

Committee of Inquiry into the competition provisions  
of the *Trade Practices Act 1974*

# SUBMISSION

*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.*

House of Representatives  
Committee on Industry, Science and Technology

Rodney Hackett

17 July 2002

## SUBMISSION

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# SUMMARY

- 1 This submission supports the continued operation and strengthening of the Australian Competition and Consumer Commission (ACCC).
- 2 The submission seeks increased protection for small businesses from unfair business practices, especially practices which take place within a contract-based business relationship.
- 3 The focus is on the abuse of power to control businesses within a relationship such as a franchise.
- 4 There should be legal sanctions where a powerful business harms another business, especially when the harm occurs within a contract-based business relationship.
- 5 A franchise agreement is a "relational contract" which establishes an ongoing relationship that has to be capable of dealing with uncertain future conditions.
- 6 The *Trade Practices Act 1974* should be amended to fully address the "relational" concept of franchise and other contracts, and:
  - 6.1 Equalise power between businesses to prevent the more powerful from exercising control and harming any vulnerable businesses within a business relationship;
  - 6.2 Recognise that the contract between the franchisor and its franchisees are "relational contracts";
  - 6.3. Address unfair business practices that can occur within a business relationship;
  - 6.4 Include explicit minimum contract requirements that impose a duty of good faith and fair dealing; the object being to protect

the weaker, vulnerable party in a relationship from the misuse of power;

- 6.5 Require that contracts establishing business relationships include terms obliging the parties to co-operate (with legal sanctions for non-co-operation); the object being to preserve the broader ultimate business relationship envisaged at the time the agreement was made (alternatively, performance could be based on a prevailing community standards test);
- 6.6 Require the parties in a business relationship to commit themselves to behaving in a way which maintains the good health and where necessary, the mutual profitability of the relationship (with appropriate legal sanctions); the object being to discourage business behaviour that is improper, capricious and harmful, or acts that are undertaken for an extraneous, improper purpose, or which have the effect of benefiting the more powerful, at the expense of the weaker party.

7 Section 46 *Trade Practices Act* 1974 should be amended to:

- 7.1 Add a test to examine the effect of a business's conduct, rather than relying on the purpose test;
- 7.2 Remove the test that requires a business to have "a substantial degree of power in a market" before the use of that power in a competitive market can be examined;
- 7.3 Impose limits on the extent of harm a business can cause another before it 'effectively destroys' a competitor in a relationship;
- 7.4 Remove reference to "market" in the phrase "power in a market"; the object being to consider wider issues of control and to overcome the practical problem of defining the parameters of a market and the degree of power in that market;
- 7.5 Authorise the ACCC to issue "Cease and Desist Orders" to stop anti-competitive behaviour within a business relationship while the ACCC conducts an investigation.

8 Recommendations to improve the administration of the *Trade Practices Act* 1974 are included in section 4.

## 1 INTRODUCTION

*Franchising is an inherently unequal relationship.*

Office of Small Business *Discussion Paper*

### 1.1 Nature of submission

This is a submission from Mr Rodney Hackett, solicitor, small business operator, and a successful owner and operator of two McDonald's restaurants. Mr Hackett supports franchising and is a supporter of the McDonald's "System" and the philosophy of McDonald's founder, Ray Kroc:

*The essence of Kroc's unique but amazingly simple franchising philosophy, was that a franchising company should not live off the sweat of its franchisees, but should succeed by helping its franchisees succeed ... as equal partners (John F Love McDonald's - Behind the Arches)*

The submission seeks increased protection for small businesses from unfair business practices, especially where misuse of power takes place within a contract-based business relationship.

The submission addresses excessive market concentration and power, and how it can be used by some businesses to harm and damage other businesses. It is particularly relevant to the Committee's Terms of Reference 1 (b), and 2:

*1. The Committee is to review the operation of the competition and authorisation provisions of the Act, specifically Parts IV (and associated penalty provisions) and VII, to determine whether they:*

...

