

**CARTEL AMENDMENTS TO COMMERCE ACT – WHAT FRANCHISORS NEED TO KNOW – AND DO
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INTRODUCTION

In a rush before the last sitting day before the 2017 election, Parliament passed the “cartel” changes to the Commerce Act 1986. If your franchise system is not already prepared then you need to act now as the new rules are in effect.

This paper and the related workshop discusses whether your franchise system is affected, summarises the “cartel” changes and discusses what franchisors need to do. Spaces are included for you to make notes.

END OF A LONG JOURNEY FOR THE BILL

There were considerable delays in the passage of the Commerce (Cartels and Other Matters) Amendment Bill (**Bill**). The Bill was introduced in 2011. The Bill originally sought to criminalise cartel conduct (among other changes). Following extensive lobbying this was dropped due to the perceived chilling effect on pro-competitive behaviour and a report from Treasury that the civil cartel regime worked well. The Bill, as finally passed under some haste before the election, still brings significant changes to New Zealand competition law.

OVERVIEW OF CARTEL PROVISIONS

The “cartel” rules in the Commerce Act prohibit the entry into or enforcement of a “cartel provision”. A “**cartel provision**” is a provision or arrangement:

- between competitors
- that has the purpose, effect or likely effect of:
 1. price fixing;
 2. restricting output; or
 3. market allocating.

A written document is not required for a cartel provision.

There are limited **exemptions** for:

- collaborative activities;
- vertical supply contracts; and
- joint buying arrangements.

In many cases, “cartel” clauses will be essential to the successful operation of your franchise business. It will, therefore, be important to consider whether an exemption under the cartel restrictions will apply, or whether the affected clauses can be amended so that they no longer fall foul of the legislation. Assessment of whether an exemption applies will require an assessment of the markets you and your franchisees operate in. As this assessment may change over time, this is not something you can “set and forget”.

The cartel provisions are in force now. They apply to all new agreements and arrangements. There is a limited nine month transitional arrangement for existing cartel provisions (the transitional period ends on 14 May 2018).

The cartel obligations apply equally to both franchisors and franchisees.

The consequences of breach of the cartel rules are severe. There are significant penalties for breach of the cartel rules. And cartel clauses are unenforceable.

Competitors will be able to seek clearance for proposed collaborative activities. Seeking clearance will give certainty that the proposed activities will not breach the Commerce Act. Clearance applications will be complex, time consuming and involved for applicants and the Commerce Commission.

IS YOUR FRANCHISE SYSTEM AFFECTED?

The amendments to the Commerce Act will affect many New Zealand businesses including many suppliers, resellers, franchisors and franchisees. The cartel rules do not apply any special treatment to franchises – franchisors and franchisees are treated as separate businesses.

While you may not think of your franchise business as involving a “cartel”, or that you as a franchisor are in competition with your franchisees (being the two triggers for the cartel changes to apply), most franchise agreements will contain a cartel provision of some sort. We suggest that unless you can show otherwise, you should assume that a competitive relationship exists, either between you and your franchisees, or between your franchisees.

A franchisor or one of its related companies is likely to compete with one or more of its franchisees at some point and, if not, most franchise systems will be considered competitors of their franchisees by way of the “hub and spoke” nature of franchise systems. Under the “hub and spoke” nature of most franchise systems, franchisees have identical franchise agreements (other than for updates over time) containing cartel clauses. Franchisees are likely to have a genuine expectation that the franchisor (as the hub) will enforce those agreements against other franchisees who do not comply with the cartel clause – for example by trading in another franchisee’s territory.

This is a potentially complex area of law and economics for you and your advisers to work through!

WHAT IS A CARTEL CLAUSE?

As we say above, a “**cartel provision**” is a provision or arrangement:

- between competitors;
- that has the purpose, effect or likely effect of (in summary):
 1. **price fixing** – controlling the price at which the parties buy or sell goods or services, or any related element of price, for example a discount, benefit allowance, rebate or credit);
 2. **restricting output** – preventing, restricting or limiting production, supply, capacity to supply or the acquisition of goods or services; or
 3. **market allocating** – allocating or restricting the customers or geographic areas each party can sell to or buy from.

Typical franchise clauses that might be caught by the cartel restrictions include clauses which:

- allocate geographical territories to franchisees;
- require a franchisee to only purchase stock from an approved supplier;
- require a franchisee to sell at a specified price, for example, as part of a promotion; or
- restrict a franchisee from carrying on other business activities (restraint of trade).

We will discuss cartel clauses during the workshop but this discussion is, of course, not intended to be a complete list of all cartel clauses.

WHAT EXEMPTIONS APPLY?

The three exemptions are (in summary):

1. **Collaborative activity** – exemption covers cartel clauses if *at the time of entry or giving effect*.

