3 Franchising

> Good franchising is very good. It is undoubtedly the most efficient, effective distribution system ever invented. It is the greatest invention of Western capitalism since the invention of the corporation. Good franchising is so much better than independent small business operation and bad franchising is so much worse.[1]

Introduction

Structure of chapter

3.1 This chapter deals with franchising in general explaining the nature of franchising and its extent in Australia. It goes on to draw attention to previous concerns raised regarding business conduct in franchising as well as the serious concerns raised in evidence on this occasion. It also describes the protection available under the Franchising Code of Practice and the limitations of that protection, before drawing attention to recent problems in relation to the administration of that code. The chapter also looks briefly at regulatory arrangements applying to franchising in general in the United States.

3.2 Problems in the particular area of motor vehicle dealerships and the proposition that such dealerships are not franchises are discussed before looking at regulatory arrangements in the United States of America (US) and Europe.

3.3 The other area of particular concern examined is the area of petrol retailing. The chapter draws attention to concerns expressed by petrol retailers and distributors as well as the protection currently available under OilCode. Regulatory arrangements in the United States are then described. It also draws attention to recent policy announcements affecting the industry. The chapter concludes that current protection available to franchisees is inadequate and examines the options proposed.

1 Professor Andrew Terry, *Transcript of evidence*, p. 92.

What is franchising?

3.4 Franchising is an increasingly popular form of economic organisation providing an alternative means of expanding an existing business or an alternative means of entering an industry. Under the system, the franchisor, holding property rights over a marketing system, business service or product (identified by a brand name or trademark) enters a contract or agreement with the franchisee and grants, under certain conditions, the right to use a business brand name or trademark and the right to produce or distribute the franchisor's product or service.

3.5 Substantial benefits exist for both franchisees and franchisors under the system. The franchisor derives income from any initial franchising fee and from access to a continuing cash flow through product sales and from licence fees without having to provide additional capital or to directly manage the franchisee. The franchisor gains from access to established business systems, developed products or services, training and business advice, group advertising and lower risk.

3.6 The US House of Representatives Committee on Small Business in its 1990 report on franchising in the US Economy stated that franchising had the potential to become the 'dominant force in the distribution of goods and services'.[2]

3.7 Franchising can be divided into one of, or a combination of:

- product franchising, where a distributor supplies the product of a manufacturer, often with exclusive right to sell within a specific market (common with motor vehicles and petrol);
- business format franchising, where a unique system of doing business is undertaken in a controlled manner usually with a trade name, trademark, specified decor (for example, restaurants, real estate and motels); and
- manufacturing franchising, where an essential ingredient or technical information is supplied (common in the soft drink industry).

3.8 Franchising has existed as a business system for many years. The first phase in the development of this system began in the United States with the creation and expansion of the automobile and oil industry franchising networks. These networks were established world wide, proving the success of the system. Franchising rapidly expanded in the 1950s and 1960s with the development of the concept of business format franchising, typified by the growth in fast food retailing.

2 cited by Professor Andrew Terry, *Submission No. 56.*

Extent of franchising in Australia

3.9 In 1994 the Australian Bureau of Statistics survey of Australian franchising found:

- 555 franchise systems;
- 26 000 franchisees;
- total turnover for 1993-94 of $42.7 billion;
- 279 000 persons employed;
- 67% growth in the number of business outlets operated by franchisees since 1991 (an annual growth rate of 14%); and
- 18% of home grown franchise systems exported. [3]

3.10 When asked to comment on the growth of franchising in Australia, Professor Andrew Terry, Head of the School of Business Law & Taxation, and Director of the Centre for Franchising Studies, University of New South Wales, said:

> *what I do know is that we do in Australia have twice as many franchising systems per head of population as the US. ... the good in that is that there are opportunities for diversity and opportunities for entrepreneurs and opportunities for people to readily enter the sector.*
>
> *The downside of that is that some 65 per cent of franchise systems in Australia have fewer than 10 franchisees. I do not know what the threshold is, but obviously a system with fewer than 10 franchisees probably does not have the critical mass that it needs to deliver the benefits of joint marketing and assistance and development and all that sort of thing.* [4]

Previous concerns

3.11 Unfair practices in franchising have been a source of concern for some time. The Swanson Committee in 1976 was concerned about the termination of franchise agreements. The Blunt Committee in 1979 made reference to the then Government's intention to enact a franchise law for the petroleum retailing sector and recommended that the Government should consider a more general franchise law instead. The Government released an exposure draft of a Franchise Agreement Bill, in 1986 and a second exposure draft later the same year. Following criticism of both proposals the Ministerial Council decided in May 1987 not to proceed with the legislation.

3.12 Evidence to the House of Representatives Industry, Science and Technology (IST) Committee in 1990 indicated that there were three areas where franchise agreements acted against the interests of franchisees:

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3 cited by the Franchising Code Council, *Submission No. 43.*

4 Professor Andrew Terry, *Transcript of evidence*, p. 90.

- absence of any requirement for prior disclosure of information clearly outlining the rights and responsibilities of the two parties;
- unilateral alteration of the agreement by franchisors without prior notification; and
- lack of clear cut statements on the basis for renewal or the grounds for termination of agreements.

3.13 The IST Committee went on to recommend that the Commonwealth Attorney-General and Ministerial Council re-examine the case for specific franchise agreement legislation which would contain:

- prior disclosure documentation;
- a cooling-off period;
- conditions for alteration to the agreement; and
- conditions for termination/renewal or transfer.[5]

3.14 These concerns were again examined in the report of the Franchising Task Force to the Minister for Small Business and Customs in 1991 which concluded that the level of concern expressed by franchisees that had entered into inappropriate, fraudulent or misrepresented systems could not be ignored. As a consequence the Franchising Code of Practice was established in 1993 along with the Franchising Code Council to administer the code.

3.15 The Franchising Code of Practice was itself reviewed in 1994.[6] That review, which reported to the then Minister for Small Business, Customs and Construction in October 1994, identified the following areas of dispute between franchisors and franchisees:

- charging excessive prices for goods supplied to franchisees;
- secret rebates and commissions from suppliers;
- discrimination in terms of trading between company owned outlets and franchised outlets;
- encroachment on the franchisee's geographic trading area;
- failure to address lack of viability of franchise outlets;
- making substantial increases to renewal fees;
- failing to provide adequate service and support to franchisees;
- unwillingness to discuss and negotiate problems;
- using advertising levies for other purposes;
- intimidation and victimisation of franchisees; and
- unfair terminations.

3.16 The review found that the standard of conduct provisions contained within the Franchising Code of Practice had not been effective in addressing serious franchise disputes.

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5 House of Representatives Standing Committee on Industry, Science and Technology, *Small Business in Australia: Challenges, Problems and Opportunities* (January 1990).

6 Robert Gardini, *Review of the Franchising Code of Practice*, Report to Senator the Hon Chris Schacht, Minister for Small Business, Customs and Construction (October, 1994).

Franchising in general

Current concerns

3.17 The Inquiry has received evidence suggesting that such problems are continuing. For example, Mr Alan Briggs, representing the Property Council of Australia acknowledged:

> *As to franchisor/franchisee relationships ... there are problems that need to be addressed urgently ...*[7]

3.18 In particular the Franchising Code Council, the body which was established with Commonwealth financial assistance to administer the Franchising Code of Practice, identified categories of disputes similar to the list above. That Council undertook a review of disputes in 1996 and the report of the Franchising Code's Dispute Review, November 1996 recorded that in the period May - November 1996 the Franchising Code Council received some 123 formal complaints and an additional 2500 inquiries.[8] Of those inquiries some 500 specifically related to requests for information regarding disputes, potential disputes or complaints.

3.19 A majority of complaints related to clause 12 of the Franchising Code which deals with standards of conduct. In addition, the review recorded that between 1 January 1996 and 30 April 1996 some 41 franchising matters were instituted in the Federal court, the State Supreme Courts (which supplied data) or the NSW Industrial Court. Most commonly these related to section 52 of the Trade Practices Act to do with misleading and deceptive conduct.

