The effect of franchisor failure on franchisees: A review of the literature

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Business format franchising, as a method of distribution of goods and services, continues to expand throughout the world. The past few decades of research have concentrated on the unique characteristics of franchising, such as contractual arrangements, the nature of the franchising relationship, economic incentives for franchising and expansion strategies.

Most attention has been devoted to the positive benefits of franchising to the economy, small business and consumers. Some researchers have also explored the more negative aspects of franchising, including franchising relationship conflict, the propensity for opportunistic behaviour amongst franchisors and franchisees and the incidence of failure.

Failure studies are the focus of this paper. Franchise failure can refer to either the collapse of the franchisor’s business or failure of the franchisee’s business (and sometimes both). The majority of research has concentrated on failure at the franchise unit level, often comparing franchising with independent small business. Fewer studies have focused on franchisor failure. Moreover, there is a paucity of research about the effect of franchisor failure on franchisees and other stakeholders in the network.

The purpose of this paper is to review the extant literature on franchisor failure to provide a synthesis of the current knowledge about this issue and to identify common themes and gaps in our understanding of this phenomenon. A multi-disciplinary approach is taken to review the literature, including disciplines such as accounting, economics, entrepreneurship, law, management, marketing, and politics.

From our extensive examination four themes are identified. Firstly, the sporadic studies of franchisor failure that have been undertaken since the 1970s are reviewed, with the most significant studies being acknowledged. The second theme developed in the paper raises issues related to potential limitations in previous studies of franchise failure. Thirdly, our discussion turns to whether the extent of franchisor failure is substantial enough to warrant further research. Finally, we conclude that the impact of franchisor failure is far reaching and affects the health of the sector. In particular, the paper examines the impact of franchisor failure on franchisees – an area that has largely been neglected in the literature – and assesses the vulnerability of the franchisee under such circumstances. In brief, this paper provides a comprehensive overview of the phenomenon of franchise failure and, by reviewing relevant international studies, proposes an agenda for future research. We conclude that the specific area of franchisor failure, proving to be enduring and significant, nationally and internationally, warrants further investigation.
Introduction

A central objective behind the initiation and operation of a commercial enterprise is to provide a financial return to its shareholders. Choosing to establish a commercial enterprise as a vehicle to achieve a financial return is motivated partially by an expectation of a higher rate of return than that which can be achieved by remaining as an employee. As market conditions and achievable returns on investment are not constant, the objective of financial return is sometimes constrained by the need to survive as an entity to make a future return. It could therefore be stated that the purpose of a commercial enterprise is firstly to survive and secondly to provide a return on input resources of capital and time that meets the shareholders’, and the financier’s, expectations. The dual aims of return and survival have been brought into sharp focus during the global financial crisis (‘GFC’). The franchise sector has not escaped the impact of that crisis (Dunn & Einbinder 2011). One of the effects of this impact on franchising is some well-publicised franchisor failures.

In franchising the initiator of the franchise, called the franchisor, and the entity which replicates the business system specified by the franchisor, called the franchisee have fundamental interests that are in some respects alike, and in others diverge. Both of these legally separate parties have a similar purpose in surviving and providing an acceptable return. Yet they cannot have the same purpose, as their business models are different, as are the expectations of each party. This divergence of purpose and expectation is likely to cause tension and reflects some of the risks and challenges that are inherent in franchising and the franchisor-franchisee relationship (Hoy 1994).

Some of this tension is managed through the franchise agreement upon which each franchise relationship is based. The franchise agreement is a legally enforceable and complex contract (Justis & Judd 2003) and is usually in a standard form (Spencer 2008). The agreement is normally drafted by the franchisor’s legal representatives and offers little room for negotiation of changes by individual franchisees. Franchise agreements usually canvas aspects of the franchisor-franchisee relationship and will often provide a series of obligations on the franchisee in the case of the termination of the agreement by the franchisor, or following the demise of the franchisee. However, the franchise agreement rarely countenances franchisor failure and its consequences, or provides specific rights to the franchisee on the franchisor’s failure (Turnbull 2008; Buchan 2010 and 2013). Though the franchisee may, albeit rarely, have a right to terminate the franchise agreement in the event of...
the insolvency or bankruptcy of the franchisor (Goldman 2003), such a termination may seriously disadvantage the franchisee whose investment is in the system and brand, known within the law as the franchisor’s intellectual property, that the franchisor controls. Those same franchise agreements and valuable items of intellectual property will be viewed as assets with the potential to satisfy the insolvent franchisor’s creditors, irrespective of franchisees’ investment.

Consistent with the tenor of franchise agreements, franchises are bought on the basis of predicted success. The scale and the international reach of this success has driven significant research on franchising, though much of franchising research in the 20th Century has responded to a relatively narrow focus on the unique characteristics of franchising (Elango & Fried 1997; Dant, Grünhagen & Windsperger 2011), particularly ownership redirection theories (Dant 2008). Comparatively little research has been directed at commercial failure within franchises. We contend that understanding the causes and impact of franchise failure is as important as understanding franchise success.

