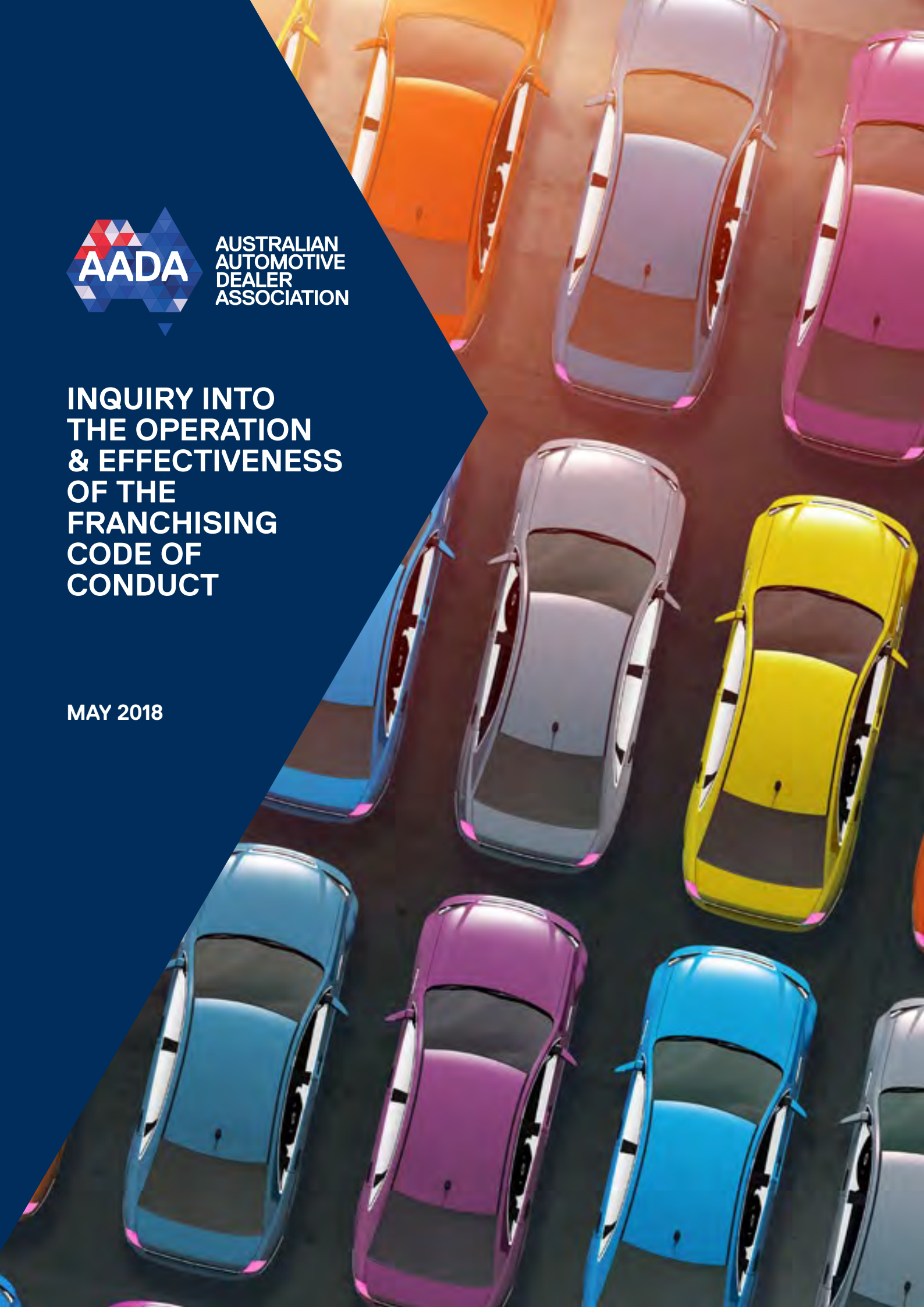




AUSTRALIAN
AUTOMOTIVE
DEALER
ASSOCIATION

INQUIRY INTO THE OPERATION & EFFECTIVENESS OF THE FRANCHISING CODE OF CONDUCT

MAY 2018



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FORWARD

AADA is pleased to lodge this submission to the Parliamentary Joint Committee on Corporations and Financial Services for its inquiry into the operation and effectiveness of the Franchising Code of Conduct (FCOC).