7 Alan Briggs, Property Council of Australia, *Transcript of Evidence*, p. 779.
8 *Exhibit No. 262.*

3.20 In relation to such disputes the report of the Franchising Code's Disputes Review said:

> *Some of the disputes identified and analysed by the review paint the most distressing picture of the results of business failure including divorce, bankruptcy, loss of savings and/or the family home. Because most people borrow to go into franchising, if they fail the consequences are devastating. Often people do not understand the nature of the work or the hours they will have to put into making the franchise work. They make rash decisions to spend significant amounts of money to buy a franchise without taking advice or they are poorly advised.*[9]

3.21 The Disputes Review also received a submission from the Australian Franchisee Association claiming that they had taken action against 32 franchisors on behalf of 53 franchisees. The franchisors concerned covered many significant franchise companies as well as some lesser known companies.[10]

3.22 Independent research conducted for the review by Artcraft research surveyed some 700 franchisees and 100 franchisors. That research showed that:

- 13% of franchisors and 1% of franchisees said they were currently in litigation or the courts;
- a further 12%, making 25% in total of franchisors, said they currently either had disputes or major disagreements or litigation in court;
- a further 9% of franchisees said they had a major disagreement, making a total of 10% of franchisees with either major disagreements or litigation in court;
- 63% of franchisors stated they gave a seven day cooling off period but only 4% of franchisees believed they received a seven day cooling off period; and
- 53% of franchisors said they had granted franchises for less than ten years whilst only 21% of franchisees believed they had been granted the franchise for less than ten years.[11]

3.23 Some of the franchising issues raised in the Fair Trading inquiry are illustrated in the case study in Box 3.1.

9 Robert Gardini, *Review of the Franchising Code of Practice*, p. vi.
10 *Exhibit No 262*, p. 33.
11 *Exhibit No 262*, p. 49.

Box 3.1 Case study: Mr Neil Mitchell

NEIL MITCHELL AND FOOD PLUS

Mr Neil Mitchell gave evidence to the Fair Trading inquiry in Submission No. 48 and at the public hearing in Melbourne on 4 October 1996. BP Australia was represented at the hearing at which Mr Mitchell gave evidence. Mr Christopher Gillman, Marketing Development Manager for BP Australia, replied to Mr Mitchell's claims (Transcript of evidence, pp. 126-39).

Mr Mitchell, is aged 45 and married with a 15 year old son. In 1991 following the reorganisation of the Civil Aviation Authority Mr Mitchell took a voluntary redundancy package and purchased a Food Plus franchise in the Melbourne suburb of Tally Ho. The franchise was operated by a an organisation called Polygon, a wholly owned subsidiary of BP Australia.

For Mr Mitchell, with no training or experience in small business, one of the major selling points when buying a franchise was acquiring the support package to minimise the possibility of business failure. Polygon had claimed that:

> *a comprehensive training programme helps prepare new Food Plus franchisees to manage their store. The training covers all aspects of operation including merchandising, accounting, security, hygiene, advertising, safety, personnel and financial control*.

Mr Mitchell said that these representations appeared to have been made with apparent disregard for their accuracy or potential consequences. The training was totally inadequate and the guidance and supervision promised was just another hollow misrepresentation.

Mr Mitchell said that the former franchisee had misled him about the performance and viability of the business and that Polygon itself had not offered accurate or cautionary advice upon which to calculate the financial viability of the business. Mr Mitchell claimed that Polygon approved the assignment of the franchise knowing that the gross profit figure was overstated by 30%. Indeed when Mr Mitchell expressed serious reservations about continuing with the purchase during the training phase, the Polygon employee who approved the assignment produced the distorted business projections and emphasised that they were a true and accurate representation of the business' performance.

Consequently Mr Mitchell found himself on his own - untrained, unsupported - in a business which could barely break even.

Compounding this injury, not long after the purchase Mr Mitchell was confronted by members of the Victorian Police Gaming and Vice Squad alleging that he was retailing illegal pornography. It was discovered that the alleged sale of illegal pornography happened long before Mr Mitchell had purchased the business. Mr Mitchell said Polygon actively promoted adult magazine sales, giving the pornography wholesaler a vendor number which lent credibility to his bona fides. Mr Mitchell said that Polygon requested him to delete information about the vendor number from his police statement, pointing out that he was in a cooperative business arrangement with them.

Approximately eleven months after taking over ownership of the business, Mr Mitchell was in a state of physical and emotional distress. Mr Mitchell surrendered the business, reselling it to Polygon at a significant loss. Polygon subsequently resold the business, apparently to an existing franchisee. Mr Mitchell claimed:

> *I paid $205 000 for it, plus stock on top of that. They bought it off me for $50 000 and then on-sold it again, I understand, to another franchisee. I assume they would have recouped the purchase price they got it off me for, which continues the process of someone failing, a franchisee being sold it, figures being worked on, being sold off to another franchisee - who in this case was me - who then falls out. It is then sold on to another franchisee. There appears to be some pattern in it.*

By this time Mr Mitchell had lost his life savings which included his redundancy package and the bulk of his superannuation entitlements. In May 1993, shortly after surrendering the business, Mr Mitchell wrote to BP Australia about the conduct of some Polygon employees but because of his physical and emotional ill health was unable to proceed with the matter.

Earlier this year he sought to reopen the matter with BP but was informed that BP will only answer questions if he litigates.

When questioned on the problems, the representative of BP Australia, Mr Christopher Gillman, said that BP had done what it could to assist Mr Mitchell. Mr Gillman went on to say that there is a difficulty where they suspect a vendor may be asking too much for a business. Whether a vendor is asking too much is a matter of opinion to some degree, so BP is reluctant to become involved. However, BP does try to ensure that the purchaser is aware of the relevant facts and that the purchaser takes appropriate accounting advice. Mr Gillman said that BP staff brought the relevant issues to Mr Mitchell's attention.

In regard to Mr Mitchell's attempts to reopen the matter, BP considers that Mr Mitchell chose not to use the procedures available under OilCode three years ago and it that it served little purpose to continue such correspondence at this point in time.

Mr Gillman acknowledged that there is quite a difference between Mr Mitchell's viewpoint of the facts and issues and BP's viewpoint of the facts and issues.

Inherent inequalities in franchising relationship

3.24 The Committee notes that franchising contracts typically impose very heavy obligations on franchisees while leaving franchisors' duties relatively undefined. But the obligations of the franchisor are vital to the franchising relationship.[12] Such contracts and the franchisees' sunk costs necessarily involve the danger of opportunistic abuse:

> *The incentive that causes a business with sunk costs to stay in operation despite losses makes franchisees vulnerable to franchisor behaviour known as 'opportunism'. Because the franchisee will continue to operate even if it is not recovering its sunk investments, the franchisor can make decisions that induce such losses without the franchisee going out of business. When these decisions benefit the franchisor at the expense of the franchisee, the franchisor opportunistically extracts a portion of the franchisee's sunk costs. A franchisor can potentially extract this value from the franchise directly in a number of ways: it can raise the price of goods sold to franchisees, increase rent, boost royalties through an increase in the required volume of a franchise, levy fees or divert advertising funds to general corporate uses. Extractions can occur indirectly as well. To increase the price of new franchises, a franchisor could require franchisees to make excessive advertising investments, to participate in promotional programs which are not cost-effective, or to undertake unnecessary renovations.*[13]

3.25 This view was supported by Professor Andrew Terry:

> *... it is naive to deny that franchising has given rise to a number of significant business conduct issues which have not been effectively addressed.* [14]

3.26 Professor Terry went on to categorise those problems as relating to 'information imbalance' and the 'power imbalance' in franchise relationships and the Business Law Committee of the Law Institute of Victoria expressed a similar view based on its experience of the problems.

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12 Hadfield, Gillian K, 'Problematic Relations: Franchising and the Law of Incomplete Contracts' in *Stanford Law Review* Vol 42: 927 (*Exhibit No. 229*).