*(b) provide an appropriate balance of power between competing businesses, and in particular businesses competing with or dealing with businesses that have larger market concentration or power; ...*

*2. The Committee is to identify, where justified, improvements to the Act, its administration and/or additional measures to achieve a more efficient, fair, timely and accessible framework for competition law. ...*

The submission argues that the *Trade Practices Act 1974* (TPA), together with the law of contract, do not adequately address the imbalance of power and access to resources which exists between parties within a business relationship, such as a franchise. This imbalance unfairly advantages the more powerful party when there are varying, competing interests, or the need to resolve a dispute between the parties. This problem is manifest within the franchising sector.

While the submission addresses franchise relationships in particular, the suggested improvements to the TPA are relevant to 'special' business relationships that are not conducted at arms length, such as franchises, partnerships and joint ventures between businesses. Weak parties within 'special' business relationships require particular protection under the TPA.

The submission also identifies improvements to the administration of the TPA by the Australian Competition and Consumer Commission (ACCC) to achieve a more efficient, fair, timely and accessible framework for competition law.

## **1.2 Relevance of franchising to this inquiry**

The franchising sector is relevant to the Committee's deliberations for two reasons:

- Franchising provides examples of misuse of market power (and unconscionable conduct) within a competitive business relationship; and
- Franchising is too large and varied to be overlooked in an inquiry into competition.

Franchising in Australia has an estimated annual turnover of \$81 billion, employing 500,000 people out of approximately 49,000 outlets through about 700 franchisors. The types of businesses include: motor dealerships, fast food outlets, courier services, printing shops, grocery networks, real estate agencies, taxis, lottery agents, licensed post offices, home cleaning and lawn mowing. (Hon Ian Macfarlane *Media Release* July 2001, and

Franchising Policy Council *Review of the Franchising Code of Conduct* (May 2000)

The nature of the franchise "system" is a key concept. The McDonald's "System" (for example) is defined in the McDonald's licence agreement as a comprehensive system for the retailing of a limited menu of uniform and quality food products, emphasising prompt and courteous service in a clean and wholesome atmosphere which is intended to be particularly attractive to families.

The foundation and essence of the system is the adherence by licensees to standards and policies of McDonald's to provide for the uniform operation of all its restaurants.

The "System" within a franchise is not the franchisor. The "System" comprises a number of franchisees operating with a franchisor; but it is emphasised that the franchisor has interests that are separate, distinct from, and sometimes in conflict with its franchisees. In this respect it is relevant to note that the franchisor may own and operate its own stores in direct competition with its franchisees (in the McDonald's System the stores operated by its employee managers and staff are called McOpCo stores). This is an example, it is submitted, of the differing and competing interests of franchisor and franchisee.

The TPA should be amended to equalise the power between businesses to prevent the more powerful from exercising control and harming any vulnerable businesses in the relationship. The focus of the submission is on the use of this power to control other businesses within a relationship.

Contract law does not fully address the "relational" concept of the franchise agreement. Traditionally contracts focus on the promise and the consent to perform specific obligations. A franchise agreement on the other hand, establishes an ongoing relationship that has to be capable of dealing with uncertain future conditions.

## 2 NATURE & REGULATION OF FRANCHISING

*the franchise was a relational contract*

New Zealand High Court

### 2.1 Introduction

This section deals with:

- The current regulation of franchising;
- The nature of the franchise agreement, including the relationship between competing businesses within the contractual relationship; and
- The relational nature of the franchise contract and the consequences that follow.

Since 1998, following the passing of the *Trade Practices Amendment (Fair Trading) Act 1998*, specific aspects of franchising have been regulated by the ACCC and the courts. This amendment facilitated small business access to protection against unconscionable conduct. The amendment also allowed industry codes to be prescribed as mandatory or voluntary, and to be enforced under the Act. This later provision resulted in the making of the *Trade Practices (Industry Codes - Franchising) Regulations 1998*, which is the *Franchising Code of Conduct* (the Code).

