Competition Law Issues

Competition law: unique risks for franchisors

Josh Simons, Partner
Minter Ellison Lawyers
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Overview

• Part 1: Understanding the basics – why comply?

• Part 2:
  – Knowing the boundaries – complying with prohibitions against anti-competitive conduct
  – Risk areas for franchises

Part 1:

Understanding the basics – why comply?
Franchises & competition

• The essential elements of a franchise network conflicts with competition laws:
  – Grant of exclusive rights, to the exclusion of other traders
  – Carving up a market to restrict franchisees to particular goods and services, or specified territories
  – Restrict how, when, where and with who franchisees conduct business
  – Require use of specified goods or services

The Act

• Anti-competitive conduct regulated by Part IV of the *Competition and Consumer Act 2010* (CCA) (formerly the *Trade Practices Act 1974*)

• Consumer protection / unfair business practices laws now contained in the Australian Consumer Law
Why get it right?

• Fines / penalties (per offence) of up to the greater of:
  – $10 million
  – three times value of benefit
  – if benefit cannot be determined, 10% of the group’s annual turnover

Importance of compliance

• Franchised networks must be carefully structured to fit exemptions/defences

• Consequences
  – Injunctions, declarations
  – Damages / class actions
  – Management time and costs
  – Reputational (particularly due to disclosure requirements)
Individual risk

- For cartels, up to 10 years imprisonment
- Fines / penalties of up to $220,000 (criminal), $500,000 (civil)
- Prohibition / limits on indemnification
- Disqualification orders
- Reputation

Who has got it wrong before?

<table>
<thead>
<tr>
<th>Franchisor</th>
<th>Breach</th>
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<tbody>
<tr>
<td>Ampol Petroleum</td>
<td>Price Fixing</td>
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<td>Seal-a-Fridge</td>
<td>Third Line Forcing</td>
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<td>Bill Express</td>
<td>Exclusive Dealing</td>
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<td>Jurlique International</td>
<td>Resale Price Maintenance</td>
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<td>Mayo International</td>
<td>Resale Price Maintenance</td>
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Part 2:

Knowing the boundaries – complying with prohibitions on anti-competitive conduct

**Risk areas for franchises**

### Summary of prohibitions

<table>
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<th><strong>Absolute (‘per se’) prohibitions</strong></th>
<th><strong>Conditional prohibitions</strong></th>
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<tbody>
<tr>
<td>- Price fixing*</td>
<td>Prohibited if has anti-competitive purpose or effect</td>
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<tr>
<td>- Market sharing*</td>
<td>- Anti-competitive agreements</td>
</tr>
<tr>
<td>- Collective boycotts*</td>
<td>- Exclusive dealing</td>
</tr>
<tr>
<td>- Bid rigging*</td>
<td><strong>Prohibited if has anti-competitive purpose</strong></td>
</tr>
<tr>
<td>- Output restrictions*</td>
<td>- Misuse of market power</td>
</tr>
<tr>
<td>- Third line forcing</td>
<td><strong>Prohibited if likely to have anti-competitive effect</strong></td>
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<td>- Resale price maintenance</td>
<td>- Mergers and acquisitions</td>
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</table>
Anti-competitive conduct – dealing with competitors

**Cartels**

What is a cartel?

- An agreement, arrangement or understanding,
- between competitors,
- which has the purpose or effect of fixing, controlling or maintaining price
  OR
- which has a prohibited purpose.
Agreement...

- Does not need to be in writing. A nod or a wink is enough.
  - Technically:
    understanding = communication + commitment
  - Practically:
    understanding = communication + parallel conduct
- Every conversation you have with a ‘competitor’ creates risk
- An attempt to create a cartel will also constitute a breach

What are ‘competitors’?

- are in competition with each other,
  OR
  would be in competition with each other;
- in relation to the supply of goods or services,
  OR
  in relation to the acquisition of goods or services.
Price fixing

- Occurs when competitors make or give effect to a contract, arrangement or understanding with:

  the purpose OR the effect or likely effect, of

directly OR indirectly fixing, controlling or maintaining prices

- ‘Price’ includes:
  - goods supplied, acquired or re-supplied
  - discounts, allowances, rebates or credits
Price fixing

What you can do:

• You can determine prices/discounts by reference to those of competitors, so long as your conduct is unilateral

   If your conduct is not unilateral (which is likely to include all dealings between franchisors and franchisees), you need an exemption or defence.