13 *Exhibit No. 229.*

14 Professor Andrew Terry, *Submission No. 56.*

3.27 The Business Law Committee of the Law Institute of Victoria considered that the ability of a franchisor to exercise control often causes many of the problems in franchising. The Business Law Committee provided the following examples:

> 1. *'rolling' audits of the franchisee to gather evidence of the franchisee's non compliance;*
>
> 2. *if the franchisor supplies goods or services exclusively, it has the ability to squeeze the profit margin of the franchisee by controlling the price that the product is distributed to the franchisee over a protracted period of time allowing the franchisee to incur debt with the franchisor to the point where the franchisor wields substantial power over the franchisee's business viability with threats to recover the debt;*
>
> 3. *the requirement and direction of franchisees to purchase equipment or product having a substantial cost on franchises or where the franchisor obtains rebates or incentives;*
>
> 4. *the franchisor utilising the tied distribution relationship to force franchisees to pay a higher price under the franchise arrangement whilst selling identical product to distributors outside the network; and*
>
> 5. *in site specific franchises, taking advantage of the franchisee's development of its economic area to force the franchisee to pay goodwill again for its business by threatening to open new stores nearby.*[15]

3.28 The General Business Format Community of Franchising and the Real Estate Sector is represented by the Franchise Association of Australia & New Zealand (FAANZ). FAANZ suggested that disputes can arise from the intrinsic nature of franchising:

> 1. *Pressure exists on the franchisor to deal with the 'bad apples' within any franchise system who refuse to comply, or otherwise allow the system to be brought into disrepute.*

15 Business Law Committee of the Law Institute of Victoria, *Submission No. 128.*

> 2. *A proportion of franchisees will be badly selected and ill suited to the business for a range of reasons or will suffer under poor business conditions, and will feel locked in and seek to blame the franchisor for everything.*
>
> 3. *Pressure always exists to maintain uniformity of standards and control in terms of the requirements imposed on franchisees in any system.*
>
> 4. *The characteristic that most franchise contracts are of a long term nature and are less flexible and therefore less able to adapt to a changing business environment than employer owned chains of outlets.*
>
> 5. *Most bilateral franchisor/franchisee relationships are necessarily lopsided, and hence lead to claims of harsh or oppressive treatment simply by virtue of unequal bargaining power ...*
>
> 6. *Some franchise chains are badly organised and accordingly their franchisors must bear a fair share of the blame for this and consequent disputes.*[16]

3.29 Some franchisees face a double jeopardy in that they are both franchisees and tenants. They can end up being squeezed from two directions at once. Even worse can be the case where the franchisor is the tenant and the franchisee sub-lets the premises from the franchisor. In these circumstances they can be denied access to the sort of information which should be made available to retail tenants as a matter of course. This information includes details of rental, outgoings and promotion expenses and details relating to tenancy mix and redevelopment proposals. Codes of practice should ensure that this information is made available to the franchisee. An additional problem arises in these cases in relation to participation in merchants' associations particularly when the tenancy mix is being discussed. Codes of practice should also provide for adequate representation of the franchisee in such forums.

16 FAANZ, *Submission No. 143.* However, FAANZ was concerned that the franchising argument tended to be very one-sided, focusing on the problems encountered by franchisees without recognising that franchisees were sometimes the source of difficulties:

> *It is important to strike a proper balance with regard to disclosure between franchisors and franchisees. Whilst complaints are made of accuracy with disclosure by franchisors, little mention is made in debate about potential franchisees wanting to 'get into' the franchise system by misrepresentation of part or more of their small business history, financial position, work experience, level of commitment, product or service knowledge and other necessary criteria. In mature franchise systems, there appears to be an increase in incidents of this.*

3.30 Recommendation 3.1

The Committee recommends that the Franchising Code of Practice and any other relevant codes should provide for full disclosure of information relating to rental, outgoings, promotion expenses, tenancy mix and redevelopment proposals to franchisees who sub-let their premises from the franchisor. The code should also provide for adequate representation of franchisees in merchants' associations.

Franchising Code of Practice

3.31 As indicated above serious problems in franchising were identified by the comprehensive 1991 report by the Franchising Task Force. The Task Force recommended the establishment of a self-regulatory code of practice to be administered by a Franchising Code Administration Council. With encouragement from the Commonwealth and State governments the FCAC was established early in 1993 with initial funding from the Department of Industry, Science and Technology. The name was changed to the Franchising Code Council in 1996. The Council comprised five franchisors' representatives, five franchisee representatives, two members representing service providers and advisers and one lawyer representative.

3.32 The Franchising Code covers such matters as:

- details of the franchisor including business experience and key financial information;
- summary of the main particulars of the franchise;
- a list of components making up the franchise purchase;
- details of any financial requirements by franchisors of the franchisee;
- number of existing franchises and list of franchisees for referee purposes;
- number of franchises terminated or not renewed over past year;
- details of any current unresolved litigation with any existing former franchisees;
- particulars of the basis for written projections regarding financial details; and
- statement as to whether territory/site has been subject to trading activity of a previous franchisor.

3.33 Following the withdrawal of Commonwealth funding from 1997-98 onwards the Franchising Code Council Limited appointed an administrator on 30 January 1997 and has ceased to operate.

3.34 Mr Gardini, the former Chairman of the Franchising Code Council stated that, while the Council was achieving a certain level of success in administering the Franchising Code of Practice, the Code suffered from the following serious weaknesses:

- *coverage of the Code at the time of its collapse was approximately 65 percent. ... an effective Code needs to be made mandatory;*
- *the Franchising Code Council was unable to inform the marketplace of those who were removed from the register of compliance as to do so would have exposed the Council to the serious risk of defamation proceedings;*
- *the Council was prevented by the Code itself from removing franchisors from the register of compliance who breached the standards of conduct provisions in the Code. In the absence of an effective provision in the Trade Practices Act dealing with unconscionable conduct this meant that there was no effective legal remedy for aggrieved franchisees;*
- *section 51AA of the Trade Practices Act did not effectively underpin the standards of conduct provisions contained in the Code.*[17]

3.35 Mr Gardini also advised that in a recent survey by the Council, some 25% of franchisees were currently in litigation or major disputation with their franchisees while some 50% of franchises surveyed did not have formal processes for dispute handling and resolution. In relation to disclosure documents, Mr Gardini said that of 150 disclosure documents audited last year only 30% broadly complied with the Code.[18]

17 Robert Gardini, *Submission No. 191*.

18 Based on the Franchising Code Council's 1996 draft report on franchise disputes and solutions (*Exhibit No. 262*).

3.36 Mr Mark Overell, representing the Queensland Retail Traders and Shopkeepers Association, was also concerned at the effectiveness of the Franchising Code of Practice:

> *It is our opinion that the code of conduct is not working adequately to protect the interests of both the consumer and, of course, the franchisee as well. The franchisor, in some instances, has been less than diligent in areas of disclosure and may operate almost in the areas of unconscionability. There were a number of circumstances in the recent past where franchise groups have fallen into difficulty and been wound up. There are certainly a number of franchise operators who have appeared on current affairs programs with grievances. The issue of franchises, I think, is well recorded.*
>
> *We would like to see a situation where all franchise groups came under the umbrella of a code of conduct. It is certainly not happening on a voluntary basis. Government may need to move towards a legislative process for the franchise industry and for the protection of very large amounts of capital.* [19]

3.37 The FAANZ went on to suggest that:

> *There seems to be agreement on all sides that the main concern currently is with franchisors who have not:*
>
> - *subscribed to the Franchising Code (with its emphasis on adequate disclosure and dispute resolution prior to litigation, cooling off period and independent advice to the franchisee before the agreement is signed);*
> - *joined FAANZ, which now requires as a condition of members that the Code be subscribed to;*
> - *committed to a code of ethics and best practice; and*
> - *provided adequate disclosure to their franchisees.* [20]

19 Mark Overell, Queensland Retail Traders and Shopkeepers Association, *Transcript of evidence*, p. 227.

20 FAANZ, *Submission No. 143.*

Overseas practice in relation to the regulation of franchising

3.38 The Franchising Code Council indicated that in the United States franchising legislation currently exists in two forms, specific disclosure legislation, and specific State legislation dealing with the franchise relationship.[21] The 1979 Federal Trade Commission rules require a disclosure document containing the following information:

- information regarding the franchisor;
- the directors and executive officers of the franchisor;
- litigation and bankruptcy histories;
- the franchise to be purchased;
- obligations to purchase;
- financing;
- required personal participation;
- termination, cancellation and renewal provisions;
- statistics on the number of franchisees;
- training;
- site selection; and
- final financial reporting, including audited financial statements.

