The Termination of Joint Ventures: How Does the Dance End

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THE TERMINATION OF JOINT VENTURES: HOW DOES THE DANCE END?

JEFFREY B. KAUFMANN†
HUGH M. O'NEILL‡

I. INTRODUCTION

The need for organizations to engage in strategic alliances such as joint ventures has become axiomatic. But as befits the recent increase in their use, the research into these alliances remains at an embryonic stage. Most studies focus on questions of why and how firms should use joint ventures. With few exceptions, there has been limited study of the phenomenon of joint venture termination.¹

By their nature, though, joint ventures are temporary arrangements.² A frequently cited Business Week article demonstrates the fragile nature of these ventures. The failure rate may be as high as seventy percent. Often, the fact that joint ventures terminate is presumed to be evidence that they have failed, prompting a search for the differences between “successful” (that is, ongoing ventures) and “unsuccessful” (that is, terminated ventures). However, these terminations may or may not represent failure, as joint ventures are not intended to be permanent structures. Harrigan concluded, for example, that joint ventures were used as transitional arrangements by parent firms.³ Gomes-

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Casseres noted the value of these temporal arrangements:

Joint ventures allow firms to tap into the resources of other firms, and, in the process, to increase their own capabilities. As the firm's capabilities grow, it may no longer need the cooperation of its joint venture partner . . . But rather than seeing this as evidence that joint ventures are prone to failure, one might well consider this self-liquidating feature of joint ventures a somewhat paradoxical sign of success.4

We adapt a guarded perspective in this study, and treat termination as a performance-neutral event. Our interest is in demonstrating how specific governance variables affect the termination rates of joint ventures. Our work is based on the belief that effective joint venturing requires planning for both the beginning and the end of the ventures. While the need for "up-front" planning (selection of partner, division of responsibilities, preparation of the contract) in joint ventures may be obvious, the need to think about potential termination of the venture is less obvious. Like marriages, few joint ventures start with the expectation of divorce. This is particularly short sighted in that joint ventures probably should be temporal arrangements.

The work presented here is based on joint venture experience in three industries: computers, pharmaceuticals and automobiles. Joint ventures have been a common practice in these industries for the nearly two decades. These industries have been at the forefront of major global change, and have witnessed substantial shifts in the patterns of production and competition. Competitors in these industries are riding the same waves of change, and may have more experience with founding and terminating joint ventures, than currently seen in financial services.

The analysis we present in this study is based on the field

of transaction cost economics. There have been several applications of transactions cost-based prescriptions to the form of governance structure or the emergent properties of the joint venture. To the best of our knowledge, this is the first application of these prescriptions to issues of termination. Like managers, researchers appear to be more interested in beginnings than endings. We readdress some of the imbalance in this study. Our research question is: "what variables derived from transaction cost economics influence termination rates?"

We present the paper in five parts. First, we describe the unique issues relevant to joint ventures. Then, we briefly review transactions cost economics, a theory base that has been used to explain joint ventures. In the third section, we use transaction cost economics to build hypotheses about joint venture terminations. The two final sections present and discuss the results.

II. JOINT VENTURES

As noted above, the domestic incidence of joint ventures has increased dramatically. In some sectors of the economy, more domestic joint ventures were announced in a single year in the 1980's than had been announced in the entire history of the industry. Across industries, a ten-fold increase occurred in the number of joint ventures established between 1980 and 1989. More joint ventures appeared in the decade of the 80's than all previous decades combined.

Why the increase? Evidently, joint ventures fill a strategic need for organizations. Joint ventures help organizations extend
resources, acquire tacit resources, and engage in forms of organizational learning. Joint ventures result from a firm's inability to develop products or services internally or to merge with providers of products or services. Mergers are difficult and expensive. Joint ventures allow for sustained rents (profits) where the competitive advantage builds on a combination of resources not contained in the firm and not easily exchanged in the marketplace.

Profits, though, offer targets for opportunism, where self-interested partners gain at the expense of non-vigilant partners. The design of a joint venture, then, requires careful attention to conditions that might encourage opportunism. Given the founding conditions surrounding the joint venture, participants can see the "shadow of the future" — that is, participants anticipate forces for opportunism, and build governance features that restrict the naturally arising opportunistic impulses. In commenting on the structure of cooperative ventures, Parkhe notes that it would be exciting if "later problems can be mitigated by doing things differently at the 'front end' — that ex ante attention to structure can improve cooperative performance."7 Similarly, forethought about the potential for opportunism might lead to more effective terminations of joint ventures.

