Submission by Professor Lorelle Frazer
Director, Asia-Pacific Centre for Franchising Excellence
Griffith University

to

Parliamentary Joint Committee on Corporations and Financial Services

Inquiry into Franchising Code of Conduct

Background - Lorelle Frazer

- Director of the Asia-Pacific Centre for Franchising Excellence at Griffith University and Professor of Marketing in the Griffith Business School
- Awarded a PhD in Franchising in 1998
- Co-author of the *Franchising Australia* surveys of the sector since 1998
- Actively involved in franchising research and education over the past 15 years
- Teaches franchising in undergraduate and postgraduate degrees
- Supervises research higher degree candidates specialising in franchising
- Member of the Australian Competition and Consumer Commission (ACCC) Franchising Consultative Panel
- Major research projects include:
    - Australian Research Council (ARC) Linkage Project with Australian Trade Commission on international franchising success factors
    - A study of the causes of franchisee failure
    - Current research – ARC Linkage Project with ACCC on the causes of conflict in franchising relationships
    - Publications in more than 100 international journals and conferences including the *Journal of Business Research*, *European Journal of Marketing*, the *International Small Business Journal* and the *Australasian Marketing Journal.*

The Federal Government is seeking input into the operation of the Franchising Code of Conduct, and to identify, where justified, improvements to the Code.

The views expressed in this submission are my own and do not represent the opinion of my employer, Griffith University.

Franchising Sector

The *Franchising Australia* surveys have been conducted since 1998. The most recent data available on the franchising sector was published in *Franchising Australia 2006* (Frazer, Weaven & Wright 2006). The survey findings include:

- 960 business format franchise systems operated in Australia.

- 93% of these systems were Australian-based.

- 62,000 franchise units were estimated to be operating (representing less than 5% of all small businesses in Australia).

- Turnover of the whole franchising sector (including fuel and motor vehicle franchises) was estimated at $128 billion.

- The average number of units per system was 22 franchised units and 1 company unit. System growth remains a challenge for many franchisors who report difficulties in finding suitable franchisee investors. Nearly half the sample of respondent systems held fewer than 20 franchised units, but these were not primarily new franchise systems, signalling possible concerns about long-term sustainability for some systems.

- Net growth of franchise systems from 2004 to 2006 was 12.9 percent. However, some franchisors identified in 2004 were unable to be identified in 2006. For instance, 25 systems were no longer operating and a further 90 systems were no longer franchising. Hence, the net growth rate represents the addition of new systems as well as withdrawal of existing franchise systems.

- Franchisees invested an average of $263,000 to enter a retail franchise system and $51,000 to enter a non-retail system. These total start-up costs include a once-only initial franchise fee of $38,000 in retailing and $26,000 in non-retail franchises (representing the 'premium' that investors pay to join a franchise rather than operate independently).

- Franchisees remain in the franchise system for an average of 7 years (note that the average franchise agreement is 5 years, thus indicating that many must renew their agreements).

- 35% of franchisors reported being involved in a substantial dispute with a franchisee over the previous 12-month period.

- The corresponding proportion of franchisees in disputes equated to less than 4%.

- Major causes of disputes were lack of system compliance by the franchisee, communication problems, misrepresentation by the franchisor, and disappointment with level of profitability of the franchise unit.

- Resolution of disputes was more often initiated by franchisors than franchisees with 29% being dealt with by mediation and 14% of disputes resolved through litigation in the courts.

- In 2005, 9% of franchised units experienced a change of ownership (and therefore, 91% of units continued operating without any change of ownership). Of those experiencing change, 6% were due to franchisees selling their businesses, fewer than 2% of units were terminated, and fewer than 2% ceased operating. This evidence provides some support than franchising failure rates are low across the sector. Note that if the incidence of 'churning' of units was widespread in the sector, the above figures could be expected to be larger.

The next survey, *Franchising Australia 2008*, is currently under analysis and the results will become publicly available on 17 October. The Committee is welcome to request a copy of the 2008 report in order to obtain the latest data and profile of the sector.

Franchisee Failure

Research that analyses the causes of franchisee failure may be of interest to the Committee. The publication: "Exits and Expectations: Why Disappointed Franchisees Leave" (Frazer & Winzar 2005) is attached. The research reveals that franchisees, whose businesses have failed, tend to lack business acumen and sales abilities. A common misconception by prospective franchisees is that customers will appear automatically. It takes some franchisees by surprise that they need to source their own customers and conduct local marketing. These inaccurate perceptions are partly due to the way that franchise opportunities are promoted by franchisors and partly due to unrealistic expectations of inexperienced franchisee investors. The research also confirms that franchise unit failures are more likely to occur in: (a) low start-up cost franchises; (b) systems which experience high levels of conflict; and (c) larger franchise systems.

Conflict in Franchising

Conflict between franchisors and franchisees occurs when their respective goals are misaligned. A team of researchers from the Asia-Pacific Centre for Franchising Excellence is currently investigating the causes of conflict in franchising relationships. This research is in progress and therefore it is not possible to provide conclusive results. Our preliminary research explored the nature of the franchising relationship by obtaining a diversity of informed views on the perception of conflict, its sources, and how mediation is performing as a post hoc remedy in such situations. A summary of this investigation "Franchising and the imbalance of power – perception or reality" (Frazer & Weaven 2007) is attached.

Further, our research to date suggests that conflict appears to occur because of (a) disappointment when franchisee expectations are not realised; (b) franchisor opportunism; or (c) changes occurring due to market forces, such as competition. We suspect that the 'expectation gap' is responsible for sowing the early seeds of discontent, which may then manifest in some other form later in the franchising relationship. The Committee may like to refer to the attached publication which summarises our research on franchising conflict to date: "Franchising Conflict – Towards Greater Understanding and Effective Resolution" (Giddings, Frazer & Weaven 2008).

In summary, I have outlined franchising research conducted by members of the Asia-Pacific Centre for Franchising Excellence that is relevant to the terms of the Inquiry. I am available to discuss the matters outlined in this submission or any other relevant franchising issues at the Committee's discretion.

Professor Lorelle Frazer
Director, Asia-Pacific Franchising Centre
Griffith University
Brisbane Qld 4111

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FRANCHISING CONFLICT - TOWARDS GREATER UNDERSTANDING AND EFFECTIVE RESOLUTION

Jeff Giddings[1],Lorelle Frazer[2],Scott Weavon[3]& Anthony Grace[4]
[1]Professor & Convenor, Graduate Program in Dispute Resolution, Griffith Law School
[2]Professor & Dean (Learning & Teaching), Griffith Business School
[3] Senior Lecturer, Department of Marketing, Griffith Business School
[4]Senior Research Assistant, Griffith Business School

Introduction

Australia has been described as 'the franchise capital of the world' (Walker 2004, p.36) because of its high level of franchising density and impressive growth in both franchise units and sector turnover. Some 62,000 franchise units belonging to 960 franchise systems, turned over $128 billion in 2005 (Frazer et al. 2006). Perhaps because of the sector's rapid development since the fast food chains were first established in the 1970s, it is not without its problems.

The Australian franchising sector continues to grow rapidly, with a 12.9% rise in the number of franchise systems between 2004 and 2006. It employed some 426,500 people and represents 14% of Australia's GDP (Frazer et al., 2006). In view of the sector's significance to the national economy, it is surprising that greater attention has not been paid to the management of franchising conflict.

This paper outlines research being conducted as part of an Australian Research Council (ARC)-supported study in conjunction with the Australian Competition and Consumer Commission (ACCC).[1] It builds on pilot research completed in conjunction with the ACCC in 2006-7 which revealed causes of franchise conflict relating to communication issues, financial concerns as well as business choices and unforeseen circumstances impacting on franchisees. Third parties such as lawyers, franchise consultants, accountants and franchise associations have all been identified as exacerbating conflict. While mediation-type processes have generally been seen as productive and efficient methods of resolving franchise conflict, there is a need to develop a series of complementary processes that can be utilised when they suit the circumstances. The research also raises interesting issues related to how franchise systems manage innovation and change as this appears to be a key source of conflict.