3.39 Similar legislation has been passed in fifteen states. Fifteen States also have legislation relating to the relationship between the franchisor and the franchisee once the franchise agreement has been entered into.

3.40 A further Bill, the *Federal Fair Trading Franchise Practice [Bill]*, was introduced into Congress on 25 May 1995. This Bill has not yet progressed any further. The Bill sought to prohibit fraud, misrepresentation in the offer and sale of franchises, prohibit termination without good cause and with 30 days notice, impose a duty of good faith on all parties, restrict establishment of outlets within proximity of established franchises, provide a right of action for injunctive relief and damages, including costs and, generally seek to place restrictions on the ability of franchisors to restrict the conduct of franchisees once they have left the agreements. The Bill also sought to codify franchisees' rights to free association and to limit the application of mandatory arbitration clauses in contracts. The law would permit each State's Attorney-General to bring civil action under the legislation.

Adequacy of existing protection for franchisees

3.41 The Committee notes that in franchising in general there exists considerable disquiet about the conduct of franchisors and about the effectiveness of the Franchising Code of Practice. The Committee notes also that similar concerns have been expressed in the United States where franchising originated.

21 Franchising Code Council, *Submission No. 43.*

Motor vehicle dealerships

3.42 The Committee gave special consideration to the area of motor vehicle dealerships in light of arguments put to the Committee about whether or not these businesses were franchises and thus subject to whatever franchising law prevailed in Australia.

Are motor vehicle dealerships franchises?

3.43 One of the particular concerns raised by the Australian Automobile Dealers Association (AADA) was the refusal by the motor vehicle suppliers to join the Franchising Code of Practice. In AADA's view:

> *the failure of the suppliers to join the Code can only be explained by an unwillingness on their part to comply with the Code requirements such as providing a disclosure document to all franchisees and to conform to the standards of behaviour as set out in the Code.* [22]

3.44 For its part, the Federal Chamber of Automotive Industries (FCAI) claimed to this inquiry that the concept of franchising is not applicable to the car industry:

> *Car dealerships are not franchises in the accepted sense of the word because manufacturers do not seek to impose uniformity in presentation, market, product, price structure, methods of operation across dealerships. Dealerships are, and must be, operated as independent businesses.* [23]

3.45 The Committee notes that General Motors - Holden's indicated to the Blunt Committee in 1979 that it franchised a large body of dealers throughout Australia. The Committee also notes that the Trade Practices Tribunal held in 1977 that dealers are franchised in that they are granted the right to sell the products of a particular manufacturer.[24]

3.46 Because motor dealers and the like claim not to be franchisors they are not registered under the Franchising Code of Practice and are not in any way bound by its provisions and the associated dispute resolution arrangements. They rely entirely on contract law.

22 AADA, *Submission No. 116.*
23 FCAI, *Submission No. 113.*
24 cited by AADA, *Submission No. 116.*

Business conduct issues raised in relation to motor vehicle dealerships

3.47 Particular concerns were expressed about problems in relation to the distribution of motor vehicles and associated sectors. In particular, the AADA indicated that it has been endeavouring to secure fair and equitable arrangements for its members in their dealings with their franchisors and other suppliers for many years. Each year AADA and the Motor Trades Association of Australia (MTAA) through their member associations receive numerous complaints from motor vehicle dealers concerning the behaviour of their franchisors or other suppliers.[25]

3.48 Surveys of franchised new motor vehicle dealers conducted by AADA from 1989 to the present, have indicated that the major areas of dispute are as follows:

- termination at will;
- rights of assignment;
- appointment of other dealers in the Prime Market Area;
- limitation of distributors' rights to terminate;
- security of tenure and duration;
- distributors' obligations to supply;
- unilateral variation of franchise agreements;
- compulsory dealer contributions;
- compensation for stock on termination;
- dealership structure;
- access to financial records;
- payments;
- performance criteria; and
- other (competing franchises, multi-franchising, superseded new vehicles).

3.49 The majority of these complaints were directed against automotive companies importing product in relatively small volumes.[26] When asked how extensive those situations were, Mr Michael Delaney, on behalf of MTAA, replied:

> *It is frequent. As our survey material discloses, we would have something of the order of 20 very serious cases per year around the country, involving large sums of money.*[27]

3.50 AADA also advised that the franchise agreements for the farm machinery, motor cycle and commercial vehicle sectors of the retail motor trade generate the same problems. In this regard Mr Delaney said:

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25 AADA, *Submission No. 116.*

26 For the period 1989 to 30 June 1996, 19 out of 109 disputes concerned the four domestic manufacturers. Nissan (manufacturing in Australia for part of this period) accounted for a further 11 disputes (AADA, *Submission No. 116).*

27 Michael Delaney, MTAA, *Transcript of evidence,* p. 332.

> *But, yes, essentially the whole of Australia's infrastructure of farm machinery dealing and servicing is held and owned by our members and they have dealings with perhaps four major suppliers. The way they are treated is off the scale and no redress is possible.*[28]

Overseas regulation in relation to motor vehicle dealerships

3.51 AADA provided details of US automotive franchising legislation. The first such legislation, the federal *Dealers Day in Court Act*, allows recovery of damages and costs if the manufacturer failed to act in good faith. In addition every State in the US has enacted laws which in varying degrees regulate the contractual relationships and business conduct between motor vehicle manufacturers, distributors, new motor vehicle dealers and the consuming public. According to AADA the *Dealers Day in Court Act* did not eliminate many of the then common unfair franchise practices, and led to the many state dealer franchise laws enacted in the 1970s and 1980s. Most State legislation is based upon drafts prepared by the National Automobile Dealers Association and common features include the following:

- uniform procedures for termination;
- fair compensation to be paid for stock upon termination;
- the supplier must show 'good cause' for termination;
- an obligation on the supplier to provide stock as ordered within a reasonable time and in reasonable quantities;
- an obligation on the supplier not to discriminate between dealers regarding warranty reimbursements or incentive programs; and
- suppliers' capacity to take control of dealership management or finance is limited, and suppliers' ability to prevent change to the financial or management structure of a dealership is prohibited.[29]

3.52 In the Member States of the European Union motor vehicle distribution agreements fall within the scope of Article 85(1) of the EC Treaty. A group exemption for motor vehicle distribution has been granted from that Article by Commission Regulation (EC) No 1475/95. The regulations contain several adjustments to stimulate competition in the car sector, to improve the functioning of a single market in cars and to re-balance the diverse interests in question. These adjustments aim in particular to:

- give dealers, the great majority of whom are small or medium sized enterprises, greater commercial independence vis-a-vis manufacturers;
- give independent spare-parts manufacturers and distributors easier access to the various markets, notably the outlets provided by the car manufacturers' networks;
- improve the position of consumers in accordance with the principles underlying the internal market; and

28 Michael Delaney, MTAA, *Transcript of evidence*, p. 337.
29 AADA, *Submission No. 116*, p. 55

- make the dividing line between acceptable and unacceptable agreements and behaviour clearer.

3.53 The regulations include in Article 6(1) to (5) a list of clauses which should not be used in an agreement and in Article 6(6) to (12) a list of 'black practices' which, if committed systematically or repeatedly, also lead to the automatic loss of the exemption. The Regulation lists in Article 8 examples of situations in which the Commission may withdraw the group exemption or alter its scope in a particular case and these include applying unjustifiable, discriminatory prices or sale conditions to dealers. The regulations also cover the duration and termination of such agreements, providing for agreements with a definite period or for an indefinite period. If the parties choose the former, then they have to agree on a minimum duration of five years. There must also be a clause that, in case one party does not want to renew the agreement, this party has to inform the other of its intention at least six months before the agreement is due to expire. If the parties conclude the agreement for an indefinite period, then they are deemed to agree on a two year period of notice for termination. Agreements can be terminated on one year's notice if the manufacturer undertakes to pay damages or if the agreement is concluded with a newcomer to the network.

