



Address to

Franchising Law Master Class

*“The ACCC & Franchising - Recent
Developments And Regulatory Directions”*

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Grace Hotel, Sydney

19th November 2004

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1. INTRODUCTION

Franchising in Australia appears to have gone from strength to strength since the Franchising Code commenced in 1998.

From an ACCC perspective we certainly have seen a maturing in the sector. From our unique position in administering the Franchising Code of Conduct the ACCC has the opportunity of examining issues right across the sector, the good, the bad and the ugly.

The Franchising Code, as many of you here are well aware, is currently the only mandatory code under the Trade Practices Act 1974.

The Code has been effective in addressing a number of key concerns that existed before the Codes commencement, and in some cases, still exist in the franchising sector. The Code provides an opportunity for prospective franchisees to have sufficient information to enable them to make an informed decision about whether a franchise system is right for them. The Code also provides mechanisms to allow franchisees and franchisors to resolve disputes in a fair and reasonable manner.

The Code by and large, has been extremely effective. However, from my position as the ACCC Small Business Commissioner, I see a need for continual improvement in certain areas. My paper provides an overview of the key issues which, from an ACCC perspective, need to be addressed by the sector.

2. SMALL BUSINESS AND THE TPA

The ACCC's interest in franchising is not due solely to our role with the mandatory code of conduct. The majority of franchisees, and in a number of cases franchisors, are small businesses. Our role in facilitating competition

and fair trading is extremely important to all businesses, in particular small businesses.

Small business and the TPA has been the focus of a great deal of attention recently. Many of you are well aware of this discussion and the concerns raised by small businesses as to the effectiveness of the TPA in providing protection for small businesses.

Our view is that through our administration of the TPA the ACCC is there to promote fair and ethical competition for the benefit of all Australians, small businesses included, but we are not here to protect any particular sector of the economy.

There are many benefits to ethical and fair competition in a market.

The promotion of customer service, competitive prices, innovation and efficient behaviour provide many benefits to consumers. However, a competitive market can sometimes lead some businesses to fail, purely because they are unable to compete – this is part of the market system. Vigorous competition is permitted, vicious competition or anti competitive conduct is not.

3. THE CODE IN GOOD HEALTH AFTER 6 YEARS

The diversity of the franchising sector presents a significant challenge for the ACCC – there is an extensive coverage of different business types including specialist retailing, courier services, domestic cleaning and other services, lawn-mowing, real estate, lottery agents, auto parts and services, motor vehicle dealers, fast food, printing and petrol outlets amongst others.

More people are attracted to the success of franchising for a variety of reasons. One reason, in my view for this attraction, is the realisation that

under the auspices of the Code, genuine franchising in Australia is conducted in a fair and ethical manner.

The Franchising Code of Conduct is now six years old and it is well established and accepted by the sector. The disclosure document to franchisees, the dispute resolution procedures and the requirement for franchisees to seek advice are all aimed at preventing problems from occurring.

Litigation

The ACCC has and will continue to rigorously enforce the Code and TPA. The ACCC pursued a number of franchising cases to ensure compliance with the Code and the TPA.

The ACCC only pursues legal action when we believe that there are serious issues which must be pursued in a court of law.

There will be occasions when, in the interest of franchisees, other franchisors and consumers, the ACCC takes strong action to ensure the law is upheld. Unfair conduct can damage franchisees, but it also has a broader effect on other businesses and consumers.

Where appropriate the ACCC takes an informal approach to resolving outstanding issues in a franchise system. This approach has included holding separate discussions with franchisees and franchisors, in an attempt to reach a workable solution.

We have also seen the benefits of group mediation in fixing up common problems which exist right across a franchise system.

However, when necessary we will continue to take enforcement action where we believe that franchisors or master franchisees have engaged in misleading or deceptive conduct, unconscionable conduct or a breach of the Code.

Increasing Education Emphasis

Since the Code's inception the ACCC's educative role with respect to franchising has changed. There continues to be an important role in educating prospective franchisees and franchisors about the general role of the Code. However, there is also a need for further compliance education to ensure that franchisees and franchisors are aware of other issues which affect their ongoing relationships.

In the past few years, we have noticed a change in the type of complaints we now receive. When the Code first commenced a high proportion of complaints and enquiries received concerned the operation of the Code and questions of compliance with the Code. The nature of complaints that we now receive are more sophisticated.

4. HOW THE ACCC DEALS WITH COMPLAINTS & INQUIRIES

In our role in administering the Code the ACCC, as you would appreciate, receives complaints from franchisees and franchisors about non-compliance with the Code and alleged breaches of TPA. It is also important to note that we do hear about many complaints that are simply contractual in nature or concern relationship management issues within the franchise system.