In the *Franchising Australia 2006* survey (Frazer, Weaven & Wright 2006), 35% of franchisors reported being involved in substantial disputes with franchisees, posing questions in relation to both the nature of power sharing within franchising relationships and the suitability of current sector regulation. The particular nature of franchise relationships and their importance to the national economy are such that specific regulatory measures are rightly considered necessary to safeguard the interests of inexperienced franchisees. The Australian Franchising Code of Conduct was introduced in 1998 and is administered by the ACCC. The Code requires disclosure of pertinent information to prospective franchisees and participation in mandatory dispute resolution processes where conflict arises. Following a review conducted in 2006, the disclosure requirements were strengthened earlier this year. It is interesting to note that many of the concerns that were significant both in the introduction of the Franchising Code of Conduct in 1998 and the conduct of the 2006 Matthews Review remain and continue to drive calls for change to the existing regulatory framework. This suggests the need for new approaches.

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Government Inquiries

Government and regulatory interest demonstrates that identifying best practice in franchise regulation and dispute resolution is a very topical issue in Australia. The Federal Parliamentary Joint Committee on Corporations and Financial Services is currently conducting an Inquiry into the Franchising Code of Conduct. (See http://www.aph.gov.au/senate/committee/corporations_ctte/franchising/index.htm) This inquiry appears set to build on the 2006 *Review of the Disclosure Provisions of the Franchising Code of Conduct* (the Matthews Review) which made significant recommendations relating to the content and timing of disclosures required to be made by franchisors to prospective franchisees.

Substantial franchising sector inquiries have been conducted in 2007-8 in both Western Australia and South Australia. The *Inquiry into the Operation of Franchise Businesses in Western Australia* was prompted by the circumstances surrounding the closure of the Rockingham KFC store in November 2007 (Small Business Development Corporation, 2008). The recommendations from the WA Inquiry emphasise the importance of franchisee education and effective disclosure requirements, including the need for clarity about rights and responsibilities in relation to renewal of franchise agreements. The Inquiry recommendations in relation to dispute resolution relate to improved flexibility and enforceability.

The *Franchises Inquiry* by the Economic and Finance Committee of the Parliament of South Australia has usefully identified the ‘atypical nature of the franchise contract – two business entities bound together in a contract seeking mutual and separate profitability’ and noted that such arrangements are ‘unsurprisingly susceptible to disputation’ (Economic and Finance Committee, 2008, p17). The Committee emphasised the need for the ACCC to take a more substantial role in regulating and educating the franchise sector. The Committee noted various advantages of mediation, including informality, confidentiality, accessibility and low cost but noted the potential for the flexibility of the process to be used to reinforce existing power imbalances in favour of franchisors. The Committee suggested the need for supplemental dispute resolution processes beyond mediation and litigation to be developed. These could include an industry ombudsman scheme and arbitration processes.

Given the depth of coverage and consideration of a range of other franchise-related issues, perhaps a more comprehensive analysis of dispute resolution options could have been expected from these inquiries. Concerns regarding the power imbalances inherent in franchising relationships are such that it should not be assumed that mediation processes will be suitable for addressing franchising conflict. The diversity of the franchising sector indicates the need for the development of a suite of complementary dispute resolution processes that can be tailored to the particular circumstances. The *Franchising Australia 2006* survey refers to there being considerable diversity across the franchising sector in terms of the industries involved (retail non-food is most prominent), the age of systems (some with considerable franchising experience while others franchise almost immediately upon commencing business), the size of systems (average number of units per system is 22 with almost half of all systems having less than 10 units), geography and structure (more than two-thirds of systems make use of a master franchise structure) (Frazer et al. 2006, 10-11).

Resolution of franchising disputes is more often initiated by franchisors than franchisees (Frazer et al. 2006). Sometimes these disputes result in protracted legal proceedings that divert time and financial resources from the respective businesses of franchisors and franchisees, as well as disrupting operations and damaging the brand. The food retailer, Lenard’s (over 190 stores servicing 10 million people annually), encountered adverse media coverage in 2005 regarding legal proceedings over earnings misrepresentations. Occasionally, litigation has resulted in franchisor bankruptcy or liquidation. One example is provided by the well-established Great Australian Ice Creamery franchise which, in the 1990s, suffered due to disputes regarding misleading and deceptive conduct. Such outcomes may appease those franchisees in dispute but can be disastrous for the remaining franchisees in the system who find themselves without a franchisor and franchise network. The compulsory mediation provided for in the Code appears to be used predominantly as a remedial method of conflict resolution, rather than a proactive means of managing long-term intractable conflict based (largely) upon the imbalance of power within the franchising relationship.

Griffith & ACCC Research Project

This project builds on research completed in 2006 by members of the research team which produced the report, *Franchising Australia 2006* (Frazer et al., 2006). This survey of business format franchisors provided demographic data, including statistics surrounding the incidence of franchising disputes and how they were resolved. Reference has already been made to the finding that 35% of franchisors had been involved in a substantial dispute (that is, a dispute with a franchisee referred to an advisor for action) within the previous 12 months. Resolution was more often initiated by franchisors than franchisees with 29% being dealt with by mediation and 14% of disputes resolved through litigation in the courts. The main causes of substantial disputes were reported as relating to lack of system compliance by the franchisee, communication problems, misrepresentation issues and lack of franchisee profitability.

A series of interviews was subsequently conducted seeking insights on issues of power and control in franchise relationships from franchising sector experts. The 40 interviewees included experienced franchisors and franchisees, franchising consultants, lawyers, mediators, accountants and brokers regarded as key figures in the sector. Participants were asked to comment and speculate about the nature of the franchising relationship and the causes and consequences of conflict in franchising. It was found that franchisors and franchisees use a range of strategies, from problem solving and persuasion to bargaining and litigating. Choice of process depended on the characteristics and complexity of the issue in conflict, the financial 'stakes' of the issue, the power and dependency relationship of the partners, and perceived levels of trust, cooperation and communication in the franchising relationship (Frazer et al, 2007).

The third stage of the research will drill down further into the causes and consequences of conflict in franchise systems. Eight case studies will be conducted, involving the franchisor and two franchisees in each case study. A series of propositions will be developed for further testing on a large sample of franchisors and franchisees. This data will then be analysed and used to inform the development of conflict management system proposals and community education materials for franchisees to be provided to the ACCC. It is clear that there are very high expectations placed on the ACCC (see for example, the reports of the WA and SA Inquiries) in terms of its public education role being a key element of its regulatory responsibilities in the franchising sector.

Understanding the Franchising Relationship

Greater understanding of the particular nature and dynamics of franchising relationships will be critical to any efforts to manage conflict across the sector. Franchisees need to understand the ways in which their interests will link with those of franchisors in some respects but not in others. They also need to understand the importance of fully informing themselves of what they can expect from the franchise relationship. Franchisors need to recognise the value of working effectively with franchisees in order to enhance their common interests. The current reliance on mediation as the key process for addressing franchising conflict raises the need for all concerned to understand the mediation process – in terms of what the process entails, when its use is likely to be productive and what other processes should be utilised to address franchising conflict where mediation is not appropriate.

Educating those involved – This will be important for those considering entering a franchise as well as those already in such a relationship. The SA Inquiry Report notes that some of those entering a franchise will have little business acumen and can be lured into a franchise 'honey trap' by promises of success (p18). Whilst it would be irrational not to take the time and use the resources to carefully evaluate a franchise opportunity, it is clear that some prospective franchisees do not pay sufficient attention to this evaluation process. In this context, one member of the SA Inquiry asked the question, 'How do you legislate against stupidity?' (p22). There is also a need to educate the various third party advisors (including lawyers, accountants and business advisors) who play an important role in advising prospective franchisees. Our research to date has identified that third party advisors are considered to be a key source of franchising conflict (Frazer et al, 2007). Interviews also disclosed that the franchise parties need to prepare for the prospect that the dynamics of their relationship will change over time.