3.54 The regulations also say that the manufacturer and dealer should refer to an expert third party when they disagree with regard to the annual setting of sales targets, stock requirements or the keeping of demonstration vehicles.

3.55 The Committee again notes that many of the issues raised as concerns by AADA are subject to regulation in the European Union.

Adequacy of existing protection for motor vehicle dealers

3.56 It is apparent that both US legislation and European Union regulations impose a far higher standard of conduct on motor vehicle manufacturers than do Australian dealership agreements. In these circumstances the question of whether or not motor dealerships are franchisees is a matter of semantics only. What is important is that such agreements are open to abuse and that that possibility arises because of the nature of the economic relationship involved. It is ironic that in their home countries, such companies are required to conform to standards of conduct which in Australia are claimed to be too onerous.

Petroleum distribution

3.57 The distribution of petroleum is another area which has generated particular concerns.

Changing face of petroleum distribution in Australia

3.58 The Australian Institute of Petroleum (AIP), representing the petroleum refiner-marketers, argues that petroleum product marketing is a fiercely competitive, low growth industry and that financial returns are generally unsatisfactory. In response to these unsatisfactory returns the refiner-marketers have sought to rationalise their networks and to improve returns on distribution and retail assets. The initiatives involved include:

- reducing the number of service stations in their franchise networks; and
- rationalising and amalgamating distributor networks.

3.59 AIP suggested that in the environment of low profitability and major structural change, it is perhaps inevitable that certain types of issues have created tensions, and are often cited as evidence of unfair trading practices by the refiner-marketers in their commercial dealings with their resellers.[30]

3.60 The move to multi-site franchising by Shell and Mobil has been a source of particular concern. Mr Grahame Henderson, on behalf of the Shell National Action Group, said:

> *The concern that we have with multi-site franchising is that the independents will be under a lot of pressure because multi-site franchising gives the oil companies the ability to control the price in an area. In the past we might have had 30 or 40 single site franchisees making 30 or 40 individual pricing decisions whereas now we have one franchisee, we believe oil company controlled, making one pricing decision. He or she then has the ability to pick off an independent, one by one, squeeze them out of business, and once the independents have gone there is the possibility for them to then have a margin enhancement and raise the price. Even a one cent a litre for Shell across Australia, for one year, is $20 million on the bottom line.*

30 AIP, *Submission No. 83.*

> *You and I will not see one cent a litre in the swings and roundabouts that we have in this fictitious price war because pegging up by one cent a litre is something you do not see, but it puts $20 million on the bottom line. We believe that this is not an exercise in cost cutting and profitability and rationalisation because that has all been done before. We are all computerised, we have all been down that tunnel, we have done rationalisation to the nth degree, it is an exercise of margin enhancement. When you have got those sorts of dollars at the end of the tunnel, the oil companies, we believe, have been doing some things that have been quite nasty to the franchisees, unconscionable conduct, economic duress, forcing them out of their franchises in the early days for very poor prices, until we came along, because the reward at the end of the day is substantial.* [31]

3.61 When asked whether the members of his group feel aggrieved Mr Henderson replied:

> *Most definitely. All of them will sit in this room and tell you that our futures have been stolen, and we say that because the Shell franchisees signed a 10-year agreement, basically from 1989 onwards as they came onto the system with the franchising. In 1993 Shell offered, and I was present at the offering, an extension to that 10-year agreement of a further five years under certain conditions; and now they have reneged on that offer. Shell's own documentation provides a statement on how the franchise will be extended beyond the 10-year period and now Shell are reneging on that offer.*[32]

Inherent disparity in power

3.62 The Australian Petroleum Agents & Distributors Association (APADA) stated that the major business conduct issues in their industry arise because distributors have little practical choice but to accept an agreement offered by an oil company - the level of investment by distributors effectively means that distributors cannot readily 'walk away' from agreements with oil companies, no matter how one-sided those agreements may be in favour of oil companies.

3.63 In its submission the AIP acknowledge that some franchisees are concerned about the degree of influence which franchisors exert over their businesses. [33]

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31 Grahame Henderson, Shell National Action Group, *Transcript of evidence*, p. 320.
32 Grahame Henderson, Shell National Action Group, *Transcript of evidence*, p. 318.
33 AIP, *Submission No. 83.*

Business conduct issues

3.64 APADA considered that the domination of the petroleum industry by four oil companies is an important factor in explaining why major business conduct issues arise. APADA summarised the issues of concern to its members as follows:

- *ongoing abuses of contractual power;*
- *extremely short termination periods, typically, thirty days;*
- *the stipulation that there will be no payment for goodwill on termination of an agreement;*
- *the refusal to warrant that goods supplied are of merchantable quality;*
- *exclusion clauses shifting the total or overwhelming majority of liability on to the petroleum distributor;*
- *inability to negotiate price at which products are supplied - prices are dictated despite petroleum distributors being major customers of oil companies; and*
- *limited power of self-regulatory codes* ***not*** *backed by legislative action.*[34]

3.65 In AIP's view the issues which have generated most attention are:

- *franchisor influence;*
- *franchisee and distributor profitability;*
- *expiry of distributor and service station leases;*
- *multi-site franchising; and*
- *solus supply restrictions.*[35]

3.66 In relation to the expiry of distribution and service station leases AIP advised that the franchise agreements of all four refiner-marketers are clear and explicit on the point that, on expiry of the contractual term, all rights regarding the service station site and its trade revert to the franchisor, and that there is no goodwill due on the expiry of the lease. There is also no automatic right of renewal of an agreement, unless this is specifically stated in the agreement. AIP acknowledges that this has not prevented some franchisees from gaining a perception that their franchises would be automatically renewed on the expiry of the current lease. When questioned on this issue Mr James Starkey, representing AIP, indicated:

> *It may go to the arrangements under which franchises were negotiated in the past. It may turn on some attitude between managers in the companies and the franchisees.*[36]

34 APADA, *Submission No. 97,* pp. 1-2.
35 AIP, *Submission No. 83.*
36 James Starkey, AIP, *Transcript of evidence,* p. 363.

3.67 Mr Ewen MacPherson, also representing AIP, added:

> *If you go back over the history of the industry, a reasonable dealer would expect over time to see that he would be renewed.*[37]

Protection for petroleum distributors and retailers

3.68 Currently, petroleum marketing is regulated by the *Petroleum Retail Marketing Franchise Act 1980* (Franchise Act) and the *Petroleum Retail Marketing Sites Act 1980* (Sites Act). Briefly:

- the Franchise Act provides lessee service station operators with certain basic rights in their relationship with lessor oil companies.
  - ⇒ the Act is only enforceable by the actual parties to a franchise-type relationship, not by the Commonwealth;
  - ⇒ there must be a contractual relationship between a dealer and his/her supplier including permission to use brands, trademarks and the like, permission to occupy a site for the retail sale of petrol and a supply agreement with the franchisor's oil company;
  - ⇒ a minimum of 360 000 litres per year ; and
  - ⇒ the site cannot be declared under the Petroleum Retail Marketing Sites Act*;*
- the Sites Act limits the number of retail sites which each of the major integrated oil companies may directly operate throughout Australia. The Act is administered by the Department of Industry, Science and Technology.

