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FRANCHISING

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WHEN IS A DISTRIBUTION AGREEMENT OR TRADE MARK LICENCE ALSO A FRANCHISE AGREEMENT?

A Federal Court decision clarifies the factors and considerations relevant when deciding what is a franchise agreement

A recent Federal Court case considered the issue of when a distribution agreement or trade mark licence is also a franchise agreement and is, therefore, regulated by the mandatory Australian Franchising Code of Conduct. The court decided that a drink machine distribution arrangement and trade mark licence was not a 'franchise agreement' as defined in the Code, because it did not incorporate the 'system or marketing plan determined, controlled or suggested by the franchisor' that is necessary for a franchise agreement. Partner Tim Golder and Lawyer Robyn Chatwood report on how the case clarified the factors relevant to a 'system or marketing plan' and detail the court's non-exhaustive list of considerations.

HOW DOES IT AFFECT YOU?

- Distributors or trade mark licensors who do not want their commercial arrangements with their Australian sub-distributors or licensees to be franchises (regulated by the Franchising Code of Conduct) need to check whether their agreements include the relevant factors for a system or marketing plan. If so, legal advice should be sought as to whether the Franchising Code of Conduct applies to the arrangement.
- To avoid the application of the Franchising Code of Conduct, distribution agreements or trade mark licences must be structured appropriately *before* they are finalised.
- If you suspect your existing Australian trade mark licence or a distribution agreement is in fact a franchise agreement, then you should note that you cannot avoid the application of the Franchising Code of Conduct to the arrangement by simply not enforcing certain provisions of the agreement – a modified agreement will be needed to avoid the Code. Legal advice should be sought as to any amendment process.

MANDATORY FRANCHISING CODE OF CONDUCT

The *Trade Practices (Industry Codes – Franchising) Regulations 1998* (Cth) (the ***Code***) is a mandatory industry code under section 51AD of the *Trade Practices Act 1974* (Cth) (the ***Act***). The Code outlaws certain provisions in franchise agreements and requires other minimum conditions. Additionally, it requires franchisors to disclose information about themselves and their associates, both before and after the parties agree their arrangements. A breach of the Code is a breach of the Act.

There are many legitimate reasons to set up distribution businesses or trade mark contracts in Australia outside the Code. Considerable expenses are incurred by franchisors in complying with the Code however and so many businesses actively try to avoid the Code by establishing their arrangements in such a way as to fall outside the Code's definition of a franchise agreement. Such non-franchised arrangements may have a competitive advantage over franchises. These arrangements should be structured carefully. The Australian Competition and Consumer Commission (***ACCC***) has noted its priority is to prosecute those who incorrectly deny their business arrangements are franchise agreements under the Franchising Code of Conduct.

HOW DOES THE CODE DEFINE A FRANCHISE AGREEMENT?

The Code sets out four cumulative criteria for a franchise agreement, which apply irrespective of how the parties describe their arrangements.[1] If all four criteria are met, then the arrangement is deemed a franchise agreement under the Code and the Code provisions apply to regulate it.[2]

1. Clauses 3 (which covers definitions) and 4 (which deals with the meaning of franchise agreement) of the Code.
2. The exception is motor vehicle distribution arrangements – which under clause 4(2) of the Code are deemed to be franchise agreements.

The four criteria are:

1. The agreement is written, oral or implied in whole or in part.[3]
2. The franchisee's business operation is substantially or materially associated with a trade mark, advertising or commercial symbol that is either owned, used, specified or licensed by the franchisor.[4]
3. The franchisee pays the franchisor fees[5] – except for four payment categories excluded by the Code.[6]
4. There is a grant by the franchisor to the franchisee of a right to carry on a business of offering, supplying or distributing goods or services in Australia, under a system or marketing plan substantially determined, controlled or suggested by the franchisor.[7]

The case of *ACCC v Kyloe Pty Ltd* [2007] FCA 1522 (18 October 2007) clearly focussed on the last of these criteria and, in particular, that of the 'system or marketing plan'.

THE POLAR KRUSH ICE DRINK DISTRIBUTION BUSINESS

The ACCC instituted proceedings alleging contraventions of the Code against Kyloe Proprietary Limited (***Kyloe***), Impact Design Accessories Proprietary Limited (***Impact***) and their associates. The ACCC alleged Kyloe, Impact and their associates were, in reality, promoting and operating a Polar Krush Ice drink franchise and so their sub-distribution arrangements would be caught by the Code. The ACCC sought various orders, including a declaration that the Polar Krush Ice sub-distribution agreements were franchise agreements and that Kyloe and others had not followed the provisions of the Code for disclosure, cooling-off rights and dispute resolution procedures.

