Queensland Law Society

Law Society House, 179 Ann Street, Brisbane Qld 4000, Australia
GPO Box 1785, Brisbane Qld 4001 | ABN 33 423 389 441
P 07 3842 5943 | F 07 3221 9329 | president@qls.com.au | qls.com.au

Office of the President

Your ref: Extending Unfair Contract Term Protections to Small Businesses – Consultation Paper

Our ref: 857/5 – Competition and Consumer Law and Franchising committees

6 August 2014

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

Submission electronically uploaded: here

Dear General Manager

Extending Unfair Contract Term Protections to Small Businesses Consultation Paper

Thank you for the opportunity to comment on the Extending Unfair Contract Term Protections (UCTP) to Small Businesses Consultation Paper (Consultation Paper) and for granting the Queensland Law Society an extension of time to lodge this submission.

We have consulted with the Society's Competition and Consumer Law and Franchising committees. Both committees consider that the unfair contract term protections should apply to small businesses but hold divergent views as to whether there should be a UCTP exemption for agreements made under the following mandatory codes: Franchising Code of Conduct and Oil Code. On this point, this letter will detail the committees' respective views.

The Competition and Consumer Law committee considers that:

1. The existing unfair contract terms protection regime that applies to consumer contracts should be extended to contracts made with small businesses. The Competition and Consumer Law committee considers that a "small business" could be defined using section 45A of the *Corporations Act*. This definition requires that a business (whether a registered company or not) has at least two of the following characteristics:

    a. an annual revenue of less than $25 million;

    b. fewer than 50 employees at the end of the financial year; and/or

    c. consolidated gross assets of less than $12.5 million at the end of the financial year.

2. The unfair contract terms protections should apply to all contracts with small businesses, even when the counterparty is another small business.

The Competition and Consumer Law committee does not believe any change to the definition of a "standard form contract" is necessary, nor do they believe that additional examples of contractual terms in small business contracts that may be unfair are needed.

Further, it is self-evident that the majority of small businesses do not have the same level of bargaining power as larger businesses. In recognising that imbalance, it is the Competition and Consumer Law committee's view that extending the unfair contract terms protections to small businesses merely improves access to justice for another group that has been identified as being at risk, or alternatively marginalised as a result of diminished access to justice.

In identifying the scope of the extended regime, it then falls to defining what a "small business" is. Australian regulators do not have a uniform definition of "small business". The Australian Tax Office limits "small businesses" to those with an annual turnover of less than $2 million (excluding GST). Fair Work Australia requires that "small businesses" must have less than 15 employees, while the Australian Bureau of Statistics defines a small business as one with less than 20 employees. Notably, this definition has been adopted informally by many other regulators. However, it is the Competition and Consumer Law committee's view that adopting the definition of small business found in section 45A of the Corporations Actwill avoid the possibility, if a more conservative definition were to be adopted, of having the effect of discriminating against many of those businesses that it is intended the extension of the regime would benefit.

It is the Competition and Consumer Law committee's view that the unfair terms regime is clear in its application. Extension of its application to small business merely requires a meaningful definition of small business.

The unfair contract terms protections should apply to all contracts with small businesses

The position of the Competition and Consumer Law Committee

A key question regarding the scope of the extended unfair contract terms regime is whether it should apply to a contract with a small business regardless of the counterparty, or whether it should only apply to a contract with a small business where the counterparty is a corporation (or other business) that is not a small business. (Other permutations are also possible, but for the sake of brevity the Competition and Consumer Law committee does not intend to analyse them.)

In the Competition and Consumer Law committee's view, the unfair contract terms regime should apply to all contracts with small businesses, even when the counterparty is another small business. Put another way, if small businesses obtain the benefits of the unfair contract terms regime, they should also bear the burden of complying with it when they enter into standard form contracts with other small businesses (as is currently the case when they contract with consumers).

The Competition and Consumer Law committee does not believe that this will result in any appreciable increase in compliance costs for small business, as the majority of small businesses would also deal with consumers (as defined for the purposes of the unfair terms regime), and therefore should already be complying with the unfair contract terms regime for those transactions.

