

Extending Unfair Contract Term Protections to Small Businesses

Submission by the SME Committee of the Business Law
Section of the Law Council of Australia

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Introduction

The Law Council of Australia is the peak national body representing the legal profession in Australia.

The Small and Medium Enterprise Committee of the Business Law Section of the Law Council of Australia (SME Committee) makes this submission in response to the Extending Unfair Contract Term Protections for Small Businesses Consultation Paper dated May 2014 released by The Treasury on behalf of Consumer Affairs Australia and New Zealand (CAANZ).

The SME Committee has as its primary focus the consideration of legal issues affecting small businesses and medium enterprises in the development of national legal policy in that domain. Its membership comprises legal practitioners who are extensively involved in legal issues affecting SME's.

Submission

The SME Committee is supportive of the Commonwealth Government's proposal to extend Unfair Contract Term (UCT) protections to small business. The SME Committee believes that many small businesses are subject to UCT's in the standard form contracts which they enter into with larger businesses.

Background – small business in Australia

As at June 2011, there were 2,132,412 actively trading businesses in Australia.¹ Of these businesses, 96% were small businesses, 3.8% were medium businesses and less than 1% were large businesses.

Of these small businesses, 85.1% were classified as micro-businesses. Micro-businesses are defined as businesses employing between 1 and 4 persons.

However, in reality only 23.9% of these micro-businesses employed any staff, with 61.2% classified as non-employing small businesses. In other words, 61.2% of all small businesses in Australia consist of sole traders or family businesses which do not employ any staff.

¹ *Australian Small Business – Key Statistics and Analysis*, Department of Industry, Innovation, Science, Research and Tertiary Education, December 2012 - <http://www.industry.gov.au/smallbusiness/keyfacts/Documents/AustralianSmallBusinessKeyStatisticsAndAnalysis.pdf>

The Problem

1. **How widespread is the use of standard form contracts for small business and what are their benefits and disadvantages?**

In the SME Committee's view, the use of standard form contracts for small business is widespread. Standard form contracts are prevalent in such areas as:

- telecommunications;
- advertising and marketing;
- property and equipment rental and leasing;
- insurance;
- financial services; and
- purchasing and licensing of computer software and hardware.

There are clearly many benefits associated with the use of standard form contracts. The use of standard form contracts reduces the time and other transaction costs which small businesses would have to incur when entering into contracts with suppliers. If small businesses had to negotiate the terms of every supply contract they entered into, many small businesses would have little time to run their actual businesses.

Standard form contracts are used by organisations, whether large or small, to ensure commercial arrangements with customers are consistent so business imperatives and compliance can be monitored and managed efficiently. It is generally only the 'commercial terms' (being counterparty details, duration, price, service/product specifications, and perhaps special terms in addition to or overriding the standard terms) usually contained in a schedule or work order annexed to the standard form contract, that are negotiated and may differ between counterparties.

However, there are also a number of negatives associated with standard form contracts. Often the standard form contracts entered into by small businesses are extremely long and complex documents, which have been written in legalese. Furthermore, many standard form contracts are presented in very small fonts in closely typed and poorly formatted documents, which make these documents very difficult to read. As a result, it is often very difficult for the average small business to actually read, let alone understand, the terms and conditions contained in standard form contracts.

SME Committee members have also noted that standard form contracts in some areas, for example software licensing agreements, have become so lengthy and convoluted that it is quite unlikely that any business consumer, regardless of whether they are a large or small business, would ever take the time to read these agreements in their entirety.

2. **What considerations influence the design of terms and conditions in standard form contracts?**

While many lawyers attempt to write contracts, including standard form contracts, in plain English, there remain many examples of standard form contracts which are written using antiquated language or legalese.

Unfortunately, there is also a tendency in many industries for large businesses to base new versions of their own standard form contracts on the standard form contracts currently being used by their competitors. This practice of using competitor's standard form contracts as "precedents" results in poorly drafted and unfair contract terms being duplicated and multiplied across entire industries.

