Trust, good faith and synergy within franchising

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“When I first joined this group my franchisor treated me like royalty... now I am treated like royalties” ~ a quote from a franchisee

ABSTRACT

This paper contributes to existing franchising thought in three major ways. Firstly, synergy between the franchisee and the franchisor is achievable. Synergy occurs when the output of a group is greater than the sum of the individual effort. Secondly, the research reveals initial insight into how synergy can be achieved; synergy requires the essential elements of trust and good faith. Finally, the construct of good faith is compared with the construct of bad faith, compounded by the franchise culture. At one polar extreme, trust and good faith produce synergy. However, at the polar opposite, distrust and actions of bad faith result in dysfunction. Many authors have researched problems such as trust and distrust through the lens of agency theory (Jensen and Meckling, 1976) with the findings of this research building on existing thought. Qualitative data in the form of in-depth interviews with franchising experts. The overarching goal of this research is to gain further understanding of how the constructs fit together as well as provide managerial insight that can preempt franchising relationship failure and increase franchise synergy.

Keywords: franchising, good faith, relationship, synergy, trust.
INTRODUCTION

It is proposed that synergy within franchising requires the essential elements of both trust and good faith. In the beginning, trust enables the franchisee and the franchisor to cooperate together in the competitive business arena. Throughout the life of the relationship, as the franchisee and franchisor learn interact with one another, actions of good faith will continue to promote a healthy level of trust between the parties. However, trust may turn to distrust because of untrustworthy actions of bad faith, the negative consequences of which can be widespread. Frazer, Giddings, Weaven, Grace & Grace (2009) found that only 52 percent of franchisees agreed that they could rely on their franchisor to keep the promises made to them. The remaining 48 percent were either unsure, or disagreed that their franchisor was trustworthy.

This paper addresses the following question: what are the major impediments to building a healthy level of trust between the franchisee and the franchisor? Qualitative research revealed three major impediments to the development of trust: (1) goal divergence, (2) non-disclosure of material information and (3) indifference. Data were gathered from twelve franchising experts in the form of in-depth interviews. Thematic analysis of the interview transcripts, using NVivo software provided insight into three key areas that influence the amount of synergy (or dysfunction) within the franchising relationship: levels of trust/distrust, the franchise culture, and actions of good/bad faith. The data is conceptualized in the trust/distrust model of franchising (figure 1). The proposed model will be quantitatively tested in future stages of research.

CONCEPTUAL BACKGROUND

TRUST
**Definition**

Trust is defined as the confidence a franchisee has in their franchisor’s trustworthiness, and vice versa. This definition parallels the work of Moorman, Deshpandé and Zaltman (1993) whereby trust is conceptualized as a willingness to rely on another. In their seminal article on relationship marketing, Morgan and Hunt (1994) identified the importance of trust as a key mediating variable that influences cooperation whereby trust is generally considered to be an essential component of exchange (Rotter, 1967; Gambetta, 1988; Fukuyama, 1995; Mayer, Davis and Schoorman, 1995; Reed, 2001; Cook, Hardin and Levi, 2007; Fulmer and Gelfand, 2012).

**Literature review on trust**

According to Ring and Van de Van (1994), there are two major schools of thought on trust within the business literature. The first examines trust from a business risk perspective whereby one party can confidently trust another because of the protection of formal mechanisms. Formal safeguards include the law, insurance policies, organizational hierarchy and industry codes such as the Franchising Code of Conduct (the Code) found in Australia. The second school of thought emphasizes the moral integrity of individuals as reason enough to trust. In this view, interpersonal interaction may lead to friendships built on goodwill and fairness. For example, franchisees and franchisors can have confidence that they will be dealt with in a fair and reasonable manner; therefore they trust one another.

Furthermore, Hardin (2002) suggests that for trust to exist, there needs to be a clear and distinct interest at stake for both parties in the continuation of the relationship.
This account of trust as encapsulated interest consists of three major elements: firstly, trust is considered to be a three-part relation, that is, A trusts B to do X; secondly, trust should be viewed as a cognitive component, as opposed to a behavioural component. For example, I may trust you (the cognitive component) yet I do not have to engage with you (the behavioural component). It is important to clearly distinguish trusting and acting from trust. Finally, acting on trust typically involves risk, uncertainty and vulnerability. An extension of Hardin’s model of trust might be surmised: can A (the franchisee) trust B (the franchisor) to do X (act in good faith). After all, Cook, Hardin and Levi (2007) suggest that trust is unproblematic in a society where everyone is entirely trustworthy. It is proposed that trustworthy behavior in a franchise system will result in increased performance because of group synergy; unfortunately, not all franchise systems have adopted a culture of good faith.

