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Review of Unfair Contract Term Protections for Small Business

21 DECEMBER 2018

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to make a submission in relation to the Treasury Discussion Paper on the Review of Unfair Contract Term Protections for Small Business.

The IPA is one of the three professional accounting bodies in Australia, representing over 35,000 accountants, business advisers, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants but also small business and their advisors. The IPA was first established (in another name) in 1923.

The IPA-Deakin SME Research Centre submission has been prepared with the assistance of the IPA and the Faculty of Business and Law, Deakin University. The IPA-Deakin SME Research Centre Submission has benefited from consultation with Rachel Burgess, Researcher, Deakin SME Research Centre and Phil Chapman from Lease1.

We would welcome an opportunity to discuss this submission at your convenience. Please address all further enquires to Vicki Stylianou at vicki.stylianou@publicaccountants.org.au or on 0419 942 733.

Yours sincerely

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Review of Unfair Contract Term Protections for Small Business – Submission

The Unfair Contract Terms provisions were introduced into the *Competition and Consumer Act* with effect from 1 July 2010 and were extended to apply to small business with effect from November 2016. This was a welcome extension of the provisions, supported by the IPA-Deakin SME Research Centre. The ACCC has been active in pursuing cases of alleged unfair contract terms with positive results (see for example, *ACCC v JJ Richards & Sons Pty Ltd* [2017] FCA 1224). However, further reform is required:

1. The consequences for including an unfair contract term in a standard form contract are inadequate to provide a deterrent effect.

2. Consideration needs to be given to whether the dual requirement of a 'small business contract' as well as a 'standard form contract' is needed. Clarity around the definition of a small business contract could remove the need for restricting application of the provisions to only 'standard form contracts'. It is also worth considering whether an additional prohibition against 'unfair trading practices' is required.

3. Improvements are needed to ensure that small businesses are aware of their rights and are able to access justice.

1. Consequences of breach of unfair contract term prohibition are inadequate (Discussion Questions 7, 9)

As currently drafted, the unfair contract term prohibition has little deterrent value for parties who include unfair terms in their standard form contracts. The consequence of a term being found to be unfair is a declaration that the term is void. In practical terms, the ACCC has also sought orders that the party does not rely on the terms in existing contracts, does not include the terms in future contracts and publishes a corrective notice. In a recent case, the ACCC has sought an order for consumer redress (see the pending case against Ashley & Martin[1] as yet undecided by the court). Although it is recognised that these sorts of orders will result in unfavourable media attention, it is unlikely that bad publicity alone will incentivise parties to review and amend unfair contract terms in their contracts.

The deterrent effect could be improved if a declaration that a term is 'unfair' also exposes the party to payment of a pecuniary penalty (as is the case with other consumer law provisions such as misleading conduct/false representations and unconscionable conduct). The IPA-Deakin SME Research Centre supports the *Treasury Laws Amendment (2018 Measures No.3) Act 2018*) which increased the

[1] https://www.accc.gov.au/media-release/accc-takes-action-against-ashley-martin-for-alleged-unfair-contract-terms

penalties payable under Australia's consumer law to align with the competition provisions. This will give the courts the ability to impose significantly higher penalties for breaches of Australia's consumer law. These penalties could be extended to apply to breaches of the unfair contract term provisions.

2. Practices not caught by the UCT provisions as currently drafted (Discussion Questions 3, 7, 9)

There are a range of practices engaged in by larger businesses to the detriment of small business for which there is currently no adequate remedy.

In a submission to the Competition Policy Review in 2014, the IPA identified a range of unfair price situations that did not have the protection of either the unconscionable conduct or unfair contract terms provisions (as then in force):

a. when goods or services are in short supply as a result of supplies being disrupted by a natural disaster or strike;
b. when alternative supplies of goods or services are not available to a particular business, at all or within a reasonable time, and advantage is taken of a business's urgent need for them;
c. when a supplier has only one significant customer who uses its monopsony power to force that business to accept an unfair selling price, or contribute to the (dominant) customer's retail marketing efforts;
d. when advantage is taken of a business's inability to obtain supply elsewhere to extract an additional payment in respect of past supplies; and
e. when advantage is taken of an existing tenant's investment in good will or fit-out when negotiating a renewal of the tenant's lease.