3. **To what extent are businesses reviewing standard form contracts or engaging legal services prior to signing them? Does this depend on the value or perceived exclusivity of the transaction?**

Small businesses rarely review standard form contracts or engage legal services to review such standard form contracts prior to deciding to enter into such contracts.

Small businesses do not seek legal advice prior to signing standard form contracts for a range of reasons. For example, often the small business needs the particular good or service immediately. As a result, the small business does not have time to seek legal advice prior to signing the contract.

Another reason why small businesses do not seek legal advice prior to entering into a standard form contract is because they do not believe there is any point in seeking such legal advice. Small businesses do not expect that the larger supplier will agree to change any of the terms and conditions in their standard form contract even if the small business obtained legal advice and then raised its concerns about particular UCT's in the contract.

The exception to this general rule is loan contracts with financial institutions. In these cases, small businesses will usually seek legal advice on both the 'commercial terms' of the contract, as well as the standard terms before entering the contract. However, often the reason why small businesses seek legal advice in relation to loan contracts is that the financial institution has made it a requirement that the small business obtain such legal advice.

Based on SME Committee members' experience, a small business will generally only seek legal advice on the terms of standard form contract after the contract has been entered into and a dispute has arisen in relation to the performance of the contract. For example, in one case a small business approached a member of the SME Committee for advice

about a contract it had entered into many years before when the supplier sought to invoke a penalty clause in a standard form contract.

Small businesses do not generally seek legal advice on standard form contracts even when the potential outlays under the contract involve significant amounts of money. For example, small businesses often enter into quite large value standard form contracts for advertising and marketing without first obtaining legal advice on the terms of the contract.

Small businesses are much more likely to seek legal advice when entering into a negotiated contract, such as a licence agreement.

4. **To what degree do small businesses try to negotiate standard form contracts?**

The SME Committee believes that it is rare for small businesses to seek to negotiate the terms of a standard form contract for the reasons identified above. Most small businesses do not believe there is any point trying to exclude or modify any of the terms in a standard form contract.

Having said that, the SME Committee believes that there may be more scope for small businesses to negotiate the terms of standard form contracts with large suppliers than many small businesses believe is possible.

For example, the SME Committee recalls a situation where a small business consumer was proposing to enter into a two-year contract with a large company for the provision of a particular service. On reading the contract more closely, the small business consumer noted that the contract included an automatic rollover provision, which was to operate indefinitely. The small business consumer advised the supplier that it did not wish to agree to this term, crossed the term out, and then signed the contract. The supplier raised no objection to the modification of this standard term.

Having said this, the main obstacles to the small business negotiating the terms of a standard form contract are their lack of time and expertise in identifying problematic terms and then taking appropriate steps to modify or exclude such terms.

5. **Is it the terms or the process by which some contracts are negotiated that is the main concern for small businesses?**

Small businesses generally have concerns about both the terms and the process by which standard form contracts are entered into. Usually, the small business will have detailed discussions with a supplier about a number of key features of the contract prior to entering into the standard form contract. These discussions will generally focus on the price payable, the duration of the contract, and details of any product or

service warranties. Often small businesses will also ask the supplier about any additional or hidden charges.

However, larger businesses will often not specifically disclose details of unusual terms or conditions in the standard form contract. For example, an SME Committee member is aware of a telco authorised reseller not disclosing in contractual discussions that the customer would have to commit to a minimum campaign period as part of the standard form contract. It was only when the SME Committee member questioned the reseller about any minimum commitments that the authorised reseller disclosed that there was a minimum campaign period. Given that this particular condition would have had the effect of significantly increasing the total cost of the contract, there is an argument that the reseller should be under a legal obligation to disclose this particular fact to the small business during the initial contract discussions.