AADA is the peak industry advocacy body exclusively representing franchised new car Dealers in Australia. There are around 1500 franchised new car Dealers in Australia that operate about 3500 new vehicle outlets. It is important to note that about 85 per cent of franchised new car businesses are owned by individual operators or family groups. The economic impact of the new vehicle retailing sector to Australia is significant. New car Dealers employ 69,165 people Australia wide. The industries total turnover/sales amounts to over \$65 billion and the estimated total economic contribution is almost \$15 billion. The industry also generates over \$6 billion in wages and \$4.7 billion in tax revenue.

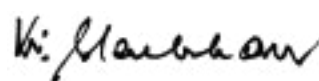
Our submission to this Inquiry builds on our long running advocacy in this area and focusses on three key points:

1. There is a Power Imbalance in the Automotive Industry: The structural power imbalance between car Manufacturers (franchisors) and franchised new car Dealers (franchisees) disadvantages both dealership businesses and consumers who purchase new vehicles from Dealers. Many Dealers enjoy good relations with their respective Manufacturers and work in a mutually beneficial partnership, but there remain many instances where Dealers are subjected to treatment

resembling a master/servant relationship. This submission provides an overview of some of these practices.

- 2. The Franchising Code of Conduct offers Limited Protection for Dealers:** The Franchising Code of Conduct has been unsuccessful in protecting franchised new car Dealers. Car Dealers are entering agreements which contain oppressive contractual clauses and unfavourable termination/non-renewal/end of term arrangements.
- 3. Australia Needs an Automotive Industry Code of Conduct:** Franchised new car Dealers are very different from the typical franchisees in terms of the scale of their investments and nature of their business. Similarly, car Manufacturers are also very different from the typical franchisors in terms of scale, as they are all powerful off-shore multinational corporations. For these and other reasons outlined in this submission, the AADA believes that an industry specific Automotive Industry Code of Conduct is required to protect the important contribution which franchised new car Dealers make to Australia.

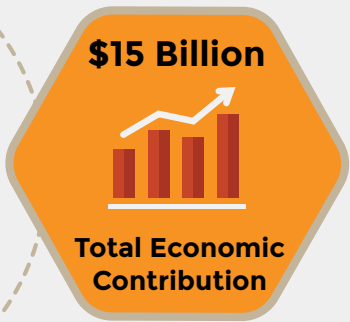
We urge the Committee to consider the points we have made and would welcome the opportunity to elaborate on our submission and/or appear before a hearing of the committee.



David Blackhall
Chief Executive Officer



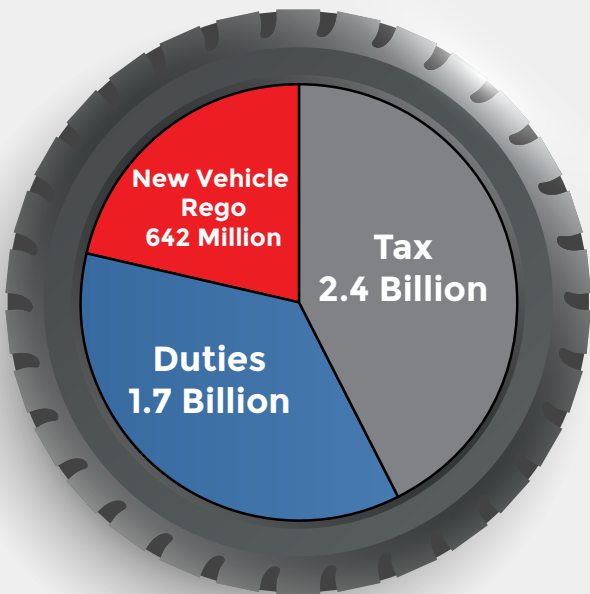
INDUSTRY OVERVIEW



85%

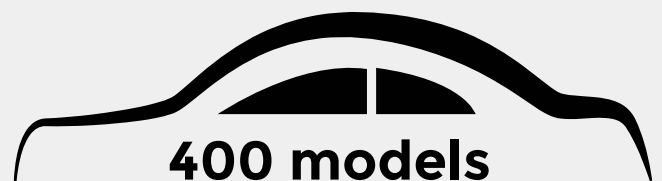


Car dealership businesses are owned by individual operators or family groups



TAX REVENUE TOTAL

4,742,000,000



THERE IS A POWER IMBALANCE IN THE AUTOMOTIVE INDUSTRY

New car Dealers in Australia are franchised to the global automotive Manufacturer brands or Original Equipment Manufacturers (OEMs).