In order to investigate franchise failure this paper develops four important themes arising from an extensive examination of extant literature. First, it follows the somewhat intermittent debate concerning franchise failure from the early 1970s to the present by considering the significant studies that span this period of time. The review then addresses some fundamental research problems constraining the debate on franchise failure that are identified by a consideration of those studies. We then assess the extent and significance of franchise failure to determine whether it represents a serious problem worthy of research, or if its importance is more peripheral. Having made this assessment, the paper concludes by adopting a specific position in the debate by examining the impact of franchisor failure on franchisees while also assessing defensive strategies that franchisees might consider on the failure of their franchisor entity. Future possibilities for theoretical and empirical research are indicated based on the outcomes of this review of literature. The review of literature thus framed is not only thorough and intensive, but is considered to be the first substantial attempt to complete such a review while referencing not only the field of franchising, but other fields and disciplines as diverse as economics, law and media studies.
The debate on franchise failure

As early as 1971, Ozanne and Hunt noted that 54 fast food franchises failed in the USA in 1968-1969, thus spelling possible disaster for their many franchisees (Ozanne & Hunt 1971). Ozanne and Hunt proposed that measures should be adopted to protect franchisees from franchisor ineptness and failure. Hunt (1977) repeated this assertion in noting that evidence was beginning to mount that many franchises were failing. The assertion made by Ozanne and Hunt seemed to have resulted in a muted response as robust debate on franchise failure is not evident during the 1980s.

Bates examined survival patterns of franchisees as early as 1988, and offered an informed comparison of franchise failure with independent small business failure in his examination of business start-ups (Bates 1995). By analysing small firm formations from 1984 to 1987 he found that franchise discontinuance rates were “dramatically different” (p. 27) from those cited by media commentators, franchisors and franchise associations and cites Castrogiovanni et al. (1993) as academics who have maintained an expectation for lower risk when comparing franchises to independent start-ups. Bates was also critical of the assertion made in a study commissioned by the IFA that declared that 96.9 per cent of franchise units opened in the USA in the previous five years were still in operation. He also cast doubt on the “conventional wisdom” (p. 26) in a statement in Business Week that illustrated what a safe bet a franchise is by suggesting that a franchise has a four times greater chance to succeed than an independent business. From a sample of 1,276 franchise start-ups and 19,278 independent business start-ups, Bates found that franchise start-ups exhibited both higher rates of discontinuance and lower mean profitability than independent businesses.

In 1993 Castrogiovanni, Justis and Julian made one of the first methodical analyses of franchise failure in Franchise failure rates: an assessment of magnitude and influencing factors. They considered that the primary referent for the risk of franchise failure indicated “that less than four per cent of all franchises fail each year” (p. 105). They sought to corroborate this assessment and isolate franchisor-specific factors influencing franchise failure rates, where a failure was defined as a closure within a franchise organisation. Data was collected from a random sample of 140 franchisors from an International Franchise Association (IFA) directory, since, as the authors noted, there was no central repository of franchisor information. They concluded that the franchise failure rate “most likely is close to 4 percent” (p. 112).
In 1994 Hoy continued the argument surrounding franchise failure in writing The Dark Side of Franchising: Or Appreciating Flaws in an Imperfect World. He observed that “franchising has received friendly attention in the media, both popular and academic” (p. 26). Despite the title, his paper was not aimed at profiling the dark side of franchising so much as using Bull and Willard’s (1993) predictive theory to find that there are risks as well as advantages inherent in franchising. He specifically identified the halo effect surrounding franchising in which the “widely heralded” (p. 29) low failure rate for franchises of less than five per cent in comparison to independent small businesses is taken as a proxy for franchising being perceived as far more successful and less risky than independent businesses. He concluded that franchise failure rates were understated and independent small business failure rates were overstated. Hoy’s paper did not reference Bates (1995), but did cite a related paper of Castrogiovanni et al. (1993) in identifying a small study by Justis, Castrogiovanni and Chan (1992) that confirmed the low franchise failure rate of less than five per cent.

In the same year Shane (1996) published one of a series of papers that considered the survival of new franchisors. His research applied agency theory to determine whether organisational forms, such as franchising, allowed firms to grow faster and improved the likelihood of survival. Shane examined a sample of 138 franchises that first published franchise-offering documents in 1983 and analysed their progress over 10 years. He asserted that his sample was representative of the population of USA franchises that started in 1983 and found that franchising enhances firm survival and growth. He also found that the failure rate of franchises was over 75 per cent over the 10 years that he studied, which he considered to be similar to non-franchise organisations.

