

SMALL BUSINESS BRIEF

**FACTORS AFFECTING FRANCHISE AGREEMENT TERMINATIONS:
LESSONS FOR THE FRANCHISING SECTOR**

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ABSTRACT

The practice of termination of franchise agreements raises significant strategic and legal issues. This paper aims to provide descriptive information about franchise terminations in relation to which the appropriateness of regulatory responses can be measured. Data were collected from surveys of Australian franchisers in 1998 and 1999 to explore the nature, reasons and outcomes of franchise agreement terminations. A model predicting the likelihood of terminations was developed, based on franchise system maturity, support structures provided, and level of conflict experienced. The results indicate that mature franchises were more likely than younger systems to experience franchise terminations. No consistent link was found between the amount of system support or the level of conflict and the incidence of franchise terminations. The data lends support to judicial responses to termination issues which accommodate the relational aspect of franchise relationships and addresses termination issues in the context of the underlying relationship and the legitimate business expectations of the parties.

INTRODUCTION

On the Richter scale of significant events in the franchise relationship, termination is in the most extreme band. The termination by the franchiser of the franchise granted to the franchisee is the ultimate sanction which is starkly expressed in the literal, but emotive, term "disenfranchised". The need to protect the franchisee's sunk investment from opportunistic termination by the franchiser has been a constant theme in the regulatory debate but the absence of quantitative data has not assisted the quality of the debate. This paper is based on a study which aims to provide descriptive information about franchise terminations in relation to which the appropriateness of regulatory responses can be measured.

THE COMMERCIAL AND LEGAL ENVIRONMENT

Termination is the ultimate contractual sanction. Under well established common law principles an agreement may be terminated prior to the expiration of its term if the other party commits a material breach or on reasonable notice if there is no specified term. The parties by agreement can modify the default principles by providing restrictions on the right to terminate or permitting termination without cause or for any breach. Traditional freedom of contract principles also allows the parties to expressly provide for the consequences of termination by specifying particular conditions or events which arise on termination. In the case of franchise agreements, termination and its consequences are invariably provided for.

In relation to termination provisions Hadfield (1990), in an analysis of the frequency of contract clauses, notes that "franchisees generally must agree that any violation of a term of the contract, including, in many cases, the details of the operations manual, constitutes material breach and is a basis for termination" (p. 944).

The wide contractual powers invariably reserved to a franchiser under the express terms of the franchise agreement are readily justified. The justification for the franchiser's wide termination powers was clearly expressed by the Supreme Court of British Columbia in *Co-ordinated Corporate Services Ltd v National Video Inc* (1984):

Obviously it is vital to the integrity and success of the entire franchise system that the standards are uniform and that they are enforced. Uniformity must be central to the identity of the system. And maintenance of identity and uniformity must be essential to continued operation of the system for the profit of all.

Hammond summarized the justification for the contractual provisions governing the consequences of termination in *Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999). Dymocks is an Australian-based franchise that has expanded internationally to New Zealand and Southeast Asia. "To put it shortly, if a franchiser could not protect its interests after termination, the franchising industry generally would collapse" (p. 659). This comment was made in the context of restraint of trade provisions but is of general relevance to other events and conditions arising on termination.

The wide contractual powers reserved to the franchiser can nevertheless be abused in an unregulated environment. Traditional common law principles leave the franchisee exposed and vulnerable. In *Dymocks Franchise Systems* (1999), Hammond explained that: "The application of the traditional law relating to private contracts to franchises can lead to very unhappy results. Franchisers can impose onerous terms, and, in the worst kind of cases, use flimsy pretexts to terminate, thereby depriving a franchisee of a justified expectation. (p. 629).

In light of these "very unhappy results" one of the key issues, which has driven the regulatory debate throughout the international franchising community, has been termination and its consequences. In introducing the federal *Small Business Franchise Act* in the US House of Representatives in October 1998, Representative Howard Coble commented that "I don't know of a single member of Congress who would stand by while their hard-working small business owners are left buck naked and defenseless against bad faith tactics which have been used by a host of corporations" (Wulff, 1999, p. 33). Similar sentiments, albeit in the more refined language of the antipodes, have been expressed in Australia in a succession of reports.