The position of the Franchising committee

The Franchising committee however does not believe that the unfair contract terms protections should be extended to franchise agreements, on the basis that these agreements are already subject to a mandatory industry code prescribed by the Commonwealth that already contains prohibitions on franchise agreements containing certain types of terms. Moreover as a result of extensive review and sector consultation the Code will be significantly expanded to prohibit or render unenforceable additional kinds of terms that the Commonwealth have decided to exclude as well as to impose significant new obligations on parties to a franchise agreement. These sorts of restrictions are not contained in other small business contracts. As a consequence the Franchising committee believe that franchise agreements (and in fact the nature of a franchise relationship) are of such an unusual and regulated relationship that they should be excluded from its application and left to the mandatory code to regulate these contractual terms.

Exclusion of application of UCT Protections to agreements

1. The Franchising committee submits that any proposed extension of the unfair contract term (UCT) protections of the ACL (Australian Consumer Law, the UCT protections) from consumer contracts to business contracts involving small businesses should expressly exclude agreements that are regulated by a mandatory industry code prescribed by the Commonwealth. This would cover agreements that are subject to the various industry codes of conduct but most specifically the Franchising Code of Conduct and Oil code.

2. It is the Franchising committee's view that they should be considered to be a contract of the nature set out in s28 of the ACL, namely a form of contract that is specifically regulated by an industry based law that affects that contract but not others.

3. The *Insurance Contracts Act* imposes a regime for insurance contracts. Contracts of insurance are expressly excluded from the application of the UCT protections. Arguably there are many similarities in the regime imposed on insurance contracts that are imposed on franchise agreements. There is a statutory duty of disclosure (not unlike that obligation of prior disclosure prescribed under the Code) and a duty of utmost good faith on an insured. The latter is arguably an implied duty of good faith which will become a statutory obligation on and from 1 January 2015. There are provisions dealing with disclosure and formation of insurance contracts as well as expiry, renewal and cancellation of contracts. There is no unfair contract term protection in that legislation specifically and relief for contravention of the duty is specified in the legislation. Insurance contracts are standard form contracts delivered in a form that is not intended to be negotiated (other than for certain subject matter items including the insured, the period of insurance the premium, any additional items covered and any exclusions that apply to coverage).

4. Any extension of the UCT protections to "*business contracts*" as opposed to "*consumer contracts*" should apply only to future contracts and not apply retrospectively to contracts entered into before the extension commences or to existing contracts that are varied after that date.

5. The nature of the UCT protections will declare "unfair" contract terms in standard form contracts (with small businesses) to be void. The Commonwealth has restrictions imposed on it under Section 51xxxi of the Constitution concerning acquiring property rights (even through declaring terms void) without just compensation. As a consequence, whilst any legislation may be prospective, consideration should be given as to the effect on existing contracts if they are varied, renewed, extended, transferred or novated after that date.

6. If the UCT protections were extended then the structural framework of that Part of the ACL would require a definition of "*business contract*" to extend the UCT provisions that currently only apply to "*consumer contracts*" because they apply to contracts for the supply of goods and services "*to an individual whose acquisition of the goods, services or interest is wholly or predominantly for personal, domestic or household use or consumption.* Normally a business to business contract would not satisfy that part of the definition although the earlier 2 subparagraphs would be useful without those qualifying words.

7. The Code specifies the formalities that must be followed before entering into, renewing, extending or extending the scope of a franchise agreement (as well as its transfer, novation or termination). They include an obligation to give disclosure with a copy of the form of agreement "in the form in which it is to be executed". As a consequence there is an argument that every disclosure document offering an attached franchise agreement in the form in which it is to be executed is by operation of legislation a "*standard form*" as once disclosed it would be a "*take it or leave it*" contract unless subsequent disclosure was given with the amended version based on further negotiations. The amended version becomes a take it or leave it contract as it is in the form in which it is to be executed. This position may change after 1 January 2015 given clause 10(3) of the Exposure Draft of the Code to allow flexibility in negotiation without the necessity for re-disclosure.

