FCAI Response to the Regulation Impact Statement: Franchising Sector Reforms

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INTRODUCTION

1. The Federal Chamber of Automotive Industries (**FCAI**) welcomes the opportunity to respond to the Regulation Impact Statement **(RIS**) in relation to the Fairness in Franchising Report of the Parliamentary Joint Committee on Corporations and Financial Services (**PJC**).

2. The FCAI is the peak industry organisation representing vehicle distributors and importers of passenger motor vehicles, SUVs, light commercial vehicles and motor cycles in Australia (**Distributors**).

3. The FCAI notes that the RIS does not consider the PJC's recommendations relating to automotive franchising as these are being addressed in related policy processes. However, to the extent to which the RIS impacts on the Australian automotive industry, the FCAI thought it might be useful to provide some comments and answer some of the questions raised in the RIS.

4. Before addressing the RIS in detail, it is worth making a couple of general comments.

Automotive 'franchises' are not really franchises

5. The relationship between Distributors and dealers is not what would normally be considered a 'franchise'. Unlike traditional franchises, dealers do not pay anything in the way of franchise fees, nor do they pay anything to the Distributor when they sell their business. All that dealers pay the Distributor for are the vehicles, parts and accessories they purchase from the Distributor, as well as special tools for servicing/repairs.

6. The relationship between dealers and Distributors is much more like a straight distribution arrangement, rather than a franchise. This is reinforced by the fact that the relationship would not be caught by the general definition of 'franchise agreements' in the Franchising Code of Conduct (**Franchising Code**). It is only caught by the Franchising Code because of a specific provision in the definition of 'franchise agreement' that deems a motor vehicle dealership agreement as being a franchise agreement[1]: but for this deeming provision it would not be a franchise agreement.

7. Globally, arrangements between manufacturers and dealers are not universally deemed to be franchises. There are numerous jurisdictions which consider such arrangements to be no more than a contract between two parties, without any additional protection offered considering the magnitude of a motor vehicle dealership and the level of business acumen of the parties concerned. Examples of such markets are South Africa and New Zealand.

Dealers are not 'mum and dad' operations

[1] Clause 5(2)(c) of the Franchising Code.

8. Dealers are invariably large, sophisticated businesses. They are not the traditional 'mum and dad' operations that are normally attracted to franchises. The largest automotive dealer in Australia is A.P. Eagers Limited. It has approximately 230 motor vehicle dealerships, represents 33 car brands and turns over in excess of $8 billion. Even the so-called 'family businesses' in the automotive industry are significant. For example, the Suttons Group has 42 dealerships representing 30 brands with a turnover in 2017 of more than $1 billion. As pointed out by the Motor Trades Association of Australia in its submission to the PJC, a typical, mid-sized metropolitan motor car dealer employs at least 40 people (and as many as 90) and has an annual turnover in the region of $100 million.

Dealers control their own sites

9. Dealers can exert substantial power through the control they have over their sites. The location of dealerships is extremely important and they tend to cluster in certain areas – think of the Nepean Highway in Melbourne and Parramatta Road in Sydney. These locations are very tightly held and there is very little, if any, land that is unaccounted for. Unlike most other franchises, the Distributors do not control the sites on which the dealers are located – the dealers do and unlike in the case of more traditional retail outlets, Distributors rarely have step in rights or a first right of refusal regarding the site (occupation or purchase). This puts the dealer in a very strong negotiating position because can surrender its dealer agreement and will have little difficulty in picking up another automotive franchise. So, not only does the Distributor lose a dealer in a prime location, it will have difficulty in finding another location and, in the meantime, it's previous dealer might be acting for a competitor. This is real power in the hands of the dealers.

