



Unfair Contract Terms and Small Business Consultation Paper
Small Business, Competition and Consumer Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: AustralianConsumerLaw@treasury.gov.au

Dear Sir or Madam,

Extending Unfair Contract Term Protections to Small Businesses

Thank you for giving the Office of the NSW Small Business Commissioner the opportunity to provide views on the impacts of unfair terms in standard form business contracts and options to curtail the use of unfair contract terms (UCT), including an extension of the existing Australian Consumer Law (ACL) protections to small businesses.

We have reviewed the Consultation Paper released on 23 May 2014.

The Office of the NSW Small Business Commissioner was established in mid-2011 to support small businesses throughout NSW. Our role is to:

- provide dispute resolution services;
- speak up for small business within government; and
- deliver quality business advice through Small Biz Connect.

We are focused on improving the operating environment for small businesses within NSW. We therefore support looking at getting the balance right between protecting small businesses against unfair contract terms, while at the same time not imposing unnecessary burden on business.

UCT protections presently apply only to 'standard form' consumer contracts. The Commonwealth Government has expressed concern that an imbalance of bargaining power exists not only between businesses and consumers, but also between large and small businesses, and has committed to extending similar protections as are currently available under the ACL to small businesses.

The Commonwealth Treasury's examination of the introduction of UCT law for commercial contracts involving small business is a welcome initiative. Extending the application of these provisions to small businesses could be expected to provide enhanced protections for the sector.

Our submission follows the format of responding to certain key focus questions outlined in the Consultation Paper. We offer the following comments.

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

The use of standard form contracts for small business is widespread, and includes not only examples familiar to consumers like telecommunications and utilities, but also examples peculiar to business-centric transactions including retail leases, sub-contracting agreements and many more.

Standard form contracts can offer a number of benefits. These benefits tend to flow more often to the contract drafters, but can also extend to their business counterparties, and to end consumers. Some such benefits include:

- Efficiency and timeliness. If each contract had to be considered and negotiated, significant costs and time delays could be expected. This could be inappropriate for minor or routine transactions.
- Completeness and legal compliance. Standard form contracts might be expected to ensure substantive issues are less likely to be overlooked. They may also be more likely to comply with various applicable regulations.
- Familiarity and risk-management. Standard form contracts may be well known to participants in an industry. They may have been developed or approved by expert practitioners, and may minimise the risk of a transaction going awry.

A negotiated contract may not necessarily be any fairer than a standard form contract. The fairness of a negotiated contract would be subject to the contracting parties' relevant bargaining positions, subject matter expertise, literacy, and legal knowledge.

Disadvantages of standard form contracts include the following:

- Differential treatment. Standard form contracts often tend to favour their drafter. Their counterparty's interests may not be adequately catered for.
- Assumed conformance to accepted standards. The formality of the document can cause the counterparty to misapprehend that the contract terms adhere to all relevant laws and standards, and delimit the extent of their own rights.
- Information asymmetry. The drafter is likely to be the party most familiar with the rights and obligations specified in the document in cases where it was prepared by them, and hasn't been subject to negotiation with the other party.

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?

Our sense is that the rate of businesses reviewing standard form contracts or engaging legal services prior to signing them is relatively low.

Small businesses generally attend more to the principal features of a transaction than to the minutiae of the consequent standard form contract that follows.

The expression: 'the large print giveth and the fine print taketh away', is apt. Marketing messages are usually far more prominently communicated than the legal obligations that accompany a transaction.

We note the research described in the consultation paper regarding the low reading rates by consumers of standard form contracts. Most consumers don't read contracts. They rely on the notion that businesses will act fairly and reasonably in enforcing their rights. We expect that many small businesses tend to share some of the same characteristics.

The majority of small businesses don't have in-house legal experts. External legal fees are generally multiples of an average small business principal or staff member's remuneration rates. Accordingly, we believe the rate of small businesses engaging legal services to review standard form contracts is low.