The first decade of the present millennium appears to have witnessed a repeat of the 1980s hiatus in the debate concerning franchise failure. The debate has been more evident in legal academic and practitioner journals than those from the fields of marketing, management and economics. Tractenburg (2000) advised on what the franchise lawyer needed to know about bankruptcy. Tractenburg’s paper is written to advise the franchisor on franchisee bankruptcy, but he suggests that similar strategies would apply to franchisor bankruptcies. He also suggests that “[k]nowledgeable drafting will yield dividends and more predictable outcomes in the event that bankruptcy is filed” (p. 7). Abell, Lombart, Waldt and de Mergelina (2009) also seek to advance understanding of insolvency, but again they advance such understanding from the franchisor’s point of view on a franchisee’s insolvency.
Perrigot and Cliquet (2004) commenced inquiry into franchisor failure outside North America by calculating the number of franchisor failures in France over a 10 year period. Legal practitioners Dunn and Einbinder (2011) contribute to the debate on franchise failure in exploring franchisor bankruptcy from a franchisee’s perspective. Dunn and Einbinder provide an explanation of the bankruptcy process, examine the possible effect on a franchisee’s business and offer practical recommendations to franchisees to respond to franchisor bankruptcy. Michael and Combs (2008) provide a contribution to the muted debate from the marketing channels perspective by analysing 88 restaurant chains, focussing on the failure of franchisees and the use of agency and resource based theories to determine how franchisors affect franchisee failure. Michael and Combs specifically constrain their research to study franchisee failure in established franchises, thus avoiding franchisor failure entirely. It is perhaps telling that of 55 papers and reports referenced by Michael and Combs only nine were published in the current millennium and of these nine, none specifically addresses franchisor failure.

These studies, between 1971 and 2011, seek to explain different aspects of the complex process of franchise failure, yet many of their arguments diverge, and not all are examining the same event, or the same subjects. We will return to the events and subjects in the next part of this paper. Ozanne and Hunt (1971) and Hunt (1977) identified franchise failure as a problem worthy of consideration and explanation and asserted that, though the franchise failure rate cannot be accurately determined, it is much higher than previous estimates indicate. Castrogiovanni et al. (1993) depart from these views in confirming the low failure rate of 4 per cent prevalent in academic and non-academic assessments during the period of their study, while Bates (1995) and Hoy (1994) argue against the comparatively low assessment by Castrogiovanni et al. Shane (1996) found franchisor start-up failures similar to non-franchise start-up failures, thereby adding a slightly different dimension to the debate. Michael and Combs extended the debate in marketing channel research by investigating how franchisors affect franchisee failure, but only in established franchisors. From a legal perspective, Tractenburg (2000) and Abell et al. (2009) advise on franchisee bankruptcy from a franchisor’s perspective, while Dunn and Einbinder (2011) consider the franchisee’s position on the bankruptcy of the franchisor.

Beyond the evidenced attempts to establish how many franchises, franchisors or franchisees fail, franchisor failure has received little academic (Morris 2006), practitioner or government attention (Buchan 2013). We assert that the divergence of approach in the cited studies...
reflects some of the fundamental research problems that have constrained the important debate on franchisor failure thus far.

**Fundamental problems in researching franchise failure**

Attempts to compare the findings of the studies by Ozanne and Hunt (1971), Hunt (1977), Castrogiovanni et al. (1993), Bates (1995), Hoy (1994), Shane (1996), Tractenburg (2000), Perrigot and Cliquet (2004), Michael and Combs (2008), Abell et al. (2009) and Dunn and Einbinder (2011) highlight some of the fundamental problems confronting researchers of franchisor failure. This paper identifies these problems in order to both inform the review of literature to which it is directed and to establish parameters and constraints to condition a research design for future empirical research.

1. Referring to franchise failure demands qualification. Failure is a complex matter as there is uncertainty as to what franchise failure means. A franchise failure may refer to a failure of an entire franchise, including the franchisor and all its franchisees, a failure of a franchisee or a failure of a franchisor. It may also refer to a partial failure of any of the above aspects of a franchise. It may include failure followed by restructuring through a process such as the US Chapter 11 or Australia’s ‘Deed of Company Arrangement’. A clear and specific definition of what is meant by franchise failure is essential (Eljelly & Mansour 2001).

2. Having defined that a franchise has failed it is necessary to specify when a franchise failure occurs. Failure is unlikely to be a binary opposite to success; it is more of a process that spans a period of time. Failure may relate to a loss of equity, a loss of solvency or liquidation. It is necessary to define that part of the life cycle of the selected franchise entity at which failure is deemed to occur.

3. Though franchise failure has been researched in the United Kingdom (UK) (Lafontaine & Shaw 1998), France (Perrigot & Cliquet 2004) and Australia (Buchan, 2006a, 2010), most peer-reviewed articles on franchise failure are restricted to franchise failure in the USA.

4. There are research design constraints in describing and specifying the population to be researched and the manner in which the sample is selected from the identified population (Eljelly & Mansour 2001). This may be due to the lack of centralised and complete information concerning franchises and the consequent reliance of academics and industry commentators on databases that are sourced from representative and
partial organisations as opposed to government-sourced data (Stanworth, Purdy et al. 1992).

5. There is uncertainty of data collection methods relating to the prevalent use of samples of existing franchise organisations, thus excluding failing or failed franchises (Hoy 1994) and their franchisees, and a further inadequacy in studies that collect data solely from franchisors, as they may be unwilling to report franchise failure. As observed by Dant, Grünhagen & Windsperger (2011) failure numbers at franchisee level can be masked by franchisors deciding to acquire under-performing units rather than allowing the franchisee to become insolvent. This further serves to ‘muddy the waters’ in that it can distort failure figures and definitions.