PRINCIPLE 1 – PROSPECTIVE FRANCHISEES SHOULD BE ABLE TO MAKE REASONABLE ASSESSMENTS OF THE VALUE (INCLUDING COSTS, OBLIGATIONS, BENEFITS AND RISKS) OF A FRANCHISE BEFORE ENTERING INTO A CONTRACT WITH A FRANCHISOR

General comment

10. Most people become dealers by acquiring an existing dealer's business, having already worked in the industry or within that dealership itself. Sometimes new dealerships are created – usually when a new brand enters the Australian market – but this is the exception rather than the rule. Acquiring a dealership will generally be a significant purchase with a commensurately significant purchase price. The purchaser will have conducted its due diligence, formed an assessment of the value of the business it is proposing to acquire and used their previously experience in determining if the opportunity is favourable or not. A prospective dealer will do this on the basis of the records provided by the vendor (i.e. the existing dealer) and will certainly form this view before entering into a contract with the dealership's franchisor. In this context, disclosure documents provided by the franchisor can be of little material value compared to the detailed dealership records.

Comments on the options

Option 1.2.2 – requiring franchisors to verify financial statements

11. Distributors are not able to, nor should they be expected to, verify a prospective vendor dealer's financial statements - they simply do not have access to the required information. Distributors know the number of new vehicles sold by their dealers as well as the volume of parts. In some instances, Distributors might even know the gross revenue received from the sales. However, Distributors will not know the total costs of the dealership (and if it is a multi-brand dealership, the apportioning of costs between the brands), nor anything to do with the other departments within the dealership, such as, for example, used cars (which most of the dealerships have).

12. Similarly, in the relatively unusual situation where the Distributor appoints a new dealer, the Distributor will not have the required financial information to enable the new dealer to be able to make a 'reasonable assessment of the value of the franchise'.

13. For these reasons, the financial information that is currently required to be provided in disclosure documents invariably has to be expressed in general terms, with a substantial number of qualifications. As such it is almost meaningless.

14. To require more detailed financial information would not solve the issue as it simply would not be available to and could not be provided by the Distributor.

15. Dealers financial affairs and business structures are complex and providing comments against one aspect would be fraught and place unnecessary risks and operational burdens on distributors.

    Question 1 – What are the critical pieces of information that should be contained in a summary document?

16. Summary documents are inherently problematic because they have to be drafted on the basis that they will be relied upon by a prospective dealer. As such, they have to be drafted on a conservative basis which means that either the summary has to be subject to a number of qualifications or needs to encompass all possibilities. In either instance the summary document becomes almost meaningless.

PRINCIPLE 2. FRANCHISEES SHOULD HAVE TIME TO CONSIDER WHETHER THE RELATIONSHIP IS RIGHT FOR THEM BEFORE COMMITTING TO AN AGREEMENT

17. For the reasons explained in the general comments about, prospective dealers (who are invariably purchasers of other dealers' businesses) have more than adequate time to appropriately reflect on their business arrangements. They do this before entering into any agreement (including the dealer agreement).

18. In the case of new motor vehicle-selling dealerships, the current 14 day cooling off period is at best useless and at worst a nuisance that can complicate completion of an otherwise agreed transaction.

19. The purchase of a dealership or an interest in a dealership, is often a long winded, complex and multi-party process (distributors, landowners, financiers, insurers for example) and therefore could never be described as a "spontaneous" acquisition.

    Preferred option

20. Whilst rarely/never utilised in the industry, the FCAI suggests that the 14 day period remains but that there be an ability for both parties to waive or shorten the cooling off period by agreement for reasons of operational efficacy.

PRINCIPLE 3. EACH PARTY TO A FRANCHISE AGREEMENT SHOULD BE ABLE TO VERIFY THE OTHER PARTY IS MEETING ITS OBLIGATIONS AND IS GENERATING VALUE FOR BOTH PARTIES

Problem 3.1 Marketing funds are not always transparent

21. In the case of most Distributors, the marketing fund consists of contributions from dealers as well as a contribution (often an equal contribution) from the Distributor. The fund is normally spent either on the basis of a recommendation from a representative group of dealers or after consultation with such a group.