Effective disclosure requirements – The Matthews Committee Review emphasised the importance of disclosure requirements as a key tool in regulating the franchising sector. Elizabeth Spencer (Bond University) gave evidence to the SA Inquiry regarding the three functions she has identified that an effective disclosure strategy must address: gauging the extent and magnitude of risks; ensuring the dissemination of reliable and accessible information; and ensuring that franchisees can act on the information. The timing of disclosures is critically important. Jenny Buchan (University of New South Wales) has identified the need for prospective franchisees to be in a position to make an informed decision as early as possible in the franchise assessment process. 'The timing of the issue of disclosure means that a franchisee is psychologically fully committed to become a franchisee of the franchise system they get the disclosure for before getting the disclosure.' (SA Inquiry p24). It has also been suggested that the current disclosure regime requires more 'teeth' in terms of the enforceability of its requirements. (See the Matthews Committee Report, the SA Inquiry Report p41 & the WA Report p19-20)

Understanding & appreciating risk – The Explanatory Statement of the Franchising Code of Conduct notes that the fundamental nature of the franchising relationship contributes to higher levels of conflict than for other business ventures. In franchising arrangements, the ownership of the business is separated from control of its capital assets. 'A franchisee invests in the business and bears the majority of the risk associated with the operation of a particular outlet while the franchisor maintains control over the design of the overall system and the quality of the output.' (Trade Practices Regulations 1998). While franchising is promoted on the basis of limiting the risks involved in setting up a small business, there are major concerns about particular risks inherent in the nature of the relationship. Franchises are promoted on the basis that franchisees will be working collaboratively with the franchisor when in fact there is a range of aspects where they potentially have directly competing interests.

The importance of good faith – Calls have been made for the introduction of a statutory duty of good faith as part of a clear framework for the conduct of franchisees and franchisors. The SA Inquiry received 'numerous accounts where a threat of termination was apparently employed to force the under-value sale of a franchise outlet by a franchisee back to a franchisor' (SA Inquiry, p58). Such accounts provide support for additional protections to safeguard the interests of franchisees. Obligations to act in good faith should be particularly important where a franchisor has an involvement with the retail premises in which any particular franchise business is operating. Jenny Buchan has identified a range of franchise occupancy models which involve either the franchisor or a master franchisee having an interest in the business premises leased by the franchisee (SA Inquiry, p78). There may be insights that can be gained from the mutual obligations that are accepted by parties to an alliance or relationship contract.

A renewal framework – Renewal is recognised as a clear pressure point in any franchise relationship. Reference has already been made to the instance of the KFC Rockingham store, which closed after a franchise relationship lasting 20 years. That instance was the catalyst for the WA Franchising Inquiry, which recommended greater disclosure of the franchisee's entitlements to goodwill or other compensation if a franchise agreement is not renewed (WA Inquiry, p48). The SA Inquiry recommended the introduction of a statutory duty of good faith as a 'good step towards creating a level playing field for the participants in the industry' and discouraging 'arbitrary termination while introducing an additional measure of accountability' (SA Inquiry, p70).

Diversity of franchise systems – Insufficient recognition appears to have been given to the difficulties involved in using one set of regulatory requirements to address such a large and diverse sector of economic activity. The measures required to safeguard the interests of parties to a small-scale franchise system will differ from those for a system involving hundreds of units. Involvement in a well-established system will raise a different set of disclosure and good faith issues to those raised for a fledgling system involving a new concept.

Sources of Franchising Conflict

Reference was made earlier to the types of conflict said to be inherent in the nature of franchising relationships. 'Given the atypical nature of the franchise contract – two business entities bound together in a contract seeking mutual and separate profitability – it is unsurprisingly susceptible to disputation.' (SA Inquiry, p17). Research in the business discipline suggests that conflict resolution mechanisms in dyadic relationships (such as franchising) are dependent upon: (1*) issue characteristics* (e.g. the intensity, complexity and financial stake associated with an issue in dispute); (2) the nature of the *relationship* between agent and principal (e.g. trust, dependency and relationism); (3) *personality characteristics* of the involved parties (e.g. importance placed upon autonomy); (4) *external influences* (e.g. limited vs. strong market demand); and (5) *structural characteristics* of the organisation (e.g. level of bureaucracy) (Dant & Schul 1992; Frazier 1999; Palmatier et al. 2006).

These research findings resonate with the characterisations made by various dispute resolution researchers. Moore (2003) characterises conflicts into five groups, relating to values, relationships, data, structures, and interests. Tillett & French (2006), Sourdin (2005) and Condliffe (2003) all provide similar characterisations. Franchising arrangements give rise to conflicts across these groups. The National Alternative Dispute Resolution Advisory Council (NADRAC) identified a range of causes of franchising conflict in a 2000 submission: financial issues can cause franchisees to seek either release or re-negotiation of their agreement; disputes with third parties; operational disputes with potential to impact on others involved in the same franchise scheme; financial issues interconnected with family and personal issues.

A suite of dispute resolution processes may be valuable in addressing franchise-related conflicts. Parties are encouraged to negotiate directly while the ACCC also notes that either party may need to consider litigation where urgent issues arise. The Franchising Code directs parties to mediation if direct negotiations do not result in agreement. If requested by either party, both parties must attend the mediation and try to resolve the dispute. Refusal to attend the mediation and/or make a genuine attempt to resolve the dispute will constitute a breach of the code and thereby a breach of the Act. However, effective enforcement of such requirements is a difficult issue.

Compulsory mediation is viewed as a 'low risk' coordinative mechanism to alleviate distrust between partner entities. However, many dispute resolution writers (eg. Boulle 2005; McIntosh 2003; Carroll 2002) have understandably questioned the use of mandatory mediation, which is likely to generate control concerns for the participants (McGillicuddy et al., 1987). Moreover, our pilot data revealed that franchisors may be using mediation as a subtle method of leveraging their dominant power position in the franchising relationship. Our initial interviews indicate that diverging expectations of parties are a significant source of franchising conflict. Franchisors viewed unrealistic expectations on the part of franchisees as particularly significant. Causes of conflict within franchise systems included poor selection (of franchisees and business sites), ineffective training of new franchisees as well as financial and cost pressures. Poor communication skills were also considered to be a difficulty faced by all parties to franchising arrangements.

Change is seen as a source of conflict in franchise systems. This includes new initiatives or a new image and can be linked to financial pressures as well as marketing funds (as the franchisee generally has to pay). Lack of consultation also created conflict as franchisees often felt forced into specific actions with limited information. Most respondents felt that if there was effective communication within the system most conflict could be prevented or dealt with in an effective manner. Franchise systems were considered more likely to be involved in increased levels of conflict if they operated without a clearly defined strategy (other than a specified number of units) and an ability to adapt to changing market trends (Frazer et al, 2007).

Lawyers, franchise consultants, head office staff, accountants, franchise associations (including the Australian Franchisees Association [AFA] and the Franchise Council of Australia [FCA]) as well as the ACCC were all identified as likely to exacerbate conflict in some situations. External advisors, such as lawyers, accountants and franchise sales consultants were seen to exacerbate conflict through miscommunication of expectations and information. The AFA was seen as interested in its own agenda to increase profile and membership. The FCA was seen as creating a negative culture in franchising (mainly due to franchisor dominance of the organisation). The ACCC was seen as exacerbating conflict which had already commenced within a system when they intervened under the Code of Conduct. This was seen more as mismanagement but certain respondents were concerned about the perceived alignment of the ACCC with the FCA and the impact this might have on its neutrality. Much of this suspicion is obviously a matter of very differing perspectives (Frazer et al, 2007).

Franchise systems which do not focus on innovation and development or which do not include franchisees in the innovation process were said to be more likely to generate conflict. Mature franchise systems tend to utilise monitoring in a formal manner to ensure that innovation occurs in a productive and controlled manner in accordance with a defined strategy (although this is not mentioned clearly in the interviews, it is derived from the fact that respondents felt these systems were well structured). Respondents tended to be critical of the use of informal controls in franchise systems due to concerns about the potential for manipulation. However, respondents felt that when other types of informal systems such as “pats on the back” and other positive reinforcement strategies were introduced with strong communication channels that this was likely to be viewed as proactive and positive and less open to misinterpretation (Frazer et al, 2007).

Promoting Effective Resolution of Franchising Conflict

The Australian Government’s *Response to the Recommendations of the Review of the Disclosure Provisions of the Franchising Code of Conduct* (February 2007) emphasises the role of the ACCC in educating potential franchisees regarding the importance of risk analysis and the significance of clauses giving a franchisor rights to unilaterally alter or terminate a franchise agreement. In order to discharge its increasingly important functions in this area, the ACCC recognises the benefits of enhancing its understanding of the dynamics of franchising conflict.