The courts have of course had a continuing involvement in resolving franchise disputes through (for example), the doctrine of contract law, and by determining on breaches of the TPA, both prior to and after 1998.

### 2.2 Business relationships - the nature of a franchise

Businesses often work in co-operation with each other, in partnership, in joint ventures, and in franchises.

With respect to franchising, the Code provides that a franchise is the rights and obligations that arise from entering into an agreement whereby the franchisor grants to a franchisee the right to carry on the business of offering, supplying or distributing goods or services under a system or marketing plan.

The system or plan is substantially determined, controlled or suggested by the franchisor under which the operation of the business is substantially or materially associated with a trade mark, advertising or a commercial symbol owned or controlled by the franchisor.

Before starting the business, the franchisee agrees to pay an amount including an initial capital investment fee, and to make payments for goods or services (including training), as well as a fee based on a percentage of gross or net income. (clause 4 of the Code)

Franchisees invest their own money and enter into contracts with the expectation that they will be running a small business from which they expect a growth in their capital investment, as well as an income. If this was not the case, the franchisee would be merely providing low interest capital (at a rate determined by the franchisor) for the franchisor. Franchisees expect the franchisor to be profitable, but not just from their sweat; but that franchisors should succeed by helping its franchisees succeed as equal partners (Ray Kroc's philosophy).

Although the purpose of the Code, in clause 2 (1), is to "regulate the conduct of participants in franchising towards other participants in franchising", it is submitted that the Code does not address all aspects of the franchise relationship. The Code is mainly concerned with disclosure, certain conditions of agreements, and the resolving of disputes between the franchisor and its franchisees. It does not seek to regulate anti-competitive behaviour or the misuse of power between the parties.

This submission is not seeking a review of the *Franchising Code of Conduct*, as the Code is a regulation made under Part IV B of the TPA and thus outside the Terms of Reference of the Committee. Some of the matters raised in this submission should also be addressed in the Code.

The Committee is requested to consider extending coverage of the TPA to address wider problems that can occur within any business relationship, such as unfair business practices.

Parliament has started to regulate the relationship between the franchisor and its franchisees through the provisions of the TPA. It is submitted however that the TPA should be further amended to:

- a) Recognise that the contract between the franchisor and its franchisees are "relational contracts"; and to
- b) Provide that the business relationship should be conducted within the obligations of good faith and fair dealing.

### 2.3 The "relational" nature of the franchise contract

The franchise agreement is a "relational" contract where the obligation between the parties evolves over the course of the period of the contract, and depends on continuing co-operation, compromise and flexibility. The parties enter into these contracts to share the financial reward of their combined efforts.

The legal nature of a franchise contract (that in this instance was the subject of the laws of New South Wales) has been considered in the New Zealand High Court. In a dispute involving the Dymocks franchise, Hammond J discussed the concept of a franchise and held that the franchise was a relational contract. His Honour considered that the relationship between franchisor and franchisee was not merely a simple bilateral contract but a relational one in which an ongoing relationship is set up for the benefit of the parties. (*Dymocks Franchise Systems (NSW) Pty Ltd v Bilgola Enterprises Ltd* [1999] 8 TCLR 612)

A relational contract has been defined by Charles J Goetz and Robert E Scott in an article on the *Principles of Relational Contracts*:

*A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance. (67 Virginia Law Review, at page 1091)*

Professor Hadfield in *Problematic Relations: Franchising and the Law of Incomplete Contracts* also argues that the franchise contract is incomplete because of the "uncertain and long-term nature of the relationship" and importantly "fails to address the franchisee's problem of controlling franchisor opportunism". (42 Stanford Law Review at page 99) The implications of these propositions are discussed in the next section.

### 3 MISUSE OF POWER WITHIN BUSINESS RELATIONSHIPS

*If the relationship is subject to abuse franchisees can then be placed in positions of economic disadvantage by the franchisor.*

Office of Small Business *Discussion Paper*

#### 3.1 Introduction

This section deals with:

- The use of power to exercise control over other businesses in a franchise;
- The competing interests within a franchise;
- Damaging a competitor within a business relationship; and
- Recommended improvements to the TPA.