Where a transaction is perceived by a small business as high-risk, or is central to their business model, one would expect more careful review of contracts prior to agreeing. The 'value or perceived exclusivity of the transaction' may be relevant, but we think these factors are less determinative than perceived risk and centrality to business model.

Many form contracts that small businesses sign are incidental to their main operations. Where the value is low, or the product or service doesn't present an obvious risk to the profitability of the small business, and where the resources of time and money are at a premium, careful review of standard form contracts is often not a high priority.

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

We expect that small businesses rarely try to negotiate standard form contracts in the assumption that to attempt to do so would be futile. The 'take it or leave it' situation described, is generally borne out in the understanding of both parties.

Once you have sunk costs in the identification of an apparently suitable vendor, product or service, most people will be unmotivated to search out the potential downside. In some cases, they may have no better option than to overlook unfavourable terms in order to secure a necessary transaction.

Even if resources have been expended to read and understand a standard form contract, it is often not negotiable. It would be wrong to think small businesses can somehow barter their way through editing or deleting clauses they consider unfavourable in most standard form contracts.

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

While the terms or the process by which some contracts are negotiated may be of concern, it can be how a particular clause operates in practice, which may not have been foreseen by the small business at the time it entered into the contract, that is often of ongoing concern.

Small business operators can struggle to understand key clauses of contracts they've entered into, and may have limited knowledge of their rights and obligations.

Complex structure, poor readability, lengthy documents, legalistic content and confusing terms can present challenges with some contracts for small businesses.

If contractual disputes arise, the costs of enforcing rights can sometimes outweigh the value of what is at dispute, and the time and stress associated with enforcing rights directly with a counterparty or through the legal system can discourage small business operators from attempting to do so.

A contract may not be a single self-contained document that succinctly sets out the rights and obligations of participants. It can be part of a *collection* of documents, with some dimensions left unspecified. The lack of comprehensiveness can reflect the discretionary character of a relationship. In relationships with more powerful entities this characteristic can permit unforeseen problems to be created for small business operators.

For example, there may exist some combination of deed, schedules, policy documents, requests for quotation, emails, even verbal discussions, that interact to define, alter, and sometimes contradict, the character of the interaction. We've observed this kind of complexity in sub-contracting arrangements between small and large businesses.

It can be difficult for small businesses to keep track of all this over time, but they will generally be held by their counterparty to the combination of terms. As for whether such documents individually or collectively constitute a 'standard form' contract would be open to legal debate on a case by case basis.

Administration of the contract can be a source of much pain for small business operators. Larger parties can apply rules inconsistently or unreasonably, or require they be convinced of their need to take an action. Working through protracted administrative bottlenecks, often handled by junior staff at large companies, can consume such time and patience from small business operators that they opt instead to forfeit rights and revenue they believe they're contractually entitled to.

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

A layperson's impression of an 'unfair' term is likely to be very different from a term that would actually satisfy all of the elements set out in the ACL in order to establish that a contract contains a UCT.

Under the ACL, there are three main prerequisites that must be satisfied for a court to declare a term of a standard form contract void:

- i. **Consumer contract.** Defined as a contract for:
 - the supply of goods or services; or
 - the sale or grant of an interest in land to an individual who acquires it wholly or predominantly for personal, domestic or household use or consumption.
- ii. **Standard form contract.** A 'standard form' contract will typically be one that:
 - has been prepared by one party to the contract; and
 - is not subject to negotiation between the parties, i.e. is offered on a 'take it or leave it' basis.
- iii. **Unfair.** A term is considered to be 'unfair' if it:
 - would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
 - is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and
 - would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

The three limbs of the unfairness test make clear that it's insufficient for a term to be merely unfair in itself. Further, in determining whether a term is unfair a court must consider the extent to which the term is transparent, and take into account the contract as a whole. We consider the totality of these tests sets a high bar.