3. Clause 4(1)(a).
4. Clause 4(1)(c).
5. Clause 4(1)(d)(i)-(iv).
6. Clause 4(1)(d)(v)-(viii).
7. Clause 4(1)(b).

Kyloe, Impact and their associates promoted the distribution of Polar Krush Ice drinks. Kyloe's principal, Mr McCann, and Kyloe imported 32 ice drink machines and entered into agreements with Impact and its directors, the Morpeths, giving Impact an exclusive right to buy machines for resale. Impact had to advertise and submit an annual advertising and promotional program for approval to Kyloe, observe all directions and instructions given by Kyloe in relation to promotion, and comply with Kyloe's conditions for use of the trade mark.

Sub-distributors entered into machine purchasing agreements with the Morpeths and Impact signed up sub-distributorships (in agreements with Kyloe and the overseas machine manufacturer) to allow the sub-distributors to place drink machines in outlets. Through sub-distributors, Kyloe, Impact and their associates licensed use of their registered trade mark, as part of the distribution system. Sub-distributors had to promote the products, observe all directions and instructions given by Kyloe in relation to product promotion, and obtain approval for the method, form, style and content of advertising. Kyloe had to supply samples of instruction booklets to them.

The parties called their Polar Crush sub-distribution contracts 'sub-distribution agreements', not 'franchise agreements'.

WAS THE POLAR KRUSH DISTRIBUTION BUSINESS IN FACT A FRANCHISE REGULATED BY THE CODE?

In relation to the four criteria for a franchise agreement, the Federal Court accepted that the Polar Krush arrangements met the first and second criteria (that is, there were agreements[8] which involved a trade mark[9]). The court found it unnecessary to rule on the third criterion (payment of fees), although it noted that the mandatory distributor-provided training of sub-distributors was conducted for fees set on a cost-recovery basis rather than for profit[10] (which would mean that the third criterion should not be met).

The court spent much of its judgment on the fourth criterion for a franchise agreement, that being the 'system or marketing plan determined, controlled or suggested by the franchisor' required under clause 4(1)(b) of the Code. Although there was a grant of a right to carry on a business,[11] the court found that the Polar Krush ice drink business conducted by Kyloe and Impact did not constitute a franchise, because there was no system or marketing plan.[12] Therefore, the ACCC's application was dismissed.[13]

RELEVANT FACTORS FOR DETERMINING 'SYSTEM OR MARKETING PLAN' UNDER THE CODE AND WHEN TO CONSIDER THESE

The Code has no definition for 'system or marketing plan' and does not explicitly state when it is necessary to consider if such a system or plan is present. The court provided a useful list of relevant factors to these issues.

FACTORS INDICATING PRESENCE OF SYSTEM OR MARKETING PLAN

The court noted[14] an earlier Federal Court case, *Capital Networks Pty Ltd v .au Domain Administration Ltd* [2004] FCA 808, had considered the Code term, 'system or marketing plan', and resorted to United States case law

8. *ACCC v Kyloe Pty Ltd* [2007] FCA 1522, [26].
9. *Kyloe*, [64].

10. *Kyloe*, [65]-[68].
11. *Kyloe*, [27]-[38].
12. *Kyloe*, [40]-[63].
13. *Kyloe*, [72].
14. *Kyloe*, [40].

for guidance. Although Justice Bennett in the Capital case had commented that US legislation dealing with franchising did not precisely replicate the terms of the Code,[15] and so caution was needed in referring to US authorities for guidance on the Australian regulations,[16] it was decided that, on the basis that the US legislation had 'marked similarities'[17] with Australian legislation, certain 'factors' or 'provisions' relevant in the US could be used for indicators of a system or marketing plan under the Code in Australia.[18]

Justice Tracey in *Kyloe* reviewed the *Capital* approach, agreeing the following factors were 'helpful indicators' of the presence of a 'system or marketing plan'[19] being established by the head distributor. Many factors listed by his Honour are sales-oriented. They are as follows:

a. Detailed compensation and bonus structures for selling products.

b. Centralised bookkeeping and record-keeping computer operations.

c. Assistance conducting 'opportunity' meetings.

d. Comprehensive advertising and promotional programs.

e. Schemes for appointment of distributors, direct distributors, district directors, regional directors or zone directors.

f. Rights to screen and approve promotional materials.

g. Prohibitions on repackaging of products.

h. Suggestions for retail prices charged for products.

i. Division of states into marketing areas.[20]

j. Establishment of sales quotas.

k. Rights to approve sales personnel employed by the sub-distributor.

l. Mandatory sales training regimes.

m. Provision of quotation sheets to the sub-distributor's employees or prescribed invoices and other sales forms.

n. Requirement that the sub-distributor gather information from customers for the head distributor.

o. Restrictions on sub-distributor selling products without consulting the head distributor.

In both cases, the judges expressed their lists as non-exhaustive relevant considerations,[21] with the Kyloe judge noting also that such a list:

> *does serve to focus attention on the type of matters which will inform a judgment on whether the necessary 'system, or marketing plan' exists in a particular case*[22]

WHEN SHOULD THE FACTORS BE CONSIDERED?

The court also noted that the time to consider if an agreement is a franchise under the Code is before it becomes operative; thus enforcement or otherwise by the head distributor or trade mark licensor of the provisions in its agreements is not relevant to that matter.[23] This statement is not ground-breaking, but a useful reminder that all issues need to be carefully considered before arrangements are finalised.