Preferred option

22. There is no need to change the current regime. The FCAI does not support the potential increased frequency of reporting.

PRINCIPLE 4. A HEALTHY FRANCHISING MODEL FOSTERS MUTUALLY BENEFICIAL COOPERATION BETWEEN THE FRANCHISOR AND THE FRANCHISEE, WITH SHARED RISK AND REWARD, FREE FROM EXPLOITATION AND CONFLICTS OF INTEREST

Problem 4.2 Conflicts of interest in the context of capital expenditure

23. Distributors do not require their dealers to undertake capital expenditure in order to benefit only the Distributor. It is both the dealer network (i.e. each individual dealer) and the Distributor that benefits from all dealers having up-to-date, appropriate, facilities.

24. The RIS suggests that some franchisors require franchisees to undertake capital expenditure and then do not renew the franchise agreement. Since 2015, there have been significant limitations on the ability of a Distributor to require a dealer to undertake capital expenditure during the term of their dealer agreement. With these amendments and the law relating to misrepresentation, unconscionable conduct and other equitable remedies, it is highly unlikely that a franchisor could get away with requiring a franchisee to undertake capital investment and then not renew their franchise agreement. Ultimately there is a great deal of discussion between the franchisor and franchisee well before any demand for significant capital expenditure occurs.

25. A Distributor can, and should, be able to make it a condition of renewing, or granting a new dealer agreement, that the dealer undertakes some/reasonable capital works. If the dealer does not want to accept this condition, the dealer scan do so – it is a matter for the dealer. If the dealer thinks that it will be able to get an adequate return on the capital expenditure, presumably it will accept the condition and enter into the agreement.

26. In any event, as explained above, Distributors do not have full visibility against each dealerships operational costs, and particularly less visibility in multi-franchised operations.

Accordingly, the Distributor will not be in a position to determine the likely profitability of a dealership.

Preferred option

27. There is no need to change the current regime.

Problem 4.3 Unilateral variations can lead to conflicts of interest and exploitation

28. Distributors need to have some flexibility to introduce changes during the term of a dealer's agreement, for the benefit of the entire dealer network and for its own legitimate commercial interests. Generally, these changes are relatively minor - for example, to streamline administrative processes. It is possible however, that there might be a need for more substantive changes to be made quite quickly to respond to commercial demands. The automotive industry is going through an enormous period of change, which is likely to accelerate over the next 5–10 years (due to factors such as autonomous vehicles, electric vehicles, and subscription models etc.) and flexibility will be required to keep up to date with these changes.

29. Dealers (and franchisees more generally) are protected from mid-term unilateral variations having an undue impact on them. The 2015 amendments to the Franchising Code specifically protect dealers from having to undertake undisclosed, unnecessary capital expenditure. At a more general level, the prohibition against unconscionable conduct,[2] the obligation to act in good faith[3] and other equitable doctrines provide more than adequate protection to dealers in the context of unilateral variations.

30. Without the ability to exercise some flexibility, Distributors will be reluctant to grant long term dealer agreements or may even be dissuaded from entering the Australian market.

Preferred option

31. There is no need to change the current regime.

PRINCIPLE 5. WHERE DISAGREEMENTS TURN INTO DISPUTES, THERE IS A RESOLUTION PROCESS THAT IS FAIR, TIMELY AND COST EFFECTIVE FOR BOTH PARTIES

Problem 5.1: Some disputes are not being resolved in a fair, timely and cost effective manner

32. The vast majority of disputes between Distributors and dealers are resolved by agreement either before, or during a mediation. The reality is that there will always be a few disputes where the parties are unable to reach an agreement and the only alternative is for there to be a determination.

[2] See Part 2-2 of the Australian Consumer Law, a breach of which attracts a maximum fine of up to $1.1milion.

[3] Clause 6 of the Franchising Code, a breach of which attracts a maximum fine of approximately $60,000.

