Franchisees are unrealistically optimistic about risks of setting up their business, even after those risks have been disclosed to them, our research shows .

We tested this unrealistic optimism by surveying 205 current US franchisees from 26 brands. We chose the US because there is publicly accessible data about the identity of franchisees there (in Australia this does not exist). It's this information US franchisors are required to provide that should alert intending franchisees to the risks of their agreement being terminated.

We asked individual US franchisees to answer the degree to which they are more or less likely to experience a certain risk than the "average" person operating a franchise in the same brand. This focused on the risk of the franchisor terminating their franchise agreement in two scenarios:

1. Solely so the franchisor could sell their business to a new franchisee for higher franchise fees.
2. So the franchisor could operate the successful unit themselves.

Our data revealed that for both scenarios, more than 80% of franchisees believed they weren't likely to be affected, which is concerning considering the serious consequences to a franchisee of either event occurring.

Policy makers assume that the presence of disclosure laws mean franchisees will do their homework before committing to a particular franchise. Our research shows that these assumptions are wrong.

The risks of early termination of a franchise agreement

A franchise is a complex, expensive, purchase that will commit the franchisor and franchisee to a business relationship with each other for several years. The franchsior has usually sold many franchises, and signed many franchise agreements but buying a franchise is something a franchisee may do only once in their life.

To help franchisees avoid making such a significant decision on impulse, the law requires that franchisors provide a disclosure document replete with information. Although the contents vary from country to country, the disclosure requirement is widespread.

Disclosure laws are based on an assumption that franchisees are rational. They will read and understand the disclosed material, take professional advice on anything they do not understand and will not commit until they understand the risks and satisfy themselves as to how they will manage them.

US franchisees are alerted to the possibility that their franchisor might terminate their agreement in one of four ways. The franchisor has to summarise how it could terminate the agreement in a disclosure document by law.

This includes stating whether the franchisor has the right to terminate “at will”; meaning that the franchisor is not required to give the franchisee any opportunity to remedy defaults. The franchisor must disclose the annual number of franchisees terminated to date without compensation and must include the names and contact details of former franchisees whose agreements have been terminated by the franchisor.

Surely, equipped with all of this information, a prospective franchisee would realise that they too, could find their newly minted franchise agreement opportunistically terminated by their franchisor. Our research shows that most do not.

Optimism of franchisees

Franchisors do sometimes terminate franchisees’ agreements “at will”. A statistical analysis by Emerson of 342 US cases involving a franchise agreement terminated by the franchisor, shows in 49 cases the cause of termination is listed as being “at will”. Of these 49 cases, only 11 found in favour of the franchisee.

These results indicate that there is a real risk faced by franchisees that a franchisor will opportunistically terminate the franchise agreement. This information about US franchisees makes us wonder about Australian franchisees.

Franchisors in Australia provide pre-contract disclosure prescribed under the Competition and Consumer (Industry Codes—Franchising) Regulation of 2014. This includes information such as the identity and business experience of the franchisor.

It also discloses any litigation the franchisor is involved in, who the franchisor pays to introduce franchisees to the system, the number and business address details of up to 50 existing franchisees and key details of relevant master franchise agreements. It explains the status of intellectual property like registered trademarks that the franchisee will be allowed to use.

Under headings related to supply of goods or services to a franchisee, there is financial and logistical information that covers aspects like online sales. The franchsior's policy and practice about sites or territories is explained.

Financial issues are disclosed, as are arrangements that will apply at the end of the term. The franchisor must provide a signed statement that it is solvent, although research shows that a small number of franchisors sign the disclosure statement confirming they are solvent when they are not.

All this information makes franchisees think the disclosure documents tell them all they need to. But, because there is no public database of franchise disclosure in Australia, franchisees can not compare their chosen franchisor with other brands.

And, as our US-based research shows, even a detailed pre-contract disclosure document that clearly outlines real risks may not convince franchisees that franchising can be risky.

Jenny Buchan receives funding from CPA Australia. She is a member of the Australian Competition and Consumer Commission's Small Business and Franchising Consultative Committee.

Read more http://theconversation.com/franchisees-dont-do-their-homework-and-are-too-optimistic-about-risks-research-68333