The automotive retail sector in Australia is one of the most competitive in the world. Around 72 brands offer more than 400 models for sale in a relatively small market of about 1.2 million units annually (less than 1.5 per cent of global demand). The competition means there is significant pressure on the Australian subsidiaries of the global automotive Manufacturers and by extension their franchised new car Dealer networks to achieve sales targets.

In short, success in this highly competitive industry is by no means assured and franchised new car Dealers often run on razor thin profit margins. A modern well-run dealership will generally achieve a net profit of around 2% to revenue, but research from 2015 shows that almost 20% of all franchised new car Dealers failed to make a profit¹.

Dealers who enter into a franchise agreement (Dealer Agreement) with OEMs are given the exclusive right to market and sell new vehicles and associated services within a specific geographic location. In return, Dealers are bound by these Dealer Agreements, the terms of which are very much skewed in favour of the OEM. The imbalance in relationship leads to a number of practices, such as:

- **No security of tenure:** Despite Dealers making significant capital investments, the length of tenure offered by OEMs varies from a minimum of one-year to a

maximum of five-years making it difficult to recoup investments. Furthermore, Dealers are not always given a right of renewal. When they are it is generally at the discretion of the OEM.

- **Non-Renewal Notices:** OEMs issue 'non-renewal notices' to Dealers despite them having met or exceeded their performance targets and/or not being in breach of the Dealer Agreement. Dealers have been given only a few months' notice that an agreement will not be renewed, which is very little time for a business which has made significant investments, employs a substantial number of people and has an ongoing relationship with customers.
- **Inadequate Capital Expenditure Protections:** OEM's easily circumvent the FCOC's safeguards to franchisees with respect to having to incur significant capital expenditure during the term of an agreement.
- **End of term arrangements:** There are Manufacturers that do not mandate buying back of vehicle stock, parts, tools or equipment once a Dealer agreement expires or is terminated, leaving dealers vulnerable to further financial hardship.
- **Consumer complaints:** Dealers are often constrained by the OEM in responding and assisting consumers in relation to a potential product defect due the OEM exercising strict control around the warranty/repair processes.

¹Deloitte Australian Motor Industry Overview - 'Changing Lanes' – 2015

The reasons why a well informed and educated business person would enter into such a one-sided agreement are often difficult to understand for an outside observer, until you consider that dealerships are predominantly (85%) owned and operated by individuals or are family businesses.

Dealers of this type, take their commitment to the local community and their employees very seriously. Equally, the financial commitments they have made, the facilities they have invested in and, as is often the case, the proud reputation they have built as a trusted family business, means that the loss of all they have established by not signing an agreement, is too great a price to pay.

Dealers also expect that the franchisor they are entering into an agreement with, will behave responsibly, ethically and morally and given the nature of the business and the size of the investment, most would say that this is a reasonable expectation. Despite this, franchisors regularly behave in ways that may pass legal scrutiny, but which would not satisfy community expectations of how an honourable business partner should act.

Above, we have briefly touched on some of the common features inherent in the OEM/ franchised new car Dealer relationship. We invite the committee to read the supplementary submission we lodged with the [ACCC's New Car Retailing Industry Market Study](#). This submission dealt exclusively with the power imbalance between vehicle Manufacturers and

franchised new car Dealers and elaborates on each of the above-mentioned elements.

THE FRANCHISING CODE OF CONDUCT OFFERS LIMITED PROTECTION FOR DEALERS

The FCOC has generally been ineffectual in addressing the imbalance of power in the relationship between franchised new car Dealers and car manufacturers. This submission outlines some of the gaps in the FCOC and has provided some case studies from within the industry.

Unfair Contract Terms

Most franchisees captured by the FCOC also enjoy protections from the Australian Consumer Law (ACL) Unfair Contract Terms provisions on new, renewed and terminated franchise agreements since 12 November 2016.

Unfortunately, franchised new car Dealers, have not benefited at all due to the “small business” threshold requirements of the legislation. Small business is defined in the ACL unfair contract terms legislation as being under 20 employees and the overwhelming majority of franchised new car dealerships in Australia exceed this number.

The lack of capacity and bargaining power of Dealers, combined with long term commercial relationships and investment, results in franchised new car Dealers entering into contractual agreements which contain oppressive contractual clauses, or which permit distributors to engage in opportunistic and/or exploitative conduct.

The Code does not fill this gap. It is likely that from a regulatory perspective only a specific Automotive Industry Code of Conduct would fill the gap.