The extension of the unfair contract term provisions to small business contracts in 2016 does not fill this gap if the contracts are not standard form or the contract value exceeds the relevant threshold.

The IPA-Deakin SME Research Centre is aware of practices frequently used by stronger market players in negotiations with small businesses that are unfair and not covered by the unfair contract term provisions. The case study provided by Lease1 illustrates this point.

> ***Lease1 Case study***
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> Advantage Retail Management Pty Ltd (T/A Lease1) was formed in 1997 to represent retailers in the area of retail tenancy leases and to tackle the inequities between landlords and lessees. The company has been actively involved in the reforms of retail shop lease legislation/regulations on behalf of retail industry stakeholders since 1999 and was a noted contributor to the *Productivity Commission Report and Recommendations 2008*.
>
> Lease1 is endorsed as a service provider to the members of the Pharmacy Guild of Australia, Australian Retailers Association, Restaurant & Caterers Association and members of the Franchise Council of Australia. The company also manages retail lease portfolios for franchisors and chains.
>
> The managing director of Lease1 stated: "Our role on behalf of these peak retailer industry stakeholders is to initially provide free advice and initial support for their members on any matter relating to retail shop (commercial) leases and the lessee/landlord relationships and dealings." Lease1 receives daily calls from retailers/lessees from all categories of retailing and from all regions of Australia. This includes the broad spectrum of retail marketplaces, from standalone/strip locations, through community and regional shopping precincts, to the super-regional shopping centres and town centres.

The company is, therefore, uniquely positioned to comment on actual coal-face issues that the retailer/lessee sector experiences every day. Although robust retail lease legislation exists across all states and territories that have harmonised minimum lease standards, deficiencies in achieving fairness on a reasonable commercial basis still exist.

Numerous (current and past) members/clients of Lease1 were contacted to provide details of their particular situation as evidence towards clearly identifying these deficiencies. Although each saw the benefit of such identification, they all remained restrained by the fact that identifying details about their lease disputes and outcomes may have significant repercussions with regard to future lease dealings with landlords.

This has always been an issue. To protect business members from landlords (or their agents), Lease1 does not publicly post business members' testimonials relating to the outcomes achieved on their behalf. The company is, hence, somewhat restricted when it comes to reviews of retail lease legislation, inquiries into the market for retail leases and reports on the functionality and fairness of the commercial dealings between lessees and landlords, due to a reliance on case examples.

When applying an arm's length view of the main issues, from the perspective of a reasonable and business-savvy person, on the 'fairness' of a retail lease contract/dealing, there are presently four recurring categories that the retail shop leases (RSL) legislation does not cover adequately:

a. End of lease provisions (lease expiry and continuation of business)
b. Duplication of permitted use
c. Demolition clauses and limited compensation
d. Market rent reviews at lease option (excluding QLD and NSW)

a. End of lease provisions

Any contract for lease has, as its primary essential terms, commencement and expiry dates. The core issue, particularly in shopping centres, is that the level of capital investment in attaining the landlord's approval for fit-out design cannot be reasonably amortised over the term of the lease. This leaves the lessee wholly vulnerable at lease-end, as they have a remaining debt facility over the fit-out, from which they cannot walk away. This is leveraged by the landlord to enter into a renewal of the lease at rental rates that would otherwise not be achieved in a fair and open market.

Added to the amortisation of the initial fitout is the loss of the business goodwill that again may be leveraged by the landlord in taking the opportunity to lease these premises to direct competitors who are prepared to pay a premium in rent with the knowledge of the incumbent lessee's goodwill value and no consideration required for the value of the business. Landlords are strategically positioning themselves to benefit directly from the goodwill established from the lessee's investment in capital and effort. This scenario is common industry practice, with landlords' planning and facilitating predatory competitor outcomes, usually without the knowledge of the Lessee and up to two years prior to the lease expiry.