The regulatory debate in Australia is almost as old as business format franchising. The paint was barely dry on the first golden arches in Australia in the early 1970s when the Swanson Committee proposed a right to compensation for "losses, not now recoverable at law, arising from the termination of the franchise by the franchiser" (Trade Practices Review Committee, 1996). A long history of petroleum dealer dissatisfaction, in particular the opportunistic termination of successful franchisees pursuant to contractual unilateral termination provisions and their conversion to company managed outlets, led to the introduction in 1980 of the Australian *Petroleum Retail Marketing Act of 1980* (Cth.).

In enacting this legislation which guaranteed minimum tenure and regulated termination within this period the government ignored the recommendation of the Trade Practices Consultative Committee that franchising law of general application dealing with the protection of franchisees in relation to prior disclosure, assignment and termination be enacted (Small Business and the Trade Practices Act, 1979). Since then the issue of termination has been a constant concern in a succession of government reports that have led eventually to the introduction of the mandatory Franchising Code of Conduct prescribed by the Federal Government in 1998. This was to ensure, in the words of Peter Reith, the Federal Minister for Small Business, that "small businesses operating in this important industry are finally given a fair go" (in foreword to Australian Franchising Code of Conduct, 1998).

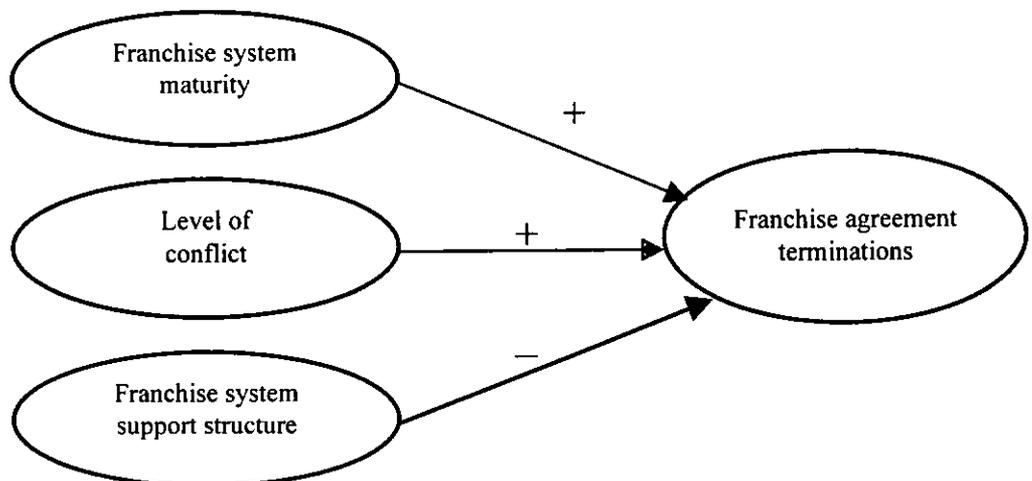
The Code was introduced to address problems associated with the perceived imbalance of power in the franchising relationship, as portrayed by anecdotal evidence and media reports. However, little empirical evidence supporting this assertion is available. In the next section of this paper, survey data about franchise agreement terminations in Australia from 1995 to 1998 are reported. Over this three-year period only the Common Law governed franchising as no dedicated regulatory regime was in place.

FRANCHISE TERMINATIONS IN AUSTRALIA: EMPIRICAL EVIDENCE

Hypotheses development

In this section, hypotheses predicting franchise systems most prone to agreement terminations are developed and the constructs used in the analysis are explained. A model predicting franchise agreement terminations is displayed in Figure 1.

FIGURE 1: Proposed Model of Franchise Agreement Termination



Franchise system maturity. The termination of agreements is not a desirable outcome in a franchise system. Anecdotal evidence suggests that franchisers desire short-term franchise agreements that may be renewed provided the franchisee operates the outlet successfully. Hence, the expiry of the agreement may provide an opportunity for the franchiser and franchisee to depart each other's company if the association has not been mutually beneficial. On the other hand, an agreement termination occurs mid-term and signifies problems that can only be rectified by ending the relationship.

In the early days of a franchise system's development the franchiser is often personally involved in the day-to-day running of the organization. As the system matures, that is, becomes larger, older and more dispersed, it becomes increasingly more complex to manage, often experiencing rapid growth and involving additional layers of management (Dant, 1995). Larger systems may experience greater challenges in maintaining adequate communication which may ultimately be reflected in deterioration in the relationship between franchiser and franchisee (Nathan, 1996). Over time franchisees develop an increasing sense of independence (Peterson & Dant, 1990) and may deviate from system procedures to demonstrate this independence. Hence, despite the experience that a mature franchise system acquires in recruiting, selecting, training and supporting suitable franchisees and despite the ongoing success of the franchise, the greater complexity of the system may hinder relationships. It is hypothesized that:

H1: Mature franchise systems are more likely to experience franchise agreement terminations than immature systems.

