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Influence of the Franchising Code of Conduct on the Franchisor-Franchisee Relationship

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Abstract

The Australian government introduced the first mandatory Code of Conduct as part of the Trade Practices Act (1974) to regulate its franchising sector in July 1998. In this research fifteen interviews were conducted to obtain feedback from franchising participants regarding their views on the influence of the Franchising Code of Conduct (the Code) on the franchisor-franchisee relationship.

It was found that although many of the interviewees thought the Code was ambiguous in many areas, as well as being costly and time-consuming to comply, they were generally supportive of the new legislation. In general, interviewees felt that through its numerous requirements, the Code was able to increase the level of trust and commitment between franchisors and franchisees at the beginning of the relationship. The Code was thought to be most beneficial when conflict occurred because it helps facilitate communication and provides a balance of power between franchisors and franchisees. However, it was revealed that the Code had the least amount of impact on the termination/renewal phase because most interviewees had not experienced the situation to be able to comment on it.

INTRODUCTION

The Australian franchising sector has developed rapidly since the arrival of high profile United States fast food franchises in the early 1970s. Over the following three decades many Australian-based systems developed and there are now examples of business format franchising in most industry sectors, including motor vehicle and fuel retail. In 1999 some 747 franchisors were estimated to be operating more than 55 000 outlets and producing A\$76.5 billion in sales (Frazer and McCosker 1999). Rapid growth has taken place in the last decade in particular. Over the period 1991-98, the number of outlets increased by 16 percent per annum cumulative (DITAC 1992, ABS 1994, McCosker and Frazer 1998). This rapid growth has been accompanied by problems in the sector, including franchise failures, abuse of franchisor power and termination of agreements.

The perceived imbalance in franchising relationships led to the introduction of a mandatory Franchising Code of Conduct by the government in 1998 under the Trade Practices Act (Franchising Code of Conduct 1998). The purpose of the Code was to regulate the conduct of participants in the franchising sector towards fellow participants.

One year after the Code's implementation the present research was conducted to obtain qualitative information on the impact of the Code on the franchisor-franchisee relationship. Data were collected via in-depth face-to-face interviews, conducted with six franchisors and their franchisees, together with three franchising consultants. The six franchises used in this study were three large and three small franchises (in terms of number of outlets) from the retail non-food, fast-food and service industries in south-east Queensland, to obtain a balance of participants and viewpoints. The three franchising consultants who contributed to this research were a franchising lawyer, accountant and consultant, and they were included to provide independent views.

In-depth interviews were deemed suitable as the data collection method for exploratory research (Minichiello, Aroni, Timewell and Alexander 1995). The primary value of in-depth interviews is the flexibility offered enabling the researcher to interact with the respondent and to gain access to their accounts and articulations (Mason 1996). As this research was exploratory in nature, personal interviews allowed the researcher to become more familiar with the topic before conducting more conclusive research (Malhotra 1996).

The research is presented in this paper as follows. Firstly, the factors considered important in different stages of the franchising relationship are discussed. Next, observations are made regarding the Code's influence on franchising relationships. Conclusions and recommendations for future policy are made in the final section.

THE FRANCHISOR-FRANCHISEE RELATIONSHIP

Many relational factors have been suggested in the literature to be important in business relationships. Five factors were selected as being more relevant to franchising relationships: trust, commitment, mutual goals, balance of power and communication (Justis and Judd 1998; Barry 1995; Wilson 1995; Morgan and Hunt 1994; Dwyer, Schurr and Oh 1987).

However, it has also been suggested that different factors could have different levels of importance as franchisors and franchisees progress into the various stages of the franchising relationship. The stages experienced in the franchising relationship suggested by Nathan (1996) were simplified into start-up, conflict and termination/renewal phases.

Start-up phase

The initial phase of the franchising relationship occurs when a new franchisee enters into an agreement with the franchisor. *Trust* was cited by five out of six franchisees as being a critical attribute of franchisors during this early stage of the relationship. This is because franchisees feel they can only build a relationship with someone of upright character and who is sincere. It is difficult to trust people who are not perceived as being honest. These findings support previous research such as Anderson and Weitz (1990), Morgan and Hunt (1994) and Wilson (1995) who find that trust is a fundamental factor in any relationship.