Case: Pharmacy 1

Pharmacy 1 is a business that has been located in the same premises for 18 years, with its second 10-year lease expiring in two years' time. The business is professionally run and has never breached its lease. It employs 21 people (full-time and part-time), including pharmacists, pharmacy assistants and retail shop staff. The business turns over several million dollars and is valued as an asset accordingly. The landlord, without prior notice, wrote to the owners advising that Pharmacy 1 will not be offered a new lease in two years.

Within days of this notice, the owners are contacted by a national pharmacy discount chain (which has no previous ties to this community) advising that it will be taking over the premises in two years. The lessee has not been offered the opportunity to negotiate to match the new commercial terms. The new lessee will gain significant goodwill, without fair and reasonable consideration to Pharmacy 1 as a long-standing, successful business.

Outcome:

With the restrictions of having to move the pharmacy at least 500 metres, and with no suitable premises prospectively available, this business will more than likely close in 18 months, realising a total loss in excess of $3 million. This figure is the equivalent of the joint owners' superannuation. It means the owners are likely to have to continue working well into their 70s.

b. Duplication of business / permitted use

This is an area about which much has already been published, as a result of the Sumo Salad v Westfield disputes which played out during 2016 and 2017. Sumo sought to have several of its commercial lease terms reviewed, based upon the mass duplication of similar types of business being introduced into the respective shopping centres. These duplicate businesses took Sumo's sales and significantly increased the occupancy cost for its stores. The real issue relates to permitted uses being directly duplicated in close isolation, rather than across a broad retail category such as 'takeaway food'. These direct duplications do not take into account the commercial landscape for the incumbent, who has usually paid a premium in rent and capital to achieve a suitable return on investment, based on the sales and market conditions at the time.

With the landlord introducing a direct competitor, it is effectively diluting the incumbent's business overnight, without regard to reviewing or adjusting the commercial terms to match the immediate change in the primary market and business opportunity. Although retail leases will include clauses that provide the landlord with the right to lease premises to any type of business without exclusivity, there is no mechanism of fairness in the contract to bring these significant changes into review. This often leads to the failure of the incumbent which, in turn, results in the landlord's further opportunity to churn the previous lessee's site and goodwill, again without having invested in the benefit.

Case: Pharmacy 2

This business has traded in the current location for the past 12 years and employs 19 staff, including pharmacists, pharmacy assistants and retail shop staff. The business turns over several million dollars and is valued as an asset accordingly. The business is two years into a 10-year lease and the owners seek to re-brand and refit the pharmacy, which will require an outlay of $500,000. Presently, there is only one pharmacy in this shopping centre. The owners present their business case to rebrand and seek approval for their fit-out design. The landlord has significant input into the level of the fit-out, which adds to the capital expense of the project.

Three months after the pharmacy completes its rebrand and fit-out works, and is starting to realise the benefits in sales growth, the landlord introduces a second pharmacy into the centre. Immediately, sales drop to levels below those achieved of the previous two years, before the $500,000 investment. The lessee is now left with an unsustainable occupancy cost and a loan that cannot be supported. At no stage did the landlord reasonably advise that it intended to duplicate the permitted use and, in fact, was party to the level of capital investment the business would incur through its fit-out design approval processes, which compounded the outcome.

In such cases, it is only reasonable and fair, if the Landlord is party to a significant change in the trading market, that they also be held to review the corresponding commercial outcomes to allow profitable trade.

Outcome:

The lessee is seeking rent relief from the landlord, and is trying to sell the business at a significant loss of several million dollars to clear the debt for the shop fit-out. It has already been put on notice by its bank in relation to loan covenants. Regardless of the outcome from the landlord, without a sale of the business, the owner will have to sell the family home.

c. Demolition clauses

Presently, RSL legislation nationally does not provide adequate compensation to lessee's when the landlord seeks to repurpose a building with the demolition of the leased premises. The current legislation only provides for the depreciated (or written down) value of the lessee's shop fit-out at the time of the demolition notice.