6. Hoy (1994) also observed that the references available to inform research on franchise failure were derived from the marketing literature and noted that research on franchising is thematically dominated by examining the franchising process through marketing channels. Hoy advocated a multi-disciplinary approach in which a wider range of theoretical perspectives could be applied to analyse franchising, including, but not limited to, legal theory, contract law, organisational theory, information theory and financial theory. Dant (2008) echoed the need to think critically about the applicability of various theories to the specific context of franchising.

7. Terminology has been noted to be an ongoing source of confusion by franchise practitioners and researchers (Buchan 2013). This problem is one that also confounds research into franchisor failure. Some studies refer to franchise failure but focus uniquely on franchisee failure; while other studies deal with franchisor failure, also terming it franchise failure. Yet others frame their research in terms of ‘success’ but describe a success rate of significantly less than 50 per cent (Perrigot and Cliquet 2004). Despite the media reporting on failure at national level (eg: Carter 2013), there appear to be no studies that address master or area franchisor failure or their consequences. The confusion over terminology does not end with the question of whose business failed. Failure itself is termed bankruptcy in US law, whereas in other jurisdictions corporate failure is termed insolvency. The initial, divergent presentation of arguments surrounding franchise failure, illustrated by the cited papers, and the fundamental problems affecting research on franchise failure, may have contributed to the observed decrease in the intensity and even the maintenance of the debate. It is possible that the strong growth exhibited by franchising in many of the decades since the 1950s, and in many countries, has resulted in franchising achieving excessively
generous attention in the popular and academic media (Hoy 1994) so that a halo effect has developed with respect to franchising. Though no causality is suggested between the friendly attention observed by Hoy and the absence of sustained and vigorous debate on franchise failure, it is noted that research on franchise-related topics that might have supported further investigation along initial lines drawn by Hoy have been conspicuously absent.

We seek to provoke and inform the important debate surrounding franchise failure by providing, in the first instance, a comprehensive overview of literature. This overview specifically responds to the seven fundamental problems detailed above by:

1. Specifying that part of the complex debate of franchise failure at which it is directed as the failure of the franchisor entity, at the time the administrator is appointed. From that moment the franchisor directors cease to be in absolute control of the future of the network.

2. Defining the exact moment of franchisor failure as the time at which an administrator is appointed to the franchisor entity. Insolvency is a set of statutory procedures through which a company can move, or be moved from a situation of financial stress to a resolution of that stress. The appointment of an administrator is the first of these statutory procedures and can be compared to the granting of a Chapter 11 status in the USA. An administrator is appointed to determine (a) whether the company is able to be returned intact to the control of the directors, (b) restructured and returned to the control of the directors or (c) put into liquidation. Strict time frames are accorded to each step in the insolvency process. In Australia, for example, from the time the administrator is appointed, the first meeting of creditors must be held within eight business days. Following the first meeting of creditors the administrator has up to 30 business days in which to evaluate the potential for the company, formulate a recommendation to creditors, and hold the second creditors’ meeting. At the second creditors’ meeting the creditors vote to pursue one of the above three outcomes (a), (b) or (c) (Australian Securities and Investments Commission). Similarly, in the US, the Chapter 11 route facilitates reorganization for companies in distress that believe continuing in business is a viable option. The process allows the subject enterprise time to rearrange its business pursuant to a plan of reorganization so that it can exit bankruptcy as a viable, continuing operation (Einbinder & Dunn 2011). This may involve a future for the company without franchisees.
3. Situating the research within the Australian franchise sector while referencing internationally, thus not only initiating research on franchisor failure in the Australian franchise sector, but also adding to the internationalisation of the debate.

4. Establishing a data set. Research on the impact of franchisor failure on franchisees and the economy has been hampered by lack of data, the cost of buying data and the difficulty of locating and interviewing former franchisees who are often financially and emotionally traumatised by their experience, or unable to participate in research for fear of breaching the non-disclosure contracts they have signed as a condition of exiting the franchise (Buchan 2006a). They, like the Cheshire cat, often disappear from view with alarming speed when the franchisor fails (Buchan 2006b; Gehrke 2012a, 2012b). This inability to access data on which to base empirical research has hampered the evolution of policy to address any deficiencies in the law (Buchan 2013). This paper identifies the population of failed franchisor entities by comparing successive Franchising Australia biennial surveys and identifying the franchises that ceased to exist.

5. This review has not restricted itself to one discipline. We have sourced empirical, theoretical and practitioner oriented articles from accounting, business organization, economics, entrepreneurship, finance, labour relations, law, management, policy and the business press. Table 1 summarises the literature that has informed the review.

Table 1: Franchise Failure Literature

<table>
<thead>
<tr>
<th>Year</th>
<th>Authors</th>
<th>Field of research or Discipline</th>
<th>Franchisor or franchisee failure</th>
<th>Country focus</th>
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<td>Franchisee</td>
<td>USA</td>
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<td>Economics</td>
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<td>USA</td>
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<td>Franchisor</td>
<td>USA and UK</td>
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† The biennial Franchising Australia surveys have been published since 1998.