3.69 In introducing both pieces of legislation the then Minister for Business and Consumer Affairs said:

> *The measures in this Bill, the companion Sites Bill, and the inquiry by the PJT constitute an integrated policy which the Government has developed to deal with the serious problems that have arisen in the petroleum retail marketing industry over a number of years. These problems have not appeared overnight. There has been a long history of discontent and a great deal of criticism of certain practices in the industry.*
>
> *... In the petroleum retailing industry the Government has found it necessary to intervene to correct certain marketing practices and to maintain fair competition.*[38]

37 Ewen MacPherson, AIP, *Transcript of evidence*, p. 363.
38 *Parliamentary Debates*, Vol H of R 119 , pp. 1021 & 1022.

3.70 In addition the industry in 1989 adopted an industry code of practice known as OilCode. The code of practice was proposed as one of a package of measures recommended by the Trade Practices Commission in 1988 to overcome identified problems in the petroleum products market. It was developed through a process of consultation and negotiation involving representatives of all industry associations and of independent operators and received broadly based support from all sectors of the industry. At the time it was developed it was not seen as a replacement to the Franchise Act or the Sites Act. In particular it was seen as operating 'in front of' the Franchise Act by providing an alternative, low cost dispute resolution process. OilCode does not cover pricing arrangements but such matters as:

- the circumstances under which certain forms of 'business closure assistance' will be provided by oil companies to resellers where a reseller agreement is terminated early by agreement and the service station concerned closes;

- the circumstances under which an agreement of less than the full standard term can be entered into by an oil company and a franchisee or lessee dealer and the aspects of the agreement that must be brought to the dealer's attention in advance;

- procedures for handling proposals, whether from the reseller or from the oil company, for investing in new business activities to be conducted from the reseller's business premises;

- factors to be taken into account by an oil company when considering a request by one of its branded retailers either to terminate its service station agreement or to operate a new or rebuilt station, where the oil company has opened a new or rebuilt service station in the immediate trading area and this is likely to damage the business of the existing branded retailer;

- disclosure of all materially relevant information by an assignor, the oil company and the proposed assignee in relation to the assignment of an oil company franchise agreement and the business to which it relates;

- the right of resellers not to participate in arrangements between oil companies and their recommended suppliers of non-fuel goods or services, and the obligation of the oil companies to apply for the benefit of their resellers' businesses financial contributions received from recommended suppliers based on their sales to resellers;

- acceptable time frames for reimbursing resellers in respect of sales transacted by means of oil company cards required to be accepted by resellers under their agreements with the oil companies;

- the grounds upon which and the methods by which an oil company may terminate a franchise agreement under which the retailer supplies the oil company's motor fuel under the oil company's trade mark. This supplementary agreement reflects section 16 of the Franchise Act and its adoption makes the conciliation process available where the Franchise Act would require litigation; and

- more recently, service station security to reduce the incidence of crime and to improve safety aspects of the service station for customers and employees.

3.71 Small business groups in the petroleum industry have strongly opposed proposals to repeal the Franchising and the Sites Acts. Indeed they seek the strengthening of the Sites Act which is seen to have been circumvented. For example, Mr Grahame Henderson, on behalf of the Shell National Action Group said:

> *From our point of view, we would support most strongly any strengthening of the Trade Practices Act regarding harsh and unconscionable conduct as per Senator Schacht's recommendations last year, or a stronger version of that if possible. Obviously, we want retention of the legislation, the PRMF and PRMS Acts, which is the total protection that is given to franchisees such as us at the moment. There is some talk of repealing those Acts, which is outrageous and should not be considered as far as we are concerned.* [39]

3.72 The Committee's attention has also been drawn to the Joint Statement by the Treasurer and the Minister for Industry, Science and Tourism on 11 December 1996 in response to the Australian Competition and Consumer Commission (ACCC) Petroleum Products Declaration report. The Ministers said, inter alia:

> *The Government is disposed towards the removal of the Petroleum Retail Marketing Sites Act and the Petroleum Retail Marketing Franchise Act once oil companies, distributors and retailers reach agreement on a new OilCode and appropriate Code of Conduct. The Government expects that all parties will enter negotiations to achieve this outcome over the next 12 months. The Department of Industry, Science and Tourism will work with industry participants to address concerns about OilCode.*

39 Grahame Henderson, Shell National Action Group, *Transcript of evidence*, p. 319.

> *The Government recognises distributors' and franchisees' concerns about market power in the industry. Business conduct issues are currently being considered by the House of Representatives Fair Trading Inquiry.*

3.73 The Committee notes that both the Industry Commission and the ACCC have recommended that OilCode should be strengthened before the industry-specific legislation is repealed. The AIP has agreed that there are a number of areas in which OilCode can be improved.[40] Similarly, MTAA and APADA also believe that OilCode needs to be strengthened.

Overseas regulation of petroleum distribution

3.74 Certain aspects of the petroleum retailing sector in the US are regulated by the Federal *Petroleum Marketing Practices Act (1978)* (PMPA). This Act deals with the relationship between branded suppliers and their contractual arrangements for the supply of fuel to wholesalers and retailers of the same brand. In commenting on this legislation the US House of Representatives Committee on Small Business said:

> *Prior to the passage of this bill, refiners were able to use their dominant position over branded lessee dealers to enter into short-term leases with 30-day cancellation clauses. Under such contracts, refiners were able to wield enormous power over their branded lessee dealers by requiring them to satisfy their every whim or risk cancellation of their leases.*
>
> *... The control of supply and the pricing of that supply by refiners provide powerful instruments to influence the economic viability and ultimate survival of retail outlets. Any refiner who also operates his own retail outlets can, by way of subsidising these outlets, place a sharp limit on the prices which independent competitors can afford to charge without losing market share.*[41]

3.75 The Australian Petroleum Marketing Franchise Act was largely based on this US legislation. The PMPA prohibits branded suppliers, which includes refiners and any other wholesalers who sell under a refiners' trademark, from terminating or failing to renew a supply contract with any wholesaler or retailer of that brand except under the following circumstances:

40 Ewen MacPherson, AIP, *Transcript of evidence*, p. 362.

41 Committee on Small Business, House of Representatives, Ninety-sixth Congress (second session), *Petroleum Products: Supply, Price, and Marketing Problems* (US Government Printing Office, 1980), cited by the MTAA, *Submission No. 118*.

- certain operational failures by the retailer such as bad debts, lower than agreed volumes and poor site cleanliness;
- failure of the parties, following 'good faith negotiations' to agree on renewal terms;
- a retail outlet has become uneconomic to supply, or intended to be converted to a use other than the resale of petroleum products; and
- the supplier intends wholly withdrawing from the entire market locality.

3.76 The PMPA prohibits cancellation or non-renewal for purposes such as converting the operation of the site from tenancy to commission agency or company management. It does, however, allow the supplier to determine opening hours, minimum volumes, rental and other charges.[42]

3.77 The issue of vertical integration through company operated sites is not addressed in the PMPA but according to MTAA it is for this reason that many US States have introduced their own form of divorcement and/or divestment legislation. MTAA has also drawn attention to the price discrimination prohibition in the Robinson-Patman Act which prohibits sellers from discriminating on price.

Summing up

3.78 The Committee notes again that a high level of concern has been expressed about the conduct of the major oil companies in their relationships with their franchisees and that those concerns have had a very long history. The Committee also notes that similar concerns have led to specific regulatory action in the United States.

3.79 Recommendation 3.2

The Committee recommends that the Petroleum Retail Marketing Sites Act and the Petroleum Retail Marketing Franchise Act remain in force until new generic franchising legislation is enacted.

42 MTAA, *Submission No. 118,* pp. 66-67.

Regulation of franchising

Need for action

3.80 There is no doubt that franchising relationships are open to abuse because franchisors occupy a coordinating position within the franchising system and this provides them with a significant level of market power in relation to any single franchisee. This structural power is compounded when the franchisor is a major corporation with access to significant managerial, financial and legal resources. Such market power is open to abuse in a way that normal competition cannot effectively control.

3.81 The Committee believes that widespread abuses are occurring in practice. It is simply not credible to dismiss all the complaints made to this Committee and to previous inquiries. It is also clear that other countries are grappling with similar issues. It is necessary to make adequate provision for redress when such abuses occur as well as to encourage both franchisors and franchisees to work together cooperatively to resolve the inevitable disputes as they arise.

3.82 The Committee notes that the Franchising Code Council, which administered the Franchising Code of Practice, is now being wound up following the withdrawal of Commonwealth funding from 1997-98 onwards. This appears to be due to the reluctance of the industry to fund the Council through increased registration fees. The Committee believes that the collapse of the Council and the absence of a code administration committee with balanced representation from both franchisors and franchisees and small and large business has seriously weakened the usefulness and credibility of the Franchising Code of Practice and of codes of practice in general. At the same time MTAA has withdrawn from OilCode and that withdrawal also weakens the credibility of OilCode.

