

# **Extending Unfair Contract Term Protections to Small Businesses**

**SUBMISSION by the OFFICE OF THE  
AUSTRALIAN SMALL BUSINESS COMMISSIONER**

**AUGUST 2014**

We are writing to provide some observations on the small business environment that relate to the *Extending Unfair Contract Term Protections to Small Businesses* discussion paper.

This submission is based on practical insights from the Office's experience of commercial contracting practices within the small business community. In doing this, we take a broad view of the types of contracts that small business operators enter into, and note that such operators are regularly treated in the same way as large businesses in terms of rights, responsibilities and liabilities.

We address the impact of a number of features of standard form contracts that are frequently offered without consideration of the nature and size of a business, and on a "take it or leave it" basis. This approach leverages the bargaining power of larger business and, even where contracts may be open to negotiation, small business operators often do not have the time, resources and skills to negotiate contracts in a meaningful way (and may not even be properly aware that they could negotiate).

The impact on small business is cumulative since small businesses will normally have a large number of such contracts (telephone, power, internet etc.) that may individually be at relatively low values but when taken together may be significant to the businesses. Of course, standard form contracts may also apply to more significant commercial matters, such as retail leases. The inability to negotiate advantageous terms in such a contract can have a real impact on the profitability of a small business.

In our observations, we provide coverage of some specific contracting issues that have been raised with our Office by small businesses. We believe that a key approach to these issues is to improve the overall business environment by focusing on behaviours and business relationships rather than mere contractual terms:

1. Facilitating and encouraging small business access to information and professional services; and
2. Ensuring access to efficient methods to resolve disputes and preserve business relationships.

This approach recognises that even where small business is able to negotiate a contract, it will not always be possible to negotiate a significantly better outcome than provided by a "take it or leave it" contract due to unequal bargaining positions and the resources that a small business can apply to negotiating such a contract. It is also common that a small business that is in its early stages of development will not fully appreciate the range of potential situations where a contract can apply (as the business grows).

An approach that applies across the overall business environment also avoids boundary issues such as strict meanings of "small business", "unfair contract terms" and the like. It means that improvements to the small business environment are not restricted to standard form contracts or particular industries, and can extend to entities that are not even a business (for example, non-profit organisations).

The approach that we recommend is focused on the fairness of result (not contractual term) and is in keeping with the government's broader deregulation agenda.

## Specific issues

Through our engagement with small business, we have observed a number of unfair contract issues and we understand that the state-based Small Business Commissioners have also provided further similar examples at the state and local levels.

### Use of market and commercial power

Market dominance of larger businesses can impact the ability of small business to negotiate contracts terms. This manifests in a number of ways:

1. Small business may be offered contracts on a “take it or leave it” basis that are not tailored to suit business needs and, for example, can include lock-in clauses, significant early termination costs and wide indemnities;
2. Small businesses that operate out of their homes are usually placed on a commercial contract by virtue of being a business despite usage and approach being similar to private situations.

We have observed instances of this sort of contracting practice for telephone and internet services and office or commercial equipment leasing. In these situations, small business is unlikely to seek professional advice for “take it or leave it” contracts since it is often perceived that the small print is the price that you pay for the good or service provided under the contract. There is generally little consideration given to negotiating such contracts and, in any case, there will often be little ability to negotiate.

The result is that various risks are assumed by small business (often without clear understanding) and the fitness of such contracts for the purpose of the business is not fully achieved. For example, we recently engaged with a car dealer in Western Australia about the difficulty of inflexible licensing and leasing terms which makes it impossible to be able to align expiry and renewal dates. Having a five year licence agreement, yet only being able to have a three year lease agreement results in business uncertainty and the inability to effectively implement a business plan.

This is compounded by small business operators entering into the contracts without first obtaining legal and other professional advice. There is no excuse for small business operators to do this, but inexperienced operators will often fail to understand the full meaning of what they are signing. Even where operators understand their rights and responsibilities, they may not realise that there may be unfair terms in the contract until something goes wrong and the precise implications are understood.

As a small business grows, commercial power may even grow in the other contracting party. For example, we have instances of small businesses building goodwill at leased locations and through the use of licensed property. When starting a small business, the operator may not be looking far beyond 1-3 years of operation (given the various uncertainties). Leases and licences may be entered into at this less certain time and are subject to terms that may be appropriate at the time. However, when leases and licences come due for renewal, there may have been considerable investment in, say, a location in terms of goodwill. Where this is the case, a landlord might then leverage “unfair” terms in a lease to extract greater value from the lessee.

We also had a recent situation where the lease for a retail outlet came up for renewal and the landlord sought to push various building maintenance and other costs onto the lessee

(for example, costs relating to the security of the wider area beyond that of the outlet). These costs would normally belong to the landlord and not the tenant who operates the outlet. However, the investment of the small business in the location meant that the landlord could press for additional advantage.