This notwithstanding, terms that small businesses are encountering that might be considered 'unfair' include:

- Levying of interest on outstanding monies at usurious rates.
- Clauses attesting that the party has obtained legal advice prior to signing the contract (when it may in fact not have).
- Confidentiality clauses (intended perhaps to fetter one party's ability to obtain advice or assistance) in relation to the contract.
- Automatic rollover of contract, e.g. for a substantial period, if not cancelled (via narrowly specified means) within a narrow timeframe.
- Levying of fees at rates that exceed cost recovery, applicable in the event of an adjudged irregularity or default.
- Terms that give one party rights to unilaterally and without notice limit its performance of the contract.
- Terms dealing with forfeiture, at the discretion of the drafter, of surety bonds or guarantees.

What protections do businesses currently have when they encounter UCT and are they sufficient?

What regulatory responses are already in place that aim to protect small business from UCT and how effective are these mechanisms?

The Consultation Paper, at pp. 49-56 summarises legislative and other protections available for certain forms of business conduct, and we see no need to revisit those discussed in much detail here.

The Consultation Paper omits discussion of the *Small Business Commissioner Act 2013*. This legislation was developed and passed by the NSW Parliament in May 2013, and commenced by proclamation on 18 September 2013. The Act establishes the NSW Small Business Commissioner as an independent statutory officer. Under the legislation the Commissioner is able to:

- require parties to a dispute to attend mediation prior to the initiating of a legal process, and can impose penalties on those who do not cooperate;
- investigate allegations of unfair treatment and unfair contract terms in a neutral and independent manner;
- require local councils, State Government bodies and businesses to provide information or answer questions if the Commissioner acts upon a complaint; and
- report directly to Parliament where there is an issue of real importance to small businesses.

Over 90% of disputes mediated through the Office of the NSW Small Business Commissioner are resolved. Mediation of this type reduces the need for litigation and its consequent costs.

Contract law presumes consent exists between the contracting parties. It is enforced on the basis that parties who make undertakings to others that rely on them ought to be held to their commitments. Contract law doesn't take formal account of bargaining power. It effectively presumes the contracting parties freely enter into contracts on an equal basis, wishing for them to be performed according to the terms agreed. The presumption of the validity of this consensus will stand unless sufficiently impaired by evidence of duress, misrepresentation or unconscionable conduct.

Small businesses can lack the resources to defend their rights under contract law, especially in disputes with better-resourced counterparties. Legal redress from contractual breach is generally thought by the majority of small business operators to be insufficiently responsive or accessible. Court based review is generally perceived as being complex, time consuming and costly.

The ability for unconscionable conduct provisions to address UCT is questionable. We understand that courts have not found contract terms, in themselves, to be unconscionable, but have focused more on the surrounding circumstances. The cautious interpretation of the unconscionable conduct provision suggests that only egregious conduct is likely to be regarded sufficiently unconscionable. Conduct that simply appears harsh or unfair may not meet the requisite threshold.

In relation to whether enforcement and redress mechanisms can be effectively used by small businesses to enforce their rights, we understand that each year the ACCC receives roughly 160,000 complaints and enquiries, and from this pool conducts around 140 'in-depth' investigations. This equates to less than one 'in-depth' investigation per thousand complaints or enquiries. From these investigations, the ACCC may determine to litigate several cases.

The ACCC readily discloses these statistics, and we repeat them not to disparage. We're inclined to consider, nonetheless, that there exists a chasm between apparent levels of community concern and the availability of remedy (or even review) under trade practices law.

Our view is that the protections and regulatory responses already in place at the Commonwealth level that aim to protect small business from UCT are not sufficient or sufficiently effective.

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?

We would caution that where benefits or revenues extracted via UCTs in standard form contracts are voided by extension of existing provisions to contracts involving small businesses, it is likely that attempts to recover these benefits or revenues will surface elsewhere, e.g. in contracts that permit negotiation sufficient to no longer be deemed 'standard form', or in the *administration* of contracts, or in prices. Thus regulation ought to be mindful of, and seek to minimise, any unintended consequences.

If the Commonwealth Government pursues its policy commitment of legislative amendment to extend the existing UCT provisions to contracts involving small businesses, we consider there are several responses that could be implemented to help businesses ensure contract

terms respect the legitimate business objectives and interests of both big and small contracting parties.