The problem with codes of practice

3.83 Strong support has been expressed by major business groups for voluntary codes of practice. In particular it has been claimed that experience with the Franchising Code of Practice and OilCode argue for such an approach. However, two of the parties to OilCode clearly do not agree that OilCode has been a success. In commenting on big business support for voluntary codes of conduct the ACCC submission said:

> *There have been frequent calls by business interests for self regulation but the track record to date indicates that there is a clear lack of commitment by industry overall to schemes that deliver beneficial outcomes.* [43]

43 ACCC, *Submission No. 62.*

3.84 When questioned on this issue Mr Allan Asher, Deputy Chairman, ACCC, said:

> *It is certainly a huge personal disappointment to me, for another reason: when the then Trade Practices Commission first was involved in negotiating with franchisors and franchisees about the first version of the code five years or so ago ... it looked as though there would be some very substantial information disclosure provisions, dispute provisions and all of those things.*
>
> *Unfortunately, when it came time for the code to be brought to us for authorisation, a lot of clauses had disappeared. A lot of franchisors said they would not participate, and a number of banks said they would not participate unless many of those clauses were removed. So, the document that was finally authorised was a fairly pale shadow of the goal and, needless to say, it failed. Unfortunately, the recent one was not vastly better.*[44]

3.85 Mr Tony Garrisson, representing the Business Law Committee of the Law Institute of Victoria, also argued that the Franchising Code needed tightening:

> *My view is that the voluntary code also needs tightening up in its disclosure requirements because there are many important representations and statements that need to be looked at in setting up franchises. That is a very effective way to solve one half of the problems which we see. What happens is that when they go and buy the business, they are under unrealistic expectations. They have paid too much for the business, there has been key material not disclosed and what happens is that it sits and festers.*[45]

3.86 In regard to the content of the Code, Professor Andrew Terry said:

> *In relation to the actual content of the code, the most glaring problem relates to the standards of conduct, which are there as advisory standards and are beyond the scope of the very limited disciplinary powers of the Franchising Code Council.*[46]

44 Allan Asher, ACCC, *Transcript of evidence,* p. 647.
45 Business Law Committee of the Law Institute of Victoria, *Submission No. 128.*
46 Professor Andrew Terry, *Transcript of evidence*, p. 84.

3.87 Professor Terry concluded:

> *I think self-regulation in the present form just has not worked. The comments of Mr Gardini are unanswerable. ... Very clearly, the challenge for the inquiry is to make the practice of franchising fit the promise of franchising. And that really requires all people who want to trade off the name franchising, who want to participate in it, being subject to the same standards.* [47]

3.88 Mr Mark Overell of the Queensland Retail Traders and Shopkeepers Association commented:

> *The fact that it is a voluntary code is the main difficulty.* [48]

3.89 The ACCC stated that ideally codes should operate on a voluntary basis but where this has been demonstrated to be unsuccessful in gaining sufficient coverage, some other means, either one that makes it commercially attractive, or a more coercive means including legislation, should be used. [49]

3.90 The MTAA argued that without the Petroleum Retail Marketing Franchise Act there could be no OilCode and that OilCode has not worked as was originally intended. The MTAA believes that if industry self-regulation is to be successful then there must be some legislative backing for the code. Mr Delaney said on behalf of MTAA:

> *Having been involved with both the now defunct OilCode and the franchising code since their inception, MTAA firmly believes that codes of practice cannot succeed without legislative underpinning which provides some incentive: first, for industry participants to become signatories to the code, and second, for code signatories to adhere to code standards of conduct.*
>
> *In the case of OilCode, which was underpinned by legislation which prescribed the dealings of behaviour which were the subject of the code, the threat of the removal of the underpinning has been sufficient to render the code unworkable and irrelevant, but inimical to the interests of the parties to the code.* [50]

47 Professor Andrew Terry, *Transcript of evidence*, p. 88.
48 Mark Overell, Queensland Retail Traders and Shopkeepers Association, *Transcript of Evidence*, p. 227.
49 ACCC, *Submission No. 62.*
50 Michael Delaney, MTAA, *Transcript of evidence*, p. 329.

3.91 The FAANZ has also acknowledged there are problems where franchisors do not subscribe to the Code of Conduct. As the ACCC acknowledged, the advantages of enforceable codes are:

- their coverage is not reliant on industry association membership and can therefore cover all participants in a relevant industry;
- they can provide both private and public enforcement;
- they can provide for effective remedies for those adversely affected by breaches of the code; and
- in some industries the mandatory nature of the codes may be accepted by industry businesses because while they would willingly comply with a voluntary code, they cannot afford to do so while there is a real risk that competitors will acquire an advantage by not complying.[51]

3.92 The Gardini Review of the Franchising Code suggested that any attempt to strengthen the standard of conduct provisions within the context of a voluntary code would result in a loss of registrations under the Code.[52]

3.93 The Treasury, in its submission, acknowledged that where codes are purely voluntary there may be significant parts of an industry which will remain outside the coverage of the relevant code, and that enforcement may be problematic.[53] Indeed, the Treasury has previously supported underpinning such codes through the Trade Practices Act. For example in its submission to the Hilmer Review the Treasury said:

> *A drawback of such codes is that, for the most part, they are not legally enforceable. In situations where serious competition problems arise, market participants may resort to legal solutions in any case. The scope for recourse to a nationally consistent legal framework such as the TP Act would have obvious advantages as a fallback to codes of conduct and in keeping the participants voluntarily 'honest' under the code of conduct.* [54]

51 ACCC, *Submission No. 62.*

52 Robert Gardini, *Review of the Franchising Code of Practice*, Report to Senator the Hon Chris Schacht, Minister for Small Business, Customs and Construction (October, 1994).

53 Treasury, *Submission No. 168.*

54 Treasury, Submission to the National Competition Policy Review, *Treasury Economic Papers* Number 16, (The Treasury, Canberra, 1993).

3.94 When questioned on this issue, Mr David Parker, Assistant Secretary, Competition Policy Branch, Treasury, said:

> *To sum that up, our view is that voluntary codes have some advantages over mandatory codes if done well; and, in doing them well one needs to embed into them some means to enforce them - and that has tended to be the downfall of some existing voluntary codes.*[55]

3.95 In the light of the experience recounted above, the Committee has concluded that there is no option but to underpin codes of conduct with legislation. Clearly, self-regulation has not worked. In particular there has been a strong reluctance on the part of big business to participate in the development of such codes and there has been a general reluctance to adequately fund their administration. In addition the level of compliance with disclosure provisions and codes of practice generally leaves much to be desired.

Options for legislative underpinning of franchising codes of practice

3.96 The MTAA suggested that there are three options for underpinning franchising codes of practice:

> *i) that the Government adopt the recommendation proposed by Mr Gardini as a result of his review of the Franchising Code of Practice in 1994 that -*
>
> *The existing exemption for franchising contained in the Corporations Regulations should be amended to apply only to franchisors who register with FCAC and incorporate the Code of Practice into franchise agreements.*
>
> *ii) that the Government underpin the franchising code of practice (and other industry specific voluntary codes of practice) through an amendment to existing legislation - such as the Trade Practices Act.*
>
> *iii) the enactment of generic franchising legislation which either makes membership of the franchising code compulsory or adopts the principle outlined in (ii) above.*[56]

55 David Parker, Treasury, *Transcript of evidence*, p. 875.
56 MTAA, *Submission No. 118.*

3.97 The MTAA expressed a preference for option (i) or (ii). The Business Law Committee of the Law Institute of Victoria stated that it is important:

> *1. that there be an effective code of practise regulating **ALL** relevant conduct for **all** franchise systems;*
>
> *2. that there is an economic incentive to ensure that parties that wish to offer franchises have the choice to either register a prospectus under the Corporations Law or agree to comply with the Code of Practice. It is our view that due to the lack of barriers to entry, many of the problems associated with misrepresentations by offering franchises could be solved by economic incentives to register via the Code (thereby improving the economic efficiency of franchise systems and reducing failures through allowing the Code to effectively monitor appropriate disclosure in Australia);*
>
> *3. that the Trade Practices Act be amended to deal with unfair practices that occur during the course of commercial relationships as exercised by suppliers of services or goods (this would include franchisors, landlords, and third party suppliers).*[57]

3.98 Currently, franchisors are exempt from the prospectus and prescribed interest provisions of the Corporations Law. In the Carnot case in 1981 it was held that advertising a business opportunity or franchise could amount to the offer of a 'prescribed interest' under the Companies Act, requiring a prospectus. In response, franchisors were given a partial exemption from the 'prescribed interest' provisions later that year. The MTAA's first option would remove that exemption from franchisors who did not register with the code administrator or who did not include the code of practice in their franchise agreements.