III. JOINT VENTURES AND TRANSACTION COST ECONOMICS

Transaction cost economics (TCE) is an analytical framework that focuses on the costs and difficulties associated with cross-party exchanges. TCE recognizes various impediments to purely efficient exchanges between organizations. Four of these are of special interest for understanding the issues related to joint ventures termination.

First, information asymmetry refers to situations in which parties negotiating a transaction may not have the same information. Problems with information asymmetry may occur in a joint venture, for example, when a firm is unable to accurately assess the value of contributions offered by a potential partner.

7. See Parkhe, supra note 5, at 795.
Second, bounded rationality refers to the cognitive limitations of economic actors and assumes that their decisions are intended to be rational but are actually only limitedly so. The underlying idea is that even when a party has access to all relevant information, there are bounds to an individual's ability to understand the information. This assumption implies that for complex transactions, most parties will be limited in their ability to write contracts that cover all possible contingencies. In most instances, joint ventures will be complex transactions.

Third, opportunism refers to "self-interest seeking with guile." The presence of opportunism, and its potential, leads to decreased returns and increased risk. Problems arise not because everyone acts opportunistically, but because they may. As a result, parties must factor the possibility of such behavior into an exchange, and choose mechanisms to protect against the incidence of opportunism. Joint ventures can be an arena for opportunism, and some firms have used joint ventures as an avenue for entering a partner's business after absorbing the partner's tacit knowledge.

Finally, idiosyncratic gains without guile are possible. One party in the transaction can gain unexpected valuable information that creates economic opportunity beyond the life or structural boundaries of the joint venture. This information or knowledge is a free good for the firm that acquires it. Failure to account for the free good can lead to tensions between the parties in the joint venture.

All joint ventures face some of these impediments to efficient exchange. The relevance of these impediments may be increasing, as the proportion of joint ventures formed for the purpose of knowledge management has increased in recent years. The exchange of knowledge is difficult because it presents parties with three types of problems not found in most other exchanges. First, knowledge is intangible. As such, it is impossible to adjudge the value of contributions across partners, and asymmetric distributions of contributions are likely to emerge. Second, knowledge may be embedded in organizational routines, and may be unarticulated. This tacit property of knowledge makes it difficult to anticipate either the pathways or the costs to exchang-
ing the knowledge, thus reducing the utility of contracts. Finally, knowledge once exchanged can not be returned, as something that is learned by a party can not be unlearned. This last property of knowledge increases the importance of managing the risk of opportunism as any knowledge gained through opportunistic behavior (or by accident) may result in permanent advantage to the opportunistic party, at the expense of the offended party.8

In financial services, many of the most interesting joint ventures involve the exchange of knowledge across firms. Given the natural fit between the contracting conditions covered by TCE and the conditions present in knowledge creating joint ventures it is unsurprising that concepts and constructs developed in TCE have found ready application to joint ventures.

IV. JOINT VENTURE TERMINATIONS: TCE BASED HYPOTHESES

Ventures will last longer when partners have similar cultures, similar asset sizes, and experience with venturing. The presence of similar cultures and experience with venturing might decrease opportunism and bounded rationality. Partners with similar cultures and experience don’t evidence the problems addressed by TCE (asymmetry of knowledge, bounded rationality, opportunism) and therefore, last longer, or terminate less frequently, than ventures that do evidence these problems. Unfortunately, the ventures which don’t present these problems don’t add significant new knowledge to the partners.

How, then, can firms engage in ventures which do create knowledge, without facing excessive risk of loss to the partner? Ventures which adopt the appropriate governance procedures suggested by TCE should last longer, or terminate less frequently, than ventures which do not adopt the appropriate governance procedures. In this section, we develop hypotheses to predict joint venture termination, based on TCE. Transaction cost

analyses use a semi-standardized framework in which transactions are differentiated on the basis of specific variables: asset specificity, liquidation of damages clauses, transaction complexity, behavioral transparency, and frequency of exchanges. Our hypotheses are based on these variables drawn from the transaction cost framework.