33. Other than some streamlining for administration purposes, such as merging OFMA and ASBFEO[4], there is little merit in changing a system that works on the most part.

34. The FCAI sees benefit in clarifying the availability of multi-party mediation due to its ability to increase the cost-effective and timely resolution of disputes. (Option 5.1.2(c)).

Question 13 - Would you consider including arbitration to resolve disputes in your franchising agreement, if a clear voluntary option were provided?

35. The FCAI does not have a problem with arbitration rather than court proceedings but points out that while arbitration is generally more timely, it is generally more expensive than Court proceedings for the parties involved.

PRINCIPLE 6. FRANCHISEES AND FRANCHISORS SHOULD BE ABLE TO EXIT IN A WAY THAT IS REASONABLE TO BOTH PARTIES

Problem 6.1 Reasonable exit arrangements may not be, or may not be perceived to be, available or accessible for some franchisees

36. Under the current regime, the only fetter on a dealer's right to terminate their agreement are the terms of the dealer agreement itself and common law. On the other hand, the ability of Distributors to terminate their dealer agreements is severely constrained by the Franchising Code. In addition, Distributors are often not even able to use these limited means of termination because:

    - the 'special circumstances' ground (clause 29 of the Franchising Code) is, in a number of regards unclear;[5] and

    - a dealer cannot be terminated even if they repeatedly commit the same breach of their dealer agreement, provided the dealer rectifies each breach within the reasonable time nominated by the Distributor (see clause 27 of the Franchising Code).

Option 6.1.2 Limit termination in circumstances where the franchisee seeks mediation, and/or breaches have occurred for fraud or public health and safety reasons, and introduce statutory termination rights into the Franchising Code

37. The FCAI agrees that franchisors need to have effective termination provisions in order to protect the franchise brand, as delaying or preventing termination may cause reputational damage that affects the entire franchise network and its remaining franchisees. The FCAI also makes the point that the Distributor's right to terminate in special circumstances is designed to be available in only the most serious of circumstances, where immediate termination is appropriate and justified. For the dealer to be able to postpone termination when, for example, it is operating the franchise in a way which endangers public health or safety (clause 29(1)(f) of the Franchising Code) is, completely unacceptable.

[4] As contemplated by option 5.1.2(a).

[5] For example, what constitutes 'acting fraudulently' per clause 29(1)(g)? Also, is a 'serious offence' considered to have been committed by the dealer (which is always a company) if a senior employee of the dealer commits the offence?

38. The reality is that immediately terminating a dealer agreement is a very serious matter and Distributors only do it in the most clear-cut circumstances, and even then, only when absolutely necessary. Such decisions are not taken lightly, and distributions would always consider the costs associated with the defence of claims.

Problem 6.3 - There are different expectations around the treatment of goodwill in franchise arrangements

39. In the automotive context, the Distributor receives no value for any goodwill. This is different to most traditional franchises. When a new dealer is appointed, it pays no goodwill to the Distributor (in the form of an upfront entry fee), while a dealer is operating its business it pays no good will, and when a dealer sells its business, the Dealer receives an amount (presumably) for the sale of the dealership, including goodwill, which is paid by the purchaser.

40. Given that dealers do not pay the Distributor for any goodwill, if a dealer agreement comes to an end, the Distributor should not have to pay the dealer for any goodwill.

41. Should a dealer agreement expire or be terminated, the dealers will retain the benefit of the goodwill that is in the site (i.e. locational goodwill) and is able to capitalise on same.

Question 14 – Under what circumstances should franchisees be allowed a no-fault exit from the franchise system?

42. The FCAI is of the view that dealers should not be allowed a no-fault exit from their dealer agreement. The dealer agreement is like any other contract, that both parties should be held to and may rely upon. There are circumstances where the current laws allow a party to exit an agreement and these are more than adequate to govern dealer agreements.

43. If there are to be any no-fault termination rights given to franchisees, then franchisors should be given these same rights.