Submission to Review of Franchising Code of Conduct

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Greg Nathan is a registered psychologist and Founder of the Franchise Relationships Institute (FRI). He has been researching the nature of the franchise relationships for 23 years. This research has involved over 300 franchise networks around the world, including small emerging franchise systems to large established corporations with thousands of franchisees. The franchisees studied have also encompassed the full "mad, sad, glad" spectrum. In some companies franchisee satisfaction and performance have been high, whereas in others, there have been vast numbers of franchisees who have been angry, confused or demoralized[1]. Our research into the nature of healthy and unhealthy franchise relationships is thus drawn from a balanced and valid cross section of the franchising sector and draws on a combination of the following methods:

Quantitative methods use rating scales to measure the attitudes, attributes and performance of franchisees and their perceptions of the relevance of various franchisor support strategies to their satisfaction and success.[2] Quantitative data is useful for analysing differences between groups, identifying underlying trends within the data and measuring changes in attitudes over time. Most of this quantitative data is collected using a psycho-metric instruments.[3].

Qualitative methods use open-ended questions to draw out the opinions and experience of franchisors and franchisees.[4] Qualitative techniques are useful for identifying themes or underlying issues which may be overlooked if people are not given the opportunity to express themselves openly.

Ethnographic methods, also known as participant observation, involve members of the FRI team spending time with franchisors and franchisees, observing their behaviour as they interact together, and talking with them in a casual manner. This enables the team to observe actual behaviour, as opposed to measuring people's claims of what they say they do which are often unconsciously distorted or biased [5].

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[1] In addition to our own research we have strategic alliances with a number of academics and businesses around the world working in this area, enabling us to tap into a broader pool of data.

[2] Success in this context relates to their profitability, their ability to build a customer base and their willingness to participate constructively in the franchise program.

[3] These psychometrically validated tools consist of statements that measure how franchisees feel about specific issues known to impact on the health of the franchise relationship. Franchisees indicate whether they Strongly Agree, Agree, Disagree or Strongly Disagree with each statement and these results are weighted and reported on an Index of Positive/Negative Affect.

[4] This data is collected through written responses to internet based surveys or verbal responses to interviews.

[5] Participant observation is enlightening because much of the available literature on franchise relationship practices comes from industry articles and conference speeches delivered by franchisor representatives who understandably tend to present an overly favourable impression of how their companies operate.

Expenditure and other payments

Unforseen Capital Expenditure

In our work with franchise systems a consistent source of strain in the relationship is the introduction of new initiatives which involve significant capital expenditure by franchisees.

Unfortunately these initiatives are often poorly planned and executed by the franchisor. We believe this lack of thought is partly because it is not the franchisor's money that is being invested. This can lead to bad decisions regarding the management of suppliers and a lack of accountability. Franchisees who then complain are seen as "just being negative" which further puts a wedge in the franchise relationship.

If there was a way of encouraging franchisors to give evidence that they have conducted proper due diligence in their planning and risk management practices, this may help to alleviate a significant source of frustration for all stakeholders.

We do not have any specific solution for preventing this other than raising the standard of education for franchisors on how to effectively implement new initiatives and change. This is a well researched area of organisational psychology and there are proven practices that reduce the risk of poor decisions. Appendix A contains a list of common mistakes we have observed in this area.

Good Faith in Franchising

We believe that some sections of the Canadian franchising sector have recently introduced the concept of good faith into their franchising codes. This would provide a good case study for an evidence based review of the implications of this practice. There is anecdotal evidence of an increase in legal cases being brought against franchisors by opportunistic law firms who now can now use this formal obligation as an excuse to launch a class action.

Class actions are distracting to the commercial operations of a franchise system and, it could be argued that they are not in the interests of either franchisees or franchisors, unless there a clear and extreme case of wrong doing.

Care should be taken to not inadvertently encourage dysfunctional behaviours into the franchising sector through well intentioned modifications designed to protect people's interests.

End of Term Arrangements

One area that deserves further consideration is not just whether franchisees are entitled to renewal their terms, but the basis of these terms. There are inconsistent practices between franchise systems regarding the fees associated with the renewal of franchise agreements. While some franchise systems renew a franchise agreement for a nominal administration fee, others charge a new upfront franchise fee similar to that being charged to new franchisees. While this provides a significant revenue stream for larger franchisors, it is often also a major imposition on the franchisee who, at the time, will also be faced with other costs. For instance they may need to make a capital reinvestment in the business.

Consideration could be given to providing greater protection for unfair or unreasonable renewal fees because the franchisee is now in a vulnerable position in terms of their emotional and commercial investment in the business, more so than when they started. They may have established a considerable client base and reputation in their local market which they would lose if they didn't renew under the franchisors conditions.