Buchan and Frazer: 11
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<th>Journal</th>
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<td>Franchisor</td>
<td>generic</td>
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<td>Dant, Gronhagen and Windpeperger</td>
<td>Multi (excluding law)</td>
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<td>Buchanan, Qu and Frazer</td>
<td>Law</td>
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<td>Accounting (insolvency)</td>
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<td>Buchanan</td>
<td>Law</td>
<td>Franchisor</td>
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Of the 66 publications identified in Table 1; 13 are from Australia, 2 from Canada, 1 from Finland, 2 from France, 2 from Spain, 1 from Sudan, 3 are multi-jurisdictional, 6 are from the UK, and 30 from the USA; 17 are concerned with franchisee failure and 31 with franchisor failure. The remainder are non-specific, or not confined to one party. The discipline focus of the articles referred to is as follows: 2 from accounting, 1 from business organization, 10 based in the field of economics, 3 are by academics from within enterprise studies, 5 from entrepreneurship, 1 from finance, 2 from labour and urban affairs, 20 from law, 7 from management, 3 from marketing, 2 cross disciplinary and the remainder did not indicate a specific disciplinary base. The large number from law is likely to be a consequence of a number of legal practitioners taking an active role in writing in this field.

In addition to specifying the way in which the seven fundamental problems identified are approached, this paper chooses to elucidate the particular consequences of franchisor failure on franchisees.

The significance and extent of franchisor failure

Franchisees are the tens of thousands of faces of the brands that they buy into and outnumber franchisors significantly (Buchan 2013). Each franchisor has between one and thousands of franchisees. The average ratio of franchisors to franchisees is about 1:60 in Australia (Frazer, Weaven & Bodey 2012), 1:39 in France (La Fédération française de la franchise et la Banque Populaire 2010) and 1:55 in New Zealand (Flint-Hartle, Frazer & Weaven (2012) and 1:500 in USA. These ratios assume that one franchisee operates one outlet, though it is common for franchisees to own and operate numerous franchisee units (Buchan 2013). In all of the above countries it can be concluded that the complete failure of a franchisor entity may have a domino effect on many more franchisees.

In Australia, estimates of the size of the problem of franchisor failure are varied. McCosker and Frazer (1998) found that in the six month period from checking firm details in the Telstra White Pages on the internet to follow-up of non-respondents to a survey that they conducted, 127 out of 946 franchisor entities could not be located and were presumed to be no longer operating. The *Franchising Australia 2010* survey revealed that some 56 franchise systems ceased operating and a further 88 ceased franchising in the two year period from 2008 to 2010, (Frazer, Weaven et al. 2010). Connors (2010) speculated that there was a ratio of six franchisor failures to one success over a period of 20 years and Buchan et al. (2011) found
that 72 per cent of franchisors exited franchising over the period 1999 to 2011. Buchan et al. found that the 1999 Australian Franchising Yearbook and Directory listed 347 franchisors and of these, 251 (72 per cent) were no longer franchising by 2011. Though this assessment of 72 per cent included franchisors that had exited franchising, but possibly remained in business, many of the franchises in the assessment of 72 per cent can be identified, due to the public notification requirements surrounding insolvency processes. Eight identified franchises carried the potential to seriously affect the survival or profitability of slightly less than 1000 franchisee businesses. The identified franchises included Kleenmaid with 15 franchisees, Kleins Jewellery with 134 franchisees, Traveland with 270 franchisees, Beach House Group with 60 franchisees, Healthzone Limited with 80 franchisees, Refund Home Loans with 320 franchisees, Tyrecorp with 33 franchisees and Worldwide Online Printing with 85 franchisees (Buchan et al. 2011). Any attempt to analyse the failure of franchisors in Australia suffers similar problems to those identified in relation to data collection in the USA. No comprehensive database of franchisors or franchisees is available in Australia, let alone those of failed franchisors; consequently researchers must develop their own databases.

In the USA, Cross (1994) found that the only systematically compiled statistics on franchise failures have been provided by the Franchising in the Economy reports. These reports were produced up until the late 1980s by the US Department of Commerce (‘USDOC’) but have since been discontinued. Cross also cited periodic membership surveys by the IFA as a source of information on franchise failure, but recognised that both data sets are based on potentially incomplete and inaccurate data submitted by franchisors. Shane and Spell (1998) found that fewer than 25 per cent of franchise systems begun in the first year of their longitudinal study were still around 10 years later, while Blair and LaFontaine (2005) used USDOC (1988) data to report the number of franchisor failures and departures out of an estimated population of 2,177 franchisors in 1986. They assessed that a total of 104 franchisors operating 5,423 outlets failed during 1987. That the problem of franchisor failure is continuous in USA is instanced by Einbinder and Dunn (2011) who named eight large and three small USA franchisors that became bankrupt in 2010.

In the United Kingdom (UK) Stanworth et al. (1992) could only describe one franchise in four as an unqualified success over a ten year period and Lafontaine and Shaw (1998) observed that around half of their initial sample was judged to have failed completely and utterly.
In France, Perrigot and Cliquet (2004) studied 952 franchising networks during the period 1992-2002 and found that only 42.13 per cent survived.

The above studies in Australia, USA, UK and France indicate that the problem of franchisor failure is continuous, international and significant. It is of particular significance to franchisees that may have no warning of the impending failure of their franchisor. The failing franchisor will be unlikely to meet any of its contractual obligations to its franchisees (Dunn & Einbinder 2011) and the franchisees will find little or no remedy in the franchise agreement (Spencer 2008). Franchisees will therefore be restricted in applying defensive remedies to arrest the potential domino effect of franchisor failure on their continued existence.