A. Asset Specificity

Asset specificity refers to the fungibility of assets dedicated to a venture. If the assets have a broad range of uses, the firm investing in the venture is at less risk of opportunistic behavior by a partner because the assets can be readily deployed elsewhere in the firm. Where assets are specific to the joint venture, they will have limited value in alternate applications. The presence of specific assets, then, increases the level of partner vigilance before and after the venture agreement, and also increases the potential cost of a termination. Due to the combination of increased care and cost, joint ventures with high levels of specific assets should have lower termination rates.

As Williamson notes, asset specificity has “the greatest significance for examining the governance of contractual relations.” Despite their significance at the inception of the joint venture, specific assets devoted to joint ventures may vary in their impact over time for several reasons. First, the assets devoted to joint ventures generally represent a small total of an organization’s total assets. In this regard, what is specific in the economic sense may not be material in the organizational sense. Second, just as in the case of mergers, responsibility for initiating the merger may be separated from responsibility for implementing the merger. Individuals involved in implementing the merger may face a different set of incentives for continuance or discontinuance of the merger than implied by asset specificity. Similarly, the individuals responsible for starting ventures may be organizationally distinct from the individuals responsible for

9. See Williamson, supra note 5, at 548.
managing the firm's risk profile. Venture starters may not be fully aware of the hazards associated with specific assets. Third, the dynamic nature of joint ventures suggests that costs and returns might be subject to high discounts in assessing capital flows, lessening the impact of the loss of the assets initially invested.

The impact of asset specificity on the incidence of joint venture termination has not been tested. Based on this success in predicting other forms of structural variance, we predict:

H1: The level of recoverable assets in a joint venture will be lower in a terminated venture than in ongoing one.

B. Liquidated Damages

The complex nature of the joint venture transaction leaves each party at risk of opportunism by the other. One way to minimize opportunism is to impose a cost of termination on each party. Contract provisions known as liquidated damages are thought to provide deterrents to opportunism. Where present, these provisions alter a party's termination decision by forcing it to factor these costs into its perceived benefits from the termination.

Liquidated damage procedures may not be a panacea for termination, though, because the negotiation of these clauses is difficult and expensive. Individuals and courts have difficulty evaluating the value of intangible assets. As noted earlier, the individuals responsible for forming the joint venture may differ from those responsible for making the implementation decisions. Where they exist, however, comprehensive liquidation damage provisions should provide some deterrent to the desire to terminate a joint venture. This leads to the second hypothesis:

H2: The level of comprehensive liquidated damage provisions will be lower in a terminated venture than in an ongoing one.

C. Transaction Complexity

One form of complex transaction is the international transaction. Organizations and managers must conform to a set
of relevant norms of behavior, or face social consequences. These societal norms originate within distinct historical, political and social frameworks that are largely shaped by national contextual factors which are thought to "embody different attitudes, values, and beliefs that find their materialization in distinct business cultures, styles and practices." Managers in different countries, then, exhibit different strategic behaviors and interpret behavior differently. These differences add a level of complexity to joint ventures. The complexity, in turn, increases termination rates:

\[ H_3: \text{Differences in national norms of the parent organizations will be higher in a terminated venture than in an ongoing one.} \]

D. Behavioral Transparency

As with all new social relationships, each partner to a venture is uncertain about the actions and motives of its counterparts. There is some uncertainty, for example, about a partner’s willingness to unilaterally terminate an alliance.

One protection against uncertainty in a joint venture is the level of behavioral transparency. A party’s behavior is transparent if one partner is able to detect opportunistic behavior by the other. In his examination of joint venture restructuring, Parkhe found that the transparency of opportunistic behavior lowered the presence of ex ante contractual safeguards. The issue explored here, however, centers on the relationship between behavioral transparency and joint venture terminations:

\[ H_4: \text{The level of behavioral transparency will be lower in a terminated venture than in an ongoing one.} \]

E. Transaction Frequency

If parties deal with each other in a variety of ways, their transactions are frequent. Repeated contacts act to build trust.

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11. See Parkhe, supra note 5, at 819.
Trust and opportunistic behavior should be inversely related. If the perceived threat of opportunistic behavior increases the need for ex ante safeguards and these safeguards add costs, then a lowering of this threat should have the effect of lowering the need for safeguards and their associated costs.