Level of conflict. Positive franchising relationships are not likely to result in agreement terminations. Terminations occur because problems such as poor performance, low profitability or breaches of operating standards ultimately cannot be resolved. Parties to the franchising relationship may need to turn to mediation or litigation to resolve such issues, with the franchise experiencing a negative impact due to the conflict (McGlinchey & Thompson, 1991). However, it is inevitable that some disputes will never be reconciled, resulting in the termination of agreements. Hence, it may be expected that franchise systems that experience high levels of conflict between the parties will also experience agreement terminations. It is hypothesized that:

H2: Franchise systems that have greater levels of conflict are more likely to experience franchise agreement terminations.

Franchise system support structure. Franchisees typically rely on the established brand name, training and support of the franchiser as a mean of gaining entry to business (Knight, 1984). Many franchisers will accept franchisees that have no previous experience in the industry (Mendelson, 1999) and some even actively recruit inexperienced franchisees because they feel they will be easier to indoctrinate into the system.

Of the franchisers who participated in the mail survey used in this research, fully 52 percent indicated that industry experience of potential franchisees was not essential to gain entry to their systems (McCosker & Frazer, 1998). Hence, franchisers must supply the necessary training and provide a supportive structure for franchisees to succeed. In addition, the franchiser's brand name is often well established and must be maintained. One means of protecting a franchiser's reputation is by providing a system of initial and ongoing support to its network of franchisees (Sherman, 1993). The greater the assistance provided to franchisees the higher the likelihood they, and the whole system, will be successful (Terry, 1993). A successful system, based on a thorough support structure, is less likely to experience

problems in the relationship that may lead to franchise agreement terminations. Hence, it is hypothesized that:

H3: Franchises that offer comprehensive support structures are less likely to experience franchise agreement terminations.

Constructs used in the analysis. The constructs used to test the hypotheses, variable names and descriptions, and descriptive statistics are reported in Table 1. Below is a discussion of the indicators used to measure each construct.

TABLE 1: Constructs, Variables and Descriptive Statistics

Construct	Variable description	Variable name	Min.	Max.	Mean (or proportion)
Franchise agreement terminations	Experienced agreement termination/s 1995-1998 (Dummy variable)	TERM			48.0%
Franchise system maturity	No. of years franchising	AGE	2	32	9.59
	Total No. of outlets 1998	SIZE	4	499	76.36
	No. of states	DISPERSE	1	7	3.57
Level of conflict	No. of substantial disputes (mediation, litigation or other action, such as arbitration) 1995-1998	DISPUTES	0	12	2.15
Franchise system support structure	No. hours start-up support	STARTUP	3	500	76.42
	No. working days initial training	INTRAIN	0.5	90	13.69
	No. pages in operations manual/s	OPSMAN	12	3000	245.97
	No. working days ongoing training per annum	ONTRAIN	1	98	10.02
	No. hours field visits per franchisee per month	FIELD	1	40	7.5
	Proportion head office staff to franchised outlets	PROPPO	0	5	0.45

(N = 68)

Franchise agreement terminations. A dummy variable was used to code firms that did or did not experience franchise agreement terminations in the three-year period from 1995 to 1998.

Franchise system maturity. The level of maturity of franchise systems was measured according to age, size and dispersion. Age was indicated by the number of years franchising experience. Size was indicated by the total number of outlets (franchised and company owned) in the system. The number of states in which franchise operations were concentrated indicated the level of dispersion.

Level of conflict. The level of conflict experienced by a franchise system was measured by the number of substantial disputes (that is, disputes resulting in mediation, litigation or other action) over the three-year period from 1995 to 1998.

Franchise system support structure. The support structure offered by a franchise was measured according to the degree of initial support and ongoing support provided. Initial support was indicated by the number of hours of start-up support offered to new franchisees, the number of working days of initial training, and the number of pages in the operations

manual/s. Ongoing support was indicated by the number of working days of ongoing training provided per annum, the number of hours in field visits per franchisee per month, and the proportion of head office staff to franchised outlets.