8. The Commonwealth is also implementing a civil pecuniary penalty regime and infringement notice regime to encourage and compel compliance that will apply to contraventions of civil penalty provisions of an industry code. That regime will not apply to business contracts generally, only to franchise agreements regulated by an industry code that contains civil penalty provisions.

9. Unlike other business contracts, on and from 1 January 2015 franchise agreements will be subject to additional statutory protections to contracting parties to a franchise agreement that are not afforded to other small business contracts including:

   (a) an express obligation on the parties to act in good faith – and declaring void any provision that seeks to limit or restrict that obligation;

   (b) restrictions of the contractual ability of a franchisor to specify a particular jurisdictional forum for litigation and an obligation to attend mediation in Australia;

(c) restrictions on the ability to attribute and recover costs of dispute resolution from franchisees;

(d) restrictions on the ability to enforce a restraint of trade unless compensation is payable for non-renewal of the franchise;

(e) restrictions imposed on and statutory procedures that must be followed to lawfully enter into, renew, extend, transfer or novate an existing franchise agreement or to extend its scope;

(f) procedures that must be followed before contracting including a 14 day pre-disclosure period ,an obligation to provide a risk statement, recommending independent legal, accounting and business advice and giving prospective franchisees a mandatory 7 day cooling off period;

10. The nature of a franchise is well recognised to involve a degree of inequality in bargaining position. It also traditional that certain contractual terms that are alleged to be unfair (for example uniform supplier arrangements) are already subject to an immunity offered under the CCA after a notification or authorisation has been made by a franchisor. The test applied by the ACCC in considering those applications is based on public benefit and not a fairness test. It is unclear how a UCT protection regime would interact with such approval by the ACCC.

11. The unconscionable conduct provisions of the ACL already afford a great deal of protection for franchisees for unconscionable conduct by franchisors including attempts to unilaterally change the terms of a franchise agreement.

12. Franchise agreements have traditionally included unusual commercial terms not contained in other business contracts including:

(a) an obligation for a franchisee to follow policies, procedures and guidelines in an operations manual and a right for the franchisor to vary it unilaterally;

(b) limits on the obligation of a franchisor to renew or extend a franchise agreement;

(c) a right to terminate without cause on reasonable notice (a clause 22 type right to terminate) which is more prevalent in Motor dealership agreements;

(d) a right to require franchisees to acquire goods or services from suppliers approved, nominated or specified by the franchisor- usually this is subject to authorisation by or notification to the ACCC

Extension of Section 26

Currently if a franchise agreement was subject to the UCT protections and it was considered to be a standard form contract the protections would not apply to a term that is "*required or is expressly permitted by a Commonwealth state or territory law.*"[1] The way the Code currently is framed there are some typical clauses that already could be considered to be "required or expressly permitted" by an industry code including:.

(a) Cooling off clause – this is expressly permitted and right to deduct non-refundable expenses.

(b) Right for a franchisor to claim reimbursement for reasonable administration and audit costs of a marketing fund. Marketing fund provisions generally.

(c) A franchisors right to terminate for non-remedy of a Breach notice - Clause 21; a franchisor's right to terminate on notice and reasons if the franchise agreement contains an at will no fault termination right- Clause 22;, a right to terminate for special circumstances - clause 23.

(d) Transfer or novation provisions – which include the circumstances in which it is considered reasonable for a franchisor to withhold consent (clause 20).

(e) Clause 20A notice – the obligation for a franchisor to make a decision and give a notice whether it will renew or not renew a franchise.

(f) Part 4 consistent Dispute resolution provisions and costs provisions.

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

In a franchise agreement many clauses are often alleged to be unfair but their existence and application are not unusual in a franchise relationship. In fact over the years reviews of the Code have sought to require greater disclosure of some of these so called "unfair terms" in specific items of disclosure.