Market sharing / allocation

• Occurs when competitors make a contract, arrangement or understanding regarding:
  – from which suppliers they can purchase
  – which customers they can supply
  – what goods or services they can supply
  – in what geographical territory they can operate

• Each one of those restrictions commonly found in a franchise agreement...
Output restrictions

- Competitors make or give effect to a contract, arrangement or understanding that has the purpose of preventing, restricting or limiting:
  - production or likely production of goods
  - capacity or likely capacity of supply of services
  - supply or likely supply of goods or services

Cartels exemptions and defences

- Related bodies corporate
- Authorised conduct
- Joint ventures
- Collective acquisitions and joint advertising
- Notified conduct (collective bargaining)
- ‘Anti-overlap’ exemptions for exclusive dealing, mergers and resale price maintenance
Cartels: risk area for franchises -#1

- Where a franchisor supplies products directly to customers (eg national accounts) in competition with franchisees

**Problem**: Risk of price fixing between franchisor and franchisee as to price of product/delivery charge

**Solutions**:
- Franchisor can specify a maximum resale price to franchisee
- Franchisor can sub-contract franchisee to deliver products

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Cartels: risk area for franchises -#2

Where franchisees wish to form a joint buying group for products or inputs

**Problem**: Risk of price fixing between franchisees as to price at which franchisees acquire product/input

**Solutions**:
- Exempt to extent that arrangement fixes price of products/inputs collectively acquired, or is for joint advertising of the resale price
- But cannot agree to boycott other suppliers
- Can make collective bargaining notification to ACCC
Anti-competitive conduct – dealing with customers and suppliers

*Strict prohibitions – other than cartels*

Third Line Forcing

- Prohibited in all cases, unless notification approved by ACCC
  - Supply of goods and services on the condition that the purchaser also acquires goods or services of a third party
    OR
  - Refusal to supply goods or services because the purchaser will not acquire goods or services of a third party
Third line forcing

Unrelated parties

- Supply of goods or services (including supply of discount or benefit etc.) on the condition that the purchaser acquire goods or services from a third party.

FRANCHISOR

Conditional grant of franchise

THIRD PARTY SUPPLIER

Must source supply from 3rd party supplier

FRANCHISEE

Third line forcing - exceptions / defences

- **Recommending** a third person’s product or service is legal
- Requiring that goods or services meet a reasonable specification is OK if it doesn’t effectively require that they be purchased from particular third parties
- May be authorised by, or notified to, the ACCC
- May be circumvented by ‘bundling’ (tying) the services into a package supplied by one party (supplier sub-contracts)
• Bundling
  – Two products/services are offered together as a “bundle” in the one agreement
  – Common for franchise systems
  – This is legal
  – No notification required

• ACCC notification
  – Lodge notification with ACCC
  – Wait 14 days
  – If ACCC decides that the public benefits of the conduct outweigh the public detriments, it will approve
  – Different fees for third line forcing ($100) compared to normal exclusive dealing ($2,500)
Third line forcing: risk area for franchises

- Where franchisor supplies products to franchisee on condition that franchisee acquires other products from unrelated third party.

**Problem:** Third line forcing

**Solutions:**
- Have franchisor acquire product from third party and supply to franchisee
- Franchisor can require goods or services which meet reasonable specification
- Franchisor can notify ACCC

### Notification examples

<table>
<thead>
<tr>
<th>Franchisor</th>
<th>Conduct</th>
<th>Outcome of notification</th>
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<tr>
<td>The Fairies</td>
<td>Franchise only granted on condition that person will acquire point-of-sale software and back-end accounting software and related services from nominated suppliers.</td>
<td>Conduct accepted. ACCC made specific mention of the clear disclosure document in place.</td>
</tr>
<tr>
<td>Seal-a-Fridge</td>
<td>30 franchisees required to acquire goods/services from approved suppliers which were yet to be nominated.</td>
<td>Revoked – ACCC saw ‘little, if any public benefit’. Franchisees were against it and there was no guarantee quality would improve.</td>
</tr>
</tbody>
</table>
Resale price maintenance

• Involves a supplier:
  – supplying a person with goods or services (goods) on the condition that the person agrees not to resell the goods at or below a specified price, OR
  – inducing a reseller not to resell the supplied goods at or below a specified price, OR
  – withholding supply of goods because the person has sold the goods below a specified price, or has not agreed not to resell the goods at or below a specified price

• Recommended Price is permitted, provided it is made clear that there is no obligation to comply with the recommendation

• Setting a maximum price is permissible

• Selling the good under a true agency arrangement will not constitute resale price maintenance
Resale price maintenance: risk area for franchises

- Where the franchisor supplies products to a franchisee for resale by the franchisee