As will be recognised by Treasury, the establishment of some central definitions, including 'small business' and 'business contract' may be necessary. Until these and other matters are defined there will be uncertainty as to the scope of extended UCT provisions.

Indefinite concepts including 'legitimate interests', 'reasonably necessary' and 'significant imbalance' could lead to uncertainty when businesses transact with each another and may benefit from definition in the legislation to the extent practicable. Concepts like this tend to necessitate legal advice and can be difficult to prove in court.

Many entities that contract with small business would need to consider any legislation on unfair contracts and may need to review their existing standard form contracts to determine whether they contain terms that might be voided as 'unfair' and, if so, the potential implications for their contractual arrangements.

Some entities may need to revisit their business model, reassess their risks and consider repricing of goods and services. Some may benefit from training in relation to contract design. Further, associations, industry groups, or Government agencies might consider developing best-practice draft contracts for industries (with largely homogenous characteristics) to adapt.

We encourage the Federal Government to consider carefully the impact such reform would have and ensure details of proposed legislation are clearly and effectively communicated to affected parties.

Given the Commonwealth Government's commitment to extend existing UCT provisions to small businesses, what should be the scope of the protections?

We have considered the policy options discussed in the Consultation Paper:

- Option 1 — The status quo. No action is taken, contrary to the Commonwealth Government's policy commitment.
- Option 2 — Light touch or non-regulatory responses.
- Option 3 — Legislative amendment to extend the existing UCT provisions to contracts involving small businesses, in accordance with the Commonwealth Government's policy commitment.
- Option 4 — Legislation to require contracts with small business to be negotiated on request.

We consider there to be sound in-principle arguments for a new national provision against UCT affecting small business. We therefore favour the third option presented: *legislative amendment to extend the existing UCT provisions to contracts involving small businesses*. A cost-benefit assessment conducted by Treasury or the Productivity Commission would be valuable in estimating the public benefit of such a new provision.

In the event that the third option is pursued, we would see benefit in UCT laws being incorporated within the *Australian Securities and Investments Commission Act 2001*, extending financial services UCT provisions to small businesses, as they are for consumers.

Should the ACL 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 Office of the NSW Small Business Commissioner doesn't define 'small business', because we would not want to exclude a small business needing help, because it fell just outside of a standard definition.

We consider relevant to this question recommendation 10 of the Productivity Commission's research report – 'Regulator Engagement with Small Business':

Governments should not impose upon regulators a single definition of small business as this could lead to inflexibility and higher costs for some businesses and for the community more generally. Policy makers and regulators are best placed to define small business in ways that are practical and appropriate for their regulatory area.

The Consultation Paper summarises at p.64 four options for defining 'small business' for the purpose of the UCT provisions:

1. Apply to all business-to-business standard form contracts with an exception that a publicly listed company cannot rely on the provisions.
2. Define on the basis of a transaction threshold.
3. Define on the basis of annual turnover.
4. Define on basis of the number of employees.

The Consultation Paper asks about the benefits and disadvantages of each definition option and invites alternative suggestions from stakeholders. In the following table we attempt to summarise some key benefits and disadvantages of each option, and have added a potential alternative option* for examination. We are reluctant to endorse any particular definition at this stage.

	Benefits	Disadvantages
Apply to all ... with an exception that a publicly listed company cannot rely on the provisions.	<ul style="list-style-type: none"> • Readily identifiable characteristic. 	<ul style="list-style-type: none"> • Many large (unlisted) companies could rely on the provisions.
Define on the basis of a transaction threshold.	<ul style="list-style-type: none"> • Reasonably forecast-able characteristic. 	<ul style="list-style-type: none"> • Many large companies could rely on the provisions. • Transaction value may not be static, or may be of a repetitive nature. • Transaction value may not be known in advance. • Transaction value can be an imperfect guide to business size.
Define on the basis of annual turnover.	<ul style="list-style-type: none"> • Quantifiable. 	<ul style="list-style-type: none"> • Turnover unlikely to be known to counterparty. • May change markedly over time. • Turnover can be an imperfect guide to business size.
Define on basis of the number of employees.	<ul style="list-style-type: none"> • Quantifiable. 	<ul style="list-style-type: none"> • Employee head count unlikely to be known to counterparty. • May change markedly over time. • Employee head count can be an imperfect guide to business size.
*Apply to all ... with an exception that an <u>incorporated</u>	<ul style="list-style-type: none"> • Readily identifiable characteristic via ABR search. 	<ul style="list-style-type: none"> • As many as 32% of small businesses (<20 employees) would be unable to

