



Franchise updates September 2009

Product and Supply Issues for Franchisors and Franchisees

A. Third Line Forcing and Full Line Forcing

Must I buy products from my franchisor, even if I can source these products at a better price from non approved suppliers?

A Franchise agreement may require the franchisee to purchase products exclusively from the franchisor or its approved suppliers. The franchisor may be supplying a particular product which can not be sourced elsewhere, or they may be using their buying power and supplying products at a reduced cost.

Franchise agreements which require the franchisee to purchase stock from a particular third party may also breach the “third line forcing” provisions of the *Trade Practices Act* (“**Act**”). A franchisor, is however, entitled to impose quality standards which must be met by other approved suppliers if requested by the franchisee. Third line forcing is prohibited by the Act without regard to its effect on competition in the market place.

Franchise Agreements are generally worded to avoid this issue and franchisors can seek ACCC approval to enable them to provide such a restriction.

Where a Franchise Agreement requires the franchisee to purchase product only from the franchisor, this does not amount to third line forcing as it is between the parties themselves. This is ‘Full Line Forcing’ and is prohibited by the Act only if it ‘substantially lessens competition’. In most industries, this is highly unlikely to be the case.

Example:

Big Bite Pty Ltd (a sandwich bar) agreement reads as follows:

- *To protect the reputation of Big Bite franchise, all raw ingredients purchased by the franchisee must be supplied by the franchisor.*
- *The franchisee shall acquire all ingredients from the franchisor.*

This type of conduct (exclusive dealing) will only breach the Act if it has the ‘purpose or effect or likely effect of substantially lessening competition’.

Whether this substantially lessens competition requires detailed analysis and independent advice should be sought. The burden of proof rests on the franchisee alleging the conduct. Those allegations are difficult to prove, even if it prevents a franchisee from purchasing product from other suppliers at a reduced cost as the ‘market’ may not suffer.

B. Resale Price Maintenance Issues

Can my franchisor force me to sell products at, or below, my cost price?

My franchisor has been advertising my products at the same price as my cost price. I am not making any profit by selling these products. In fact, I'm losing money because I still have to pay freight and other add on costs and then pay royalties under the Franchise Agreement. I must honour the advertised price but can my franchisor force me to continue doing this even if I am selling at a loss?

The law prohibits a franchisor from stipulating a *minimum* price, but not a maximum price at which the product must be sold. This concept is called Resale Price Maintenance.

A Franchise Agreement may state the franchisee has the sole discretion in determining prices, except where the franchisor has stated a price in advertising material, in which case, the franchisee can not sell the product for more than the stated price in the advertisement. This is lawful, and a failure to comply will amount to a breach of the Franchise Agreement by the franchisee.

However, where the franchisor is obtaining royalties from gross sales (probably at increased levels due to successful marketing campaign) at reduced prices, and the franchisee is making a continued loss on sales, it may arguably amount to unconscionable conduct under the Act. Much depends on the circumstances, particularly how long this pricing structure is expected to be in place for.

For further information contact a member of our franchise team at Wisewould Mahony Lawyers.

C. Exclusive Supply

Can my franchisor force me to sell products if I know there are no spare parts readily available?

A franchisor may, under the Franchise Agreement, require a franchisee to acquire products exclusively from the franchisor.

Where a franchisor can not supply spare parts, can a franchisee source spare parts from other sources without being in breach of the Agreement?

Where there is a breach of a statutory warranty (for example, the product sold is not of merchantable quality, or fit for its purpose or requires spare parts) the retailer must provide a remedy to the consumer. The remedy may, in some cases, be a refund or, in other instances, it may be appropriate to repair the product. If there are no spare parts being offered by the franchisor, who has supplied the product, repair may be difficult, or impossible if the parts can not be sourced elsewhere.

Fortunately for franchisees, the Act protects the consumer and also the franchisee as a retailer to a limited extent.

It protects retailers by making the manufacturer of goods liable for manufacturing defects. A manufacturer must ensure spare parts are reasonably available for their products. The time frame considered 'reasonable' will vary depending on the industry and the particular product. The Act provides that a manufacturer who unreasonably fails to provide spare parts may be liable for damages for up to 10 years.

There is an exception to this general proposition. If the manufacturer of the goods provides notice of their inability to provide spare parts, they will not be liable for damages.

This may be significant where a franchisee is aware of the lack of spare parts, however, is pressured to sell the product by its franchisor.

The Act prohibits a corporation from making misleading representations concerning the availability of spare parts.

A franchisee should therefore advise the customer in the clearest terms that spare parts may not be available. It then becomes the customer's choice whether to purchase the advertised product on that basis. If they do purchase on these terms, have the customer sign a written acknowledgement.

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