It is important to consider *systems-based approaches* when seeking to address conflict management with franchise *systems.* The range of possible conflicts suggests that both individual franchising schemes and the sector more generally can benefit from the development of Integrated Conflict Managements Systems. In 1988, Ury, Brett & Goldberg codified various systems design principles aimed at heading off unnecessary disputes, emphasising the value of processes based on interests as opposed to positions. These insights were further developed by Costantino & Merchant (1995), the Society of Professionals in Dispute Resolution (2001) and the British Columbia Attorney-General's Department (2003). Bingham (2002) has identified that the field of systems design 'offers particularly rich ground' for collaboration 'between the research and practice communities.' Laurence Boulle has identified that 'despite the existence of a sophisticated regulatory scheme administered by two government-funded agencies, there are several shortcomings in the system from a dispute systems design point of view, including the lack of diagnosis for mediation suitability and the need for more specificity in aspects of the scheme' (Boulle, 2005, 356).

John Levingston has drawn on his experience as a mediator of franchise conflict in a recent article (Levingston, 2008). He documents a range of deficiencies and problems with the existing Franchising Code of Conduct mediation process. Process deficiencies include the scope for a franchisor to issue a default notice before a reference to mediation and a lack of sanctions (for the absence of good faith, lack of authority or breaching confidentiality). One further deficiency identified by the SA Inquiry relates to the unavailability of options for a multi-party mediation, where several franchisees engaged in the same dispute with their franchisor might be represented as a group in the process.

Problems identified by Levingston include inequality of negotiating power, parties who prepare poorly, attend without representation and independent advice or with limited authority. Inadequate party preparation might be addressed through the use of more substantial intake processes designed to inform parties so as to enable them to more effectively prepare. A higher level of preparation of parties should be expected where a compulsory process is involved, as in the case of Franchising Code of Conduct mediations.

Levingston describes the problem of a refusal of one or more parties to compromise. He goes so far as to state that 'A refusal to compromise any issue at a mediation constitutes an absence of good faith and arguably amounts to unconscionable conduct.' (Levingston, 2008, p94). This raises questions about the nature of the mediation process that is being used. It indicates a process that many would not describe as mediation, given that definitions of mediation emphasise the voluntary nature of participation without expectations that the parties will necessarily reach agreement. Levingston offers a clear message that franchisees are not always well served by the current dispute resolution arrangements. He considers that the Franchising Code should include an express obligation for parties to a Code mediation to act in good faith and to compromise their disputes.

The SA Franchise Inquiry Report refers to a range of other processes that could usefully be integrated with the existing mediation arrangements. These include an industry ombudsman scheme or industry expert panel and a rights-based arbitration model for suitable disputes. The SA Inquiry considered the current Code mediation process was not sufficiently comprehensive 'in terms of expertise, breadth, flexibility of approach or durability of outcome' and recommended consideration of the establishment of a Franchise Ombudsman or Franchise Tribunal or a Franchise Arbitration Unit (SA Inquiry, p49-54). Boulle notes the importance of emphasising the early use of unassisted negotiation as well as the early provision of information and guidance on preliminary steps that might productively be taken prior to a conflict escalating (Boulle, p361).

Future Prospects

The franchising sector will no doubt continue to attract considerable attention from regulators as its importance to our national economy continues to grow. Franchising has thrived during the period of sustained economic growth enjoyed by Australian business over the past decade. Given the recent declines in business and consumer confidence, the *Franchising Australia*

2008 survey may well highlight changes in this regard. The strength of the economy may also be a key factor influencing the incidence of franchising disputes.

In our research, a series of respondents suggested that a Franchise Industry Ombudsman should be established. While such a proposal warrants further examination, it should be noted that there has been little in the way of critical analysis of existing private sector ombudsman schemes (O'Shea, 2004). Earlier this year, the English National Consumers Council published a report written by Steve Brooker calling into question the effectiveness of ombudsman schemes and noting that there is a pressing need for such schemes to be developed strategically rather than in an *ad hoc* manner (NCC, 2008).

The reports from the Franchising Inquiries in both WA and SA are very useful in providing an understanding of the range of issues involved in efforts to foster a more equitable and efficient franchising sector. Given that the Commonwealth Government has responsibility for the operations of the ACCC, the current Joint Parliamentary Committee Franchising Inquiry should pay particular attention to the education and enforcement roles of the ACCC as well as to enhancing the range of processes that can be used in addressing franchising conflict. Perhaps, if the sector is to continue to develop and thrive, it needs to be more focussed on the fairness and equality that tend to characterise effective partnerships.

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Exits and expectations: why disappointed franchisees leave

Lorelle Frazer[a,*], Hume Winzar[b,1]

[a]Service Industry Research Centre, Griffith University, Brisbane Qld 4111, Australia
[b]Department of Marketing, Griffith University, Brisbane Qld 4111, Australia

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Abstract

Numerous studies of franchisee failure have been conducted with mixed results reported due to methodological differences and the definition of failure used. There has been an emphasis in the literature on estimating and comparing the failure rates for these organisations. This paper acknowledges that franchisee failure is a concern but concentrates on the causes of failure. To do so, a definition of 'negative franchisee exits' is developed to overcome deficiencies in previous definitions of failure. The research is carried out in two stages. Firstly, franchisors and their ex-franchisees are interviewed. Then, the insights gained from the qualitative research are used to develop a model for the second stage of the research. Findings from a survey of franchisors indicate that franchise system size, level of franchisee investment and degree of conflict are related to the incidence of negative franchisee exits.

Keywords: Small business; Franchising; Failure; Franchisee selection; Exits; Australia

1. Research problem

The topic of business failure is quite controversial. Two streams of literature are relevant to the current study: small business failure and franchising failure. Both topics have been researched widely, but the studies have resulted in disparate conclusions. Hence, the area of small business failure and, more specifically, franchising failure deserve further investigation.

1.1. Small business failure research

A major theme in the small business literature has been estimating failure rates for small enterprises. However, the results of this stream of research vary widely and are thought to be due to the choice of definition of 'failure' used and the methodology employed (Watson and Everett, 1996; Pinfold, 2000). For instance, Watson and Everett (1996) report, in a single study, differences in failure rates of small businesses from less than 1% to more than 9%, depending on the definition of failure used. These definitions have included discontinuance of business ownership (for example, Williams, 1993), cessation of business (for example, Bates, 1998), bankruptcy (for example, Hall and Young, 1991) and failure to 'make a go of it' (Cochran, 1981, p. 52) (for example, Gaskill and Van Auken, 1993). Hence, the failure rates of small businesses are not really known with any certainty, although they are probably lower than commonly believed (Stanworth and Purdy, 1998).

Other studies have focused on the causes of small business failure, ranging from financial reporting practices in the finance literature (for example, McMahon and Davies, 1994) to personal characteristics of the entrepreneur in the marketing literature (for example, Perry et al., 1988). Overall, the two major causes of small business failure have been attributed to a 'lack of appropriate management skills and inadequate capital' (Everett and Watson, 1997, p. 636).

The view that small business closure is equivalent to failure has been challenged by Stokes and Blackburn (2002), whose research revealed positive benefits of business closures. Many entrepreneurs reported positive learn-

* Corresponding author. Tel.: +61 7 3382 1142; fax: +61 7 3382 1981.
E-mail addresses: L.Frazer@griffith.edu.au (L. Frazer), H.Winzar@griffith.edu.au (H. Winzar).
[1] Tel.: +61 7 3875 7659; fax: +61 7 3875 7126.

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ing experiences that were often applied to the next business venture. Hence, business closures need not be entirely negative experiences as there are many non-monetary rewards, such as independence and social status, associated with small business operation. Similar to the small business literature, the issue of franchising failure has been widely debated.

1.2. Franchising failure research

Whereas there is some concern that small business failure rates are overestimated, there is now widespread belief that franchising failure statistics are underreported (Pilling, 1991). There are several reasons for the level of disagreement about these failure rates. While there are many positive attributes of franchising, such as employment opportunities and industry sales, there are also negative perceptions, including the level of disputes in the sector (Hoy, 1994). Hence, representative bodies such as the International Franchise Association (IFA), the British Franchise Association (BFA) and the Franchise Council of Australia (FCA) have been motivated to promote franchising as a successful means of doing business. The IFA, in particular, has been promoting franchising as a more successful business practice than independent business ownership since the 1960s, despite its claims being refuted by United States' government bodies and academic scholars (Bates, 1998). The use of uncorroborated statistics (Stanworth and Purdy, 1998) and inaccurate, incomplete data (Cross, 1998) has been blamed for the distribution of such franchising propaganda.

In addition, it has been suggested that the 'murky nature of the research question and the tremendous data collection and methodology problems' are responsible for the mixed results found in franchising failure studies (Cross, 1998, p. 4). In brief, the different methodological approaches and databases used in franchisee failure studies have led to inconsistent results being reported.