GOOD FAITH

Definition

In the Australian franchising sector, issues are still being raised concerning the rights and obligations of acting in good faith. The 2013 review of the Franchising Code of Conduct (the Code) focused on several major issues, one of which being good faith in franchising. Good faith reform is considered by some to be the Holy Grail of reform for the Australian franchising sector (Terry & DiLernia, 2009) with scholars and reformers continuing to search for the elusive formula to bring equity to the franchising relationship. This quest is challenging, and perhaps impossible, due to the inherent power imbalances of the business-format-franchising model.

The practical implications of good faith
A good faith provision was first added to the Code in 2010; clause 23A states that “nothing in this code limits any obligation imposed by the common law, applicable in a State or Territory, on the parties to a franchise agreement to act in good faith.” The inclusion of this implied obligation to act in good faith was met with mixed feelings. On the one hand, some believed it would positively change the general culture within franchising; that is, both franchisees and franchisors would be more likely to accept the fundamental element of acting in good faith toward one another. However, on the other hand, some commentators believed that a duty to act in good faith could be contracted out. Others suggested that because of the ambiguous nature of the term, the resulting confusion as to how good faith should be defined, would result in a “lawyer’s picnic” (Wein, 2013: pg 67).

The 2013 review of the Code recommended that the Code be amended to include an express obligation to act in good faith. Legally, an express obligation is usually spelled out in direct and comprehensive terms, narrowing the concept much more than an implied obligation (Bradfield, 2013). In the Australian Government’s response, although the recommendation was accepted in part, emphasis was placed on the need to ensure that both the franchisee and the franchisor understood what it meant to act in ‘good faith’. Although good faith might seem to be an ambiguous and confusing term, Mason (2000), elucidates the concept in light of three related notions: loyalty to the promise, compliance with honest standards and compliance with reasonable standards as per the individual interests. The Government recognized the importance for further education in the franchising sector around this ambiguous concept to assist practitioners with understanding the implications of choosing to act (or not act) in good faith.
Case law: an example of good faith rulings in the Australian context

Furthermore, it was also recommended that the new express obligation to act in good faith should clearly state that it does not prevent any of the parties from acting in its legitimate commercial interests (Wein, 2013). But what does it mean to have a legitimate commercial interest, and moreover, what if the commercial interests of a franchisor conflict with those of their franchisees? For example, In Rod Hackett v McDonald’s Australia¹ the question was raised as to whether the franchisor’s decision to open two new stores in close vicinity to the existing franchisee’s (Hackett) stores had breached implied provisions to act in good faith. It was also considered whether McDonald’s had acted in an unconscionable, misleading or deceptive manner. Under McDonald’s ‘expansion policy,’ an existing franchisee could qualify for the grant of additional stores based upon their meeting certain quality standards, however they were not guaranteed any additional licenses. When McDonald’s unveiled their plans to open 2 new stores, one only 800 metres from Hackett’s current store, they chose not to offer the stores to Hackett. Hackett argued that McDonald’s ‘expansion policy’ was not honest, reasonable or fair; a policy carried out in bad faith. The Victorian Supreme Court disagreed with him, awarding the decision to McDonald’s Australia; suggesting that McDonald’s decision to open the new stores and not offer the licenses to Hackett was not substantially motivated by bad faith. Instead, both parties knew that the opening of new stores was an ordinary part of McDonald’s way of doing business; it was in their commercial interest (self-interest) to open new stores, even though it may have an impact on the existing franchisee’s business.

