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The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Mr Hawkins,

Trade Practices Amendment (Australian Consumer Law) Bill 2009 - Unfair Contract Terms

Thank you for your invitation to provide comments to the inquiry into unfair contract terms arising from the *Trade Practices Amendment (Australian Consumer Law) Bill* 2009 (the **Bill**) referred by the Senate to the Senate Economics Legislation Committee on 25 June 2009. We note that the Bill seeks to amend the Trades Practices Act 1974 to establish and apply the Australian Consumer Law and to amend the consumer protection provisions of the Australian Securities and Investments Commission Act 2001 (**ASIC Act**).

The Australian Institute of Company Directors (AICD) is the second largest member based director association worldwide, with over 24,000 individual members drawn from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, and government and semi-government bodies. As the principal professional body representing a diverse membership of directors, we offer world class education services and provide a broad based director perspective to current director issues in the policy debate.

1 Summary

The AICD supports the national harmonization of consumer legislation, in circumstances where it leads to greater clarity for company directors as to the law with which they must comply and where it has the capacity to improve the business environment within which companies and their directors operate. Despite this, the AICD expresses strong reservations as to the introduction of the Bill on the basis that the proposed unfair contract provisions have the potential to create uncertainty for companies and cause price increases for consumers.

In summary the AICD's key concerns in respect of the Bill include:

- the provisions have the potential to introduce uncertainty for companies and their directors as to the enforceability of contractual terms;
- many of the key terms in the proposed provisions lack clarity and will only be understood after judicial interpretation, making it difficult for directors to determine whether their company's contracts comply with the provisions;
- material detriment is not an element of the proposed unfairness test;
- the provisions will render it increasingly difficult for directors to assess, allocate and manage risks arising from contractual arrangements, which will necessarily translate into higher prices for consumers;

- the provisions have the potential to increase litigation, the burden of which will be borne by companies, diverting the time and attention of boards and management away from other strategic business decisions which increase wealth, jobs and income tax revenue in the long term; and
- the provisions have the potential to impose personal liability on directors for the acts of the company, discouraging talented people from accepting directorships and adding to the already overwhelming number of laws at a state and federal level which create director liability.

Although the AICD has strong reservations about the inclusion of unfair contract provisions in the Trade Practices Act and the ASIC Act, if the Government decides to proceed with the Bill the AICD:

- supports the exclusion of business to business transactions from the scope of the Bill;
- supports the exclusion of constitutions of companies and managed investment schemes from the scope of the Bill; and
- recommends that "material detriment" be included as an element of the unfairness test.

A discussion of each of these issues is set out in more detail below.

2 The Bill is likely to erode certainty of contract

A vital component of a healthy and prosperous economy is the ability for consumers and businesses to enter into transactions with the understanding that any agreement made will be enforceable and that each party will live up to the obligations to which they have freely entered. Enforceable, low cost and impartial contractual procedures "enhance predictability in the system by restraining opportunism among contracting parties. This reduction in uncertainty decreases the cost of exchange and promotes transactions."[1]

Standard form contracts therefore play an important role in the Australian economy by ensuring that enforceable bargains can be made by companies with a minimum of delay, cost and risk, allowing goods and services to be offered to consumers efficiently and at lower prices.

Any erosion as to the uncertainty and enforceability of contractual obligations will have the effect of causing the product or service the subject of the contract to assume more risk. As risks increase, they will be factored into the price of the product. It follows that any wholesale changes to the certainty of business to consumer transactions will have the potential of increasing the prices at which consumers are offered goods and services, adding to inflationary pressure.

3 The Bill lacks clarity on key terms

The unfair contract provisions included in the Bill are likely to create uncertainty in business to consumer standard form transactions because many of the key terms lack clarity and because the scope of key provisions will largely require and depend upon the width of judicial interpretation. In order for the Bill to be confined to contracts that are truly standard form

[1] Satu Kahkonen and Patrick Meagher *Contract Enforcement and Economic Performance* IRIS Center, University of Maryland, May 1997.

contracts with consumers, the provisions and definitions must be precise and targeted.[2] Unless this occurs, the legislation is likely to become unwieldy and lead to unintended and possibly perverse consequences.

The AICD is concerned that as drafted, key terms of the Bill remain unclear and that directors will find it difficult to assess whether their company's contracts comply with the provisions. In practical terms, even if companies devote significant time, cost and effort to review and amend contracts they consider to be standard form contracts it will not be clear which contracts actually fall within the provisions. Further, it will not be clear whether any amendments made by companies to their standard form contracts will be sufficient to ensure compliance with the new provisions. We set out below, examples of terms where the drafting is likely to create uncertainties for companies.