6. How do small businesses differ from consumers in relation to their interaction with standard form contracts?

The SME Committee does not believe that there is a great deal of difference between the way in which small businesses and consumers interact with standard form contracts. Both groups are unlikely to read the terms of the standard form contract before entering into the contract. Furthermore, neither group is likely to seek legal advice prior to entering into the contract.

7. What terms are businesses encountering that might be considered 'unfair'?

There are wide range of terms which small businesses are encountering which may be considered "unfair". The following are a number of examples of such terms:

Delaying passing of property – a number of larger companies decided to unilaterally change their standard form contract terms of trade with their suppliers to delay the date that property in some of the delivered items passed from the supplier to them. As a result, the small business supplier continued to be on risk for those items after delivery, even though the item was no longer under their control. In this way the major retailers were able to save a significant amount of money by forcing both the costs and risks onto the small businesses.

Penalty terms –

Standard form contracts are known to contain penalties that far exceed the damages suffered.

It is common for aUCT clause in standard form contracts to state that the small business customer acknowledges that what is clearly a penalty

clause is in fact a realistic pre-estimate of the losses incurred by the larger company.

Unilateral variation clauses –

Another common UCT clause gives the large provider the ability to unilaterally change any of the terms in their contracts with their small business customers, including the product which is being supplied, as well as the price at which that product is being supplied.

Furthermore, another UCT clause may state that the large provider is not obliged to advise the small business consumer of any unilateral change if it believes that the change will have a minor detrimental impact on “most customers”. Obviously a change to a particular customer's product offering will not have any detrimental effect on “most customers”, although it is likely to have a profoundly detrimental effect on that particular customer.

8. What detriment have businesses suffered from unfair contract terms?

Small businesses often suffer significant detriment from UCT's.

For example, one of the SME Committee members is aware of a situation where a small business was required to pay a supplier a significant amount of money for lost support items as a result of the operation of the penalty clause identified above. While the small business was able to negotiate a discount off the amount initially claimed by the supplier for the lost support items, the amount the small business ended up paying was significantly more than the replacement cost of the items which had been lost.

SME Committee members are also aware that the deferred passing of property clause, described above, which was introduced by all of the major grocery retailers a number of years ago, resulted in many small business suppliers suffering significant financial detriments.

The SME Committee acknowledges that large businesses will often make a commercial decision not to enforce a particular UCT. However, in the SME Committee's view, that is not argument against the introduction of UCT protections for small business. Rather, the fact that large businesses may routinely chose not to enforce UCT's seems the best evidence that these large businesses themselves recognise that such contract terms are often unfair in their application.

9. **What protections do businesses currently have when they encounter unfair contract terms and are they sufficient?**

Small businesses have few protections when they encounter UCT's.

One potential approach which small businesses have sought to argue in the past in relation to UCT's is that the failure by the large company to disclose the UCT constituted misleading and deceptive conduct. Some small businesses have argued that the large business has a positive duty under the *Australian Consumer Law* (ACL) and the common law to disclose to the small business any unusual contract terms included in the standard form contract. In other words, the small business has argued that the failure by the large business to disclose unusual terms constituted a misrepresentation by silence or by omission.

These arguments have generally not been successful, mainly because it is difficult to argue that a particular UCT is "unusual" when it appears in virtually every standard contract used in a particular industry.

Small businesses have generally not been able to rely on the unconscionability provisions of the *Competition and Consumer Act 2010* and the ACL in order to challenge UCT's. One reason why unconscionability provisions have not been used in relation to UCT's is because courts generally do not consider the reliance by a party on a legal contractual right as being unconscionable. Rather, courts tend to see unconscionability in terms of one party using commercial pressure to extract a concession or advantage from another party for which they did not have a legal right. Recent appellate authority in Victoria requires a demonstration of "moral obloquy" before a finding of unconscionable conduct can be made. This imposes a test far beyond unfairness, even clear unfairness. Federal Court authority on the issue is less stringent.

Therefore, it is unlikely that UCT's would be seen by a court as constituting unconscionable conduct given that UCT's embody a legal right which the large business is simply seeking to enforce against the small business.

