et al. (2001) for a systematic empirical analysis of the variation in the strength of sales and services incentives in these contracts.

We have uncovered, moreover, important constraints on the use of termination by the manufacturer which further reduce the role that termination may play in the relation. Termination usually requires the intervention of the courts. This not only increases its cost as a method for contract enforcement, but it also creates the need for the manufacturer to actually prove the breach of contract, which involves important monetary and time costs. In addition, the judiciary process creates some uncertainty, since, as we have seen, the courts are concerned about factors other than breach, such as “fairness.”<sup>22</sup> In this respect, it is worth noting that the evaluation and compensation system we observe has a larger component of self-enforcement than termination often does. Setting sales targets and discounts does not require judiciary intervention, while termination is subject, often regardless of the ex ante will of the parties, to third party review.

## 5. Conclusions

Franchising dominates the organization of automobile distribution because of the need to decentralize pricing and service decisions. However, incentive incompatibility problems persist due mainly to the existence of double-sided moral hazard. These problems concern the level of sales, the quality of service provided and the risks of expropriation of the investments undertaken by both parties. Parties to these transactions formulate contracts whose aim is to deal with these problems.

The auto dealer contracts analyzed in this paper present a large degree of homogeneity both within brands and across brands. They use three mechanisms to solve the incentive conflicts confronted. First, all contracts limit ex ante the decision rights of dealers to achieve optimal sales and ensure minimum quality levels, while granting extensive interpretation, implementation and enforcement powers to manufacturers. Second, contracts establish evaluation and monitoring mechanisms that allow manufacturers to observe two dimensions of the output vector (sales and customer satisfaction) and a variety of the inputs (number and quality of workers, local advertising, machinery) and performance (financial data). Third, contracts use two types of instruments, price discounts and termination, to ensure compliance and to align the incentives of dealers and manufacturers.

Quantity related price discounts are characterized by their large size, by their increasing in a more than linear manner up to the sales target, and by the reliance of the monitoring system to which they are linked on relative performance measures. Price discounts linked to customer satisfaction increase also in a non-linear way with this variable and, when they exist, are relatively large. This dual system of price discounts allows manufacturers to affect two crucial

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<sup>22</sup> Klein (1995:28) has also pointed out that the legal system is often reluctant to allow termination at will when this involves the danger of expropriation of quasi-rents or initial bonds.

choices made by dealers: the prices they set for automobiles and the sales and service effort they provide.

Termination of the contractual relation by the manufacturers plays a role as a last resort incentive and disciplinary device. In the contractual process and practice we observe, termination is mostly used to punish repeated and serious non-performance.

The asymmetry that characterizes the assignment of decision rights to the parties is present in all phases of the contract. Not only do manufacturers assume the role of policing the relation and completing the contracts, but their obligations are less specified. Moreover, there are no contractual enforcement mechanisms, apart from reputation, to punish their non-performance.

The analysis undertaken here sheds light on the role of both the monetary and non-monetary clauses of contracts in solving the incentive conflicts created by franchising. It reveals a complex incentive and enforcement system. The non-linear price discount mechanism, together with the role of the manufacturer in completing, interpreting and enforcing the contract, and with the possibility of termination as an ultimate sanction, may go a long way towards aligning the incentives of both parties, in contrast with the simple, often linear, incentive schemes encountered in other relations. By extensively relying on ex post adjustments, and giving one of the parties (the manufacturer) the right to police such adjustments, contract incompleteness provides a mechanism to adapt the decisions of both parties to day-to-day changes in circumstances. Further theoretical work is necessary to illuminate how this contractual incompleteness endogenously results from the need for adaptation.

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