3.1 Standard Form Contract

The Bill does not tightly define the meaning of "standard form contract" making it difficult to determine which contracts fall within the scope of the Bill. Instead, the Bill presumes that a contract is a standard form contract unless another party to the proceeding proves otherwise. Whilst the AICD supports the exclusion of the constitutions of companies and management investment schemes from the scope of the Bill, such exclusions may not be necessary if the definition of standard form contract was precise. This open-endedness and uncertainty in drafting cannot in AICD's view be in the best interests of an affluent and productive economy.

Although the provisions list certain factors that a court must take into account when determining whether a contract is a "standard form contract" the parameters of these provisions will remain unclear until judicial interpretation occurs and may change depending on whether "any other matters" are prescribed by the regulations. In addition, a court may also take into account any other matter it thinks relevant.

The AICD cautions that without a precise definition of "standard form contract" or until judicial interpretation is forthcoming, companies and their directors will be required to take "educated guesses" to determine which contracts fall within the scope of the Bill. Presumably, a standard form contract will need to be a written agreement, although it is not clear from the current drafting whether the scope of the Bill is even confined in this way. It is anticipated that an unintended consequence of the Bill will be to classify a greater number of contracts over time as "standard form contracts" than those currently intended to fall within the scope of the Bill.

3.2 Unfair

The AICD has concerns about the adequacy of the unfairness test included in the Bill. First, it is unclear why "material detriment" has not been included as an element of the unfairness test and secondly it is anticipated that any inquiry into what is in the "legitimate interests" of a party advantaged by a term may not be straightforward.

[2] The Productivity Commission in its April 2008 report entitled *Review of Australia's Consumer Policy Framework* (Volume 2, 403) noted that proper design of any unfair contract provision regime would include limits to its application, clear definitions of, and guidelines about unfair terms.

Material Detriment

The Bill provides that a term of a contract is unfair if "it would cause a significant imbalance in the parties' rights and obligations arising under the contract" and "it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term." The Bill does not require that a consumer have suffered any material detriment as a result of the term in order for it to be rendered unfair. Although "detriment" must be considered by Courts in determining whether a contractual term is unfair it is not an *element* of the unfairness definition.

The AICD recommends that if the government intends to include the Australian Consumer Law in the Trade Practices Act and to make corresponding changes to the ASIC Act, the definition of "unfair" should at the very least be amended. The definition of "unfair" should include as an element, that a party must have suffered material detriment (or that there is a substantial likelihood that the party will suffer material detriment) as a result of the enforcement of the term. In its April 2008 report into Australia's consumer policy framework, the Productivity Commission recommended that for a term to be unfair there must be material detriment to consumers (individually or as a class).[3] Despite this recommendation the Bill contains no such requirement.

Legitimate Interests

The AICD is also concerned as to how Courts will be able to accurately determine what is "reasonably necessary in order to protect the legitimate interests" of the party who would be advantaged by the term. At present the Bill does not define or provide any guidance as to the meaning of the term "legitimate interests."[4]

Before companies offer products or services to consumers, the board and/or management will take a range of commercial factors into consideration. These factors will determine the structure and price of the product or service and the contractual terms upon which the product or service will be offered. These factors include (and are not limited to), the risk portfolio of the company, company strategy, budgeting, insurance considerations, the position of competitors, marketing, profit margins, the company's product range, the company's experience with consumer default, returns to shareholders, and legal considerations.

Companies may choose to take more risk on particular products knowing that this risk is balanced by the sale of other products at less risk on strict standard terms. Companies may also choose to experiment and innovate with new product offerings knowing that a steady and risk adverse stream of income is flowing from products offered on standards terms. As a result, requiring courts to review one contract in isolation to determine whether a term is "reasonably necessary to protect the legitimate interests" of a company may be susceptible

[3] *Review of Australia's Consumer Policy Framework*, Productivity Commission Inquiry Report, April 2008.
[4] The Explanatory Memorandum (at 19) states that the provision would "require the respondent to establish, at the very least that its legitimate interest is sufficiently compelling on the balance of probabilities to overcome any detriment caused to the consumer or a class of consumers and that therefore the term was reasonably necessary."

to error. In some circumstances an understanding of the company's entire business strategy and risk portfolio may be required.[5]

For good reason, courts have expressed their reluctance to interfere with the commercial judgment and strategic decision making of boards and management on these issues. Further, by including a rebuttable presumption that a term is not reasonably necessary to protect the legitimate interests of the party advantaged by the term, the Bill will place an undue evidentiary and cost burden on companies.