### **Online and telemarketing**

We regularly receive complaints over contracts that are entered into online or via telemarketing. Common issues relate to undisclosed or misunderstood terms and various sharp practices that include lock-in via significant early termination penalties, onerous obligations on the small business to prevent a contract being automatically rolled-over and the ability of the vendor to increase prices under the contract despite the customer being locked-in.

For example, in phone contracts, customers are regularly signed up without any written documentation. Customers may be asked to agree to standard terms without being able to read or even hear them and then they are locked into a series of rolling contracts. Recorded conversations can be used to demonstrate inappropriate practices, but these recorded conversations are not easily available to the small business that has entered into the contract. When reviewed, the conversations also can show that a salesperson has effectively amended the businesses' standard terms without specific acknowledgment (or even authorisation to do so) and that the amendment is not noted in the businesses' system (and the system may not even have this capability).

In online contracts, the issues are similar in that a contract can be split across a number of documents and can be in such dense fine print that the contract effectively becomes incomprehensible to small businesses. Of course, there is also the common online practice of people to simply accept terms to get the product or service given that there is generally little or no scope to negotiate or amend terms.

### **Franchising arrangements**

Although Franchising Code reforms are being separately progressed, examples in this area are instructive in considering unfair contract terms more broadly. Specifically, we have come across a number of "unfair" franchising terms and even (arguably) fair franchising terms being used in unfair ways.

For example, we have identified terms in franchises where:

1. Franchisors are able to extract sensitive commercial information from franchisees and restrict their ability to grow their business in order to maintain the value of the franchise in a way that goes beyond what would be reasonably necessary to protect the interests of the franchisor;
2. In some situations, franchisors may be able to push all costs of franchise disputes onto the franchisees regardless of fault, meaning that the ability of franchisees to ensure that they are fairly dealt with is compromised and cost is pushed onto franchisees by a franchisor merely alleging a breach; and
3. Unreasonable restraint of trade clauses that we have observed attempted to be used to prevent competition across large regions, with non-competing businesses and for extended periods.

As noted, these sorts of practices may also be present in other types of contracts and, depending on the outcome of the Franchising Code reforms, it may be appropriate to consider whether there is scope to approaches to unfair contracts in the franchise area.

## Framework for governmental activity

Government has a role in improving the business environment, with two enduring core responsibilities; namely the provision of information and justice. These pillars have a critical impact on the profitability of business and negative impacts can be viewed as business costs.

Our Office has a credo that '*No small business should fail through lack of access to information*'. The facilitation of access to information is a core responsibility of government. It is appropriate for government to commit resources to information and other supporting services, especially where the behaviour of businesses participating in a particular sector is regulated. Access to information is a key component of a competitive and equitable marketplace.

The second enduring core responsibility of government when intervening to regulate business is to provide an appropriate system of justice. Previously, provision of justice focused on placing wrongdoers in prisons. Refinements and sophistications over time have developed various means of providing systems of justice, which are not confined to punishment of offences against the Crown but extend to finding justice for those in private conflicts. Alternative dispute resolution has emerged as an appropriate measure for according justice in business dealings.

A small business focuses on plying its trade or profession. Disputes will arise from time to time, but small businesses will often not have the skills and resources on hand to deal with these incidents that arise in the course of business but are not a part of the *ordinary* course of that business. These types of business disruption are not easily catered for by small business and, depending on the particular dispute, can impact small business disproportionately (particularly where there is unequal bargaining power).

In applying the pillars of access to information and justice, a deregulation lens should also be applied. The government's red tape reduction programme aims to reduce unnecessary red tape costs on individuals, businesses and community organisations. Our Office encourages small businesses to participate in the deregulation agenda, and identification of regulations that are ripe for reform. Further to this, we encourage regulators to adopt a facilitative approach to the administration of regulation, with a focus on educating to comply, rather than leaping to enforcement of compliance.

## Access to information

By accessing appropriate information and resources, small businesses are empowered to work smarter, compete more effectively and reduce the costs of operating their business. This relates to small business operators getting the right information, adopting the right business management practices to utilise that information (and propel the business) and accessing the right advisors. These are a focus of our Office in engaging with small business.

Our Office regularly meets with people who are very enthusiastic when they go into a business and who are prepared to work 100 plus hours a week. However, good management practices are key to the success of these small businesses. Business owners wear many hats and have many responsibilities, and it is often not feasible to be an expert in all areas of business management; a small business operator is rarely a lawyer, accountant, marketer and strategist all in the one package. Seeking professional advice can provide valuable information and services to assist business operators in the management of their business..