The main complaints/inquiries we receive include:

- clarification of the Code of conduct from both franchisees, franchisors and solicitors;
- what options are available to franchisees when their relationship with the franchisor has deteriorated;

- why franchisees are required to go through the franchisor to obtain the supply of goods or services;
- how the mediation service works and what steps can be taken to resolve a dispute; and
- complaints about the franchisor not honouring terms or conditions in franchise agreements, particularly in relation to advertising and back up support provided by the franchisor.

The Franchising Code's dispute resolution mechanism provides a self help mechanism for franchisees concerned about their franchisor's conduct.

This dispute resolution mechanism enables franchisees to require their franchisor to attend mediation if they have raised a concern with their franchisor and the issue is not otherwise resolved. Current reports from the Office of Mediation Adviser indicate that 70% of these mediations resolve the complaint, this success rate that has been consistently achieved over the past few years.

The ACCC realises the important role that dispute resolution mechanisms such as mediation play. The majority of franchising disputes can in fact be resolved without the relationship reaching a point of no return.

When notified of a complaint, the ACCC generally advises both parties to attempt some form of dispute resolution. We recognise that for the future viability of the relationship it is important that outstanding issues are resolved without our intervention.

5. ANALYSIS OF PROBLEM AREAS

The ACCC has seen a steady decline in the number of complaints and inquiries which we receive concerning franchising. However, what we have noticed is that complaints generally fall into three broad types:

- scams and exploitation;

- structural pressures; and
- poor relationship management.

I discuss each of these three categories in turn.

Type one: scams and exploitation

The first type of complaint involves circumstances in which a company or individual appears to be intentionally engaging in misleading or deceptive conduct or is wilfully exploiting its superior bargaining position. Complaints falling within this category include business scams as well as harsh and oppressive behaviour as outlined in the *Simply No Knead* and the *Cheap as Chips* litigation matters.

These complaints often include misleading or deceptive conduct and which may also risk contravening other laws such as fraud. Conduct can include gross misrepresentations about earning capacity and level of work required or simply that the scheme does not comply with the Franchising Code with no disclosure or disclosure that is misleading.

This type of conduct is not unique to the franchising sector. The characteristics of this sector, however, invite such scams with:

- a large payment up front for the business;
- the statement exhortation that no business or technical experience is required of prospective franchisees; and
- the business marketing/sale opportunities provided by franchising expos or advertisements in “business opportunity” sections of newspapers.

Type two: structural pressures

The second type of complaint occurs when the provision of goods or services by an otherwise genuine franchising system does not fit well with the conditions of supply and demand in the market in which that franchising

system is competing. These structural problems can arise where a franchise system:

- expands more rapidly either in the number of outlets or the nature of the products or services supplied by the system;
- is unable to maintain the level of service promised to franchisees, for example training and support for franchisees;
- fails to deliver in terms of its advertising strategies or in the achievement of profit projections as the system expands into new markets or faces increased competition;
- does not respond to changing market conditions, for example changes to consumer demands or increased competition, with the result that its franchisees may be unable to compete effectively within the uniform business system; or
- responds to changing market conditions by rationalising the number and/or location of outlets or by requiring franchisees to invest in signage or other system changes that are costly at a time when turnover is low (the initial impact of the changing market).

The various ways in which franchisees can be negatively affected as a result of structural dissonance can lead to perceptions that a franchisor has treated its franchisee unfairly and may generate complaints alleging misleading or deceptive conduct and unconscionable conduct.

Type three: poor relationship management

The third type of complaint generally arises as a result of poor communication or consultation between parties to a franchise agreement. This can be partly related to issues of structural problems.

It may occur when one party wishes to change the manner in which either the system or an individual franchise does business. Complaints alleging a lack

of consultation often arise in relation to advertising campaigns or changes to product lines offered by a franchise system.

Alternatively, relationship management problems may result from the manner in which one party responds to concerns raised by the other party to a franchise agreement. This may include a reluctance to acknowledge the legitimacy of concerns held by the other party or one party perceiving a complaint to be a personal criticism and responding in kind.

Relationship management issues differ from structural issues in that while the substance of the original concern that gives rise to a relationship management issue may appear quite minor, the manner in which the dispute is raised or responded to can result in significant distress to one or both parties.

5. CURRENT KEY ISSUES

Some of the current key issues in franchising relate to:

- the recruitment and expansion of franchise systems;
- the purchase of goods from recommended wholesalers, and
- the distinction between a franchise and a licence.