Adding to the problem is a lack of consistency in use of a definition of 'failure' (Cross, 1998; Holmberg and Boe Morgan, 1996). It is difficult to estimate true franchisee failure rates because these failures are easy to disguise (Hoy, 1994) or are regarded by franchisors as only temporary. Often failed franchisee units are either taken over as company units by the franchisor or are transferred (sold) to new franchisees (Stanworth and Purdy, 1998).

1.3. The research problem

As the above discussion of the literature reveals, researchers have had a fixation with proving or disproving failure rates or with stating failure rates precisely (Haswell and Holmes, 1989). It is not the intention of the current study to enter the failure rate debate. Cross (1998, p. 9) notes that 'the underlying cause of the failures is of much more importance. Hopefully, those researching franchise failure can let go of some of the past controversies and move this stream of research forward'. Hence, this research is concerned with the question: What are the causes of negative franchisee exits? In order to explore this theme and to overcome deficiencies posed in early definitions of franchisee 'failure', a unique measure of 'negative franchisee exits' is proposed. Using this new definition, a model is developed and tested on a sample of franchise systems.

2. Stage 1—qualitative research

2.1. Methodology

Confidential face-to-face interviews were held with 30 franchisors chosen as a convenience sample from a range of industries and covering systems of various sizes and ages. The industries included retail food and non-food, property and business services, education, personal services and accommodation, cafes and restaurants. The organisations ranged in age from 9 months to 31 years of franchising experience and in size from 6 to 1900 total units. The response rate was 100%, an excellent result, and most probably obtained because of the perceived importance of the issue and of the respondents' desire to share their experiences with others in the sector.

A convergent interviewing approach was used for the in-depth interviews that lasted approximately 1 hour. The interviews were taped with respondents' permission and later transcribed and analyzed manually by the researcher. The convergent technique was appropriate in this study for several reasons. The research was exploratory and its aim was to build rather than test theory. In addition, the interview process was cyclic in nature, enabling the research issues to be continuously narrowed down (Dick, 1990). Hence, interpretation of the data gradually converged (Carson et al., 2001) enabling a tentative framework of understanding to be formed as the basis of future research. Respondent franchisors were asked to discuss a number of issues relating to negative franchisee exits, including examples of franchisees who had left their systems, reasons for exit and operational practices such as franchisee selection procedures, fee structures, support systems and franchisee compliance levels.

A difficulty in conducting research on franchisee exits is locating franchisees who have left the system. Therefore, the franchisor respondents were asked to supply contact details of franchisees who had left the system due to their non-success. Most franchisors complied and the confidentiality of the data supplied by both parties was promised. However, a few preferred that their ex-franchisees not be interviewed and their request was granted.

Next, the franchisees who had left franchising were contacted. As they were located around Australia, telephone calls were made. Around 60 telephone numbers were provided but nearly half of these were disconnected and the ex-franchisees could not be contacted. Of the remainder, 33 ex-franchisees were available. Two were excluded following interview because they did not fit the definition of 'exit' used in this research; they had left their systems for other reasons. One person declined to be interviewed because he was currently involved in legal proceedings with the franchisor and he deemed such an interview to be inappropriate. Finally, 30 ex-franchisees were interviewed for around 20–30 min. Hence, the response rate was 97%. The interviews were not tape-recorded but handwritten notes were kept.

Despite the very sensitive nature of the topic, most of the respondents were forthcoming and many seemed pleased that a third party was willing to listen to their stories. Respondents were asked to relate the reasons behind their departure from the franchise, as well as their opinions on issues such as the franchisee selection process, the level of support provided, the effect of franchise fees and their suitability as a franchisee. The qualitative data gathered from the two sets of interviews is discussed next.

2.2. Findings—franchisor interviews

While the sample of respondents contained organisations that were in both the early and mature stages of franchising, the mature systems were apparently learning from their experiences and were now taking corrective action. All respondents admitted to choosing unsuitable franchisees in their early days, sometimes out of a need to quickly start up the system and other times due to incorrect selection criteria. One franchisor confided 'once upon a time, we'd break his legs and not let him get out'. Several respondents related similar stories of selecting franchisees primarily on their ability to pay.

A common practice was that franchisees were initially recruited on the strength of their technical background. However, these people often lacked business acumen, particularly sales ability. Many franchisors were now selecting on the basis of business ability and teaching the technical side of the operation. Similarly, many franchisors confessed to attracting franchisees to their systems on the promise of a desirable lifestyle. Indeed, advertising copy in a regular franchising magazine still reflects this trend. Consider, for example:

> Can you imagine a job where your working day is spent visiting and chatting to fellow dog lovers?

> . . .think about how your lifestyle will improve. Instead of having the same old mundane sweatshop blues and getting hassled by the boss, you can have the time of your life. . . (Franchising and Own Your Own Business Magazine, 2002, pp. 28, 47)

These statements imply that franchising is a means of escaping the restrictions of employment and that being a franchisee will offer lifestyle and monetary rewards. This anecdotal evidence indicates that some franchisors continue to promote franchising as a means of achieving wealth and satisfaction without having to work very hard.

Ironically, one of the major concerns of the franchisors interviewed in this research was that the franchisees who were less successful did not have a strong work ethic or were unwilling to put in the necessary hours to work their business adequately. Perhaps, this was because the franchisees had been lulled into believing that franchising was an easy option. Several respondents indicated that the less successful franchisees tended to work to a minimum level of performance: 'Some of our franchisees seem to reach a comfort zone. They become complacent and don't want to work harder'. Such a situation is often unsatisfactory for a franchisor who is motivated to meet peak demand in a franchisee's territory. Two of the more mature organisations that had previously allocated exclusive territories to franchisees had ceased this practice due to unmet demand going to waste when a franchisee did not fully develop the territory.

In terms of financial issues, none of the franchisors interviewed believed that franchise fees were responsible for franchisee exits in their systems. However, they correctly predicted that franchisees would tend to disagree with this view, as it was a well-known phenomenon that franchisees resent paying fees (Nathan, 2000). Similarly, franchisors noted that initial and ongoing support structures in a franchise would be critical factors in a franchisee's success, but most felt that the support they offered was either adequate or very good, although not necessarily well utilized by some franchisees. Finally, although most respondents reported that franchisees generally failed to fully comply with correct operational procedures, such as the wearing of uniforms or undertaking local marketing initiatives, the franchisors did not feel that minor transgressions were responsible for franchisee exits. These findings may now be compared with the franchisees' perspectives.

2.3. Findings—franchisee interviews

Not surprisingly, the former franchisees interviewed often interpreted the set of events differently. The varying perspectives are expected because of the nature of the franchising relationship. Whereas the franchisors appeared to view the association more like a marriage, that is, as an interdependent relationship, the franchisees in the sample viewed it more as a parent–child arrangement, or a co-dependent relationship.

There were several characteristics common to this group of franchisees who had not been successful. Firstly, most had entered franchising after leaving employment. They were generally inexperienced in business, but for various reasons, including redundancy and a desire to be self-employed, had made their first foray into the business world via franchising. In addition to this common background, very few of the franchisees conducted in-depth research into the franchise, such as comparing different franchise systems, contacting existing franchisees in the system or investigating the possibility of independent business ownership or investment. In many cases the franchisees simply had their hearts set on joining a particular franchise and did not carefully consider their own personal suitability to the task. In fact, a common belief expressed by the respondents was that they had found the means to 'buy themselves a job', a catch phrase often used in the franchising sector to attract potential investors. Despite the belief on the franchisees' part that they were being guided by the franchisor 'employer', the franchisors were expecting their franchisees to be more businesslike in the relationship.

There were also fairly consistent comments made by franchisees regarding the operational aspects of the franchises. Most rated the level and type of franchisor support services quite low, often commenting that they had been promised or expected more assistance. Likewise, the level of communication between the two parties was felt to be lacking (particularly in quality), although there were certainly a few respondents who were content with the situation and did not necessarily require greater contact or access to the franchisor.

When asked what criteria they thought had been used to select them, the majority of respondents felt that their ability to pay the franchise fee was the franchisor's main concern. Other responses included their trade background, sales ability and personality. Most felt that the selection process was cursory, although they were possibly unaware of the franchisor's selection procedures behind the scenes. Quite a few respondents admitted that they did not fully comply with the expected operational procedures. Deviations from the system included offering lower prices, failing to pay franchise fees on time and minor changes to operations. Despite admitting to this level of non-compliance, the franchisees concerned did not attribute the practice to their poor performance.