1

UNFAIR CONTRACT TERMS THAT ALLOW MANUFACTURERS/IMPORTERS TO CLAIM BACK FROM FRANCHISED NEW CAR DEALERS LEGITIMATE WARRANTY CLAIMS

Several Manufacturers/importers issue policy and procedure documents to franchised new car Dealers in relation to warranty payments. Often the policy and procedure documents contain onerous requirements such as taking a photograph of the part that is replaced. Some requirements are necessary in order to ensure that franchised new car Dealers are not making fraudulent claims.

However, Manufacturers are using minor non-conformity such as not having a photograph of the part as a reason to “claw back” the warranty payment made. This is despite the customer being available to confirm the warranty work was carried out.

Even worse, the policy and procedure documents then permit the Manufacturer to extrapolate the minor non-conformities based on the sample audited to the entire warranty period. For example, if one photograph is missing for one part in a sample of 10 claims and the entire audit period consisted of 100 claims, the Manufacturer will assume that there are another 9 missing photographs.

There is no legitimate purpose for either clawing back legitimate warranty claims for minor non-conformities, or extrapolating claw backs based on a sample when the Manufacturer could conduct a full audit.

2

UNFAIR CONTRACT TERMS IN DEALER AGREEMENTS

Term: We are aware of one overseas Manufacturer that issues Dealer Agreements via its local importer with an effective term of one year despite the Dealer often investing millions of dollars on facility and other requirements required by the overseas manufacturer.

The return on investment may take many years but the franchised new car Dealers has no secure tenure. Once invested in the franchise it is extremely difficult to negotiate more balanced commercial terms.

Unilateral Variation: Many Dealer Agreements, allow the local importer to unilaterally vary the terms of the Dealer Agreement. Unilateral variation is specifically prohibited by the unfair contract terms legislation, but such legislation does not apply to franchised new car Dealers.

Termination/Non-Renewal/End of Term Arrangements

The Inquiry's terms of reference (ToR) queries the adequacy and operation of termination provisions in the Code.

This is the single biggest failure of FCOC. Numerous attempts to improve disclosure of end of term arrangements and FCOC obligations have failed to address the significant financial loss suffered by franchised new car Dealers when the local distributor of an overseas based Manufacturer terminates or fails to renew a Dealer Agreement. At the stroke of a pen, these distributors wipe millions of dollars in goodwill from a dealership business.

The AADA advocates a position whereby fair and reasonable compensation is paid to a franchised new car Dealers and/or all franchisees at the end of term. Depending on the circumstances, in the automotive industry this may range from zero to many millions of dollars.

The AADA notes that this was a recommendation made in the Swanson and Ripoll inquiries into franchising.

The AADA notes that other specific mandatory codes, such as the Oil Code, contain obligations on the franchisor to purchase or nominate a purchaser to purchase stock, merchandise and equipment. This is a significant advantage as compared to the position of franchisees under the FCOC.

As mentioned earlier there is a growing trend of non-renewal notices being issued by OEMs to Dealers. While the FCOC requires a franchisor to cite reasons for the termination of an agreement for breach, the FCOC does not require a reason to be provided for the issuance of a non-renewal notice. Non-renewal notices are essentially used as a means to exit a Dealer from their network rather than having to serve breach notice in accordance with the Code. This avoids the possibility of the Dealer remedying the breach and retaining their dealership.

3

NON-RENEWAL TO PROFITABLE DEALERSHIP AND NO BREACH

An overseas Manufacturer recently issued non-renewal notices to approximately 25 Australian Dealers in circumstances where:

1. there was no breach of the Dealers' Dealer Agreements;
2. some of the Dealers had incurred un-recouped capital expenditure;
3. many of the Dealers were profitable and had been Dealers for several decades;
4. in most cases, without reviewing the Dealers' business plans in accordance with the process required under Manufacturer's own Dealer Agreement;
5. in each case neither offering an explanation of the basis on which they were chosen as a Dealer nor offering any compensation; and
6. in some cases, the Manufacturer had rejected the Dealer from taking on additional brands in the past and in all cases requiring stand-alone dealership facilities, stand-alone service facilities and no shared employees making multi franchising extremely difficult. Multi franchising spreads risk for Dealers.

The Manufacturer based its decision to not renew the Dealers' Dealer Agreements on the basis of a broader 'network footprint review' and a desire to reduce its Dealer network footprint, however, no details were provided, and the network was not even aware of a review.

The right of renewal is at the absolute discretion of the Manufacturer.