¹ Far Horizons Pty Ltd and Rodney Hackett v McDonald’s Australia Ltd (2000 VSC 310). Judge J. Byrne presided.
SYNERGY

Definition
The etymology of the word ‘synergy’ is derived from the Greek term for working together. Synergy is achieved when two elements working together produce a greater output than the individual efforts would have, hence the saying – two minds are greater than one. However, synergy may not always be achievable in human teams whereby emotion and interpersonal conflicts can prevent effective cooperation (Amabile, 1997; Buchanan and Huczynski, 2010; Ketchen and Hult, 2011). Nevertheless in the context of organisational behaviour, a cohesive group is more valuable (and perhaps profitable) than a group plagued by dysfunction. Furthermore, specific to the franchising relationship, it is proposed that synergy refers to the bonus effect achieved if the franchisee and the franchisor can work together toward a common goal in an effective manner.

THEORETICAL BACKGROUND

AGENCY THEORY
Agency theory provides a comprehensive framework for understanding the typical franchising relationship whereby the principal (the franchisor) delegates rights and responsibilities to an agent (the franchisee). A major assumption of agency theory is that agents are self-interested (Combs, Michael and Castrogiovanni, 2004); furthermore, they possess goals that may not be in complete harmony with that of their principal, resulting in the need for the principal to expend resources to ensure compliance (Jensen and Meckling, 1976; Eisenhardt, 1989; Bradach, 1997). Achieving compliance and goal congruence is challenging as the franchisee and the franchisor are separate commercial and legal entities (Felstead, 1993). However, they
typically exist and operate together in an ongoing exchange relationship that is mutually beneficial to both parties. The lifeblood of this relationship is trustworthiness; prior research indicates that once betrayal has occurred, the parties to the relationship are more likely to begin searching for an exit (Wright and Grace, 2011). The agency problem predominantly exists because the principals’ and the agents’ interests do not align perfectly (Rubin, 1978) providing a major impediment to the development of trust between the franchisee and the franchisor.

**RESEARCH METHOD**

Qualitative data were gathered along an interpretive line of inquiry into the nature of trust. Within the interpretive perspective, researchers seek to understand and interpret how people create and maintain their social reality (Mertens, 2010; Denzin & Lincoln, 2011). Because these meanings are subjective, varied and complex, the goal of this type of research is to develop a comprehensive understanding of how people construct meaning in their own natural settings (Neuman, 2011). As this research contributes to a much larger PhD project, the initial data were collected as an exploratory investigation, utilising in-depth interviews to collect data. Recognised as a key method for qualitative data collection, interviews yield rich information about people’s experiences, perceptions and feelings (Patton, 2002). Furthermore, direct quotations provided raw data that revealed the respondent’s depth of emotion on the topic of trust within franchising. This type of inquiry and research design was chosen as the most appropriate and efficient way to collect and access data in this initial stage of the PhD journey. The researcher’s intent, then, is to make sense of (or interpret) the meanings of other peoples’ worldviews. This is why, according to Creswell (2013),
qualitative research is often called ‘interpretive research’. Interviews with franchising experts were cost effective and provided a foundation for future quantitative inquiry.

In-depth, open-ended interviews were conducted with 12 franchising experts. The group of experts consisted of franchising consultants, mediators, lawyers, bankers, and franchisee advocates, shown in table 1. Where possible the interviews were conducted face-to-face, but some were conducted via telephone and Skype. All interviews were audio recorded (with the permission of the interviewee), then transcribed. The transcriptions were analysed using NVivo software; allowing for the identification of major themes. Nvivo software enable researchers to systematically analyse qualitative data whereby major themes can be identified and coded into categories. The categories provided some interesting observations with respect to trust, good faith and synergy within the Australian franchising sector, discussed in the following section.

Table 1: Matrix of interviews conducted

<table>
<thead>
<tr>
<th>Participant category</th>
<th>Number of participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Franchisee advocate</td>
<td>1</td>
</tr>
<tr>
<td>Franchising banker</td>
<td>1</td>
</tr>
<tr>
<td>Franchising consultant</td>
<td>5</td>
</tr>
<tr>
<td>Franchising lawyer</td>
<td>3</td>
</tr>
<tr>
<td>Franchising mediator</td>
<td>2</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>12 interviews</strong></td>
</tr>
</tbody>
</table>
FINDINGS