In summary, it is anticipated that assessing whether a term is in the "legitimate interests" of a party may be a complex inquiry and have the unintended consequence of requiring courts to consider commercial and business judgments in a vacuum, leading to unsatisfactory outcomes.

4 Increase in Litigation

It is anticipated that the unfair contract provisions in the Bill will cause an increase in contractual disputes and litigation between businesses and consumers. This is likely to occur, not because there is evidence suggesting the widespread use of "unfair terms" by companies in standard form contracts, but because key provisions of the Bill lack clarity and because consumers are not required to show that they have suffered any detriment as a result of the term alleged to be unfair.

The AICD is concerned that another unintended consequence of the Bill will be the avoidance by consumers of contractual obligations, or the delay in the performance of contractual obligations by consumers, on the basis that a term is "unfair" in circumstances where the obligation has instead become disadvantageous or inconvenient.

Litigious claims founded on inconvenience, negligible or trivial detriment place an undue cost burden on businesses and cause boards of companies to be distracted by litigation rather than focusing on the commercial and strategic issues discussed previously. Further, if individual consumer actions or consumer class actions increase as a result of the Bill, the costs of the litigation will largely be borne by companies. This is particularly so given that each reverse onus of proof included in the Bill, will place a greater evidentiary and discovery burden on companies. The AICD questions whether this is "fair" from a supplier's viewpoint.

We note that the Bill does attempt to confine the reach of the unfair contract provisions by excluding terms that "define the main subject matter of the contract" and "set the upfront price payable" from the scope of the Bill. Despite this, the scope of the proposed legislation will inevitably turn upon the width of judicial interpretation given to these terms and others.

In other contexts, well meaning attempts to incorporate "unfairness" provisions into legislation and to confine these provisions to addressing real instances of "unfairness" have instead resulted in ongoing litigation that extended well beyond the matters intended to be cured by the enacting legislation. In this regard we refer the Committee's attention to the experience of the

[5] In this regard it is noted that the Explanatory Memorandum (at 19) states that the "respondent may introduce any evidence relevant to this element of the test."

unfair contract provisions in the *NSW Industrial Relations Act* 1996 (NSW) and in particular the evolution of section 106 (formerly section 88F) of that Act.[6]

5 Penalties

The Bill appears to provide that once a term has been prohibited by the regulations or declared unfair by a court, it will be a contravention of the Australian Consumer Law or the ASIC Act for a person to apply, or rely on, or purport to rely on, that term. It is unclear to the AICD how imposing penalties on persons who attempt to apply, rely on, or purport to rely on, a void term will protect consumers from "unfair" contractual terms. If a term of a contract is void, the term is simply unenforceable. The consumer is under no obligation to abide by a void term regardless of attempts made by any other party to enforce it or to rely upon it.

We note that the Act does not state that it will be a contravention of the Australian Consumer Law for a *party to a contract* to apply, or rely on, or purport to rely on a term prescribed to be unfair, instead the word "person" is used. The use of the word "person" and the extension of the enforcement and remedial provisions to "persons involved in a contravention" have the potential to impose personal liability on directors for acts of the company.

Further, the Bill creates a risk that directors could be disqualified from managing a corporation if their company purports to rely on a prohibited term.[7] Such provisions highlight the disconnect between the imposition of liability on directors and an understanding of the role directors are supposed to carry out. It is not in the interests of a prosperous economy for directors to devote their time to reviewing every term of every contract their company has entered in order to avoid personal liability. The role of the director is to focus on strategic issues and to identify avenues of wealth creation.

Presently, there are at least 660 laws that impose personal liability on directors. The AICD is concerned that the continual introduction of provisions that impose personal liability on directors for acts of the company, will continue to discourage talented people from accepting directorial positions. The Hon Dr Craig Emerson MP was recently reported to have said "The basic issue is the concern that we could be making life so difficult for company directors that nobody would want to be a company director…we need a balance in our corporate laws between promoting accountability and ensuring suitable people are willing to serve as directors and take appropriate business risks."[8]

The AICD is also concerned that the Bill allows terms to be "prohibited" by way of regulation. The concept of "unfairness" is subjective, in one context a term which is "unfair" could be completely fair in another situation. On this basis the AICD cautions that if in the future, terms are ear marked to be prohibited by way of regulation, adequate notice and consultation in

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[6] See for example, *Canzizales v Microsoft Corporation & Ors* (2000) 99 IR 426, 427, 428. In that case, the court noted that it was a current zenith in cases brought pursuant to section 106 of the NSW Industrial Relations Act and that the applicant, a senior executive of Microsoft Corporation, was seriously advancing a claim for more than $14 million dollars in compensation for loss. The court noted that the applicant was not a person who was bargaining under some restraint or inequality or who was being oppressively exploited and that the facts of the case hardly suggested unfairness. Despite this, the court noted that the jurisdiction had developed to a point where the view that courts should not interfere with bargains freely made by a person under no restraint or inequality had been overreached by the provisions of section 106(2) of the Act. Even though the contract was exceedingly generous in an objective sense the contract could be unfair in the statutory sense because of the manner of termination.