Recruitment & Expansion of Franchise Systems

Recruitment is becoming very critical to the success of the franchise and selection of franchisees is a key area for the ACCC.

One of the biggest issues with franchising is choosing the right franchisee. **Some** franchisors should take more care with the selection of franchisees.

A good description of the challenge was recently provided by a leading franchise expert in the following terms.

“Problems arise, when a franchisor is looking to expand the business too quickly. When this occurs there is little consideration:

- for where the businesses are being sold;
- who is purchasing the business; and
- whether or not the franchisor can maintain the level of support that many franchisees require and have grown to expect.

The franchise selection process is a mutual one. It has to be the right investment from both sides.

The franchisor is looking for the kind of partners who are going to make their brand successful. The franchisor is making, in many cases, as much as an investment with the franchisee as the franchisee is making themselves.

A franchisee is bringing their hard earned capital to the table but the franchisor is bringing their brand reputation and their prospects in the market place. So a franchisor should, and in most cases does, invest a great deal of time in making sure that you have a square peg in a square hole. That it is a right cultural fit, both in terms of the relationships with the franchise and the suitability to the business or the sector in which the franchisee intends to operate¹”.

The disclosure regime imposed on franchisors by the Franchising Code requires those who sell franchise businesses to disclose key business information to prospective franchisees enabling them to make more informed purchasing decisions.

The disclosure regime informs prospective franchisees about, amongst other things, any relevant business experience the franchisor has, the likely cost of establishing the franchise business, and contact details of existing franchisees. As well as providing prospective franchisees with relevant

¹ Matthew Penfold, Chief Executive Officer, Errington Pty Ltd, ACCC Competing Fairly Forum, *Franchising is it right for you?*; July 2004.

information, the disclosure obligations arguably act as a deterrent to those who wish to sell business opportunities that are not genuine.

The dual protection provided to prospective franchisees by the disclosure regime means that failure by franchisors to meet disclosure obligations is a serious contravention of the Franchising Code.

Sometimes the ACCC hears from franchisees when a franchise system has expanded too quickly – either domestically or internationally.

It is important that any expansion occurs in measured fashion. Whilst there might be some short term gain in selling a high number of franchises – there is the potential for serious longer term damage. The ACCC has received complaints from franchisees when this has occurred – the concerns include:

- Reduction in service and assistance provided to franchisees;
- Increased number of franchisees competing for a smaller piece of the pie;
- Increasing demands placed on franchisees – which many feel greatly impact on their viability and profitability;
- Cutting costs of products and services to a degree that can result in inferior quality products;
- Limiting a franchisee's opportunity to obtain goods and services from other sources; and
- Differing levels of services and goods provided to different franchisees in the same system – which affects the position of a franchise system in a highly competitive market place.

The success of a franchise relies upon the individual success of each franchisee. Yet some of these problem areas can effectively undermine franchisees individually or as a group.

Sourcing from Recommended Suppliers

A number of franchisees have complained over franchisors insisting that franchisees purchase necessary goods from a recommended wholesaler or the franchisor. Franchisees often complain that this conduct breaches third line/full line forcing provisions in sections 47(6) and 47(7) of the TPA. However, this type of behaviour is not necessarily a breach of TPA.

Third line/full line forcing provisions prohibit a franchisor from supplying the franchisee on condition that the franchisee acquires goods or services from a particular third party or the franchisor. It also includes a refusal to supply because the franchisee will not agree to that condition. To amount to a breach, the franchisor must impose on the franchisee a strict requirement to purchase goods from a third party or the franchisor. Without this requirement, recommended suppliers won't normally breach the TPA. In addition to this, the franchisor's behaviour must lead to a substantial lessening of competition.

Nevertheless, franchisors may impose quality standards on franchisees and can also nominate suppliers who meet these standards. However, franchisors must not stop a franchisee from purchasing goods or services from another supplier so long as that supplier meets the quality standards.

Immunity for third line forcing can be sought by parties through the notification process. Immunity comes into force fourteen days from the time the ACCC receives the notice. The Commission may issue a notice revoking the immunity if the likely benefit to the public from the notified conduct would not outweigh the likely detriment to the public resulting from the conduct.

It is important the franchisors when informing franchisees that they should acquire goods or services from a particular supply are not only aware of the requirements under TPA, they also need to be aware of the effect that this has on franchisees. Many franchisees do not understand why they can't choose a particular supply, many franchisees believe that the only reasons

particular supply arrangements have been nominated is to benefit the franchisor.

Franchise v Licence

The ACCC continues to receive complaints about businesses that advertise and sell licenses, when in fact the scheme is a franchise operation.