While there is a strong argument for allowing the "free market" to determine what is fair and reasonable in a renewal fee, the unique nature of the franchise relationship fundamentally alters a franchisee's freedom of choice. It could be argued that the franchisor's ongoing revenue stream over the course of the franchise agreement provides them with their remuneration for use of their intellectual property and that charging a large lump sum renewal fee is price in opportunistic.

Dispute Resolution

The interdependent nature of the franchise relationship makes a certain level of disputation inevitable. For instance we have been researching the levels and causes of disputes since 1996 and have consistently found that an average of 16% to 18% of franchisees in our studies claim to be in a significant dispute with their franchisor that is fundamental to their future in the franchise. It should be noted the severity of the disputation will vary from mild to extreme. In our latest study[6] involving 1,800 Australian franchisees, 16% claimed to be in conflict with their franchisor. However only 3% strongly felt they were in conflict, with the others only mildly agreeing.

We believe the current mediation requirements under the Code have been effective in assisting franchisees and franchisors to attend to these inevitable disputes and do not see any need to make any changes to this element of the Code.

Ongoing education for franchisors and franchisees on how to create a healthy franchising culture and how to work constructively together is recommended. This has formed a major part of our work over 23 years and we have regularly been able to prevent and contain disputes from getting out of hand by using group educational and facilitation processes.

In relation to the inevitability of disputation, a model called the Franchise E-Factor[7] first developed in 1992, explains the psychology of how these disputes are inevitable. Research conducted by FRI [8] has validated the Franchise E-Factor prediction that satisfaction inevitably drops from the moment the franchisee signs the franchise agreement and continues to decline where, on average, it reaches its lowest level at 3 to 5 years. Appendix B contains details on the model and the findings from this research. Franchisee satisfaction is defined as the extent to which a franchisee's expectations are being met. Naturally as franchisee satisfaction drops the likelihood of disputation increases.

[6] Franchise Relationships Institute, Franchise Excellence Research Report, 2012 available at www.franchiserelationships.com

[7] Nathan, Gregory. 2007, The Franchise E-Factor, Franchise Relationships Institute, Brisbane, Australia

[8] Nathan, Greg. Validating the Franchise E-Factor Model of Franchisee Satisfaction. Paper presented at International Congress of Applied Psychology Brisbane 2010. See also Franchise Excellence Research Report quoted above.

Final Comments

While franchisor organisations are subject to ongoing criticism in the media for unfair treatment of their franchisees, we have generally found the conduct of most franchisor organisations and their senior executives to be fair and reasonable. In our most recent study which includes 50 well established franchise systems with an average size of 95 franchisees, 83% of franchisees agreed they were treated with respect by their franchisor, 79% felt they were treated fairly and 75% believed the franchisor team was trustworthy in their business dealings. These ratings form part of a psychometric scale known as franchisor integrity. Not surprisingly there is a high correlation between low ratings of franchisor integrity and franchisees being in conflict with their franchisor.

As mentioned earlier some conflict is inevitable in a franchise system. When trying to identify the predictors of conflict it is not always easy to discriminate specific factors because some, for example the quality of leadership, have such a broad impact on a range of areas. Similarly separating symptoms and causes can also be a challenge. Does optimism about the future direction of the group cause a franchisee to be more satisfied? Or do satisfied franchisees tend to feel more optimistic about the future?

We have used a combination of three research methods - quantitative, qualitative and ethnographic – to identity what we believe are eight specific areas that have a significant impact on the health of the franchise relationship. These are:

1. Franchisee stress
2. The management of change
3. Communication
4. Leadership and culture
5. Franchisee profitability
6. Franchisee recruitment practices
7. Management of expectations
8. Management of The Franchise E-Factor

All eight areas are all discussed in detail with supporting data in a paper I prepared for the American Bar Association[9]. This may be worth reviewing by the panel.

In summary, we would argue that education of franchisors and franchisees, and mediation are the most effective processes for minimising and managing the inevitable conflicts in franchise systems.