Our Office encourages business operators, particularly those who are executing a contract or signing a retail lease, to get professional advice. This professional advice often brings attention to obligations that a business operator may not be aware of, saving businesses significant time and money. We stress that when using an advisor, the approach should not be to merely get a “yes” or “no” on a contract and get out of there as quickly as possible to avoid additional charges. Entering into a business arrangement is an important decision and it will have continuing implications for the business. A practical approach is to have the professional advisor highlight in different colours what each of the parties must do. This approach provides clarity of the obligations and allows small businesspeople to return to the document in the future and more easily find their way about.

Some specific actions that relate to a small business’ access to information in a contractual setting include:

**Education programme** – An education or publicity programme around the changes to unfair contract terms would significantly benefit Australian small businesses. Keeping small business operators aware of changes in the area and their own responsibilities when entering into contracts could significantly improve the business environment.

**Colour coding** – In the same way that advisors can draw attention to contractual rights and obligations using highlighters, standard form contracts can use the same approach. This assists in ensuring that small business is clear in terms of those rights and obligations and can “access” the thrust of the document more easily. This is the approach that the Commonwealth Government is adopting in its small business procurement contractual suite.

**Plain English contracts** – Such simplified contracts have has the benefit that small business is more likely to understand the impact of the contractual terms since the document is more understandable and avoids technical legal language. This is particularly important since a layperson’s understanding of a technical term can differ significantly from its technical legal meaning. This extends to ensuring that the entire contract is in a single document without additional amendments and other documents that must be read into a contract to understand its full operation.

**Simple disclosure clauses** – The introduction of disclosure obligations for certain critical elements of contracts might also assist small business in understanding the application of contracts. This might include the contract term, price (and ability to increase the price), early termination penalties etc.

## Access to justice

The cost of a dispute for small business is not just the financial cost of the lost business and the cost of pursuing resolution (such as legal costs), but also the opportunity cost and

emotional stress involved. The opportunity cost includes what the small businessperson would otherwise have achieved for the business using their time and effort. For small business, resolving a dispute takes someone out of the business. Added to this cost is the emotional stress that disputes have on small business operators.

A particular difficulty of small business disputes is that they do not generally arise in the ordinary course of operating a small business. They tend to arise periodically and in unusual circumstances. Accordingly, small business operators may not identify an emerging dispute until a late stage and they will not necessarily have developed the skills to resolve the dispute. Through the early identification of emerging disputes, financial and time costs can be dealt with easily, incurring much less of a financial cost to both parties. This also means that business relationships that are critical to running a small business may be maintained.

Effective alternative dispute resolution, that operates with speed, at low cost, informally and collaboratively, will generally be of greater benefit to small business – principally because it facilitates parties continuing their commercial relationships. Also, the potential cost of legal proceedings will in many small business disputes outweigh the amount in dispute. Drawn out legal proceedings with the possibility of appeal may also mean that parties do not deal with each other commercially while the action proceeds and the breaking of this business relationship is likely to persist beyond.

The success rate of mediation of small business disputes is extremely high. Mediation conducted or organised by the State Small Business Commissioners consistently exceeds a success rate of 80%.

Our Office recently launched an online dispute resolution portal – *Dispute Support*. The online portal was developed in collaboration with states and territories, and consolidates dispute resolution information, resources and services available for small businesses across Australia. This single portal provides easy, tailored access to the most appropriate low cost service available to small business operators to resolve disputes, while also providing information on dispute resolution processes and strategies for avoiding and managing disputes.

By ensuring that small business has easy access to justice through alternative dispute resolution one of the potentially most costly parts of operating a small business is relieved. For disputes that ultimately require determination by the courts, streamlined processes for lower-value disputes are also beneficial for small business.

Some specific actions that relate to a small business' access to justice in a contractual setting include:

**Alternative Dispute Resolution** – Standard form and other contracts should include an alternative dispute resolution clause that can provide a clear and cheap route for the determination of contractual disputes.

**Certification** – Before proceeding to court, an alternative dispute resolution certificate should be required (as a condition of progressing a commercial matter to court). The certificate, which could be provided by officials such as small business commissioners or ombudsmen, would constitute advice to the court that alternative dispute resolution had been attempted but had not resolved the dispute. Alternatively, the certificate may advise that a party refused to participate in or withdrew from alternative dispute resolution. In this latter situation, a court could take the recalcitrant party's behaviour into account when

considering awards of costs. Failure to engage appropriately in such processes could also form the basis for further reporting by ombudsmen and small business commissioners to parliament.

## **Conclusions**

Two significant ways to improve the contracting environment for Australian small businesses is through accessing:

1. the right information and skills; and
2. efficient dispute resolution services.

These are key roles for government. However, there is also a responsibility on small business to adopt good management practices, access skills that they do not possess (such as through the use of professional advisors) and operate in a way to minimise and manage unfair contract terms.