Multiple interactions provide information about how a partner is likely to behave. Extra-transactional dealings may also serve as cross-hostages. Hostages in this context generally refers to transaction specific investments whose value decreases substantially outside the transaction but may be related to other dealings between the parties. When multiple interactions exist, any termination decision concerning one interaction may have an effect on others. A party maybe less likely to seek termination of a joint venture when the offended party can retaliate by withdrawing from another relationship. Relationships become more important than specific transactions, as predictors of the venture's status:

**H5:** Multiple corporate interactions will occur less frequently in a terminated venture than in ongoing one.

This discussion of transaction frequency implies that there is a level of trust between the partners in the venture. This trust should influence the way the venture is managed. If both owners are equally involved in the management of the venture, the cost of management will be high based on the need for frequent communication. Alternately, if management of the venture is delegated to one partner or another, the speed of decision-making can increase, and the cost of management decrease. Killing found that equal levels of ownership, that is, equal levels of management involvement, led to a higher probability of failure.\(^\text{12}\) Where one partner takes responsibility for the venture, the likelihood of failure should decrease:

**H6:** Joint ventures with equal ownership will terminate more frequently than joint ventures with dominant ownership by a single party.

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V. METHODS AND RESULTS

This study consisted of a survey mailed to joint venture participants in three industries (computers, pharmaceuticals and automobiles) that evidenced a high rate of joint ventures for the late 80's and early 90's. We surveyed both terminated and ongoing ventures. We compared terminated and on-going ventures, to assess any significant differences that might occur between them. Thus, we were interested in the variables predicting termination. Standard survey methods were used, and the variables measured with instruments developed in other studies.

Table 1 summarizes the statistical analysis. The overall model proved significant. The significant variables included the amount of non-recoverable assets (based on a perceptual measure and a quantified measure), behavioral transparency assessed on the basis of timing (how quickly could opportunism be noticed), behavioral transparency based on the source (the partner), and the level of shared management.

The measure of asset specificity adopted was the respondent's assessment of non-recoverable assets, based on a perceptual measure and a quantified amount. The perceptual measure and the quantified measure were not correlated with each other. The perceptual measure assessed the level of non-recoverable assets on a scale of "none" to "heavy," while the quantified measure assessed the amount as a percentage invested in the venture, from 0 to 100%. Thus, it was possible for a small loss to be a 100% loss, and for a large loss to be a fraction of the entire venture. While the measures have opposite coefficients, the two measures imply the same interpretation, since they were reverse scored. We will discuss the results in terms of the perception of non-recoverable assets, as the coefficients for this variable are generally larger.

The presence of specific, non-recoverable assets (a negative coefficient) implies a decrease in the probability of termination (terminated firms were scored "1", ongoing ones, "0"), indicating that the venture lasts longer. In the ongoing ventures the respondents feel that they can not recover their assets, and the venture continues. This is consistent with our hypothesis.
Increases in behavioral transparency led to decreases in termination rates. This is as hypothesized.

The governance structure measure, at the .10 level, did differ between ongoing and terminated ventures. Consistent with the logic of the hypothesis, the information requirements of shared governance seem to make the transaction more costly, and therefore, more subject to termination.

VI. DISCUSSION

The initial issue prompting the study was the need to directly assess the relationship between governance mechanisms suggested by transaction cost economics and the termination of joint ventures. It's fair to say that the set of variables derived from a TCE perspective did an adequate job in differentiating terminated from on-going ventures. Hypothesis one, four and six were supported, and these were the hypotheses dealing most directly with the concepts used in TCE (asset specificity, behavioral transparency, and ownership/management governance) agreements. In retrospect, the two hypotheses with no support (the use comprehensive damage clauses and international joint ventures) may reflect issues that can be resolved ex ante. With respect to contracting clauses, they apparently serve as sufficient support to get the venture going, and then other factors drive termination. With regard to international ventures, they are not sufficiently different from domestic ventures as to have unique termination impacts.

Two important points emerge from the pattern of results. First, the presence of non-recoverable assets leads to a lower probability of termination. Persistence is a favorable factor if persistence is a signal of the venture's success. Alternately, though, persistence is a trap if it is evidence that the partner firms have not achieved their goals in the venture. As time passes, the persistent report of non-recoverable assets may be an indication that partners have not paid sufficient attention to how to internalize the value from the joint venture.

Second, the presence of behavioral transparency lessens the likelihood of termination. This finding, as the previous one, is
exactly what transaction cost economics would predict. The practical importance of the finding, though, varies with how one values termination. If termination signals failure, and on-going status success, then behavioral transparency is a positive characteristic. If the reverse is true, then behavioral transparency may be a misleading target for design purposes.