3.99 The Treasury suggested that this is an unattractive option for the following reasons:

- *Concerns expressed by franchisees, and in particular small business franchisees, would be more appropriately addressed in a different context, rather than in the context of securities markets and prescribed interest regulations.*
- *With the increasing complexity, sophistication and internationalisation of securities and related markets, the conferment of a regulatory role on the Australian Securities Commission (ASC) in relation to franchising would not fit comfortably with its role as a regulator of these markets.*

57 Business Law Committee of the Law Institute of Victoria, *Submission No. 128.*

- *The prospectus and prescribed interest provisions are about securities market regulation.*

  ⇒ *The prescribed interest provisions are designed to provide protection for passive investments where there is a clear distinction between ownership and control. This is not the case with franchising.*

  ⇒ *Franchises are not offered to the public (or a section of the public) via a discrete, organised release and therefore, the disclosure requirements should be different to those for prescribed interests.*

  ⇒ *The protection offered by the prospectus provisions of the Corporations Law is not equivalent to the Code. The former deals only with fundraising and initial disclosure, whereas the Code regulates ongoing aspects of the relationship between the franchisor and the franchisee.*

- *Participants in the securities and prescribed interests arena would be likely to be critical of the diversion of market supervisory and regulatory resources away from mainstream activities to the ASC to deal with franchising. This would involve training ASC officers to determine which franchising activities came within the Corporations Law, and to supervise and enforce the application of the Corporations Law in those cases.* [58]

3.100 The Committee accepts these objections to underpinning through the Corporations Law. This leaves two other options - either through the Trade Practices Act or through specific franchising legislation.

58 Treasury, *Submission No. 168.*

Underpinning codes of practice in the Trade Practices Act

3.101 It could be argued that underpinning codes through the Trade Practices Act would be preferable from an administrative point of view given that it already deals with conduct of the type covered by such codes. When asked whether he had any suggestions as to how to give legislative underpinning to a code of practice, Mr David Parker, representing Treasury, replied:

> *The Treasury submission puts forward one possible mechanism which is something of a hybrid, if you like, between voluntary and mandatory codes of conduct. This is a suggestion that you could have so-called code based undertakings where one would have an industry based self-regulatory code, which could go through some approval process to ensure that the code was functional and met certain minimum benchmarks, and then the participants in the industry could voluntarily offer an undertaking to the ACCC or some other body to comply with the code. That has some merits in the sense that it deals with one of the shortcomings of some existing voluntary code systems whereby, because there have been no legal obligations arising under the code, there has been no mechanism to enforce compliance with the code once a party has become a party to it.*
>
> *Under the undertakings type of procedure, failure to comply with the code could be in breach of the undertaking, which would then be enforceable in the Federal Court. That is a model which is being used for other competition functions under the Trade Practices Act. It is a model which is proposed for the regulation of access to infrastructure in the electricity industry and also in the telecommunications reforms.*[59]

3.102 The Treasury submission indicates that this approach would be similar to the access undertakings regime in Section 44ZZA and Section 44ZZJ of the Trade Practices Act, as supplemented by the proposed Section 44ZZAA.[60]

59 David Parker, Treasury, *Transcript of evidence*, p. 874.
60 Treasury, *Submission No. 168.*

3.103 Mr Allan Asher, Deputy Chairman, ACCC, suggested:

> *As for the way in which codes can be made to have effect, the best example I can give you is part 7 of the New South Wales Fair Trading Act, which is a market sensitive provision. The goal is that where an industry association is administering its own code, there is no need for anybody to intervene, and it lets the market work where the market does work. But, for people who are not covered by the code - or if somebody refuses to accept the rulings under the code - then it allows some limited public enforcement of that code. In my view, that is a light-handed, market based way, but one which picks up the biggest problem of industry codes of practice, which is that you cannot do anything if people refuse to obey them.*[61]

3.104 This suggestion seems in essence to be similar to that proposed by the Treasury in that:

- it relies on a head clause in the Trade Practices Act prohibiting certain business conduct;

  ⇒ In the case of section 44ZZ (1): *The provider of a service or a user of a service . . . must not engage in conduct for the purpose of preventing or hindering the third party's access to the service under the determination.*

- it provides for the approval by the Commission of a code of practice following a public process; and

- it provides for the enforcement of those codes of practice through the Federal Court.

3.105 The major difference between Mr Gardini's proposal and a proposal based on those suggested by the ACCC and the Treasury is the proposal to make the code mandatory.

3.106 The Committee is not attracted to either of these options. The Committee is convinced that self-regulation has not worked in part because it does not provide a viable regulatory strategy when there is such a disparity in the powers of the parties. Both Mr Gardini's proposal and any proposal based on the Treasury and ACCC suggestions would simply be a matter of too little, too late.

61 Allan Asher, ACCC, *Transcript of Evidence* p. 647.

3.107 In the 1990 report on small business the Committee recommended specific Commonwealth franchising legislation. Indeed, the Blunt and Swanson Committees also made recommendations for legislation and exposure drafts of such legislation were published in 1985.[62] The Australian Automobile Dealers Association suggested such an approach to this inquiry.[63]

3.108 It has been claimed that such an approach may encounter definitional problems. In relation to those definitional problems Mr Tony Conaghan, a lawyer, said:

> *So the consequences may be disproportionate in that you are then going to have this new body of law for lawyers saying, 'Is it a franchise? If it is not, we will have to -' and the shonks that we talked about are going to adopt the view and call it different things. I have seen documents called franchise agreements, for instance, that the definition says are not franchise agreements, they are agency agreements. People start playing those sorts of silly games.*[64]

3.109 In this regard Professor Andrew Terry commented:

> *The franchisor lobby group has been very effective over the years in answering a possible perceived threat from legislation by saying, 'Look at what is happening in America. There are 51 jurisdictions and this mass of law'. Regulation in Australia would obviously be much more simple than that. There presumably would be federal legislation and we would have one set of franchising laws and not a diverse range.*[65]

3.110 The Committee notes that definitional problems are associated with almost all legislation. Given the weight of international precedent the Committee believes that these definitional problems could be overcome. In any event, the Committee's proposed general unfair conduct provision in the Trade Practices Act would catch any franchisor who sought to get around that definition. The Committee believes that the definition should be wide enough to apply to motor vehicle and farm machinery distribution arrangements and to the oil industry. The establishment of such business arrangements should be conditional on registration with the code administration body and compliance with codes of practice and dispute resolution procedures.

62 See Appendix V of this report.
63 AADA, *Submission No. 116.*
64 Tony Conaghan, Phillips Fox, *Transcript of Evidence*, p. 32.
65 Professor Andrew Terry, *Transcript of evidence*, p. 92.

3.111 The detailed content of such legislation has already been widely canvassed in previous reports. It is sufficient for this Committee to suggest that the first exposure draft of such a bill published in 1986, along with recent experience with the Franchising Code of Practice and OilCode provides an adequate starting point for drafting purposes. Regard could be paid to the proposed US Federal Fair Trading Franchise Practice Act. It would also be essential to provide for the establishment of an independent code administration body or bodies if necessary and dispute resolution procedures which should be funded through compulsory registration fees. The Committee considers that enough time has already been lost and that any bill should not go through any further exposure process. The Committee notes that some State governments have indicated a willingness to enact such legislation and it would be particularly unfortunate if the end result were a series of inconsistent State Acts.

3.112 Recommendation 3.3

The Committee recommends that the Commonwealth enact specific franchising legislation providing for compulsory registration of franchisors and compliance with codes of practice. The definition of franchising under that legislation should include motor vehicle and farm machinery distribution arrangements and the oil industry.

The legislation should provide for adequate disclosure documentation, the establishment of appropriate independent code administration bodies, and dispute resolution procedures funded through compulsory registration fees.