Some of them have been prohibited but others have not and left to the contracting parties to negotiate. As a consequence overlaying additional unfair contract term protections adds an unnecessary and expensive compliance regime on a sector already heavily regulated.

Moreover the Code in many circumstances already provides (and in respect to the impending Code changes will shortly also provide) for disclosure and, if appropriate, some forms of relief and remedies to franchisees including:

(a) *Unilateral right to vary the manual* - most agreements contain a right to change the terms of an Operations Manual – whilst that term in usually not unfair, any subsequent action by a franchisor to use it to vary the Operations Manual to include new substantive obligations may be unfair. However it is the conduct in seeking to vary the

---

[1] Refer to Section 26(1)(c).

Operations Manual in a particular way, rather than the term that gives the power to do so, that is the problem. For example if one seeks to impose a new obligation to do something (such as pay a new fee) which the franchisee did not agree to do or under the franchise agreement it did not have to do,the Code requires disclosure of the circumstances of when this right to unilaterally vary has occurred or will occur in the future (see item 17A of the Annexure 1 disclosure document). A franchisee is therefore directed to this right, made aware of its existence, its prior use by a franchisor and future circumstances where it will be applied. Disclosure of this type of information before entering into a contract is not normally required for other contracts. If the nature of a change in the operations manual was unfair it may be subject to the unconscionable conduct provisions of the code which would give greater relief to a franchisee. The UCT protections would render an otherwise useful and essential franchising term void and essentially lock in a manual that cannot be changed at all. This would significantly restrict franchising and the ability to modify procedures and policies and adapt to changes in industry practice

(b) *Refurbishment* - seeking to impose refurbishment obligations which do not allow the franchisee to recoup the cost of the refurbishment (and a return on that investment) during the term or renewal term. This is a growing area of conflict in franchise systems where franchisors expect franchisees to incur significant capital expenditure at end of term as a condition of renewal to bring the business to the then current standards. Many franchisees dispute that a full refurbishment is required given the cost and expense and prefer to embark on limited upgrades. The effect is that a franchisor may argue that the franchisee has not complied with its renewal obligations if it does not incur the expense. Whilst a franchisor should be obliged to act reasonably, often the decision to require a full refurbishment is considered to be unfair even if it has been completely disclosed to a franchisee before it enters into the agreement. The Code will shortly be changed to restrict the ability of a franchisor to impose undisclosed significant capital expenditure other than in limited circumstances including providing a business justification statement (clause 31(e) of the Exposure draft of the new code);

(c) *Termination at will* – by including a right for the franchisor to terminate without cause on notice (a so called "termination at will" right) in the franchise agreement. This type of right even if it is expressed to be mutual (and exercisable by either party) can be considered to be an unfair contractual term where the investment made by the franchisee is significant and is not able to be recouped or a return on the investment obtained unless the full term is allowed to run. Usually there is no compensation tied to this right and if exercised by the franchisor can have a serious financial consequence to the franchisee (particularly if the agreement includes a post termination restraint of trade (such as a non-compete covenant) that would continue to be binding on the franchisee and guarantors). This type of clause (expressly recognised by clause 22 of the Franchising Code of Conduct) is more prevalent in motor vehicle dealership agreements than mainstream franchise agreements. The Code recognises that these rights do exist and the Code does NOT prohibit them from being included in a franchise agreement, it simply requires a manufacturer or distributor to give reasonable notice (usually not less than 6 months) and reasons to be given if the right is exercised. If this clause was considered unfair they it would be void and more appropriate to be contained as a prohibition in the Code rather than ACL protections. It may also require an amendment to clause 22 of the Code;