Data collection

Two stages of data collection were involved in the research. Firstly, a confidential mail survey of the known population of Australian franchisers was conducted in 1998 (McCosker & Frazer, 1998). As no official listing of franchisers was available, a university database was updated (McCosker, 1989) resulting in a sample of 946 firms thought to be operating as franchisers. It is possible that some less visible firms were omitted from the database but most firms would have been included due to the thorough history of the database's development.

The mail survey was followed up with a letter and telephone call where the status of each firm was ascertained. After excluding those not involved in franchising the effective sample size was 693 franchisers. A total of 186 useable responses were received, representing a response rate of 26.8 percent which is within the acceptable range for business research (Neuman, 1994). In addition, a trend analysis was performed by comparing late with early responses to ascertain the presence of nonresponse bias (Kervin, 1992) and it was concluded that nonresponse bias was not evident.

The mail survey obtained data on a wide range of topics including franchise operations, financial arrangements, franchisee profile and demographic information. A specific question tracked the number of franchise agreements that had been terminated over the previous three years either at the franchiser's initiation, the franchisee's initiation, or mutually.

The second stage of the research was conducted in 1999 and involved telephone interviews with the franchisers from the mail survey who had terminated franchise agreements. Due to the sensitive nature of the research topic telephone interviews were used because of their personal approach and low cost. A total of 88 firms out of the 186 mail survey respondents had experienced agreement terminations. As this study occurred prior to the introduction of franchising regulation, the proportion of agreement terminations was higher than is currently experienced. It would appear that the Code's introduction has significantly reduced the practice of terminations (Lim & Frazer, 2002). Two of the respondents were anonymous and were unable to be contacted, reducing the sample frame to 86 firms. Pre-notification letters were sent to these firms informing them of the purpose of the telephone survey. Only three franchisers were uncontactable or confirmed no longer franchising and fully 68 responded, resulting in a response rate of 81.9 percent. As the data described below have been obtained directly from franchisers, there is a possibility of bias in the results as franchisee perceptions cannot be compared.

Descriptive statistics. Due to the lack of previous quantitative research on franchise agreement terminations, an aim of this research was to provide descriptive information about the franchises involved. Firstly, responses were coded according to industry type using the major categories provided under the Australian and New Zealand Standard Industrial Classification coding system (Australian Bureau of Statistics, 1993). The largest category of franchisers was the property and business services industry representing 32 percent of respondents, which included services such as domestic and commercial cleaning, accounting services, and recruitment and training. This was followed by retail non-food (27%), construction and trade services (12%) and retail food (12%), with all remaining categories having fewer than 10 percent of respondents. The industry categories of respondents are listed in Table 2.

TABLE 2: Industry Category of Respondents

Industry category	No. of responses	%
Property and business services	22	32.4
Retail non-food	18	26.5
Retail food	8	11.8
Construction and trade services	8	11.8
Accommodation, cafes and restaurants	4	5.9
Education	3	4.4
Cultural and recreation services	2	2.9
Manufacturing and printing	1	1.5
Transport and storage	1	1.5
Personal and other services	1	1.5
Total	68	100.0

Note. The total number of participants numbered 68. ($N = 68$)

The size of franchise systems in the sample was a median of 24 franchised and company owned outlets. Firms had been franchising for a median of 7.5 years and were dispersed among a median of three states in Australia. The 68 respondents reported a total of 315 franchise agreement terminations over the three-year period from 1995 to 1998. Of these, 37 percent were initiated by the franchiser, 29 percent initiated by franchisees and 34 percent initiated mutually. Firms terminated a median of only two franchise agreements during this time, although the number of terminations ranged from 1 to 70.

The main reasons for terminating franchise agreements have been listed in Table 3. The most commonly cited reasons were due to personal reasons affecting the lifestyle or health of the franchisee (32%), problems with the selection of suitable franchisees or location of their outlets (31%), franchisee failure to comply with the franchise system (31%), and financial problems faced by franchisees (28%).

TABLE 3: Reasons for Terminating Franchise Agreements

Reason for termination	No. of responses	%
Personal, lifestyle or health reasons of franchisee	22	32.4
Unsuitable franchisee or unsuitable location of outlet	21	30.9
Noncompliance or breach of operating standards	21	30.9
Franchisee financial problems or debts	19	27.9
Conflict; lack of cooperation; desire for independence	13	19.1
Underperformance or low profitability of franchisee outlet	9	13.2
Customer complaints or poor service of franchisee	6	8.8
Fraudulent, dishonest or unethical behavior by franchisee	5	7.4
Understated income or non-payment of franchise fees	5	7.4
Other reason for termination	9	13.2

Note: Multiple responses were recorded by some respondents ($N = 68$)

The median length of franchise agreements offered by firms in the sample was 5 years with a median of 3.3 years remaining when the agreements were terminated. Most franchisers (81%) warned franchisees they were in breach of their agreements and provided an opportunity for franchisees to redress the situation before terminating the agreements. More than 30 percent of franchisers provided some form of compensation to franchisees after termination of their agreements. A lease was involved with the franchisee's outlet in 51 percent of cases and only 30 percent of franchisers reported they were able to obtain release from their leasing responsibilities.