Firstly, this falls well short as, regardless of book value of a lessee's fit-out, there remains an operational in situ value of fixtures and fitout. Further, it does not take into account the financial facility or loans remaining over the fit-out. Secondly, compensation does not provide for the value of goodwill the business has built from trading at the location. The situation is wholly uncommercial and unfair, and does not consider the costs (both financially and physically) in re-establishing the business elsewhere, if that is at all possible.

Regulated and licensed businesses, such as pharmacies and licensed post offices (or other franchises that depend on set trade territories) may not be able to secure an alternative location. Particularly for pharmacies, for which 'location rules' are highly restrictive, a demolition notice has the likely effect of a multi-million dollar business being compensated for as low as only tens of thousands of dollars, and incurring losses that are unrecoverable.

d. Market rent reviews at lease options

Where a lessee has a lease that provides for options for further term(s), the industry norm is that the rent for the first lease period (year) of the new term will be reviewed to market. Over the past 20 years, reviews of the RSL legislation has resulted in amendments so ratchet mechanisms that prevent market rent reducing from the current are now void.

The issue is that the process of the parties entering into negotiations or a determination on market rent is predicated on the lessee first exercising its right for the further lease term which, once acknowledged by the landlord, becomes binding on the parties. The practice, if reasonable and fair, should involve the parties seeking to understand their respective outcomes as to the market rent before the lessee commits to the new term.

However, the RSL legislation is flawed in that there is no provision for the parties to resolve market rent before the lessee exercises its option. This has the risk of the lessee being locked into a rent (in an upswing market) that cannot be sustained.

Fortunately, we have been successful in recent reviews of the RSL Acts in Queensland and NSW to introduce 'early determination of market rent' provisions, which unfortunately leaves lessees in the remaining jurisdictions left in the antiquated situation of "signing the contract to buy the car, receiving the keys, and then being told the price".

It should be noted that, even in Queensland and NSW, the onus is on the lessee to fully understand their rights and the timing of early determination of market rent under these Acts. Most do not and the system unfairly leaves the lessee exposed to the process that favours the landlord. A sound solution here is to have the process of market rent reviews at lease option determined prior to a lessee being bound to the option period, if the rent is unsustainable, as a mandatory minimum lease standard nationally.

Case: Licensed post office (LPO)

The LPO (and sub-newsagency) has been trading in the same building for over 15 years and is approaching the last of their 5-year options for a further lease term. The business is well run by a family (primarily husband and wife) with between two and four casual staff, depending on the time of year.

Prior to exercising their option for the further lease term, the lessee sought to understand and negotiate the rental the landlord was seeking as market rent. The landlord, via its managing real estate agent, refused to respond. After several formal requests, the lessee was advised that the landlord will only advise the rent they are seeking after the lessee gives notice to exercise the lease option. Effectively, the lessee is locked into a five-year term with no knowledge of what rent they may be liable for.

Outcome:

The landlord sought a market rent increase of 20%. The parties negotiated and a 10% increase was settled on, as the cost of the specialist retail valuer was a barrier for the lessee.

3. Changes needed to address these issues

There are a number of potential changes that could be considered to address these issues:

(a) Improving awareness of the UCT provisions;
(b) Amending the definition of a 'small business contract';
(c) Removing the need for the contract to be 'standard form'; and
(d) Improving access to justice for small businesses.

a. Improving awareness of the UCT provisions (Discussion Questions 4, 7, 9)

In Lease1's experience, many small businesses are not aware that the contract (lease) they are entering into could be a 'standard form contract' which would benefit from the UCT provisions. The legislation helpfully puts the onus on the party alleging it is not a standard form contract, however, if small business is not aware that they can benefit from the UCT provisions, the presumption is redundant.