Franchisors, on the other hand, prefer to look for qualities such as *commitment* and ability to *communicate* as the two most important factors during the start-up phase of the franchising relationship. Similarly, Hardwick and Ford (1986) found that commitment is vital in franchising relationships as it provides assurance that the relationship will provide future values and benefits to the parties. As such, it is crucial that all members of the franchisor's senior management demonstrate their commitment to franchising (International Franchising Association 1992). Communication is also vital in establishing mutual understanding between franchisors and franchisees (Williamson 1995). Another important factor mentioned by both parties was the loyalty franchisees need to have for the franchise system. 'It is upsetting and damaging to the franchise system if the franchisee is not loyal to the franchise, or does things that are negative to the franchise' (case 3).

Franchising consultants felt that mutual trust and commitment by both parties were essential ingredients to make the relationship work. They compared the franchising relationship to a 'marriage' and said that these were the two most important factors to make the marriage work.

Conflict phase

Following the start-up phase, the franchisor and franchisees may experience some disharmony as their relationship matures (Nathan 1996; McCosker and Frazer 1999). It was expected that franchisees would tend to refer to the provisions of the Code during this phase of the relationship where disputes and disagreements may occur. Therefore it was proposed that the Code would be the most beneficial to them during the conflict phase.

All interviewees concurred that during this phase, the critical factors in the relationship were *communication*, *trust* and *power balance*. The power of either party in a relationship is closely tied to the interdependence of the partners in the relationship (Anderson and Narus 1984; 1990). In franchising, the relationship is interdependent (Mendelsohn 1999). When conflict arises, it was felt that franchisors should sit down with their franchisees and attempt to understand the cause of the problem. A franchisee noted: 'when a problem arises, I expect my franchisor to be there to support me through the situation and not just back away and avoid the situation. That is the reason why I am in a franchise – so that I am not alone' (case 6).

Several franchisees commented that when conflicts arise, they should be able to trust that their franchisors are there to 'do the right thing by them' (case 3). Another franchisee felt that 'there must be sincerity on the part of all parties involved' (case 1) in order to arrive at a win-win situation.

Franchisees and franchising consultants felt that it is in the conflict phase that franchisees may be disadvantaged as franchisors tend to have the upper hand. This imbalance is inevitable in most franchising relationships as the franchisor has a greater control over the activities that take place in the franchise (Terry 1991). Therefore it is important that both parties retain a balance of power and be treated as equals during the course of negotiations.

In fact, it was felt that when franchisors are willing to discuss issues and understand franchisees' situations, being prepared to say that they were wrong on an issue instead of trying to protect their image would actually foster credibility and trust (cases 2, 5 and 9).

Renewal/termination phase

The third phase of the franchising relationship occurs when the franchise agreement is due for renewal or is terminated if either party decides not to continue the association. Franchisors and franchisees were generally unable to comment on this later phase as 'Australia is a young franchising sector and the majority of franchisees have not come to that stage yet' (case 4). A franchising consultant supported this point when he said that: 'most people have only come into franchising during the last few years, and most of the agreements are for 5 or 10 years, some even as long as 20 years. most people have not yet come to the renewal stage, so it is possibly too early for people to know what generally happens on renewal' (case 9).

However, when asked what factors are important to see franchisors and franchisees out of the conflict stage and into the interdependent phase of the Nathan (1996) model, most interviewees cited factors such as *commitment* and *mutual goals*. One franchising consultant commented: 'to get out of the conflict stage, it is crucial that the franchisee is loyal to the franchise, while the franchisor has the ability to instill trust in the franchisee. Both parties must be able to communicate effectively and be willing to commit their resources for long-term benefits' (case 9). By working together, franchisors and franchisees ensure the success of each other (Williamson 1995).