Unfair Conduct

are prohibited from requiring suppliers to pay for “shrinkages”.

The Code does not regulate conduct and in particular, it does not do enough to prevent or deter opportunistic conduct. There is a unique danger of opportunistic conduct and these risks are pronounced in the automotive industry given the levels of investment.

Part 2 of the Code relates to disclosure requirements which is primarily a process of attempting to educate a franchisee prior to entering a franchise agreement.

Part 3 of the Code sets some specific rights for franchisees and obligations on franchisors. However, it is not comprehensive enough to cover the field and a generic Code cannot deal with specific industry conduct.

Although it is called a Code of Conduct, there is no specific requirement prohibiting unfair conduct and a master/servant relationship still exists in most franchise systems but particularly in the automotive industry. The most the Code alludes to is a requirement to act in good faith.

Other mandatory codes go so far as prohibiting specific types of conduct relevant to their industry. The grocery industry was well known for unfair conduct in relation to the powerful position of the major supermarkets compared to the suppliers who could be small local produce growers. Under the Grocery Code, there are a number of listed specific conduct issues that are regulated, for example, Supermarkets

4

EXERTING UNFAIR CONDUCT ON DEALERS TO UPGRADE AND RE-LOCATE

An Australian Dealer was encouraged to invest in opening a dealership in a new location identified as suitable by the Manufacturer. Significant investment was required and was incurred by the Dealer. The investment was such that it could not be recouped within the initial term of the Dealer Agreement. Self-evidently this gave rise to pressure on the Dealer to obtain a renewal of Dealer Agreement.

In that context, the Manufacturer subsequently required the following as conditions of renewal:

1. an upgrade of the facility (which would require immediate further expenditure - before the initial investment was even recouped), because the Manufacturer required the upgrade works to be completed within initial term 'to get ready for renewal term'; and
2. a commitment by the Dealer to move or expand its business by opening a new dealership at the end of the renewal term at a different location which the Manufacturer had subsequently identified as 'more suitable'.

Not only is the effect of this sort of behaviour to exert undue pressure on Dealers unfair, but it is exactly the kind of behaviour which clause 30 of the Franchising Code is designed to prevent.

Clause 30 of the Code prohibits Manufacturers from imposing an obligation on Dealers to incur undisclosed significant capital expenditure on relocating its dealership within the current term (absent the 'business case justification').

However, the behaviour did not technically contravene the Code because Manufacturer avoided the section by taking the position that the expenditure is only required for the 'next agreement' after the expiry of the term of the initial agreement. On that basis, it is not 'undisclosed expenditure' for the purposes of the initial term.

Compliance with Australian Laws

Manufacturers and franchised new car Dealers are both responsible under the Australian Consumer Law. However, recent investigations by the ACCC have found that Manufacturers have on occasion evaded responsibilities under the law.

Franchised new car Dealers take direction from the Manufacturer when it relates to a product issue and despite advocating for repairs and/or refunds to be made to the customer, the Manufacturer directs the franchised new car Dealers to reject legitimate warranty claims.

Franchised new car Dealers contractual arrangements with the OEM are such that failure to adhere to unethical business practices jeopardises the profitability and future tenure of the franchise. Franchised new car Dealers are under threat of non-renewal and terminations if they do not follow the direction of the Manufacturer.

A specific Automotive Industry Code of Conduct could fill the regulatory gap by imposing significant sanctions and fines on Manufacturer's and their importers.

5

MISLEADING CONSUMERS ABOUT ACL RIGHTS - AND USING DEALERS TO DO SO

On 26 July 2017 the ACCC announced that it had commenced proceedings against Ford in the Federal Court, alleging that Ford has engaged in unconscionable conduct, misleading or deceptive conduct and made false or misleading representations in responding to customer complaints concerning its Focus, Fiesta and EcoSport models fitted with the 'PowerShift Transmission'.

The ACCC said that about half of the 70,000 cars of those models sold experienced transmission defects between 2011 and May 2015 for which Ford refused to provide a refund or replacement without significant payments being made by customers toward replacement vehicles through its 'PowerShift Ownership Loyalty Program'.

The ACCC also alleged that, despite being aware of 'systemic issues' with the PowerShift Transmission from at least 2013 onwards, Ford continued to represent to customers that transmission defects were a result of the way in which the driver handled the vehicle. Furthermore, the ACCC alleges that where Ford took back vehicles surrendered through the 'Loyalty Program' (at significant cost to consumers), Ford then on-sold those vehicles without disclosing the systemic or specific issues experienced with their transmissions.