The use of power to exercise control over other businesses in a franchise was noted in business reviews undertaken by the Commonwealth as recently as 1997 and 1999.

The Commonwealth Office of Small Business in its *Discussion Paper* (December 1999) on the review of the *Franchising Code of Conduct* noted:

*Franchising is an inherently unequal relationship. The franchisor is in a position of considerable power, with the ability to determine a range of issues from marketing to product quality and availability. The franchisee, by contrast, does not have this same level of decision-making power. Disparity in bargaining power is not in itself a bad thing, but it can give rise to opportunities for abuse. This potential for abuse is compounded by the fact that, in a franchise system, the franchisee tends to own most of the assets in the individual franchised business, but franchisors retain authority to determine key business and investment decisions. As a result, a*

*franchisee's individual desire to gain a return on investment and develop their business in response to local market conditions may conflict with the franchisor's decisions or plans, which may reflect larger scale considerations that are not synchronised with local market conditions. In such a situation franchisees may find themselves committed to a long-term agreement with high sunk costs, but with no real power to determine their overall cost structure and make strategic business decisions. If the relationship is subject to abuse franchisees can then be placed in positions of economic disadvantage by the franchisor. (page 3 )*

These comments reflect the 1997 report of the House of Representatives Committee on Industry, Science and Technology *Finding a Balance*:

*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. (page 110)*

The parties to a franchise relationship clearly have differing and competing interests and differing levels of power.

### 3.2 The exercise of control within a business relationship

The control exercised by a franchisor (for the purpose of maintaining uniformity and quality) is greater in "System" franchises than in other franchise arrangements. This is because:

- The system franchisee is operating within a proven, unique, comprehensive but constraining business model; and
- The system franchise is more complex and controlled than the three other franchise arrangements, that is those franchisees that are:
  - Selling a franchisor's products;
  - Processing or manufacturing wholesale goods using a franchisor's ingredients or formulae; or
  - Trading within a franchise banner as a means of benefiting from group buying and promotional economies of scale.

The power exercised by a franchisor over its franchisees in a "system" is unconstrained by competitive pressure. The system has the appearance of a co-operative relationship but in actuality the interests of the franchisor and the franchisees may be diametrically opposed. The franchisor is, for example, able to exert control within the System to change the prices of its products.

Temporary discounting and loss-leadering of products (by way of marketing campaigns) benefit the controlling franchisor but are undertaken at the expense of the franchisee. Neither do these activities provide any lasting consumer benefit.

Example One below, demonstrates one aspect of these different interests. In this example, the franchisor's interest is to introduce discounts to expand sales which result in increased fee income for the franchisor. Net profit for the franchisee is however down by 16.8%.

These activities however do not fall within existing anti-competitive vertical price restrictions currently prohibited in the TPA; indeed certain loss-leader selling practices appear to be permitted under s 98(2) TPA. These pricing arrangements not only interfere with the market mechanism and substantially lessen competition, but strengthen the controlling franchisor (and its owned and operated businesses).

### Example One

#### Discounting Advantages the Franchisor, Not the Franchisee

**A: Base Case without application of a discount**

1,000 meals over a period at \$5 per meal = \$5,000 product sales revenue

(Less) Food costs 1,000 at \$2.50 per meal = \$2,500

(Less) Other consumable costs = \$1,000

Profit after consumables = \$1,500 (30% of sales revenue)

Franchise "System" fee = \$250 (5% of sales revenue)

Net profit = \$1,250

**B: Application of 10% discount, with instant price-elasticity of 1.5, increasing sales to 1,150 meals**

1,150 meals at \$4.50 = \$5,175

(Less) Food costs 1,150 at \$2.50 per meal = \$2,875

(Less) Other consumable costs = \$1,000

Profit after consumables = \$1,299 (25% of sales revenue)

Franchise "System" fee = \$258.75 (5% of sales revenue)

Net profit = \$1,040

Franchisor's revenue has increased by 3.5%

Net profit to the franchisee is however reduced by 16.8%.