10. **What regulatory responses are already in place that aim to protect small business from unfair contract terms and how effective are these mechanisms?**

The SME Committee cannot identify any regulatory responses which are currently in place that aim to protect small business from UCT's. As stated above, arguments based on alleged misrepresentations by silence have rarely been successful in relation to UCT's. Furthermore, as far as the SME Committee is aware, the unconscionable conduct provisions in the ACL have never been used solely to challenge the existence of UCT's in small business contracts.

The Policy Response

11. **What responses (including by government or industry) could be implemented to help businesses with ensuring contract terms respect the legitimate business objectives and interests of both big and small contracting parties?**

The SME Committee supports Option 3 as set out in the Consultation Paper – namely legislative amendments to extend the existing UCT provisions to contracts involving small businesses.

The SME Committee members believe that the introduction of UCT provisions in relation to consumer contracts has had a positive effect on market conduct in a range of industries. These changes forced many large companies, which were offering consumers standard form contracts, to review their existing terms and conditions and to make changes to remove terms which were likely to have been characterised as unfair.

The SME Committee sees no reason why the extension of UCT provisions to small business contracts will not have a similarly positive effect on market conduct. The SME Committee believes that there are many terms in standard form contracts which are not appropriate in terms of the allocation of risks between large and small businesses. Therefore, in our view, the introduction of UCT provisions to small business contracts will be the best way to create the necessary impetus amongst large businesses to cast a critical eye over the appropriateness of the terms in their standard form contracts.

12. **Would information disclosure requirements impact on the decision to review standard form contracts and/or consider the terms included in them?**

Information disclosure requirements are unlikely to be an adequate response to UCT's in small business contracts. This is because there is no guarantee that information disclosure requirements will be read by time-poor small business operators. In addition, product and service disclosure statements have a tendency over time to become just as lengthy, convoluted and complex as the contracts which they are seeking to explain.

The SME Committee believes that the best approach to responding to the problem of UCT's is to introduce prohibitions on the use of such UCT's in small business contracts.

13. Given the Commonwealth Government's commitment to extend existing unfair contract term provisions to small businesses, what should be the scope of the protections?

The SME Committee believes that the UCT provisions should apply across all industries, including the franchising and finance sectors.

The SME Committee is aware of arguments that UCT provisions should not be extended to the franchising sector because that sector is already regulated by the Franchising Code of Conduct (Code). However, as we understand the Code, it does not currently contain any prohibitions on the inclusion of UCT's into franchise agreements.

The SME Committee also notes the relatively high number of complaints received by the ACCC about alleged UCT's in franchise agreements. The table on page 10 of the Consultation Paper records the total number of small business UCT complaints received by the ACCC in the period from 1 January 2011 to 25 November 2013. In this 35-month period, the ACCC received a total of 894 small business UCT complaints, of which a total of 231 complaints or almost 26% related to franchising agreements.

The SME Committee also believes that the UCT provisions should be extended to the financial sector. There is no reason to exempt the financial sector from the UCT reforms given the complexity of most finance agreements. Requiring borrowers to obtain their own private legal advice before entering into such finance agreements is not an adequate protection for small businesses. Rather, steps should be taken to make UTC's in finance agreements void and unenforceable.

The SME Committee notes that the application of the extended UCT provisions to cause a term in a standard form contract to be void and unenforceable is dependent on a determination that the clause is 'unfair' as between the contracting parties, with such determination proposed to be made by a court. In the interests of improving small businesses' access to justice, the SME Committee considers that enforcement of the UCT provisions will be enhanced if a private right of action were also to be created. Small businesses should have a legal right to challenge unfair contract terms in the standard form contracts in state tribunals, such as NCAT and VCAT. In this way, small businesses will be able to take their own private action to protect their interests, rather than having to rely on regulators, such as the ACCC or ASIC, to take action on their behalf, when such regulators may look to cost/benefit imperatives and public interest aspects in assessing and prioritising what actions they are prepared to pursue. Many standard form contracts that small businesses are party to are limited to counterparties of another organisation with no public interest element or cost/benefit imperative to warrant prioritised involvement of a regulator.