The analysis of the qualitative data is categorised into 3 key areas that influence levels of synergy/dysfunction within the relationship: (1) trust/distrust; (2) franchise culture; (3) acting in good/bad faith. The first theme belongs in the category of knowledge while the remaining themes belong to the category of behavior. Levels of trust and distrust fluctuate throughout the life of the relationship, largely dependent on the behavior of the parties. Figure 1 provides an overall conceptual model of the major themes and their influence on synergy. The model is designed to incorporate both Hardin’s (2002) encapsulated interest account of trust and the key findings from the qualitative study. The major assumptions of the model are: (1) a distinction is made between trust and trustworthiness. Trust and distrust belong in the category of knowledge, which is different to acting in good or bad faith, belonging in the category of behavior. (2) Trust is viewed as a three-part relation: A trusts B to do X. It is helpful to consider specific examples when applying this model. For example, a franchisee trusts a franchisor to act in good faith (A trusts B to do X), which according to this model, will result in synergy. Another example might be a franchisee distrusting their franchisor because of misleading or deceptive conduct, thus reducing the possibility of synergy in the relationship.
Figure 1: Trust/distrust model of franchising

Source: developed for the purpose of this research.
**Theme 1: trust and distrust**

A key attribute of a thriving franchising relationship is trust. Throughout the interviews, trust was always discussed with vigor, contributing to the idea that trust is vital in the franchising relationship. One franchising consultant believed that, “the need to be able to trust the franchisor and the need for the franchisee to be able to trust the franchisor is paramount.” Furthermore, a “lack of trust can definitely undermine the profitability of both parties” (franchising consultant). By focusing on building trust within the franchising relationship, synergy can be achieved. **Synergy** within franchising is mutually beneficial for the franchisee and the franchisor. On the other hand, **dysfunctional** relationships include elements of bad faith and are less likely to produce synergy. Bitterness, suspicion and distrust will damage any relationship. One lawyer suggested that “you don’t have to act in good faith, but if you want the relationship to thrive you need to do the little things…exceed all expectations.” Actions of good faith toward one another and goal congruence help to build trust in any relationship; one franchising consultant identified the central role of trust within the franchising relationship:

> “But I am certain that if you don’t have trust, you would have a very limited relationship. It’s not healthy, and I don’t think it’s effective either. Because the parties stop looking at any form of common goal and they begin to just purely focus on their own goals, they work against each other rather than for each other.”

Economic volatility and general business risk may contribute to uncertainty within the franchising environment. However, distrust can begin to creep into the relationship if
expectations are not met. If a franchisor seems to be acting in an untrustworthy manner, then a franchisee may begin to distrust the actions of their franchisor. There are specific reasons why A trusts B, or there are specific reasons why A distrusts B. Furthermore, there may also be instances where a franchisee distrusts their franchisor, yet still has to cooperate with them. Distrust and trust were discussed in every interview with some interesting findings, as the franchisee advocate remarked:

“Franchising is not an ideal environment for trust; it is very hard to build and you will find that distrust will be the biggest reason for failure in most relationships, in particular franchising.”

Even though risk is minimized by the protection of the government (for example, the ACCC can initiate litigation against a franchisor on behalf of the franchisee) and by legislation (the Code), trust is fragile, as one franchising lawyer suggested:

“Trust goes out the window when a party perceives the other to be doing something dodgy i.e., misappropriation of marketing funds.”

The misappropriation of marketing funds may be neither immoral nor illegal, yet may be perceived to be an act of bad faith. Furthermore, a franchising mediator commented:

“Once trust breaks down, you can have a triggering event whereby levels of trust go down further and you move toward a scenario where there’s no trust on behalf of the parties and all that remains is blame.”
Distrust erodes the value of the franchising relationship with some relationships deteriorating into an unhealthy and unstable environment plagued by skepticism and uncertainty. Distrust may also pave the way for large legal battles between the franchisee and the franchisor, as described in the aforementioned case (Rod Hackett v McDonald’s, 2000). Furthermore, trust and distrust are not static elements and may change throughout the life of the relationship. A pessimistic franchise consultant stated that:

“The franchising relationship starts off as blind trust, then leads to mutual distrust because of potential dishonesty.”

It is clear from the findings that distrust damages the relationship between the franchisee and the franchisor while trust contributes to the vitality of the relationship. As one franchise consultant believed, “I am certain that if you don’t have trust, you would have a very limited relationship.” The following section describes some examples of how a culture of good faith can be created within a franchise system to increase the levels of trust.