(d) *Compulsory Acquisition rights and valuation* - it is often argued by franchisees that rights afforded to a franchisor to elect to acquire assets at the end of term at less than their market value is an unfair contract term as it allows the franchisor to acquire all of the essential business assets that will allow it to operate as a going concern (which

would have a greater going concern value than what they paid for it). Goodwill is not normally paid to an outgoing franchisee unless the business is acquired as a going concern. In some circumstances the amount to be paid by the Franchisor is much less than even the payout amount owed to financiers to secure a release of security over those assets and it is usually expressed to be the lesser of written down book value or market value. In many circumstances franchisees allege that the franchisor then subsequently sells the assets and a new franchise to a new franchisee at a much higher market value and thereby "churns" the franchise opportunistically for greater profit without passing any of this additional profit on to the franchisee. The practice of "churning" may in any event amount to unconscionable conduct. A franchisor would argue that it should not be obliged to compensate a franchisee for their failure to conduct the business in compliance with the agreement where termination has arisen from the franchisees default. The Code also requires disclosure of end of term arrangements in Item 17C of Annexure 1. It requires disclosure of any "exit payment" and how it is determined or earned as well as other arrangements concerning the purchase of stock and other assets.

The Code will be amended in January to include a right of a franchisee to claim or be paid compensation for non-renewal of a franchise if a franchisor wants to enforce a restraint of trade covenant. This provides a partial degree of protection in that circumstance under the Code. The Government accepted the recommendation of Alan Wein in respect to enforcement of restraints of trade and did not take steps to mandate any obligation for a franchisor to pay compensation for non-renewal (or for termination) was necessary to include in the Code. This issue has been canvassed in reviews and not found to be required to be included in the Code. If clauses of this kind were unfair then the appropriate relief should have been included in the Code.

(e) *No right to set off or withhold*– in most agreements a franchisor (but not a franchisee) can seek to set off amounts owing to it by the franchisee against monies it may owe to a franchisee for example if it elects to acquire the assets at end of term. In addition a franchise agreement would usually expressly provide that a franchisee is not entitled to withhold amounts it claims are due to it from payments it must make to the franchisor. Franchisors usually argue that this is necessary to prevent franchisees withholding royalties. Franchisees would argue that this is an unfair contract term and both parties should have the right to set off and when a franchisor breaches a contract or becomes subject to external administration they may want the right to withhold or set off.

(f) *Liquidated damages clauses* – Clauses in franchise agreements are similar to other contracts where a breach may lead to an obligation to compensate the innocent party for damages. These clauses are usually expressed as liquidated damages clauses that may require all franchise fees, advertising contributions and other amounts payable under the agreement to immediately be paid in full for the balance of the term. In many cases a franchisee would argue that this is an unfair contract term if the agreement is terminated as it would amount to a penalty and not a genuine pre-estimate of loss actually suffered. It is common for franchisors to argue they are entitled to claim and receive all royalties to the end of the contractual term if the agreement is terminated because of the breach of contract by the franchisee. Whilst that amount may reflect loss and damage actually suffered there is no obligation to mitigation of that if the franchisor subsequently re-grants the franchise or commences to operate it as a corporate unit. It is also argued by franchisees that a franchisor claiming full payment of certain other fees such as contributions to advertising and marketing funds for the balance of the term is also an unfair contract term. The Code requires disclosure of end of term arrangements in Item 17C of Annexure 1. It requires disclosure of any "exit payment"

(g) *Attribution of legal costs* – Clauses seeking to attribute legal costs to the franchisee are also considered to be unfair. The Code currently requires disclosure of this obligation and is being amended to prevent this attribution from happening in the future. The Code also requires parties to be responsible for their own costs of attending mediation. So whilst such a clause may be unfair, the Code will deal with it.

(h) *Reservation of rights* – In many circumstances franchise agreements grant only specific rights to a franchisee and the franchisor reserves other rights to itself. Many franchisees do not realise the effect on their businesses when the franchisor subsequently seeks to exploit those reserved rights which it is entitled to do. Examples include opening other franchised businesses or corporate units in close proximity to the existing franchised business so they become competitors, franchisors operating parallel brands that compete against the franchisee (either through other franchisees or corporate units).