Application of the discount increases the franchisor's fee income (from all franchisees).

The example demonstrate the different interests; the franchisor's interest is to introduce discounts to expand sales which result in increased fee income for the franchisor.

A franchisor may also provide discounted products to its franchisee's competitors; see Example Two. In this example, the franchisor supplies cheaper fuel to a competitor.

### Example Two

#### Franchisor Provides Discounted Products to Franchisee's Competitors

An example of a franchisor's behaviour was reported to the Senate Economics References Committee inquiry into the provisions of the *Fair Price and Better Access For All (Petroleum) Bill 1999* and the practice of multi-site franchising by oil companies. The Committee was advised that franchisees had to:

*accept fuel at prices, and on payment terms, dictated by their franchisor oil company while in some cases knowing that their franchisor was supplying cheaper fuel to an independent competitor 'across the road'.*

*Franchisees, unable to negotiate in relation to the wholesale price, essentially are having their competitive position 'undermined by their business partner, their franchisor, selling fuel more cheaply to their competitors'. (Senate Economics References Committee Report March 2001 Parliamentary Paper No. 41 of 2001)*

### 3.3 Damaging a competitor within a business relationship

Section 46 TPA provides that a "corporation that has a substantial degree of power in a market shall not take advantage of that power" for the purpose of "eliminating or substantially damaging a competitor ...". The High Court has described the object of this section in the following terms:

... the object of s. 46 is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end. Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to "injure" each other in this way. This

competition has never been a tort (see *Keeble v. Hickeringill*) and these injuries are the inevitable consequence of the competition s. 46 is designed to foster. In fact, the purpose provisions in s. 46(1) are cast in such a way as to prohibit conduct designed to threaten that competition - for example, s 46(1)(c) prohibits a firm with a substantial degree of market power from using that power to deter or prevent a rival from competing in a market. (Mason CJ and Wilson J *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* [1989] 167 CLR 177, at 191)

The problems with this provision are that:

- The section appears to condone (under certain circumstances) harmful activities between competitors;
- The TPA recognises, under certain circumstances, the activities of competitors that try to "injure" each other, and that these injuries are "an inevitable consequence of the competition s 46 is designed to foster";
- There is no contravention of this section unless a corporation takes advantage of the power it holds in a market;
- The TPA does not clearly specify any prohibited activities that damage competitors, including unfair and harmful activities that take place within a joint venture-type arrangement, such as a franchise; and
- The TPA does not consider the effects of these activities, or in many circumstances attempt to limit the harm a business can cause another.

Example Three highlights this deficiency.

### Example Three

#### A Franchisor Can Adversely Affect the Commercial Interests of its Franchisee

In *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310, Byrne J rejected the submission that the franchise contract prevented the franchisor from opening a competing restaurant in an area contiguous to that of an outlet operated by the plaintiff (Mr Rodney Hackett).

The Judge found that McDonald's decision to open a new restaurant was not motivated to apply pressure on the existing

franchisee in the area to sell the business or otherwise surrender the franchise licence. (Paragraph 122)

His Honour further found that the contract expressly entitled the franchisor (McDonald's) to do acts which may adversely affect the commercial interests of its franchisee. (Paragraph 128)

### 3.4 Recommended improvements to the TPA

The test, that a corporation is to have "a substantial degree of power in a market" should be removed. It is submitted that the test should be the effect of the actions, not the degree of power of the controlling business. The TPA should be amended to deal with the effect of a business's conduct, rather than relying on the purpose test. It is very difficult to provide evidence to prove the motivation or reason, or purpose of a business that is acting in a harmful manner. The TPA should be amended to impose limits on the extent of harm a business can cause another before it 'effectively destroys' a competitor in a relationship.