**Theme 2: Franchise culture**

The overarching franchise culture plays a major role in the development of synergy. A culture of good faith in a franchise system is more likely to produce the synergy bonus than a culture of bad faith. The franchise founder/CEO is largely responsible for setting the culture and will determine “how we do things around here” (consultant). However, franchisees still play an important role in developing the
franchise culture as they move into the system. A positive culture of good faith is an important factor in determining the presence and fruitfulness of synergy, as suggested by a franchising consultant:

“It also comes down to the selection of the franchisee. Because in the selection process you need to ask yourself, ‘am I just taking someone with a heartbeat and a cheque book or have I done the due diligence to see that this person fits the culture.’”

The health of the relationship will be a product of the surrounding franchise culture. Figure 1 shows the franchise culture positioned as a mediating variable between trust/distrust and actions of good/bad faith. There are many things people can do to change the culture because after all, the culture is not a “non-thinking, amorphous thing; it is made up of people and their attitudes” (Consultant). One franchising consultant told the story of what he used to do in his own franchise system:

“When I was general manager of a franchise system, I actually had a box in the tea room and if anyone was heard to be derogatory to a franchisee without just cause, it cost them a dollar; that very quickly changed the culture.”

Thus, the franchise culture will largely dictate the behavior of the individuals within the system. The culture can set a tone of positive and healthy attitudes to those within the system, or it can degrade into a culture of bad faith, plagued by distrust. The following section reveals the data specific to actions of good and bad faith.
**Theme 3: Acting in good/bad faith**

One franchising consultant referred to the ‘fairness equation’ as a metaphor for the interaction between the franchisee and the franchisor. It is reasonable to expect both the franchisee and the franchisor to be fair in their dealings toward one another; that is, to act in good faith. Data reveals that acting in good faith consists of three major elements: (1) goal congruence, (2) clarity, and (3) care. However, misleading and deceptive conduct does exist within franchising and is considered to be a major impediment to healthy levels of trust within the franchising relationship. The major elements of acting in bad faith include: (1) goal divergence, (2) non-disclosure of material information, and (3) indifference. As identified in the literature review, good faith is an ambiguous concept; an idea confirmed by a franchising consultant who shared his belief:

“To me it’s about being fair, how do you describe good faith, I mean that’s what the lawyers have been arguing about forever. But we all know in our heart of heart’s what’s right and what’s wrong.”

Another franchising consultant gave a practical example of how good faith may exist in a franchise system:

“I’ll give you an illustration of good faith: I got asked the question this week, a franchisor rings me and says I’ve got a 70,000 contribution to fit-out of this store in X town. What do I do with it? I said to him, ‘you give the entire amount to the franchisee!’ Because
that’s what you do in good faith. The franchisee has bought into your system because they’re expecting to get a better deal on buying and on advertising; they’ve paid for the benefits of using your system and to me that’s one of the benefits that helps build trust.”

The franchisee and the franchisor are separate legal entities cooperating together in an agency relationship. In an effort to reduce agency costs, goal congruence is considered to be an essential element of good faith. Furthermore, goal alignment will assist in the synergy bonus achieved when groups of people cooperate together in an efficient manner, with the same purpose and direction. However, the agency problem exists when the relationship suffers from goal divergence. It may be impossible to have goals that are in perfect alignment because the truth of the matter is that both the franchisee and the franchisor do have different objectives. As these objectives move further apart over time, it is more likely for one party to be suspicious of the true motives of the other party and start to question whether their goals are still in alignment. Hence, goal divergence will contribute to acts of bad faith and as one mediator suggested:

‘You couldn’t characterize their interests as necessarily shared, some of them are shared, some of them are common, but in other ways they are competing interests. And when they are competing, that’s the challenge.’ (Franchising mediator)

Furthermore, a franchising banker understood that:
“In business, people aren’t necessarily against you, they are just for themselves.” (Franchising banker)