business cannot rely on the provisions.	<ul style="list-style-type: none"> • Would apply to around 65% of Australian businesses. • Likely to be businesses of a type arguably most eligible for the envisaged protections. 	<ul style="list-style-type: none"> • rely on the provisions. • Adversely discriminates against incorporated entities.
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It should be apparent that defining small business is not as simple as it sounds. There are several definitions of small business in use across Australian Government agencies.

A business could be defined as 'small' according to a given definition, at a given point in time (e.g. at the time of entering into a transaction, or the prior financial year, for example). It may cease to be so over time, and vice versa.

The Consultation Paper, at p.31 points out that:

When determining which contracts will be captured, it would be desirable that businesses seeking to contract with another business be able to identify readily whether or not the UCT provisions would apply to a particular contract.

If options one or two were adopted, the ability to identify would be simple. To have certainty with whom one is dealing would be difficult if options three or four were adopted. Annual turnover and number of employees are not reasonably available pieces of information.

The ATO threshold for the majority of small business tax concessions was established in 2007 and set at \$2 million (annual turnover), where it remains today. If one allows for inflation, they find that \$2 million as at June 2007, would notionally equate to approximately \$2.415 million as at June 2014. Accordingly, we have previously supported increasing the ATO threshold for the purposes of removing this 'bracket-creep' effect.

According to the ABS, at June 2013, there were around 2,079,666 actively trading businesses in Australia, of which 722,198 were companies. Therefore approximately 65% of Australian businesses are unincorporated. The majority would be 'non-employing', and these owner-operators would share characteristics of individual consumers in respect of UCT. Further research could be undertaken to ascertain the characteristics of unincorporated businesses.

Small businesses deal with other small businesses using standard form contracts. We can envisage reasons that would militate for UCT extension to such contracts. However, given *disparity of bargaining power* between parties is central to the problem the Government seeks to address, applying UCT protections to transactions between small businesses may be contrary to the policy intent.

If extended UCT provisions were to apply to small business to small business contracts, then small business operators might need to spend time and money to understand their rights and obligations under new provisions. Such an action would therefore need to be mindful of minimising compliance burdens.

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

Small businesses exist primarily to *supply* goods and services. Their acquisition of goods and services is generally incidental to, or in aid of, this primary function. Unlike consumers, small businesses consume to the extent necessary to enable their supply.

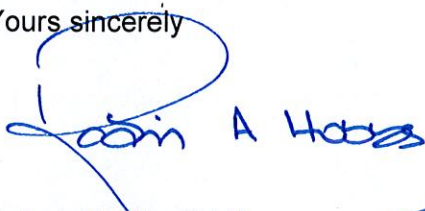
Many large businesses contract with small businesses to acquire goods and services in Australia. This type of transaction is very common. Contracts of this kind tend to be central to the viability of a small business, particularly in cases where the bulk of sales are made to a small number of clients.

We have been approached by small businesses in relation to unfair terms in their supply contracts with larger businesses. We find the issues arising out of supply contracts can be more complex and serious than for consumption contracts.

We believe that if the UCT provisions are extended there are sound reasons for them to include protection for small business when they acquire and/or supply goods or services to businesses.

We appreciate the opportunity to comment on the impacts of unfair terms in standard form business contracts. Should you wish to discuss any of the issues raised in this submission, please contact Murray Johnston, Principal Advisor, Advocacy on (02) 8222 4842.

Yours sincerely



Robyn Hobbs OAM
NSW Small Business Commissioner

1 August 2014