The ASBFEO *Inquiry into small business lending* provides excellent examples of small business owners being treated unfairly by the banks: see http://www.asbfeo.gov.au/sites/default/files/030217-ASBFEO_Report.pdf. As mortgage contracts are not normally 'standard form', ASBFEO called for the banks to introduce standard form mortgage contracts for small businesses, which would then benefit from the unfair contract terms protections. A similar solution could be sought with retail shop leases.

In addition, there is a need to increase awareness and understanding of the UCT provisions within the small business community. Government supported initiatives and resources, at both federal and state levels, would be beneficial.

b. Amending the definition of 'small business contract' (Discussion Questions 1, 2)

The current definition of 'small business contract' contains two thresholds:

(i) Less than 20 employees (which is consistent with the ABS definition); and
(ii) The upfront payment under the contract is less than $300,000 or $1 million if the contract is for more than 12 months.

The IPA-Deakin SME Research Centre is generally supportive of a definition that contains multiple criteria as research undertaken by Deakin University shows that the inclusion of several criteria to support definitional correspondence leads to more reliable outcomes.

To remain as consistent as possible with existing criteria, a 'small business' contract could be defined as a contract entered into by a business which satisfies two of three criteria:

i. less than 20 employees (based on the ABS definition) or 100 employees (based on the ASBFEO definition);
ii. up to $10 million revenue, based on the ASBFEO definition and the proposed collective bargaining class exemption (the IPA-Deakin SME Research Centre notes that the ACCC is proposing for the collective bargaining class exemption to apply to businesses with a turnover of less than $10 million, on the basis that collective bargaining between these sized businesses is unlikely to distort competition); or
iii. the value of the contract does not exceed $3,000,000 in any 12 month period, to be consistent with the current collective bargaining notification provision.

As most small businesses will satisfy the first two criteria, the value of the contract will be largely irrelevant.

c. Removing the need for the contract to be 'standard form' (Discussion Questions 4)

If the definition of small business contract is amended to create more certainty, the unfair contract term provisions could be extended to cover **all small business contracts**, not just standard form contracts. This approach would appear to be consistent with the ACCC's intended approach to make the collective bargaining class exemption applicable to all small businesses that have a turnover of less than $10 million. Small businesses will have the certainty of knowing that any contract entered into will benefit from the UCT provisions (provided they satisfy the definition of a 'small business contract').

d. Improving access to justice for small businesses (Discussion Question 9)

Ultimately, the ability of small businesses to benefit from the UCT provisions depends on their ability to access justice. The IPA-Deakin SME Research Centre considers that this is the next key area for development by government. (The IPA-Deakin SME Research Centre notes the inquiry currently being undertaken by the ASBFEO into access to justice issues for small business.)

Potential solutions need to be affordable, simple and not take much of a small business owner's time. It will be vital that small business owners know where to access information on their legal rights and the options available for resolving a dispute. Possible solutions to be explored may be court-based (such as fast track procedures, online ADR or court processes, or increasing the jurisdiction of the small claims tribunals) or non-court-based (such as increasing education or compensation schemes). Further

work is required in this area. The IPA-Deakin SME Research Centre can provide further information, upon request.

e. Other issues to be considered (Discussion Questions 8, 9)

The IPA-Deakin SME Research Centre recommends including a contractual term that specifies an unfair price as being an 'unfair term' in section 25 of the Australian Consumer Law. This issue has been raised in previous IPA submissions[2].

In addition to the changes suggested above, a wider prohibition against unfair practices could be introduced into Australia's consumer law. The potential need for a general prohibition against 'unfair trading practices' was raised in the *Australian Consumer Law Review Final Report* (2017) with the recommendation that further consideration be given to this issue by Consumer Affairs Australia and New Zealand. The IPA-Deakin SME Research Centre supports this recommendation.

[2] IPA, *Submission to Competition Policy Review*, June 2014, p 4