**The impact of franchisor failure on franchisees**

The franchisee’s business is predicated on and inextricably linked to that of the franchisor, yet, as demonstrated for Australia, USA, UK and France, not all franchisors succeed in business. The demise of a well-known franchisor is often mentioned in the business pages of the press, but the demise of a franchisee may not even warrant the attention of the local newspaper (Gherke 2012a). Blair and LaFontaine (2005) concluded that in the case of franchisor discontinuance, whether it is a departure from franchising or a business failure, there will be an impact on the survival or growth of the franchisee units that are tied to that franchisor. Franchisees simply have much more to lose in franchise agreements than franchisors, for a franchisee, the loss of a franchise is devastating and can represent the loss of not only a significant investment but their family’s sole source of income (Dolman et al. 2011) and can lead to financial devastation for the franchisee and their families (Goldman 2003). For franchisors, while they clearly rely heavily on franchisees as a group for the continued success of their business, the loss of a single franchisee is a comparatively minor setback. In fact, in the event that a franchisee defaults, franchisors will often have an opportunity to buy back the franchisee’s business, thereby significantly mitigating their losses (Dolman, Grove et al. 2011).

… bankruptcy is most often an opportunity for a troubled company to solve its operational or financial problems and emerge as a more viable company. Bankruptcy provides a useful business tool for a company to reorganize its operations, deleverage its balance sheet, accomplish a sale of assets, obtain new financing or improve its capital structure. For example, bankruptcy may assist a franchisor in addressing the following challenging business issues; overexpansion in the market and the need to
eliminate units, an unworkable equity structure, desire to sell or merge with another entity, threat of franchisee litigation, … (Foster and Johnsen 2005.)

The converse is not true for, if the franchisor fails, the likelihood of the failure of all the franchisees of that franchisor is far greater than the effect on the franchisor if a franchisee fails.

As long ago as 1971 Gilson noted that ‘[a]s franchising matures during a torpid economy, trademark problems of failing franchisors are beginning to rise.’ (p. 467). The inter-related nature of the franchisor and franchisee’s business together with the pattern of contractual relationships that bind the franchise network are strengths that become weaknesses for franchisees if a franchisor fails. The standard form of the franchise agreement limits the ability of the franchisee to self-protect (Jenvey 2006) and insolvency legislation, in existence long before franchising became popular, exposes the full extent of the franchisees’ vulnerability. Nowhere are the differences between employees, suppliers, independent contractors and franchisees more exaggerated than if the franchisor fails. Holding (1995) rightly observes that employees are vulnerable in their employer’s insolvency, but the law plays out even more opportunistically when franchisees are left out of the insolvency equation. The currency that liquidators trade in is debtors and creditors, assets and liabilities and a franchisee may not be any of these to its franchisor. Eljelly and Mansour (2001) provide an example of how articles about business failure do not consider franchisees to be affected by such failure. They refer to business failure as being a subject of concern for many parties, including those who have a direct interest in the business such as shareholders, employees and creditors and those who are less directly related to business such as regulators and governments, yet a franchisee, though directly affected by a franchisor failure does not meet the specification offered by Eljelly and Mansour and within Australian law may not be considered relevant to the administration process.

Franchising is often promoted as being a less risky alternative to independent small businesses. In particular, first-time business operators often become franchisees because of the benefits attached to a recognised brand and the support promised by the franchisor. In Australia consumer protection legislation within the Competition and Consumer Act 2010 (CCA), provides for a franchisor’s duty of disclosure through the Franchising Code of Conduct. This includes the duty to provide a signed statement of solvency of the franchisor entity. Empirical evidence shows that a surprisingly large number of franchisors fail and that their franchisees may suffer grave consequences from such failure, notwithstanding the
existence of the above-mentioned provisions. Neither franchisees nor prospective franchisees will be in a position to respond to a franchisor’s impending failure if they do not have access to reliable and up-to-date information on the franchisor’s state of solvency (Buchan, Qu et al. 2011).

Advance notice of the financial difficulties of the franchisor may be critical to the ability of the franchisees to organize and coordinate an effective strategy to deal with a pending insolvency. In *re Country Style Food Services Inc*, Madam Justice Feldman of the Court of Appeal for Ontario, on an application for leave to appeal a court order approving a proposal under the CCAA wrote,

I note that the franchisees as a group were not considered to be people to be officially served with and included in the CCAA process … Although the process under the Act contemplates the participation and protection of creditors, the debtor company and possibly the shareholders, in cases where the debtor company is a franchisor, the franchisees may have an interest in the ultimate structure of the franchise operation as proposed by the Plan process…It may therefore be appropriate where a franchisor seeks CCAA protection, to consider whether the franchisees ought to be given notice of the proceedings and the opportunity to request the ability to participate on an appropriate basis. (Colraine 2003, p. 14)