An area that has been overlooked in the literature is the fate of franchisees that have had their agreements terminated. The current research attempted to fill this gap by gathering data on the final status of terminated outlets and is summarized in Table 4.

TABLE 4: Current Status of Outlets from Franchise Agreement Terminations
(N = 68)

Current status of outlets terminated 1995-1998	No. of outlets	%
Closed	91	28.9
Operated by another franchisee	68	21.6
Company owned and operated	49	15.6
Operated independently by former franchisee	31	9.8
Operated by former franchisee in another franchise	12	3.8
Current status not disclosed to researcher	64	20.3
Total	315	100.0

Due to the sensitive nature of the topic, franchisers were unwilling to disclose the outcome of the terminated outlets in 20 percent of cases. Dilution of the franchise's reputation may occur when outlets are acquired as company owned operations, or are closed or operate independently (Manolis, Dahlstrom, & Nygaard, 1995). Most of the outlets previously franchised were now closed (29%), indicating that they were most likely unsuitable sites or non-viable businesses as they had not continued as going concerns, whether operated by the franchiser or a new franchisee. Nearly 22 percent of terminated outlets were later sold to other franchisees, but it cannot be concluded that the churning of outlets was taking place (Giugni & Terry, 1998). Only a longitudinal study would be able to identify the practice of churning, which involves the same outlet being sold many times.

Franchisers retained 16 percent of the terminated outlets as company operations, but possibly only as a temporary measure until a suitable franchisee operator could be found. Some 10 percent of franchisees whose agreements were terminated are currently operating the outlets independently under an alternative brand name. Almost 4 percent of franchisees joined another franchise system to continue operating their outlets. In brief, the outcome of the majority of outlets was continued operation, most often under new ownership and reflecting the stated cause of franchisee inadequacy in most agreement terminations. However, 14 percent of outlets continue to be operated by ex-franchisees suggesting that these outlets may survive beyond the confines of the franchise system.

RESULTS

Mann-Whitney U tests were used to test the three hypotheses with results shown in Table 5. These tests were appropriate for examining mean differences between groups where data are not normally distributed (Tabachnick & Fidell, 1996) as the data prescreening revealed in this

research. Outliers were identified due to the presence of some older and larger franchises but were retained because they are representative of the population.

TABLE 5: Mann-Whitney U Tests
(N = 68)

Hypothesis	Variable	Mean rank Without terminations; With terminations	Z Score; Two- tailed <i>p</i>	Significant difference: Firms with terminations and without terminations ($\alpha = 0.10$)
H1 – Franchise system maturity	AGE	80.10 97.70	-2.294	√
	SIZE	74.03 98.69	-3.256	√
	DISPERSE	80.11 100.69	-2.710	√ <i>Supported</i>
H2 – Level of conflict	DISPUTES	25.29 29.21	-0.895	X <i>Not supported</i>
H3 – Franchise system support structure	STARTUP	82.99 69.66	-1.871	√
	INTRAIN	87.25 77.63	-1.305	x
	OPSMAN	79.00 86.18	-0.969	x
	ONTRAIN	68.96 69.05	-0.013	x
	FIELD	73.70 74.31	-0.088	x
	PROPHO	88.88 70.54	-2.511	√ <i>Limited support</i>

H1 predicted that mature franchise systems were more likely to experience agreement terminations than immature systems and this hypothesis was supported. Franchisers that terminated agreements have been franchising longer, are larger and more widely dispersed than those that did not terminate agreements. Support for each of the three separate constructs of franchise system maturity implies that disputes are not simply a function of large systems. It appears that as management and communication systems become more complex over time as the firm matures and expands, the franchising relationship may suffer resulting in the breaking away of some franchisees. Despite the experience that mature franchises acquire, the lack of hands-on involvement in operations by franchisers may result in an incompatibility of franchisee-franchisee goals.