The franchisee interpretation of franchise fees contrasted directly with the franchisor attitude. Although a few franchisees felt the fees were fair, many believed they were a burden, which contributed to their poor returns. One franchisee was rather bitter that he had been told there were no ongoing franchise fees but later discovered that a flat monthly administration fee was charged: 'Call me stupid, but I'd call that a franchise fee!'

When asked whether they felt they made suitable franchisees, many freely admitted they lacked the appropriate skills or personality. A common downfall, also noted by the franchisors interviewed, was that some franchisees were not comfortable with the role of 'selling' the product or service. From pizzas to lawn mowing, a common requirement was that franchisees needed to be good salespeople with a customer service orientation. Many franchisees liked doing the work but felt they lacked the ability to build the business.

Most of the franchisees in the sample were now once again in paid employment. In fact, when asked what they would do differently if they had their time over again, the majority was emphatic that they would never get involved in franchising at all. One franchisee commented: 'I would never buy a franchise again... not even if McDonald's was going for $20'. Some were fortunate enough to be able to sell their franchised units, but most simply walked away from their businesses, resulting in a considerable loss of money in many cases. A couple of the franchisees were now running their own businesses in the same industry, indicating that the business could be successful.

Despite a rocky experience for many, the franchisees were often able to see a positive side to the whole experience. Particularly, if some time had passed (generally, more than 1 year) since leaving the franchise, the respondents were willing to concede that it had been 'a learning experience' and many had consciously decided to 'move on' with their lives. While franchising had not been for them, some felt it was not necessarily the fault of the franchise.

In summary, the perceptions of franchisees and franchisors contrasted in some areas due to the different roles each party plays in the relationship. Issues such as franchise fees, management and marketing support, and communication were perceived as being more important by the franchisees who left their systems. There was general agreement among those interviewed that selection of suitable franchisees was critical. Franchisors tended to refine this process over time after experiencing difficulties when unsuitable franchisees had been chosen. Moreover, sales ability and business acumen were regarded by most as important skills in franchisee survival.

Following this exploratory, qualitative analysis of the issue, a model predicting negative franchisee exits was developed for testing on a larger scale with a sample of franchisors. Ideally, both franchisees and franchisors should be surveyed to incorporate the different perspectives. However, the sponsor's survey only included franchisors and hence the quantitative analysis that follows contains a franchisor focus. The model specification and hypotheses development used in the second stage of this research will now be addressed.

3. Stage 2—quantitative research

3.1. Hypotheses development

Interviewees raised several key points relating to why franchisees exit the system in the first stage of the research and these have been incorporated into the proposed model of franchisee exits shown in Fig. 1. Each predictor variable is discussed below.

3.1.1. Level of franchisor experience

The franchisors interviewed agreed that they became better at franchising over time. In particular, new franchisors tended to make poor judgements when selecting franchisees and experience enabled them to learn from these mistakes.

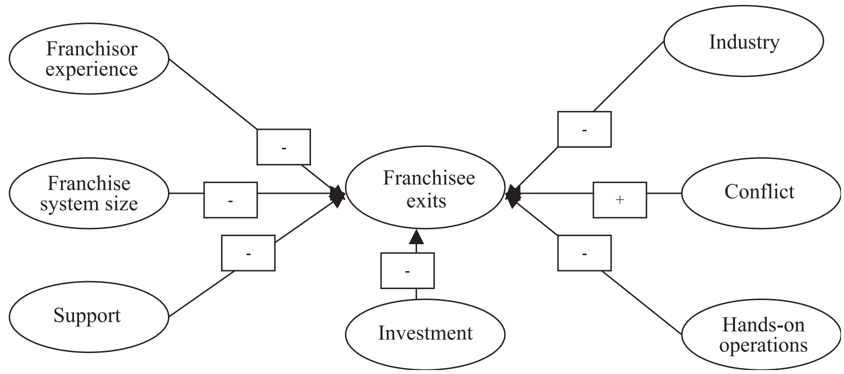

Fig. 1. Proposed model of factors influencing negative franchisee exits.

In addition, there were many positive characteristics associated with franchise system maturity, including increased brand recognition, more efficient operations, more effective marketing and better communication. As with small business success, there should be a positive relationship between the age of a business and its likelihood of success (Jovanovic, 1982; Watson and Everett, 1999). Hence, it is hypothesized that:

H1a. The level of franchisor experience is negatively related to the probability of negative franchisee exits.

In addition, experienced franchisors are generally characterized by well-established systems in terms of number of franchise units, so it is hypothesized that:

H1b. The size of the franchise system is negatively related to the probability of negative franchisee exits.

3.1.2. Level of franchisor support

Most of the interviewees in the first stage of the research felt that support from the franchisor was critical to a franchisee's ultimate success. Franchising enables people without business or specific industry experience to become owner operators of their own businesses and hence the initial and ongoing support of the franchisor plays an important role in this metamorphosis. The greater the assistance provided to franchisees, the higher the likelihood they will be successful (Terry, 1993). Therefore, it is suggested that:

H2. The level of franchisor support is negatively related to the probability of negative franchisee exits.

3.1.3. Level of franchisee investment

It was observed from the interviews that franchisees often resorted to abandoning the franchise altogether if the amount they had invested was not high. Franchisors refer to the need for a 'hurt' factor in franchising, meaning that if the franchisee invests a substantial amount of money in the business then he or she will be motivated to work hard to retrieve it. In fact, this is often a justification for charging franchisees an initial fee prior to entering the franchise (Frazer and Perry, 1998). Prior research has established a link between level of investment and firm survival (Bates, 1990). Hence, with regard to franchising it is hypothesized that:

H3. The level of investment in the franchise unit is negatively related to the probability of negative franchisee exits.

3.1.4. Industry

Respondents in the first stage of this research were from a range of industries but it was noted that retail operations tended to be more complex systems than those involved in the service sector. Service franchises are typically one-person mobile or home-based operations and are less sophisticated than retail franchises. The simplicity of service franchises makes them attractive to investors who are entering franchising for the first time. However, their operation requires more than just the technical skill of mowing a lawn or washing a dog. As noted in the interviews, selling skills are just as relevant to service industries as they are to retail operations, a point which some franchisees may not appreciate at the outset. Hence, it is predicted that service sector franchisees may be more prone to negative exits than retail franchisees because of the dual demands of both technical and selling skills.

H4. The probability of negative franchisee exits is lower in retail industry franchises than in service franchises.

3.1.5. Conflict

A degree of conflict may be expected in any franchise system. In 2002, some 19% of Australian franchisors reported they were involved in a 'substantial dispute' with a franchisee (Frazer and Weavena, 2002, p. 49). Disputes may signal problems in the franchising relationship and may be responsible for franchisees exiting the system in some cases. Hence, it is expected that:

H5. The level of conflict in a franchise system is positively related to the probability of negative franchisee exits.

3.1.6. Hands-on operations

The success of franchising has been attributed to owner–manager incentives due to the franchisee's personal involvement in the day-to-day running of the business. Franchisees who manage at a distance or who employ managers to oversee daily operations introduce another layer of management into the arrangement, thereby reducing agency incentives. It is anticipated that when the franchisee has direct hands-on involvement in the franchise, the business will prosper. It is hypothesized that:

H6. The degree of hands-on involvement of the franchisee is negatively related to the probability of negative franchisee exits.

4. Stage 2—quantitative analysis

4.1. Method

In order to test the model developed in Fig. 1, a survey of franchisors was conducted. An estimated 700 business format franchisors were operating in Australia in 2002 (Frazer and Weavena, 2002) and, as 540 of these were on an electronic database kept by the FCA, this sample was used for the survey. The 'Franchising Australia' surveys are sponsored regularly by the FCA, which allowed the researchers to include some limited additional questions for the current study. For administrative efficiency, the survey was conducted electronically via the Internet. A total of 114 responses was received resulting in a response rate of 21%, which is acceptable in business research (Malhotra et al., 2002), including 71 responses with complete data, or 13%. A trend analysis was performed to test for non-response bias by comparing early with late respondents on the variables used in the data analysis (Kervin, 1992). This test confirmed that there were no significant differences between the groups of respondents and hence it was concluded that non-response bias was not evident.