The ACCC was successful with its Federal Court action who imposed a fine of \$10 million on Ford.

It is important to be aware that the ACCC's allegations relate to Ford's conduct, and not to the conduct of individual franchised new car Dealers. The ACCC has not commenced any legal proceedings against or made any allegation of wrongdoing against individual franchised new car Dealers.

The case is also an example of how Dealers must effectively obey instructions from Manufacturers in respect of consumer law issues raised by consumers. Dealer Agreement often specify that on request from a Manufacturer, a Dealer must perform any written instructions when handling complaints.

AUSTRALIA NEEDS AN AUTOMOTIVE INDUSTRY CODE OF CONDUCT

The Franchising Code of Conduct (FCOC) has not served franchised new car Dealers well over the years. In short, the FCOC does not address the unique circumstances faced by Dealers in the automotive industry.

The FCOC is generic in nature and attempts to cover the field. In doing so, it regulates small businesses such as a one-person lawn mowing franchise alongside a multimillion dollar franchised new car Dealer business. A generic Franchising Code is inadequate for the latter. The difference in scale of the financial and social impact of the two franchise businesses is enormous but the protection and regulation from opportunistic conduct is the same.

Franchised new car Dealers have been calling for an Automotive Industry Code of Conduct for some time. There is a precedence for industry specific codes, such as the Food and Grocery Code, the Wheat Port Code, Horticulture Code, Oil Code, Unit Pricing Code and there have been discussions in recent times over developing a Dairy Code. We believe our industry can only be properly regulated by a code which takes account of the industry's unique characteristics.

Some of these unique characteristics include:

- **High levels of capital expenditure:** Dealers are required to continually invest in expensive facilities, stock, tools and suitably qualified and trained personnel.
- **Unique facilities:** Showrooms and workshops are unique facilities which are

not easily repurposed in the event of a closure in the same way that other franchised businesses can be repurposed.

- **Large number of employees:** Dealers are significant employers relative to other franchisees and have staff across their various departments such as sales, service and repair and finance and insurance
- **Offshore franchisors:** Australian car Manufacturers are all subsidiaries of powerful offshore multi-national companies.
- **Nature of the product:** Passenger cars are high in value and mechanically and technologically sophisticated relative to other goods.
- **Post-sale relationship:** There is an extended after sales relationship between a Dealer and its customers.
- **Recalls:** Unlike most franchised businesses, Dealers perform a vital community service in the form of vehicle safety recalls – a phenomenon which has been growing in recent years.

The fact that our industry has unique issues has been acknowledged by a series of independent reviews and inquiries. Most recently, the **ACCC's New Car Retailing Industry Market Study** closely examined the commercial arrangements between Manufacturers and Dealers. The report made a number of recommendations, including further examination of: minimum tenure and capital investment requirements,

reasons for non-renewal, changes to commercial arrangements, reimbursement for remedies.

The 2013 **Wein Review into the Franchising Code of Conduct** also recommended that “an analysis of the impact of a minimum term and standard contractual terms for motor vehicle agreements should be undertaken prior to a future review of the Code”. Such an analysis has not yet occurred and the FCOC is due to be reviewed in or after 2020.

It should also be noted that this entrenched power imbalance is by no means unique to Australia. For example, there is currently a Bill before the Californian legislature which contains a number of provisions which seek to address the inappropriate treatment of Dealers by Manufacturers. The Bill has a number of clauses which deal with industry specific issues, such as restrictions on Manufacturer demands for facility upgrades; competition between factory-owned stores and Dealers; and reimbursement for warranty work. More detailed information on the Bill can be found [here](#), a closer reading of which shows that franchised new car Dealers in that state already enjoy significantly more protection than their Australian counterparts.

The AADA has developed a document which lists the principles which we believe would be required in an Automotive Industry Code of Conduct. These include:

1. Access to service and repair information
2. Manufacturer warranty and policy documentation to uphold ACL rights without exception
3. Unfair conduct to be prohibited
4. Unfair contract terms legislation to be extended to franchised new car Dealers
5. Specific industry issues to be addressed in code
6. Franchising Code of Conduct provisions to be adopted as relevant

We invite the committee to read the [AADA's Automotive Code of Conduct Six Principles document](#).

CONCLUSION

We would be happy to meet with you to discuss our submission and participate in the committee's hearings.

If you require further information or clarification in respect of any matters raised please do not hesitate to contact a member of the AADA team.

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