It was proposed that franchises characterized by higher levels of conflict would also experience agreement terminations, but H2 was not supported. No significant difference occurred between the number of substantial disputes in firms that terminated agreements and those that did not. Perhaps this indicates that conflict in a franchise system is not necessarily

a negative situation and that mediation or litigation may resolve problems without resorting to terminating agreements.

Finally, H3 predicted that franchises providing comprehensive initial and ongoing support services were less likely to experience agreement terminations. Only limited support was received for this hypothesis which overall must be rejected. Whilst firms that terminated agreements offered significantly less start-up support and had a lower proportion of head office staff to support franchisees, there were no differences in other forms of initial and ongoing support. This result may indicate that constant support is not a determinant of the ability of a franchisee to stay with the system, and instead other factors such as the franchisee's willingness to adhere to the system may be a better guide.

A Relational Approach to Termination

The franchising sector is characterized not only by the wide diversity of its participants but also by relationships that defy conventional contractual analysis. Hadfield (1990) comments that franchising exists in a world of "contractual incompleteness and relational complexity" in which "the parties are not strangers; much of their interaction takes place 'off the contract', mediated not by visible terms enforceable by a court, but by a particular balance of co-operation and coercion, communication and strategy (p.928).

In North America, the work of the law and economics school has been influential in the recognition that certain contracts of a relational character, such as franchising, fall outside the boundaries of the classic "bargain" model (for example, Williamson, 1979; McNeil, 1974; Goetz & Scott, 1981) and require special solutions. However, classical contract law in the Commonwealth jurisdictions has not been "particularly supportive" of the commercial basis of such arrangements. In this context the judgment of Hammond in *Dymocks Franchising Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* (1999) in relation to the lawfulness of the termination of franchise agreements under Australian law, is particularly significant. Hammond J included in a long judgment a discussion of the judicial nature of a franchise. His Honour lends strong support for the proposition that, in relation to agreements of an ongoing and often relatively open-ended character such as franchising "it is in society's interest to accord to each party reasonable security for the protection of his or her justified expectations."

The survey data lends some support to the relational approach. The diversity of motives, reasons and circumstances surrounding terminations suggests that the real and significant issues raised by termination cannot be left to what Hammond referred to as the "very unhappy results" of the traditional, bilateral law of contracts". Although Australia's *Franchising Code of Conduct* was not applicable to the termination considered by Hammond J., (the events in question having occurred before its introduction) His Honour noted that by its introduction the Australian Parliament has shown that it has not been prepared to leave franchisees to the "dubious mercy of the classical, bilateral law of contracts" (Dymocks, 1999).

Although franchising regulation, which is now in existence in numerous countries, makes significant advances in prior disclosure and dispute resolution, the convenient legislative formula for termination is inadequate. For example, the termination provisions which apply on breach by a franchisee in Australia are firmly based on the classical bilateral model albeit modified by requiring the franchiser to provide reasonable notice of termination for breach and allowing the franchisee a reasonable time (of not more than 30 days) to remedy the breach. In not requiring the breach on which termination is based to be "material" the *Code* indeed invites unfavorable comparison with the common law. The franchisee's only protection from the provision commonly included in franchise agreements that violation of a term, including the details of the operations manual, constitutes material breach justifying

termination under normal contractual principles is the mandated opportunity to remedy within a reasonable time. Future empirical research should be conducted to assess the impact of legislation on franchise agreement terminations.

Hadfield (1990) suggests that the doctrinal tool necessary to bring the resolution of franchise contract disputes into line with the realities of the franchise relationship exists in the covenant of good faith and fair dealing, but cautions that "relying on the good faith doctrine as a method of introducing more accurate relational consideration requires that courts routinely look beyond the written franchise contract and examine the relationship in which that contract is embedded." (1990, p. 985). Such an approach accommodates the franchiser's interest in protecting the trademark and the system's goodwill as well as the franchisee's interest in protection from opportunistic use of the franchiser's control powers.

The survey data analyzed in this research lends some support to the relational approach that Hammond has strongly promoted in the *Dymocks Franchise System* (1999) Case. The circumstances surrounding termination and its consequences defy convenient categorization and termination disputes should be resolved by the Courts in the context not only of the contractual provisions but the underlying strategic relationship. A major implication for the franchising sector generated from this research is that whilst conflict and disputes are inevitable in franchising, the unique and complex nature of the franchisee-franchisee relationship requires the parties to work cooperatively beyond the confines of the contractual arrangements to achieve mutual satisfaction.

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