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[9] Nathan, Greg, Engineering Healthy Franchise Relationships, American Bar Association Forum on Franchising, 2009, Westin Harbour Castle Toronto, Ontario

Appendix A - 14 mistakes by franchisors when introducing change[10]

1. Not being able to justify the change and explain the benefits to franchisees in terms they understand. These benefits should include savings in time and money, improvements in profits and customer service, and a stronger competitive position in their local market.
2. Not being sensitive to how a change could undermine the organization's culture or the franchisees' sense of identity. Changes that touch a cultural nerve will often be described by franchisees in terms of the company losing its heart or soul.
3. Failing to test or pilot initiatives to ensure they work before releasing them into the network. Impatience and sloppy thinking are common reasons why initiatives are not adequately tested.
4. Mistaking silence for agreement, i.e. thinking that because franchisees do not question the change that they agree with it. They may just initially be too stunned to say anything!
5. Failing to communicate clearly and simply. Franchisees do not like wading through long winded documents that fail to address their concerns. Face to face is always the best way to communicate change. Any written materials should be relevant and to the point.
6. Not consulting with the people who have to implement the change. Take the time to ask them what they need in order to make it work and you are likely to be rewarded handsomely.
7. Not considering other stakeholder groups who could either help to make the change work or block it. These groups might include suppliers, competitors or the families of franchisees.
8. Running open forums on hot issues without a structured facilitation process to guide how people communicate. While it's important to have open discussion, this can turn negative if not competently facilitated.
9. Assuming you can talk a franchisee out of their feelings. People will not listen to your logic until they feel they have been heard.
10. Treating the change process as a sales exercise instead of a two way communication process. Franchisees will respond better to facts and information than razzle-dazzle and clichés.
11. Trying to gloss over or cover up mistakes in the implementation. Franchisees will inevitably find out and when they do, the long term damage to trust will be far worse than any short term damage in credibility from an honest mistake. Best to be transparent and stay focused on the bigger picture.
12. Treating legitimate franchisee concerns and questions as negativity. A franchisee who asks a question is giving you an opportunity to explain the benefits of the change. And if you can't answer the question then you have learned something that you will need to work on.
13. Forgetting that all new initiatives need to operate within an existing system. Franchisors often fail to consider the ripple effect of decisions on other people or parts of the organization.
14. Giving up when faced with resistance. If franchisees resists an initiative this does not mean it is wrong or flawed. It may just mean that you need to do more work in your communications or that people are still getting used to the idea.

[10] These mistakes are based on 23 years experience working with hundreds of franchise system

Appendix B Franchisee Satisfaction by Tenure – Validating The Franchise E-Factor[11]

The Franchise E-Factor[12] model of franchisee satisfaction predicts a franchisee's satisfaction will move through several stages, starting at a high level but quickly dropping as the franchisee moves from an eager and perhaps naive learner, to a competent sceptic. The model predicts satisfaction will then increase again as the franchisee becomes a tolerant business partner or collaborator with the franchisor.

As part of the study we investigated whether the data collected from this large sample of franchisees support *The Franchise E-Factor* model. Before sharing the findings, a summary of the model is in order.

According to *The Franchise E-Factor*, the franchisee starts in a state of "Glee" but becomes increasingly disillusioned with their franchisor as they gain more confidence in their ability to run the business. After "Glee" the relationship moves to the "Fee" stage where the franchisee questions the value they are getting for the ongoing franchise fees. Satisfaction continues to decline as they reach the self-centred "Me" stage where they attribute any positive results to themselves, but negative results to the franchisor. The model predicts satisfaction will continue to fall and bottom at what is known as the "Free" stage. This is where the franchisee is most likely to try and shake free of the restrictions they feel from the franchisor or the franchise system. The relationship is also most likely be characterised by overt conflict at this stage.

If a franchisor sets up a conversation of genuine two-way listening and respect, there will be a breakthrough in the relationship. This is called the "See stage". Finally, if the franchisor demonstrates maturity, empathy and assertiveness to properly address the franchisee's legitimate needs, while not giving into unrealistic demands, satisfaction returns to a realistic level of equilibrium, somewhere in-between the "Glee" and "Free" stages.

Putting The Franchise E-Factor to the test

We decided to put *The Franchise E-Factor* to the test by tracking how satisfaction changes with tenure in the current sample. In theory franchisees in the early stages of the relationship should be more satisfied, but satisfaction levels should consistently be lower as tenure increases. If the model is correct, at some point satisfaction should bottom out and then again increase for franchisees that have presumably moved from the "Free" stage to the "See" and "We" stages.

To test this we first created an overall franchisee satisfaction scale, combining all 26 items[13] from the 10 franchisee satisfaction scales. We then mapped this franchisee satisfaction score against tenure using a statistical technique called a locally weighted polynomial regression. This enables us to create a "best fit" curve for how satisfaction changes according to tenure. Figure 15 shows the curve that emerged from this analysis of franchisee satisfaction over time.