Franchisors are able to shelter their personal assets because they are the ones who set up the franchise system. It is much more difficult for franchisees to shelter assets as they need to come up with sufficient equity for the purchase of the franchisee business (Buchan 2008). Existing franchisees may not be aware that the franchisor is experiencing financial difficulty. In the case of the Kleins jewellery franchise, one franchisee noticed a substantial drop in stock deliveries, which were controlled by a company related to the franchisor entity, six months before the administrator was appointed and so had some advance notice of the appointment of the administrator while another Kleins franchisee had no warning at all from Kleins concerning the instigation of the insolvency process, but received a brief notice directly from the administrator, subsequent to their appointment. Another franchise entity in administration, Strathfield’s, did not even consult with franchisees before the administrator decided on their course of restructuring (Thomson 2009). Not only franchisees, but their professional advisors, such as lawyers, accountants and franchise consultants, may not be able to predict the future solvency of the franchisor. This was indicated by the National Australia Bank, described as Klein’s largest secured creditor, who was still identifying Kleins as one of its Accredited Franchise Systems on its website even after the administrator had been appointed (Buchan 2008). In any event, the appointment of an administrator to a franchisor entity does not usually represent a breach of the franchise agreement. Thus, it does
not give rise to an action for breach, though the franchisee can bravely pursue an anticipatory breach.

The number of franchisees at the time of the franchisor failure is often an under-representation of franchisees affected by the failure as many may have already left the network, disenchanted at the lack of franchisor support, slow stock deliveries or other problems symptomatic of the impending business failure of the franchisor. For example, Strathfield car radio was placed in administration at a time when they identified 75 outlets, a number of which were franchised, but 20 unprofitable stores had already been closed in the year prior to the administration process (Thomson 2009). Similarly, pet shop retail franchise Wonderland of Pets had ten franchisees at its peak, but only three at the time it failed (Buchan 2013).

The impact of franchisor failure on franchisees is shown to be potentially severe on a franchisee and the average ratio of franchisors to franchisees, internationally, predicts that this severity will be multiplied many times over. The impact of franchisor failure is exacerbated by the lack of protection that the franchisee has through the franchise agreement, statute and common law. Though the impact of franchisor failure can be severe and legal protection for the franchisee’s business limited, nevertheless, the franchisee can sometimes implement some defensive strategies to avoid or mitigate the full effects of an impending or actual franchisor failure.

**Defensive strategies for franchisees on franchisor failure**

The probability of success for franchisee investors in the 3,000 plus franchise systems operating in the USA varies greatly by system (Wadsworth and Cox 2010) and it is virtually impossible to predict *a priori* which ones will succeed and which will fail (Lee, Yamakawa et al. 2011). These observations are fundamental to risk assessment, irrespective of national boundaries, but how does a prospective franchisee maximise the chance of their success within a particular franchise and avoid joining a franchise that may become involved in the administration process? Once joined, how does a franchisee advance the sustainability of their franchise business if the franchise entity to which they are enfranchised is trading poorly or becomes insolvent?

Many of the actions that may point to the likelihood of a franchisor entity’s poor trading or potential or actual insolvency need to be undertaken prior to making a commitment to the franchise by executing the franchise agreement. This requires a thorough process of due

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diligence by the prospective franchisee and their professional advisors, prior to commitment. It must be acknowledged that a franchisee’s ability to conduct due diligence \textit{ex ante} or \textit{ex post} also suffers from a lack of access to comprehensive, objective data. The due diligence process is not central to this paper as it occurs prior to the franchisor-franchisee relationship being formed by the execution of the franchise agreement, but many of the actions specified within due diligence should continue after the prospective franchisee becomes a franchisee. Ongoing due diligence is identified as a prudent business practice for franchisees.

Ongoing due diligence can be seen as a defensive strategy to facilitate the identification, as early as possible, of a franchisor’s poor trading or financial difficulty. These ongoing defensive strategies will increase in number and intensity as the financial and trading condition of the franchisor is observed to deteriorate. Australian courts have developed a set of 13 indicia of a company’s impending insolvency (Buchan et al 2011), and Buchan et al have noted franchise specific indicia including:

a breach of a franchisor’s obligations to provide advertising support, equipment and inventory on a timely basis (Colraine 2003, Borradale), an evasive answer to the franchisor’s queries when a franchisor default has taken place (Maltby 2010); a landlord’s notice of demand, or restructuring on the part of the franchisor. Where restructuring has been arranged for the franchisor company, the franchisees may see invoices from different companies (Taylor & Hughes 2011). Also, when the probability of company’s insolvency increases, both the operating costs and the revenues of the firm will be adversely affected’ (Jensen & Meckling 1976).

A franchisee should investigate the franchisor’s accounting methods in order to determine whether or not the company is using generally accepted procedures (Cheng and Kregor 1973). The franchisee should look for signs of the franchisor’s reduced liquidity and profitability. Various ratios, especially the current ratio and the acid-test ratio should be accessed, provided that the franchisor is obliged, by agreement or by public listing procedures, to make them available. Attention should also be directed to the leverage of the company, as it may be heavily in debt. Analysis of these ratios and debts of the franchisor entity may assist the franchisee to identify possible financial problems for the future (Cheng and Kregor 1973) or identify a trend earlier than would otherwise be possible. Companies that have had legal action taken against them are nearly eight times more likely to fail than those that have not. Thus, willingness to resolve disputes through litigation may provide an early indicator of increased risk for franchisees (The Australian 2006). Disruption to supply chains, stock dumping and diminished franchisor support are other indicators that the franchisor has financial problems (Buchan 2006a, Gehrke 2012). Unfortunately the restricted availability of accurate information concerning many franchisor entities, such as those who are private limited liability companies, makes it more difficult for franchisees to measure such risk accurately (Lafontaine and Bhattacharyya 1995).