14. Should the Australian Consumer Law UCT provisions be extended to cover small businesses defined using contracting party characteristics or transaction size? Should small business to small business contracts be included?

The SME Committee supports including small business to small business contracts in the extended UCT provisions for standard form contracts as the objective is for unfair contract terms to be void and unenforceable where contracts have not been properly negotiated.

The SME Committee notes the Options outlined in the Consultation Paper concerning how to define “small business” for the purpose of the proposed UCT provisions - ie:

Option A.1: Apply to all business-to-business standard form contracts with an exception that a publicly listed company cannot rely on the provisions

Option A.2: Define on the basis of a transaction threshold

Option A.3: Define on the basis of annual turnover

Option A.4: Define on the basis of the number of employees.

The SME Committee supports any definition of “small business” that provides clarity to a determining forum on whether the extended UCT provisions apply to a standard form contract and therefore clarity to the contracting parties that a risk exists that if a term in the standard form contract is held by such a forum to be unfair, that term would be void and unenforceable. A term in a contract that is held to be unfair, will be unfair no matter the defined standing of the parties.

The SME Committee recognises that there are some definitional criteria that it is easy for contracting parties to know or find out, such as whether a party is listed, or whether the transaction covered by the contract is over a certain threshold, while other criteria may not be apparent to another contracting party, or could vary depending on positions taken or commercial information only made available sparingly, such as number of employees (which can depend on how that term is itself defined) or annual turnover figures.

In order to ensure compliance certainty for parties to standard form contracts, upon a practical assessment of appropriate criteria for defining a "small business", the SME Committee supports Option A.1 because it removes the necessity to debate the issue of the legal standing of the contracting parties, and enables the extended UCT provisions to focus on applying to make terms void and unenforceable should a determining forum hold the term to be 'unfair'. Given the objective of the proposed legislative extension is to balance the playing field by removing the impact of such unfair terms, this position also enables the determining

forum, when assessing whether a term is unfair, to concentrate its focus on the circumstances between the contacting parties, rather than having to assess and determine a threshold question of a party's legal standing.

The SME Committee alternatively supports Option A.4 and believes that number of employees is the next most appropriate way to apply the new UCT provisions to small businesses.

The SME Committee believes that the number of employees which a business would have to employ in order to qualify as a "small businesses" for the purpose of the UCT provisions would be less than 20 employees as this criterion would result in the UCT provisions applying to approximately 96% of all businesses in Australia.

The SME Committee does not support the other Options for defining what constitutes a "small business", outlined in the Consultation Paper, for the following reasons:

Option A.2: This option creates an arbitrary threshold for the application of the UCT provisions

Option A.3: While the SME Committee believes that the annual turnover option is also a valid means of defining a "small business" for the purpose of the UCT provisions, in our view, employee numbers are a more appropriate measure. We believe that the deficiency with annual turnover measures is that they may have the effect of excluding many small businesses in low margin, but high turnover businesses, such as independent stand-alone supermarkets and many larger internet retailers.

15. Should the extension of the UCT provisions provide protection for small business when they both acquire and supply goods or services?

The SME Committee believes that the UCT provisions should be extended to small businesses when they are both acquiring or supplying goods or services. As shown in the example above, concerning the contract terms which delayed the passing of property in support items, small businesses can also be subject to UCT's in supply situations. Having said that, the SME Committee believes that the incidence of UCT's in standard form contracts for the supply of goods and services is likely to constitute a much smaller area of concern than the acquisition situation.

Further discussion

The SME Committee would be happy to discuss any aspect of this submission.

Please contact the Chair of the SME Committee, Coralie Kenny, on 0409 919 082 if you would like to do so.