Due to the problems associated with defining 'failure' outlined in Section 1.2, an alternative definition was carefully considered for this research. The main proxies that have been used for measuring failure in small business research are discontinuance of the business, bankruptcy, disposal to prevent further losses and failing to make a go of it (Watson and Everett, 1993, 1999). The four criteria thought to be appropriate in selecting a measure of failure, identified by Watson and Everett (1993), were: objectivity, relevance, reliability and simplicity. Most proxies for failure do not meet all four criteria but are used because of accessibility of data.

However, in the current study, primary data were accessible and a unique and more suitable measure was captured. In this research, franchisors were asked to report the total number of franchisees who had left the franchise, and then these were systematically decomposed into groups who left for differing reasons. Here, we are concerned with the number that left for negative reasons, namely unprofitable operations, personal or family reasons, conflict with the franchisor or personal unsuitability to franchising. Franchisors were asked to nominate how many of their franchisees had left the system in the previous 12 months for these negative reasons, and included closure of units, conversion to company-owned units, transfer (sale) of units to other franchisees, termination of franchise agreements and non-renewal of franchise agreements. In brief, the definition of exits used in this research is comprehensive and is particularly relevant to franchising as it includes events that are not included in other definitions. By incorporating these additional and unique elements in this research, a more accurate picture of negative franchisee exits may be observed.

4.2. Data analysis and results

Each of the hypothesized predictor variables was examined for validity and suitability for analysis. Experience was operationalized as the number of years of operation with franchisees. Size of a franchise ranged from just one franchise unit to more than 3000. Similarly, the investment capital required to buy in to a franchise ranged from several thousand dollars to over a million dollars. Such data tend to be both highly skewed and platykurtic (flat). In these situations, it is appropriate to take the log of each measure to bring the data closer to a normal distribution. The treatment has the added advantage of defining the data in relative terms. As a unit of measure, at log base-10, increases from 1 to 2 to 3, we can say there is an increase from tens to hundreds to thousands. Support provided by the franchisor was measured as the ratio of head office staff to number of franchisees. Whether a franchise was in a service industry or a bricks-and-mortar retail industry was measured with a simple binary scale. Although it would be interesting to analyze more industry categories, the small size of the Australian franchising sector makes this impractical. Hence, the sample was categorized as retail or non-retail only. Similarly, conflict was defined as whether a franchisor had been in a substantial dispute and was measured as a simple binary (yes, no) scale. Degree of hands-on involvement with day-to-day operations was measured with five separate questions related to whether or not the franchisee was personally involved in serving customers, daily administration, inventory control, local marketing activities and staff supervision. The sum of each of these yes–no questions gave a "hands-on" measure ranging from zero (none at all) to five (total involvement by franchisee.)

The dependent variable was originally measured with the total number of negative exits per franchise. The original measures were highly skewed, censored and dependent on temporal events. The conditions under which a franchisee could leave can brew for some time, which means that we could record a departure due to events in the past or we may fail to record a departure that will happen next season. Not surprisingly, the largest franchises had the largest number of franchisee exits. Other techniques used in the biological sciences, such as the Cox proportional hazards model and the accelerated failure time model (AFT) are popular regression methodologies for survival data (Buckley and James, 1979), but these would require the tracking over time of individual franchisees until most have exited. Reluctantly, we settled on the measure presented here: the square root of the gross number of negative franchise exits. The square root improves slightly the skewed distribution of the dependent variable.

Table 1 provides appropriate univariate statistics for the dependent variable, negative franchisee exits, and each of the predictor variables.

Each of the research hypotheses may be handled one at a time using Pearson correlation. This simple measure of course does not take into account the collinearity among the predictor variables.

From this analysis, we would conclude that those franchises that are larger and have been in operation for a longer time, and to some extent offer lower levels of support from head office, are more likely to experience franchisees exiting for negative reasons in the last year. On the face of it, we can conclude that is the end of the matter, but correlations (Table 2) among these predictor variables suggest a more complicated picture. Each of the predictors is moderately related to at least one of the others. This implies that, for example, there is a part of the measure of "experience" contained in the measure for "size" and also contained in the measure for "startup cost". Useful explanations of and tests for the antecedents of negative franchisee exits demand that we examine the effects of a combination of influences that the predictors have on franchisee exits.

4.2.1. Multiple regression

Suitable, non-missing data were available from 71 franchisors. Table 3 presents results for a multiple regression, using standard type III SS, with the square root of exits as the dependent variable, and the independent variables log (10) of total average startup costs, log (10) of years of operating experience, log (10) of size (number of franchisees), level of hands-on management, franchisor support, plus dummy variables for retail vs. non-retail industries and conflict.

Table 1
Descriptive statistics

Linear predictors untransformed and transformed

	Min	Max	Mean	S.D.	Skewness	Kurtosis
Total average startup costs	4025	785,000	146,098	141,831	2.096**	5.596**
Experience: years operating experience	2	117	20.90	21.836	2.899**	9.068**
Size: n_Franchisees	1	780	68.99	119.613	3.697**	16.432**
Hands-on management	1.00	5.00	3.6154	1.32304	−0.579*	−0.763
Franchisor support	0.00	2.50	0.6333	0.66662	1.362**	0.616
Log_startup cost	3.60	5.89	4.9832	0.41611	−0.219	0.061
Log_experience	0.30	2.07	1.1704	0.35361	0.094	0.736
Log_size	0.00	2.89	1.3961	0.66424	−0.122	−0.495

Categorical predictors

Retail vs. non-retail

	Frequency	Percent
Retail	21	30
Non-retail	50	70
Total	71	100

Conflict

	Frequency	Percent
No	56	79
Yes	15	21
Total	71	100

Dependent variable: EXITS

	Frequency	Percent
No exits	20	28
Exits	51	72
Total	71	100

* Normality significant at the 0.05 level (two-tailed).
** Normality significant at the 0.01 level (two-tailed).

Table 2
Correlations

	Root_exit	Conflict	Retail	Hands-on	Support	Log_startup cost	Log_exper	Log_size
Root_exits	1	0.400**	−0.089	0.157	−0.249*	−0.026	0.426**	0.762**
Conflict	0.400**	1	0.109	0.158	−0.048	0.083	0.103	0.286*
Retail	−0.089	0.109	1	−0.364**	−0.021	−0.526**	−0.291*	−0.104
Hands-on	0.157	0.158	−0.364**	1	0.067	0.259*	0.089	0.086
Support	−0.249*	−0.048	−0.021	0.067	1	0.297*	0.095	−0.260*
Log_startup cost	−0.026	0.083	−0.526**	0.259*	0.297*	1	0.331**	0.140
Log_experience	0.426**	0.103	−0.291*	0.089	0.095	0.331**	1	0.523**
Log_size	0.762**	0.286*	−0.104	0.086	−0.260*	0.140	0.523**	1

Pearson and point biserial correlations for the binary variables retail and conflict against the other variables.
* Correlation is significant at the 0.05 level two-tailed.
** Correlation is significant at the 0.01 level two-tailed.

Results show that the important predictors of negative franchisee exits are conflict, startup cost and size. The franchisees' level of investment was found to be negatively related to franchisee exits as predicted and hence Hypothesis 3 was supported. The presence of conflict in the relationship was positively related to franchisee exits as predicted and Hypothesis 5 was also supported. The relationship between size of the franchise system and franchisee exits was significant in a positive direction, whereas Hypothesis 1b predicted a negative relationship. Hence, our argument that large franchise systems are more experienced and will therefore be better at franchising needs to be revised. It is possible that systems with a large number of franchisees will be more prone to franchisee exits simply because of their size. Large systems are bound to have more complex structures and additional layers of management.

In summary, it seems that the key influences on negative franchisee exits are the following. Large franchises that have been in operation for some time are more likely to have some departures in any 1 year. This may, however, be a small proportion of franchisees in the franchise. Franchises with higher startup costs are less likely to lose members. And those that have experienced significant conflict tend to lose franchisees. Of course, variables not in the final equation may still have an impact on the problem of negative exits; however, the data we have collected provides insufficient evidence to support that proposition.

Table 3
Multiple regression results: dependent variable: square root of total negative exits

	Standardized β	t	Significance
(Constant)		1.494	0.140
Conflict	0.221	2.785	0.007
Retail	−0.118	−1.237	0.221
Hands-on	0.079	0.979	0.331
Support	−0.010	−0.117	0.907
Log_startup cost	−0.249	−2.637	0.011
Log_experience	0.101	1.080	0.284
Log_size	0.659	6.876	0.000

R^2: 0.665.