DID THE POLAR KRUSH ARRANGEMENT HAVE THE RELEVANT FACTORS?

In considering the Polar Krush evidence,[24] his Honour found that, despite the provision of some sales materials and guidance by Kyloe and Impact to its sub-distributors, there was no 'sales or marketing plan'.

Particular findings were as follows:

15. *Capital Networks Pty Ltd v .au Domain Administration Ltd* [2004] FCA 808, [100].
16. *Capital*, [101].
17. *Capital*, [101].
18. *Capital*, [114]-[118].
19. *Kyloe*, [40]
20. In matters 1.1(i) to 1.1(n), Tracey J, at *Kyloe* paragraph [40] referred to Bennett J's agreement in her judgment at paragraph [104] with the Court of Appeals of Indiana in *Master Abrasives Corporation v Williams* (1984) 469 NE 2d 1196.

21. *Capital*, [116] and *Kyloe*, [40].
22. *Kyloe*, [40].
23. *Kyloe*, [56].
24. *Kyloe*, [41]-[55].

- **Opportunity meetings** – Advice by distributors of best machines locations in schools and script ideas for potential customer approaches were not considered the same as assistance with opportunity meetings, as that term is used in the US. [25]
- **Advertising and promotional programs** – Restrictions on sub-distributors' use of advertising material were 'minor'[26] and there was no comprehensive advertising and promotional program,[27] even though sub-distributors were provided with a customer approach script, advice regarding placing of advertisements, information in training sessions about promotional activities and a limited amount of advertising material.
- **Marketing areas** – Sub-distributors had unrestricted rights to distribute anywhere in Australia, as long as they undertook training.[28]
- **Sales quotas** – Minimum stock purchase requirements were not sales quotas.[29]
- **Approval of sales personnel** – Limited evidence of one distributor principal's intention to vet new distributors was not the same as approval of sales personnel.[30]
- **Sales training regime** – As there was no mandatory sales training (only operational training in cleaning and operating machines or diluting concentrate), and 'point of sale' material (a checklist and 'script ideas' for sales pitches), there was no sales training regime.[31]
- **Customer information** – Sub-distributors' reports of activities to distributors was considered to use information from their own records rather than customer information.[32]
- **Selling products without consultation** – Sub-distributors had rights to distribute anywhere in Australia, so long as they undertook training – insufficient to be this factor.[33]

The court further noted that, even where a distributor does not 'substantially control'[34] a system or marketing plan in the agreement under which its distributorship business is conducted, the agreement may still be found to include a system or marketing plan if the system is 'substantially suggested' by the distributor.[35] The evidence in the case, however, was that the distributors' dealings with their sub-distributors merely 'touched on matters which might relate to a system or marketing plan',[36] without the requirement for a particular system or plan to be adopted.[37] The sub-distributors were able to develop their own business plans and distributors only had the right to make what the judge described as 'some helpful suggestions on a few aspects of what might be incorporated in such a plan'.[38]

In summary, Kyloe's and Impact's activities were found to be well short of a 'system or marketing plan', especially in light of the fact that they did not have any right to inspect sub-distributors records or premises, conduct audits, or control of the sub-distributorship businesses,[39] and sub-distributors did not need to produce business plans.[40]

CONCLUSION

If you are seeking to ensure your arrangement is a mere distribution agreement or trade mark licence, and not a franchise agreement regulated by the Franchising Code of Conduct, then you need to take the following action.

Before you finalise the agreement, check whether your arrangement includes any of the factors that indicate a system or marketing plan. If appropriate, you should make the necessary adjustments.

If you have arrangements already in place, then you should review them against the criteria developed by the court for a system or marketing plan and consider whether any relevant factors are substantially controlled or suggested by you.

In our view, many factors on the Kyloe list are equally consistent with a franchise or a distributorship or trade mark licence. Legal advice should be sought if you are unsure as to whether the Code will apply to your arrangement.

The ACCC has stated that it is 'considering the wider implication of the judgment'.[41] We will report any further developments.

25. *Kyloe*, [43].
26. *Kyloe*, [54].
27. *Kyloe*, [49].
28. *Kyloe*, [45].
29. *Kyloe*, [47].
30. *Kyloe*, [51].
31. *Kyloe*, [46].
32. *Kyloe*, [46].
33. *Kyloe*, [45].
34. *Kyloe*, [60].
35. *Kyloe*, [60].
36. *Kyloe*, [60].
37. *Kyloe*, [60].
38. *Kyloe*, [60].
39. *Kyloe*, [55].
40. *Kyloe*, [55].
41. See http://www.accc.gov.au as at 23 October 2007 – ACCC Press Release # MR 284/07 issued 19 October 2007.

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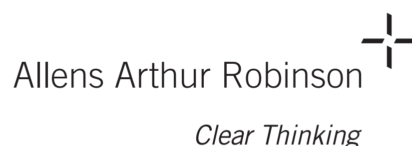

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