- the parties are in a collaborative activity (an activity in trade carried on *in cooperation*); and
- the dominant purpose of the collaboration is not to lessen competition between them; and
- the cartel clause is *reasonably necessary* for the purposes of the collaboration.

To meet the cooperation test, the parties need to be combining their businesses, assets or operations in some manner in a commercial activity, or otherwise operating a commercial activity jointly. Simply agreeing how to run separate businesses does not qualify.

2. **Vertical supply agreement** – only available if the cartel clause:

- is in a *contract* between a supplier and customer; and
- relates to the supply of goods or services between the parties (or the on-sale price). A relatively close connection is required between the cartel clause and the supply; and
- is not for the dominant purpose of lessening competition between the parties.

3. **Joint buying and promotion** – relates only to price fixing clauses. Applies where competing buyers purchase goods or services under collectively negotiated terms.

The most useful of these for franchisors is likely to be the collaborative activity exemption. This exemption will be the focus for the workshop.

WHAT STEPS DO I NEED TO TAKE TO COMPLY?

If you are not already prepared for the cartel restrictions you need to act now. For existing franchise agreements and any other cartel contracts you may have, there is a nine month transitional period which will give time to consider existing arrangements. However, there is **no** transitional period for new contracts – the new laws apply now.

How the cartel changes apply to your franchise business will depend on your franchise arrangements, and the competitive market you operate in. We recommend that you:

1. **Become familiar with the cartel changes:**

This will enable you to respond to potential competition issues as they arise in your day to day business. For example, if a franchisee complains to you about the behaviour of another franchisee.

2. **Review and amend your franchise agreement:**

We recommend you review your current franchise agreement(s) and:

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- identify any potential ‘cartel’ clauses;
 - consider alternative arrangements that can achieve the same or similar commercial outcome – some cartel clauses may not be necessary;
 - consider whether an exemption applies (for franchisors this is likely to be the collaborative activity exemption) and carefully document how any applicable exemption applies;
 - consider amendments that may be needed to ensure that the clause is reasonably necessary for the collaborative activity exemption (if this applies);
 - amend your template and current franchise agreements where necessary; and
 - prepare for discussions with current and potential franchisees who will be looking to you for assurance that the franchise system complies with the new cartel arrangements.
- 3. Review and update your policies and any other contracts with cartel clauses.**
- 4. Schedule regular compliance checks:**

As your business changes over time, so too will the assessment of whether your business complies with the Commerce Act. We recommend that you schedule regular compliance assessments as part of your compliance programme – this will be important to protect you from a cartel investigation.

CRITICAL DEFECT IN BILL ADDRESSED

Darryl and Michael worked with The Franchise Association and the Ministry of Business, Innovation and Employment to address a critical defect in the Bill. As the Bill was drafted, businesses relying on the “collaborative activity” exemption would not have been able to enforce restraint of trade clauses in their agreements at the end of the collaborative activity. By way of example, this would have meant that otherwise lawful restraints of trade in joint venture agreements or franchise agreements could not be enforced on termination.

The Ministry of Business, Innovation and Employment and the Commerce and Consumer Affairs Minister agreed to change the amendments to the Commerce Act to allow the enforcement of restraint of trade clauses following the end of a collaborative activity – with limitations. While this was great news for franchisors, most franchisors will need to amend their restraint of trade clauses to ensure they can comply.

Unfortunately the Commerce Commission did not agree to address another important drafting issue with the Bill. The Bill as enacted provides that the collaborative activity exemption applies only if (among other things and summarised) the parties “**are** involved in a collaborative activity” at the time of agreeing to the cartel provision. We and other experts in this area consider that the wording should have been amended to clarify how the exemption applies to new cartel arrangements.

For new cartel arrangements there will generally not be a collaborative activity in place at the time of entering into the underlying agreement – in practice the collaborative activity will commence after the agreement is signed. The plain wording of the exemption does not appear to be satisfied. While it could be said that the collaborative activity commences on signing the agreement, this is not clear, and there could be conditions that need to be satisfied before the agreement or the collaborative activity commences.

The Commission has told us that it considers the Court would interpret the words more broadly than our stricter interpretation. We believe that legislation should be clear so that there is no ambiguity. Important threshold questions such as this should not be left to the Court to interpret – and the risk that the Court takes a different interpretation.