The value of transparency may vary with the purpose of the joint venture. To the extent that the cooperative venture represents a symmetric opportunity for the partners, transparency may be possible and valuable. To the extent that the cooperative venture provides asymmetric opportunity - where the partners differ in their desired outcomes and contributions - behavioral transparency may be less attainable or desirable.

The main point here is that the conditions that appear attractive from an ex ante perspective may not be as attractive from an ex post perspective. The firms entering into the joint venture should consider both perspectives. In a companion analysis, looking at the impact of these variables on the time to termination, the results implied that firms quickly terminated ventures where there were non-recoverable assets and high behavioral transparency. It seems illogical to expect opportunistic behavior in the presence of high behavioral transparency. Rather, it seems that at this early stage, the level of commitment makes partners nervous, and they terminate quickly. This pattern is consistent with a view of partners that are quite not sure what they want to or should do. Once again, the indication is that pre-venture understanding of purpose should lead to a better overall management of the venture.

As noted earlier, the joint ventures created for the purpose of sharing or creating knowledge may be the most important type. These ventures generally foster the use of non-recoverable assets, and might join partners who share little in common with respect to culture or experience. Under these conditions, behavioral transparency will be low. As we demonstrated above, on-going joint ventures generally require transparency. This implies, then, a unique requirement for partner firms in knowledge focused joint ventures. They must pay special attention to understanding the differences in goals and contexts held by each of the
partner firms, and work to assure attention to both sets of needs. Put somewhat abstractly, behavior can’t be transparent unless goals and contexts are public. Cooperative discussions to attain understanding of diverse needs are difficult to obtain in permanent relationships; they will be more challenging still in relationships explicitly designed to be temporary.

The results of the tests of governance variables suggest that shared governance increases the likelihood of termination. This finding no doubt reflects the transaction costs of governance. Sharing responsibility (and information and decision making and the like) is expensive or exhausting. Perhaps both.

When combined with the results about transparency, the shared governance findings present an interesting paradox. If transparency helps forestall termination, and this is valued, shared governance may be a path to transparency. Yet, shared governance induces problems that have the same impact as the lack of transparency, namely they increase the chance of termination, but for different reasons. Once again, the results illustrate the importance of thinking thoroughly about potential long run impacts of decisions made early in the venture.

One potential interpretation of these findings is that joint ventures exhibit a form of inertia, and endure longer than they should. The level of non-recoverable assets may impose inertia based on a fear of loss, while the perception that behavior is transparent may signal the presence of an enduring social bond between the partners. This interpretation of the results suggests the importance of recognizing the strategic value of a temporary relationship early in the venture, and planning effective exit by recognizing the inertial tendencies.

In summary, the analysis supports two important conclusions. First, the factors that predict a venture will to continue include high levels of non-recoverable assets invested in the venture, the presence of transparency in the partner, and the absence of shared governance. Second, the use of liquidation contracts and extra-transactional relationships do not influence termination rates.

This pattern of results implies that on-going understanding of each partner’s behavior and motives may be more impor-
tant than ex ante attention protections in avoiding termination. In turn, the ongoing understanding may not be possible without explicit shared understanding of each firm's intentions as they enter the venture. The more asymmetric the goals and contributions of against partner, the more difficult the task of obtaining this understanding. Ventures with asymmetric goals and contributions, though, may be the most interesting type in that these conditions seem to offer opportunities for the creation of knowledge. Finally, the pattern of results suggests that decisions about ending the venture may require as much forethought as decisions about starting the venture.

Put differently, the dance can't end well without starting well. As with many social relationships, strong commitments that recognize both similarities and difference assure endurance, and endurance requires the acceptance of differences and the will to adapt. Also, the dance can't end well unless it ends on time. Unlike many social relationships, defining an ending point early may increase chances for success.
Table 1: Full Model

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-2 Log Likelihood: 24.974
Cox & Snell $R^2$: .443
Nagelkerke $R^2$: .618

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† $p < .10$  * $p < .05$  ** $p < .01$
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-2 Log Likelihood: 21.075
Cox & Snell $R^2$: .477
Nagelkerke $R^2$: .682

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<tbody>
<tr>
<td>Model</td>
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$\dagger$ p < .10  $*$ p < .05  $**$ p < .01  $***$ p < .001