[7] This would depend upon whether a director is deemed to be a "person involved in a contravention."

[8] *Directors remain trapped in liabilities jungle,* Australian Financial Review, July 25-26 2009 at 62.

regard to the proposed prohibitions should occur. In addition, adequate time should be provided for companies to review and remove any prohibited terms identified in their contractual templates. Unless such a process is rigorously followed, there is a risk that companies and directors could be subject to liability without having had time to adjust to the changes.

6 Risk assessment and allocation

To ensure companies are sustainable enterprises directors need to have systems and mechanisms in place to identify, assess, manage and allocate risk (a factor often mentioned in the analysis of the global financial crisis). Where the contractual landscape is uncertain, it is difficult for companies to balance the risk of loss and the opportunity for gain presented by a particular transaction. Further, it is difficult for companies and their directors to predict with any certainty which transactions will pose the most significant risks to the company's business.

The AICD is concerned that an unintended consequence of the Bill will make the identification and assessment of risk more difficult for companies and directors. For example, it is difficult for companies to mitigate risk by amending standard form contracts if it is unclear which contracts fall within the scope of the Bill and whether any amendments actually made will be sufficient to avoid a term being rendered "unfair." This is likely to occur for some time and even after any decided cases are forthcoming, given that these may be confined to their particular facts.

As examples, a company may also perceive that a product or service is more susceptible to risk if:

- it is unclear whether contractual terms are enforceable;
- the laws by which the contracts are governed lack clarity;
- the costs of complying with the governing law are high;
- the laws or regulations governing the transaction are likely to change;
- there is a greater propensity or opportunity for the other party to avoid contractual obligations;
- there is an opportunity for another party to the contract to delay the performance of contractual obligations;
- there is a low threshold to be met before one party can initiate legal proceedings in respect of the transaction;
- the cost of legal proceedings is expected to be high and will be borne largely by the company;
- the costs of insurance will increase in respect of the product or service; or
- the laws governing the contractual obligations may impose personal liability on directors for acts of the company.

If the Bill, in attempting to protect consumers, has the effect of increasing the risk for companies who offer products or services through standard form contracts, these risks will immediately be factored into the prices of goods and services or even the supply of such goods. The AICD reiterates that the cost of these increased risks will necessarily be shouldered by consumers in the form of higher prices or the supply of such goods may be withdrawn.

7 Cost of compliance and time for transition

The AICD recommends that if the Bill is to be adopted, sufficient time be allowed for businesses to prepare for the changes. The process of reviewing and amending contractual templates and reviewing existing agreements (which may be subject to renewal or variation) is expected to be a time consuming and costly process. Again, the cost of compliance will translate into higher prices for consumers.

8 Exclusion of business to business contracts from the Bill

Although the AICD has strong reservations about the inclusion of unfair contract provisions in the Trade Practices Act and the ASIC Act, should the government proceed with the legislation, the AICD supports the removal of business to business transactions from the scope of the proposed provisions. As set out above, given that the Bill is expected to create significant compliance costs and uncertainties for companies in regard to consumer contracts, extending the scope of the changes to include business to business transactions would only exacerbate these issues.

Further, the AICD remains of the view that as the government has not demonstrated the existence of any detriment to Australian businesses or the economy through the use of standard form contracts it is sensible that business to business transactions continue to be excluded from the scope of the Bill. Generally, businesses are well equipped to seek advice on the terms under which they enter commercial agreements and should be free to enter contracts on terms that are considered to be commercially sensible.

The removal of business to business transactions from the scope of the Bill will allow companies to continue to create efficiencies through the use of standard form contracts and will allow smaller companies to benefit from purchasing goods and services at lower prices. For Australia to remain a centre of innovation and efficiency unnecessary intervention into well established business conduct should not occur. As such, business to business transactions should continue to be excluded from the scope of the proposed Bill.

If you require further information on any of our views please contact me.

Yours sincerely

John HC Colvin
Chief Executive Officer