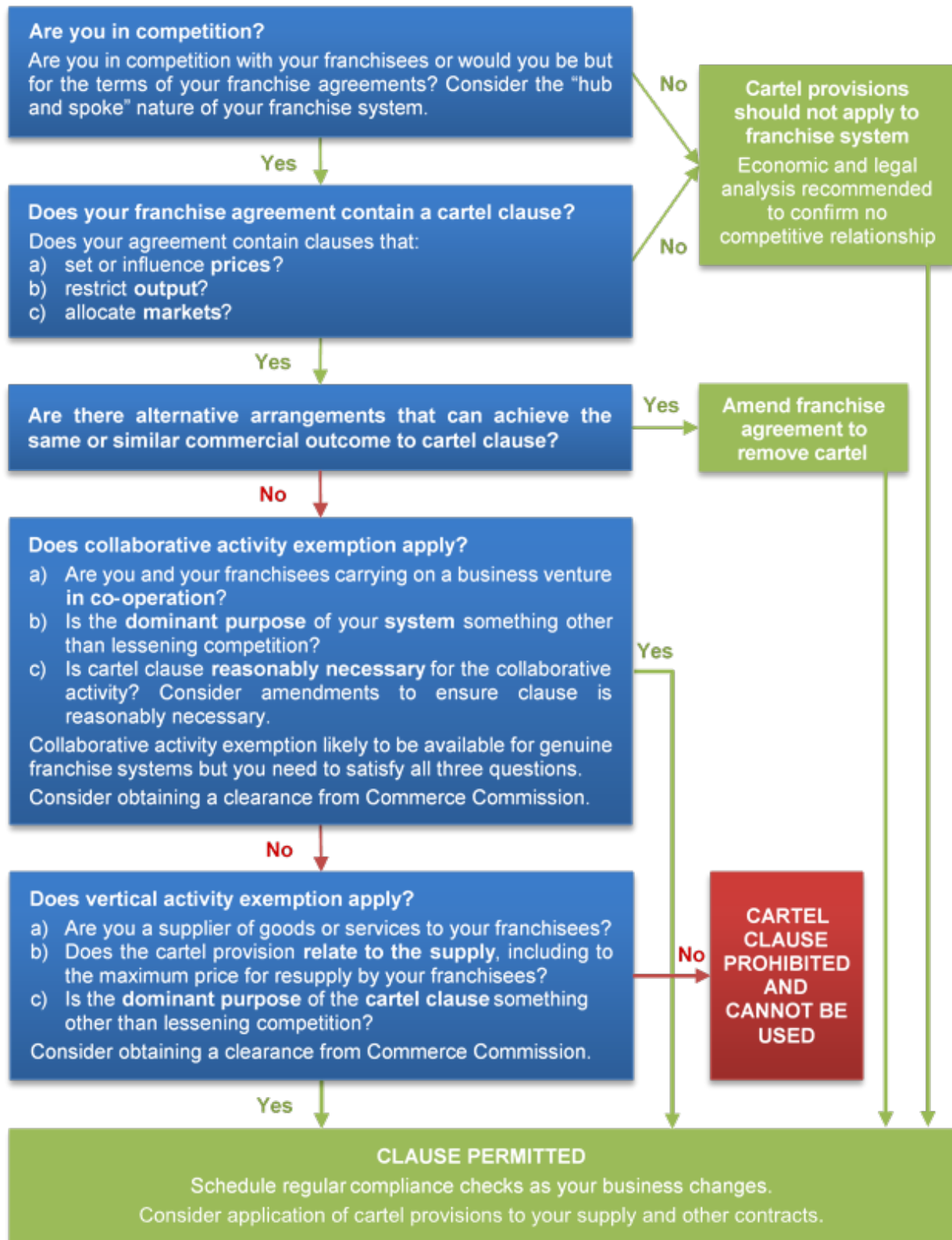
FOR MORE INFORMATION

If you have any questions on how the changes may affect your franchise system or if you would like assistance with complying with the Commerce Act, please get in touch with one of the contacts listed below or see the articles on our website.

A copy of the Bill as enacted (the Commerce (Cartels and Other Matters) Amendment Act 2017) can be found at legislation.govt.nz.

The Commission issued draft Competitor Collaboration Guidelines in 2014 in anticipation of the Bill. The Commission is currently updating the guidelines to reflect changes made to the Bill and will publish the updated guidelines on the Commission’s website in the future. The Commission has also offered to provide specific guidelines for franchisors and franchisees – but these are also yet to be published. For further information on the draft Guidelines please refer to <https://www.jacksonrussell.co.nz/PUBLICATIONS.html> and select Competition from the category options.

ILLUSTRATIVE OVERVIEW: DO THE CARTEL PROVISIONS APPLY TO YOUR FRANCHISE SYSTEM?



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Workbook

Possible cartel provisions in a franchise relationship

Cartel category	Type of provision
Fixing prices	
Restricting output	
Allocating markets	

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Collaborative Activity Exemption (is there a collaborative activity)

Exemption criteria	Type of provision or evidentiary documentation
Indicators of a collaborative activity	
Dominant purpose of the collaborative activity	

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