Influence of the Code on the franchisor-franchisee relationship

The Code prescribes certain standards in the conduct of franchising relationships. A major requirement is that franchisors provide a standard form of disclosure document to prospective franchisees fourteen days prior to signing a franchise agreement. The disclosure document must be updated annually, and must be available to existing franchisees upon request. The Code also lays out certain conditions for the franchise agreement. For instance, franchisees are provided with a seven day cooling off period following execution of the franchise agreement. Finally, the Code also provides procedures for dispute resolution. Any substantial disputes between franchisors and the franchisees have to seek resolution in the form of mediation and conciliation respectively, before seeking litigation procedures.

This research revealed that the Code was most effective at the start-up and conflict phases of the franchising relationship. At the beginning of the franchisor-franchisee relationship, the Code helps to bring about honesty and trust through its requirement of disclosure documents. It forces franchisors to provide a clear picture of their franchises, in terms of history, experience and financial capability. This factual information assists franchisees to make an informed decision prior to entering into the franchise agreement. In addition, the Code's requirement for a seven day cooling-off period helps to recruit and retain more committed franchisees. The Code's recommendation for potential franchisees to have the franchise documents explained to them by a lawyer or an accountant contributes to the recruitment of more committed franchisees.

The Code enhances the franchisor-franchisee relationship in the conflict phase of the relationship via its conflict resolution procedures. Franchisors and franchisees who find themselves in dispute need to communicate their problems with each other, either directly or through a mediator. This process facilitates and enhances communication channels because communication often breaks down in the event of conflict. In addition, communication between franchisors and franchisees in times of conflict helps reduce the possibility of misunderstanding. It allows both parties to understand the underlying reasons behind the actions and conflict and provides opportunities to remedy the situation. This may result in a higher level of trust between the parties.

Where franchisees were formerly viewed as the weaker party in the event of franchising disputes, the Code now redresses the balance of power through the requirement that the complainant must tell the respondent in writing the nature of the dispute and the outcome which the complainant wants, as well as the action the complainant thinks will settle the dispute (Franchising Code of Conduct 1998). This gives franchisees the opportunity to remedy the situation should they be in the wrong, rather than have the franchisor terminate their contracts based on a minor transgression. In providing for mediation, the Code also assists franchisors and franchisees in disputes to develop mutual goals to help them move towards the interdependence phase.

The Code is seen as the least helpful in the termination/renewal phase due to the early level of maturity of the Australian franchising sector (Frazer and McCosker 1999), and many of the franchises have not yet reached that phase. Still, the expected benefit would be that the Code helps the franchisee who is selling his business to know the correct value of his franchise, and protects the potential buyer from paying too high a price for it. This is

because the Code requires franchisees who are selling their franchises to provide disclosure documents to potential buyers.

However, many interviewees felt that the Code does assist franchisors and franchisees in the process of getting from the conflict phase towards a more interdependent relationship. They commented that upon settling their differences in the conflict phase, it is important that franchisors and franchisees strive to set mutual goals and put commitment into reaching them.

Conclusions and recommendations

In conclusion, although there are limitations about the Code being ambiguous, costly and time-consuming, it was found that the Code is successful in providing guidelines in the franchisor-franchisee relationship. Franchisors and franchisees tend to look for different qualities in the franchising relationship. During the start-up or beginning of the relationship, franchisees want franchisors who are honest and trustworthy while franchisors look for franchisees with commitment and ability to communicate effectively. Franchising consultants, on the other hand, feel that mutual trust and commitment are essential to start the relationship off on the right note.

During the conflict stage, all interviewees cited communication as the vital factor. Franchisees want franchisors to be there to support them, to understand their situation and to be sincere. Franchising consultants viewed the franchisees in a less powerful position in this instance, and they urged franchisors to handle the situation fairly and equally.

Although most interviewees were unable to comment on the qualities needed during the renewal/termination stage of the relationship, many interviewees felt that franchisors and franchisees need to develop mutual goals and commitment for the association to continue.

It is recommended that the government reword some aspects of the Code to clarify grey areas and to make it more user friendly. In addition, there needs to be greater flexibility because certain requirements of the Code may not apply to all industries or types and sizes of business. Therefore, these franchises should be allowed to be exempted from complying with certain aspects as long as they can provide evidence that the clauses are not applicable to them.

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