Those parties that deliberately try to avoid the obligations and protections imposed by the Franchising Code by referring to the arrangement as a license not only risk contravening the TPA, they also risk litigation by the ACCC.

In a recent case that the ACCC took, *ACCC v Ewing*, commonly known as “Synergy”, the Federal Court declared by consent that 31 licence agreements entered into by Synergy were in fact “franchise agreements” as defined in clause 4 of the *Franchising Code of Conduct* (“the Code”).

The ACCC alleged contraventions of a number of provisions of TPA including a contravention of an applicable industry code in contravention of s51AD, misleading or deceptive conduct in contravention of s52, and misleading representations about certain business activities in contravention of s59(2) of TPA.

In the *Synergy* case, the subject agreements were in writing and gave the licensee the right to carry on the business of offering, supplying and distributing the Best Practice Program developed by Synergy. The licensee also had the right to use Synergy’s intellectual property and was required to pay a fee to Synergy before the licensee could commence business.

The ACCC alleged that Synergy had specifically attempted to exclude the licence arrangement from being characterised as a franchise by requiring the licensee to acknowledge that it was not entering into a franchise relationship. The ACCC considered Synergy was a franchise and operated as one in practice.

After considering the terms of the licence agreement and the agreed statement of facts consented to by the parties, Justice Stone was satisfied that the Agreements were Franchising Agreements and that a contravention of the Code and therefore s51AD of TPA had occurred. Contraventions of section 52 and section 59(2) of TPA were also found.

6. EXPANDING THE ACCC'S CONSULTATION AND EDUCATION ROLE

The ACCC finds it extremely beneficial to work with industry to promote greater awareness and compliance with TPA.

From the ACCC's position the interaction with franchisees and franchisors improves our knowledge and understanding of the situations that face franchisors and franchisees. The ACCC's Franchising Consultative Panel which meets biannually is an important part of the ACCC's strategy to promote awareness and compliance with the Code and TPA. It involves frank and informal dialogue between the ACCC and industry representatives.

The ACCC has and continues to work directly with the sector to increase awareness amongst franchisors of the concerns that are raised with franchisees.

There is mutual benefits from the industry working with the ACCC in this collaborative manner. A key example of this is the recently released Competing Fairly Forum on franchising.

The ACCC's "Competing Fairly Forum"

The forum was developed to respond to enquiries from prospective franchisees regarding how to choose the right franchise system, and queries in relation to the role of the ACCC in franchising.

The key messages conveyed in the forum included:

- Franchisees and franchisors must be aware of their rights and obligations under the Franchising Code of Conduct.
- It is important that franchisees obtain the relevant and necessary information prior to entering into a franchise.
- Transparency across the whole franchise is essential so that both franchisees and franchisors know where they stand.
- It is vital that franchisees and franchisors work together as the success of the franchisee goes hand in hand with the success of the franchisor.

The forum is hosted by Emma Alberici from ABC's News and Current Affairs and the panel consists of the following members:

- Graeme Samuel (Chairman ACCC)
- Richard Evans (Chief Executive, Franchise Council of Australia)
- Pippa Colman (Mediator with the Office of Mediation Advisor)
- Matthew Penfold (Kwik Kopy Franchisor)
- Scott Roworth (Baker's Delight Franchisee)

The panel discussion focused on the ACCC's role in administering the Franchising Code of Conduct. The rights and obligations under the Franchising Code of Conduct and the TPA are discussed along with some of the key issues raised by franchisees to the ACCC. This discussion is based around three trigger videos. These videos develop the "story" of a franchise operation chronologically. The audience is guided through the purchase of a franchise, problems that may arise during the franchise agreement, and the expiration or possible sale of the franchise agreement.

7. CONCLUSION

Businesses should not be looking for ways around the TPA. This is not good business practice and risks tarnishing the reputation of an organisation and the industry in which it operates.

The ACCC does not look to make examples of franchisors or other businesses. It is important to remember that what we are looking towards is compliance – with the TPA and the Code.

It is also important to note that most small businesses are not looking to penalise – they are simply looking for an opportunity to continue running their business in a fair and ethical environment.

The message of compliance with the Code is extremely important. The success of a franchise business depends on the individual success of franchisees as well as the individual success of the franchisor.

This is a symbiotic relationship that needs to be managed carefully. One unhappy franchisee, whether it is legitimate or not, can have a cascading effect throughout the franchise system, now and in the future.

The ACCC aims to create a culture of compliance, by helping businesses understand the TPA and how best to deal with the obligation and protection it provides.