Use of the term "power in a market" limits the examination of power to pricing and other economic value judgements, rather than its wider meaning relating to the use of control. Removal of the reference to markets would also overcome the practical problem of defining the parameters of a market and evaluating the degree of power in that market.

Competition between businesses should not result in the substantial weakening and eventual annihilation of competitors. Harmful business practice can lead to the creation of powerful businesses operating and abusing an unbalanced market. Further, a distinction needs to be made in instances where there are special relationships between businesses. This matter was referred to by Byrne J in *Far Horizons Pty Ltd v McDonald's Australia Ltd* [2000] VSC 310, when His Honour made reference to the case where the impact caused by a franchisor opening a competing business could be such that it "effectively destroys the business" which the impacted operator had negotiated for. (at paragraph 130)

In certain circumstances it may be appropriate for the ACCC to have the power to issue "Cease and Desist Orders" to stop anti-competitive behaviour within a business relationship and before a business is destroyed while the ACCC conducts an investigation.

### 3.5 Implied terms of a contract - good faith and fair dealing

The TPA should be amended to codify what is being increasingly expressed by the courts, and that is that contracts establishing business relationships are deemed to include performance standards of good faith and fair dealing.

Even though there are disclosure provisions within the Franchising Code, the uncertain relational aspects of the business relationship that might occur in future years (despite professional advice at the time of making the contract), demand the need for statutory protection.

This protection, in the form of explicit minimum contract requirements, should be in the form of an amendment to the TPA, imposing a duty of good faith and fair dealing. The object of such an amendment would be to protect the weaker, vulnerable party in a relationship from the misuse of power. Legal sanctions should also be provided.

The amendment should require that contracts establishing business relationships include terms obliging the parties to co-operate so as to preserve the broader ultimate business relationship envisaged at the time the agreement was made. Alternatively, performance could be based on a prevailing community standards test.

The TPA should oblige the parties in a business relationship to commit themselves to behaviour necessary to maintain the good health and where necessary, the mutual profitability of the relationship. The object of such an amendment would be to discourage business behaviour that is improper, capricious and harmful, or acts that are undertaken for an extraneous, improper purpose, or which have the effect of benefiting the more powerful, at the expense of the weaker party. Legal sanctions should also be provided.

Such a provision would bring Australian law in line with USA *Restatement of Contract* legislation that recognises a duty of good faith and fair dealing in contract performance, and would extend the business efficacy tests established in *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* [1977] (180 CLR 266).

## 4 ADMINISTRATION OF THE *TRADE PRACTICES ACT 1974*

*Such market power is open to abuse in a way that normal competition cannot effectively control.*

House of Representatives  
Committee on Industry, Science and Technology

### 4.1 The ACCC

This submission supports the continued operation and strengthening of the Australian Competition and Consumer Commission (ACCC).

### 4.2 Monitoring business practice

The ACCC (or another government agency or department) should be given powers to:

- a) Establish small business forums to discuss, consider and address issues raised by small businesses, including franchisees. The groups could be used as a forum for the ACCC to discuss policy initiatives and as an access point for small business to raise policy issues with the ACCC.
- b) Establish an organisation to represent the interests of franchisees; the body could be funded by a compulsory franchise registration fee.
- c) Monitor activities in the franchising industry.
- d) Require large franchise systems to register and provide a compliance scheme with the ACCC relating to financial capacity, capital adequacy, participatory governance with franchisees, and professional management.
- e) Authorise the Australian Electoral Commission to conduct ballots if 25% of the parties in a business relationship request a supervised secret vote on a key issue (the AEC conducts ballots in the industrial arena).

#### 4.3 Effective utilisation of section 51 AC

- a) The ACCC should be funded and otherwise encouraged to investigate and vigorously pursue instances of unconscionable conduct by powerful businesses who abuse their relationship with smaller businesses.
- b) The definition of unconscionable conduct should be clarified so that the rights and obligations of the parties are understood; uncertainty favours powerful businesses who are able to expend considerable resources in the courts.

Rodney Hackett

17 July 2002