(i) *Non-renewal* – Most franchise agreements are for a fixed term and may contain an option or right to apply for a renewal for a renewal term. Sometimes these periods are concurrent with a lease term. In some cases if no lease renewal is offered in the lease the term may simply be a single fixed term and any renewal dependent on securing a new lease at end of term. Franchisees often argue that they should be entitled to seek an extension of their franchise agreement (or new agreement) at end of term if they have otherwise complied with the terms of their agreement. The Code has dealt with this issue and now will provide an alternative form of relief to a franchisee for non-renewal. So whilst a non-renewal clause may appear unfair there is a remedy afforded to a franchisee that either involves a form of compensation being paid or non-enforceability of a restraint of trade. The Code should be left to deal with renewal and non-renewal issues.

(j) *Supplier arrangements* - it is common for franchisors to seek to approach the ACCC for approval of supplier arrangements which are often granted. Franchisees often argue that these supplier arrangements and their obligation to acquire goods or services from these approved suppliers are "unfair" for a variety of reasons including that the franchisor or its associate receives a rebate or financial benefit from supplies made to the franchise network. These claims of unfairness are despite the fact that the franchisor is obliged to obtain (and has sought) protections under the CCA to include such a term in its franchise agreement. Currently the test for approval by the ACCC does not involve a fairness test but is based on whether the likely benefits from the conduct will outweigh the likely public detriment. It is not clear if a clause that requires compliance by a franchisee to comply with supply arrangements could therefore be an "unfair contract term" and subject to the UCT protections even if it were allowed to stand through the notification/authorisation process by the ACCC.

Application of Motor Dealers and Repairers Act 2013

In NSW the *Motor Dealers and Repairers Act* 2013 (the NSW Act) contains certain unfair contract terms protection that are based on parts of the ACL including some of the examples of unfair contract terms. Part 6 of the NSW Act gives certain motor dealers selling new motor vehicles the rights in relation to "*unfair contract terms*" and "*unjust conduct*" that arises from implementing those terms.

The legislation does not apply to all "*motor vehicle dealership agreements*" as the definition of "*motor vehicle*" in the NSW legislation is different to the Franchising Code of Conduct.

For example in the NSW Act definition of *motor vehicle* expressly includes trailers (such as caravans and trailers) whereas in the definition of motor vehicle in the Code its application to trailers is less clear. In addition there is no requirement to show it is a *standard form contract* in the application of Part 6. It simply must be a "supply contract" which is a defined term and means a contract (including documents forming part of, or referred to in , the contract) (which would arguably include operations manuals) that exists between a supplier (manufacturer or distributor) of new motor vehicles and a dealer.

The test of whether a term in a supply contract is "unfair" in clause 142(1) of the NSW Act is modelled on many (but not all) of the examples of unfair terms in the ACL.

There is also a right for a motor industry group (representing dealers) to have standing to seek relief for as well for a "class" or "classes" of supply contract.

As a consequence of any extension of the UCT protection under the ACL to franchise agreements (specifically to certain dealership agreements) there is likely to be an overlap with this NSW Act which may result in:

(a) arguments as to which law should apply – and uncertainty because the NSW Act seems to confer greater powers for franchisees (and motor industry groups) to seek a wide array of orders from a Tribunal – not just limiting the relief to voiding a contractual term;

(b) forum shopping where it is more likely a dealer may approach a tribunal in NSW for other orders is wider than the ACL remedy of the clause simply being void.

A practical example would be that a motor industry group may obtain an order from a State Tribunal under the NSW Act but have no right to interfere in respect to the contractual dealings between the parties to the agreement in respect of a claim that a term is an "unfair contract term" under the ACL.

If other States seek to follow the NSW Act and give similar relief then there is a serious question whether the ACL should apply to those *supply contracts*. Note also that there is no prerequisite for the supply contract under the NSW Act to reach a threshold test of being in a "standard form".

We are happy for the submission to be published and would be pleased to be involved in any public forums, conferences and consultations with respect to the paper.

If you have any further queries, please do not hesitate to contact our Policy Solicitor Ms Louise Pennisi on l.pennisi@qls.com.au or (07) 3842 5872.

Yours faithfully

Ian Brown
President