5. Implications for theory and practice

5.1. Theoretical implications

This study has provided an in-depth analysis of the factors that cause franchisees to exit for negative reasons. The emphasis of the prior literature has been on estimating failure rates or comparing franchisee failure with that of independent business failure. Hence, this study has extended the boundaries of previous research by searching for factors that may relate to the problem.

5.2. Managerial implications

Research on the causes of franchisee exits has important implications for management, industry bodies and government. One of the reasons for the introduction of franchising legislation in Australia in 1998 was because problems were believed to be associated with the franchising sector. The federal government's response was to regulate the sector and the effectiveness of the legislation will need to be examined over time. By understanding what causes franchisees to exit, franchise systems may take action to minimize this risk for potential investors. Every failed franchisee unit impacts on others in the franchise system so the effects are far reaching and can be substantial.

Industry bodies such as the International Franchise Association, which represents the interests of both franchisees and franchisors, may benefit from a greater understanding of causes of franchisee exits. The education of those participating or intending to invest in the sector may help to prevent future problems from occurring. Similarly, it may be of assistance to existing franchisees and franchisors to be aware of the pitfalls of managing a unit at the franchisee level.

5.3. Directions for future research

This research was a cross-sectional analysis of the factors related to negative franchisee exits. In the quantitative stage, data were collected from franchisors. Ideally, data should also be gathered from both continuing and exiting franchisees. Our measures of the variables in this study are necessarily crude. Data from franchisees would give us finer detail. In addition, a longitudinal analysis of franchisee exits would enable trends such as age of the franchise unit and size of the franchise system to be observed.

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Franchising and the imbalance of power – perception or reality?

Professor Lorelle Frazer
Dr Scott Weaven
Griffith University

Introduction

This project was initiated by Griffith University and the Australian Competition and Consumer Commission (ACCC) as a pilot study to understand the nature of the franchising relationship and to obtain a diversity of informed views on the perception of conflict, its sources, and how mediation is performing as a post hoc remedy in such situations. An attempt at identification of predictive models of conflict was also made to provide a method by which early warning signals could be developed and monitored, thereby preventing high level conflict. While it is too early to clarify any success in this area some themes were developed that can be incorporated into future research for the development of those models.

Given the number and size of franchise systems in Australia it appears that larger, more mature, franchises may tend to develop a positive culture that rewards franchisees in a fair and appropriate manner. This is coupled with proactive communication utilised to prevent and/or minimise potential sources of conflict. These systems generally do not use third party sources to communicate to potential franchisees and employ mature people that are able to represent the franchisor in an appropriate and consistent manner. They also embody a culture that maintains discipline but adapts to market changes. There are, however, instances of arrogant and dominant behaviour at times from these systems.

It is evident that many of the 960 franchise systems in Australia have not reached the same level of maturity as some of the older and more experienced franchises. While many franchisees experience conflict after entering these less mature systems it remains unknown as to what percentage of conflict escalates to a point where the ACCC may become involved. Hence, the themes developed in this report are put forward as tentative, but significant issues that require further exploration.

Methodology

In this initial pilot phase of the research it was decided to interview a range of franchising sector participants, with a particular emphasis on professional informants who were experienced advisors or consultants. Fifteen people were interviewed comprising the following roles:

Respondent	**Number**
Franchising consultant	3
Accountant	1
Lawyer	3
Corporate Lawyer	1
Broker	1
Franchisor	2
Franchisee	3
Master franchisee	1
Total	15

The first two interviews were conducted face-to-face in a fairly unstructured manner to allow themes to follow freely and to develop a set of questions. The remaining interviews were conducted by telephone unless a participant preferred a face-to-face meeting. A snowballing technique was adopted to allow participants the opportunity to nominate other professionals. With the participants' consent, the interviews were taped and later transcribed and analysed. The following themes emerged from an examination of the data collected in the interviews.

Findings

Several themes were developed that represent respondents' perspectives on issues as well as interpretations of data content in a holistic manner. They are as follows (but not in any order):

1. The generally accepted forms of *conflict* are
    - Marketing expenditure;
    - Poor franchisee selection;
    - Poor site selection;
    - Poor interpersonal skills and lack of empathy by managers and leaders who work for the franchisor;
    - Poor interpersonal skills and lack of professionalism by the franchisees;
    - Poor training of franchisees in their responsibilities, and how to act as good franchise citizens;
    - Financial pressure on the franchisee or the franchisor, resulting in short-term decision making;
    - High cost of goods or labour percentages;
    - Difficulty of hiring effective staff (somewhat increased in periods of high employment) ;
    - Financial stress, personal pressures and/or health problems;
    - Change is viewed as a source of conflict in franchise systems. This includes new initiatives or a new image and can be linked to financial pressures as well

as marketing funds (as the franchisee generally has to pay). Lack of consultation/communication also increases conflict in this area as often franchisees are forced into specific situations with little or no information;

- Over time franchisees experience different stages of development causing periods of increased conflict;
- Fear mongering by franchisees;
- Third party involvement, including that of family members.

2. *Third parties* were perceived to exacerbate conflict. These include the following groups: lawyers, franchise consultants/sales, head office staff, accountants, franchise associations (including the former AFA and the FCA) and also the ACCC. For example, in franchise systems where an entrenched negative culture exists toward franchisees it was felt that increased conflict occurred. External consultants, such as lawyers, accountants and franchise sales consultants were seen to exacerbate conflict through the miscommunication of expectations and/or data (financial etc). The AFA was seen as interested in pursuing its own agenda to increase its profile and membership. The FCA was generally perceived as creating a negative culture in franchising due mainly to the dominance of franchisors within the organisation).
3. Franchise systems which do not include franchisees in the *innovation* process and have poor corporate communication skills tend to create conflict in one or more of the areas from item 1.
4. Franchise systems that do not innovate tend to have higher levels of conflict in one or more areas from item 1.

5. The *relationship* between franchisors and franchisees is considered as a hybridised version of traditional master-servant and division of labour (employer-employee) associations. Sophisticated systems may tend to treat the relationship in a more mature fashion with increased levels of communication and pro-activity. Less sophisticated systems may tend to view the relationship as similar to that of a master/servant and and may (as a result) foster greater levels of conflict in their systems. These perspectives were thought to be directly linked to the culture of the organisation.
6. Mature franchise systems tend to utilise *monitoring* in a formal manner to ensure that innovation occurs in a productive and controlled way in accordance with a defined strategy (although this was not explicitly mentioned within the interviews it is derived from the fact that respondents felt these systems were well structured). The opposite was said of less sophisticated systems.
7. Respondents viewed informal *controls* in franchise systems as a somewhat negative factor when linked with success factors (such as the reduction of franchise fees over pre-specified levels of sales) because they felt that these informal controls could be manipulated. However, respondents reported that when other types of informal systems such as "pats on the back" and other positive reinforcement strategies were introduced with strong communication channels that this was proactive and positive and would be less likely to be open to misinterpretation.
8. Most respondents felt that if there was effective *communication* within the system most conflict could be prevented or dealt with in an effective manner.

9. *Power* of both franchisors and franchisees was relative to the culture and maturity of the franchise system. Generally the view was that franchisees did not see themselves in a position of power. However, when franchisees became aware of their power in a negative situation conflict increased. Suggestions were that franchisees could become quite proactively mischievous in this stage of awareness causing significant conflict from many franchisees in the system. Further, franchisors that were less mature often used power as a 'blunt instrument'.
10. When franchisees experienced value based *conflict* they were much more likely to cause increased levels of friction within the system, generally relying upon third parties to reinforce their position.
11. *Mediation* was generally seen as a positive and effective/efficient way to resolve conflict. However, some respondents saw that franchisees were not well informed about mediation. Some also felt that mediation was being used as a subtle form of threatened power. Most respondents did not see sufficient value in publicly posting outcomes from mediations as this would reduce confidentiality which was seen as crucial in ensuring effective mediation.
12. Without a clearly defined strategy (other than a specified number of units) franchise systems tend to be involved in increased levels of conflict.

Conclusion

This pilot research has explored the issues of conflict and power in the franchising relationship by speaking to experienced observers about their overall impressions surrounding franchising. Next, discussions with the ACCC and Griffith University will be held with the intention of extending this research across the sector in an attempt to predict, redress and thus reduce the level of conflict in franchise organisations.