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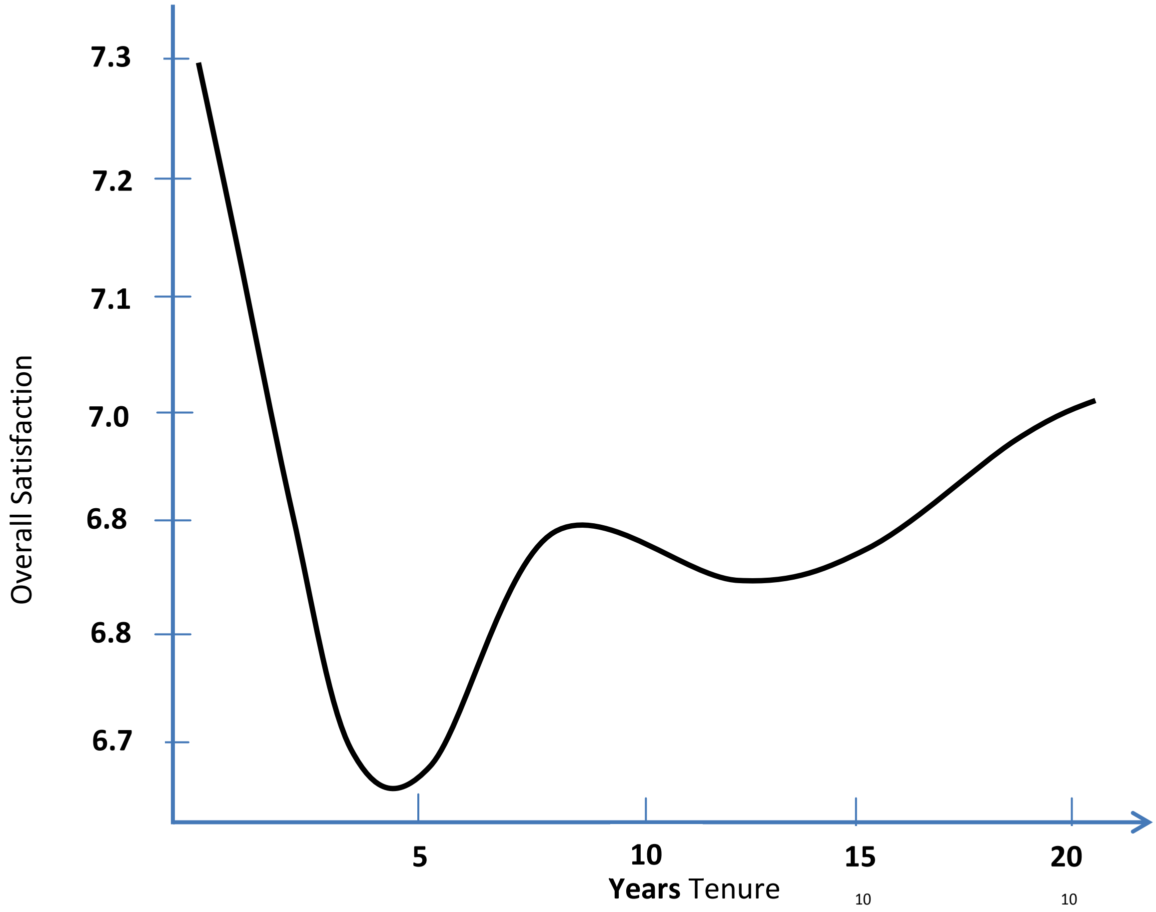
[11] Excerpt from *Franchisee Excellence Research Report*, Franchise Relationships Institute, 2012

[12] For more details about the model, see *The Franchise E-Factor* by Greg Nathan, available from www.franchiserelationships.com .

[13] The internal reliability for this overall satisfaction scale was $\alpha = 0.96$.

Figure 15: Franchisee satisfaction mapped against tenure



Note how satisfaction steadily drops as tenure increases, until it bottoms out at just before five years. Satisfaction then increases, drops back a little around the 10 year mark, and then starts to gently rise again to around half of where it began. It is probable that the shift in satisfaction that occurs at the four to five year mark is linked to the first franchise agreement renewal, which forces the franchisee and franchisor to come together to renegotiate their relationship. The gradual increase that occurs around 12 years is probably a sign that both parties have found a certain level of acceptance in how they are going to work together.

These findings appear to validate the basic *Franchise E-Factor* model, suggesting the challenging "Free" stage will on average take place between three and five years. In a previous study of the model with a larger sample of 4,686 franchisees, the lowest point in the curve was three years[14].

[14] Nathan, G. Validating *The Franchise E-Factor Model* of Franchisee Satisfaction. Paper presented at International Congress of Applied Psychology, Brisbane, 2010.