Uncertainty as to the motives of the other party will contribute to skepticism and distrust. However, a franchisee is more likely to act in good faith toward their franchisor, and vice versa, when there is clarity within the relationship. The presence of honesty and transparency assist the development of a stable franchising relationship. However, as one lawyer suggested, “it is still possible for honest people to have disagreements.” Thus, it is reasonable to expect that both parties in the relationship will not deceive one another through secrecy and dishonesty; appropriate disclosure is an important attribute of acting in good faith. On the other hand, material non-disclosure is identified as a major impediment to the fostering of trust:

“We believe that more transparency will lead to more trust. You have to earn trust, both ways.” (Franchisee advocate)

Furthermore, a franchising mediator explained, “This is a type of relationship that involves a level of candor.” Where candor is replaced with secrecy, uncertainty as to the true motives of the other party may be grounds for distrust. One interviewee discussed the lack of comprehensive disclosure of material information in the franchising relationship and how this can negatively affect the relationship. Non-disclosure can exist as strategic misrepresentation whereby the franchisor may choose not to reveal the whole truth of their situation to a prospective franchisee. It is likely to be perceived as acting in bad faith if either party is seen to be deliberately involved in material non-disclosure, as clarified by one mediator:
“In franchising, you need to avoid situations where one party doesn’t reveal information which they know is material to the actions of the other party. Almost always this is going to be on the part of franchisors – not disclosing details to potential franchisees… [And why don’t they do that?]… I imagine it’s for commercial reasons, that they would rather have this person in their system and on that basis they extend the reach of their system, its viability and so on. Self-interest is a good horse; you can almost always back it to win.”

The franchising mediator’s comment above reveals the problem of material non-disclosure and the implications to the equilibrium of the fairness equation. Care toward another is the final component of trustworthy behavior. People who genuinely care for one another are more likely to act in good faith. One consultant hinted:

“one of the keys to building trust is to demonstrate genuine care.”

Damage to the relationship might occur if either the franchisee or the franchisor becomes indifferent to the other parties needs. A lack of care and support from the franchisor will be seen as a lack of good faith, as described by one lawyer:

“I’d say that as well as the transparency and disclosure, another big reason for conflict in the relationship is that expectation of support and assistance that doesn’t materialize.”
Furthermore, one consultant discussed how indifference comes to exist within the franchising relationship:

“‘When the franchisor shows behaviour that puts a doubt in the mind of the franchisee that, ‘I can’t trust this person, or these people don’t care about me, they only care about themselves,’ that tears the fabric.’”

The roles and obligations (for example, support and quality standards) of the franchisor and franchisee are usually stipulated in the initial franchising agreement, signed by both parties at the beginning of the venture. This is the legal contract, however, a psychological contract also exists between the franchisee and the franchisor. The psychological contract complicates interaction as unwritten laws exist that may dictate the direction of the relationship and may damage the relationship if they are not obeyed. A consultant mentions the significance of the psychological contract.

“The psychological contract is more important than the legal contract because it is what drives behavior.”

The franchisee and the franchisor are inextricably linked to one another in their chosen venture. The findings suggest the importance of trust and maintenance of the psychological contract. Trust changes into distrust as confidence begins to waiver in the other’s ability to act in good faith. For example, if A begins to believe that B is acting in bad faith toward them, A begins to distrust B. Thus, distrust becomes the enemy of synergy.
CONCLUSION

The three major impediments to building a healthy level of trust between the franchisee and the franchisor were found to be: (1) goal divergence, (2) non-disclosure of material information and (3) indifference. For franchising relationships to thrive and achieve the synergy bonus, practitioners should focus on reducing these impediments. One practical recommendation is for both the franchisee and the franchisor to communicate about trustworthiness in their day-to-day activities. Placing trustworthiness in high regard, and communicating its importance throughout the system will assist in developing an internal culture of good faith and trustworthiness. The franchising relationship that is to achieve synergy involves a high level of candor, an element that will deplete if the relationship becomes plagued by distrust.

Distrust will limit the franchising relationship as well as undermine profitability; therefore, keeping trust alive between the franchisee and the franchisor is paramount. A relationship that is devoid of trust is limited. Future research should quantitatively test the proposed model (figure 1) as well as identify the root cause of goal divergence, non-disclosure and indifference within franchising. Understanding what motivates franchisors (and franchisees) to behave in bad faith toward one another might be of use in the quest for Terry and Di Lernia’s (2009) Holy Grail of franchising reform.
REFERENCE LIST