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In the absence of such specific information, decision hierarchies in which higher level agents ratify and monitor the decision initiatives of lower level agents and evaluate their performance, can also limit damage to a franchisor entity. This implies observing if the franchisor entity has an appointed board of directors and developing an awareness of their qualities, qualifications and experience. A board of directors, particularly one that includes independent directors, will establish an apex of decision control systems in which decision agents do not bear a major share of the wealth effects of their decisions. An apex structure can also help to ensure separation of decision management and control. Unfortunately such decision hierarchies are not common in franchises where the owner or owners of the franchise entity and the board are often the same (Fama and Jensen 1983).

Franchisees also have a statutory right of association, certainly in Australia and Canada, and franchisees should use this right to pool information and formulate a strategy for dealing with the possible insolvency of the franchisor. Information, and the ability to act on it quickly, are of fundamental importance in insolvency, particularly when reorganization proceedings may be underway (Colraíne 2003). It is possible that if the franchisor has a close relationship with their franchisees they may be able to avoid formal insolvency. This may be effected by a group of franchisees, with the franchisor, formulating a rescue plan that may include negotiating with the franchisor’s bank, landlord and other creditors (Mackie and Owen 2012). It is conceivably more likely that a group of franchisees will be able to support themselves, their franchise and even their franchisor through the administration process, than one or a number of franchisees working independently.

**Future research**

The authors are currently undertaking research in Australia to further explore the issue of franchisor failure and the flow-on effects to franchisees. This research focuses on franchisors under administration. Throughout the period of administration, administrator and franchisees are bound by the provisions of the Franchising Code of Conduct (the Code) and thus regulated by the Australian Competition and Consumer Commission. The administrator also has statutory obligations under the *Corporations Act 2010* (Cth) regulated by the Australian Securities and investments Commission. This dual regulatory oversight can cause tension. For example, some franchisees in the Kleins jewellery franchise tried to exercise their right under the Code to request mediation with the administrator. Under the legislation that regulates the conduct of insolvency, the *Corporations Act*, franchisees have no such right.

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Although the period of administration is ideally short, the complications created by the existence of franchisees can lead to the administration being prolonged, as for example in *Stewart, in the matter of Kleins Franchising Pty Ltd (administrators appointed) (ACN 007 348 236) [2008] FCA 721*. This results in considerable but undocumented uncertainty for franchisees. Moreover, whilst a business is ‘in administration’ there is a possibility it will exit administration and continue trading. Once the liquidator is appointed that possibility no longer exists and any ambiguity concerning the future of franchisees within the brand is past.

Data in our current empirical study will be sourced from administrators of franchisors. Hence, the research will enhance our understanding of franchisor administration in the following ways:

- by providing a better understanding of the impact of the franchisor in administration on franchisees and related stakeholders, and by
- identifying tensions experienced by administrators in meeting conflicting statutory obligations.

In a subsequent empirical study we will source data from franchisor and franchisee entities, with particular effort directed toward the inclusion of franchisor and franchisee representatives, and franchise financiers who have experience of the administration process within insolvency.

In this review we have confined our search to literature specific to franchising. There exists a large body of research into the field of business failure where franchised businesses undoubtedly formed part of the sample studied, but were not specifically identified in the resulting articles. Beyond failure, areas such as corporate governance merit attention through the lens of business failure. To what extent, for instance, does a franchisor or an administrator need to consider franchisees when making decisions that accord with good corporate governance? As noted by Falbe and Welsh (1998), quoting Gould and White (1986).

> human behaviour is affected by only that portion of the environment that is actually perceived; our views of the world and the people in it are formed from a highly filtered set of impressions and our images are strongly affected by the information we receive through our filters.

We thus propose adjusting our filters in a later phase of our research to learn what can be applied to franchising failure from other fields.
Conclusion

Few prospective franchisees would consider the prospect of the failure of the entire franchise system prior to entering the franchise agreement. Although the Code now requires a Disclosure Document to draw attention to the possibility of franchisor failure, the concept is far removed for an inexperienced franchise investor. Gatekeepers, however, are often in a position to know how profitably a business is trading. In franchising gatekeepers include funding bodies making a decision to fund a venture, regulators, accountants authorising franchisors to confirm they are solvent, lawyers, retail landlords, and industry bodies promoting franchisor members.

Franchising will continue to be a business model that crosses boundaries. The impact of franchisor failure on franchisees and franchise related stakeholders, including landlords, suppliers, employees and financiers remains under-researched. We suggest that, given that only two of the publications referred to in Table 1 reflect cross disciplinary research and only a small number are cross jurisdictional, it is timely for properly funded multi disciplinary and cross jurisdictional research to be conducted in the field of franchisor failure. Both the academic community and industry participants will benefit from a more comprehensive understanding of the complexities/nuances of franchisor failure.
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