**Problem:** If franchisor specifies a minimum resale price, below which the franchisee may not sell the product to the customer

**Solutions:**
- Franchisor can recommend a resale price to the franchisee
- Franchisor can specify a maximum resale price to the franchisee (but beware of cartel risk if the franchisor also competes with the franchisee)
- Franchisor and franchisee can enter into an agency relationship in relation to sale of the product

Who has got it wrong

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<th>Conduct</th>
<th>Penalty</th>
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<td>Chaste Corporation</td>
<td>Prevented area managers from selling product at discounts</td>
<td>Over $1 million in penalties, $600,000 to Chaste and penalties between $150,000 and $25,000 for directors</td>
</tr>
<tr>
<td>J&amp;J Franchising (Jurlique products)</td>
<td>Entered into agreements on condition that goods wouldn’t be sold below certain price</td>
<td>$700,000 fine and injunctions</td>
</tr>
</tbody>
</table>
| Mayo International          | Supplier to franchised chain of Price Attack provided 15% discount on its products, but when it discovered that the products were offered at below its RRP, they withdrew the discount. | Supplier fined $10,000 for each franchise
Director fined $20,000 |
Anti competitive conduct – dealing with customers and suppliers

*Conditional prohibitions* – *Substantial Lessening of Competition Test*

### Summary of prohibitions

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Section 45 of the CCA prohibits the entering of contracts, arrangements or understandings (‘Agreements’) which have the purpose, effect, or likely effect of substantially lessening competition.

An Agreement for the purposes of Section 45 can be about anything.

Critical issues:
- What is the relevant market?
- Is the purpose to substantially lessen competition in that market?
- Is the effect or likely effect to substantially lessen competition in that market?

Some warning signs:
- Is the agreement with a competitor? [beware Cartel Conduct]
- Will it limit existing rights or activities of a third party?
- Is it for an exclusive arrangement and/or for a long term?
- Are the relevant goods or services hard to acquire or in short supply?
- Will the agreement give a party a clear advantage over other businesses?
- Is the agreement likely to cause another business or person to suffer detriment?
Exclusive Dealing

• Exclusive dealing involves supply or acquisition subject to certain conditions

• Exclusive dealing is usually an attempt to limit, restrict or otherwise alter:
  – dealings in goods or services (both supply and acquisition);
  – the resupply of goods or services to certain customers; or
  – the resupply of goods or services in certain geographic areas of places.

Exclusive Dealing

• Third line forcing is a particular kind of exclusive dealing
• Exclusive dealing can be notified to the ACCC
• Exclusive dealing conduct is exempt from the strict cartel provisions, by virtue of the ‘anti-overlap’ exception
• Because of the strict cartel conduct protections, franchisors need to make sure that their franchise agreements properly satisfy the limited conditions in section 47
Anti-Overlap Exception

- Relatively easy concept to understand, technically difficult definitions that require careful drafting to ensure no cartel created.

- Must be used carefully:
  - whole of conduct must fall within overlap
  - must fall strictly within the relevant overlap prohibition
  - limited judicial guidance, other than to say narrow construction

<table>
<thead>
<tr>
<th>Section</th>
<th>Characterisation</th>
<th>Will not acquire from</th>
<th>Will not re-supply competitors products</th>
<th>Will no re-supply to particular persons/places</th>
</tr>
</thead>
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<tr>
<td>47(2)</td>
<td>Supply to on condition that</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>47(3)</td>
<td>refuses to supply because</td>
<td>has acquired from a competitor</td>
<td>has re-supplied to a competitor</td>
<td>has re-supplied to particular persons/places</td>
</tr>
<tr>
<td>47(4)</td>
<td>Acquires on condition that</td>
<td>will not supply to particular persons/places</td>
<td></td>
<td></td>
</tr>
<tr>
<td>47(5)</td>
<td>refuses to acquire because</td>
<td>has supplied to particular persons/places</td>
<td></td>
<td></td>
</tr>
<tr>
<td>47(6)</td>
<td>Supply on condition that</td>
<td>will acquire from a third party (TLF)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>47(7)</td>
<td>refuses to supply because</td>
<td>has not acquired from a third party (TLF)</td>
<td></td>
<td></td>
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Exclusive dealing: example

- Franchisor
- Franchisor’s competitor
- Customers
- Franchisor’s competitors products
- Particular customers/types of customer
- Customers in a particular place(s)

Josh Simons
Partner

T +61 8 8233 5428
F +61 8 8233 5556
E josh.simons@minterellison.com

MinterEllison