Unfair Contract Terms:

Practical Steps to Assess and Alleviate Risk of Contravention

Paper by

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This paper is produced as a source of further information for attendees who attended the session at the Franchise Council of Australia's 2016 National Franchise Conference Legal Symposium in Canberra, Australia titled *Unfair Contract Terms: Practical Steps to Assess and Alleviate Risk of Contravention*, in which panellists, Tim Byrne (of the ACCC), Simon Tolhurst and Marshall Bromwich provided considered commentary on the impact and issues that will arise with the introduction of the unfair contract terms regime, as posed by Bruce McFarlane.

The paper sets out information and personal observations which are provided to assist those that will need to deal with the unfair contract terms regime. It is not intended that this paper be an academic study of these issues.

This paper does not share the views of the ACCC.

1 Introduction

The extension of the unfair contract terms regime is significant for both franchisors and franchisees as many of the contracts used in the franchising relationship may now be captured.

Provided that the arrangement between businesses meets the relevant criteria, the regime applies to all: new contracts; pre-existing contracts that are renewed; and terms of a pre-existing contract that are varied, on or after 12 November 2016.

The following assumes that the contract under review is one for the supply of goods or services.

For a contract to fall within the operation of the unfair contracts regime two tests must be applied to the contract. First, the contract must be considered as ‘standard form’ and secondly, the business must fall under the ‘small business’ thresholds with respect to the upfront price payable under the contract and number of employees in the business.

The practical effect of these tests is that the regime may apply to some franchisees in a franchise network and not others. Given that the tests are applied at the time the contract is entered into, it may also mean the regime will apply to new franchisees (even if the new franchisee will not be a

"small business" by the time it commences operations), but not existing franchisees that already have 20 employees at the time of renewing a contract or entering into a new contract.

2 Interpretation of "standard form contract"

There is no express definition of a 'standard form' contract; however, there are several factors that will be considered when determining if a contract falls within this class.

Importantly, there is a presumption that a contract is 'standard form' when there is:

(a) uneven bargaining power between the contracting parties;

(b) the contract was prepared by the stronger party before any discussion;

  (i) the weaker is required to either accept or reject the terms of the contract;

  (ii) the weaker party is given little or no opportunity to negotiate the terms of the contract; or

  (iii) the terms of the specific transaction are not taken into account.[1]

The first step is to determine what comprises the terms of contract under review. Usually this will be easy to identify however in some cases, reference may need to be had to multiple documents to locate the terms that encapsulate the whole of the contract. Don't fall into the trap of merely looking at the standard terms that form part of the contract. To do so may limit your analysis of whether the contract is in fact 'standard form'. The legislation uses words like "a contract", "the contract" and not words like "standard form terms" or "standard form terms and conditions".[2]

This point was made clear in the UCT consumer context in *Ferme v Kimberley Discovery Cruises Pty Ltd*. Jarrett J, referring to the contract constituted by both the booking form, which was individually tailored to each consumer's needs, and the standard terms accompanying that booking form, invited future litigants to test the meaning of "*standard form contract*". His judgment reads:

> *"That each contract was not identical to any of the other contracts was potentially important because ss.23(1)(b) and 27 refer to a standard form contract, not standard form terms or standard form terms and conditions.*
>
> *The reference in [the UTC] to standard form contract might suggest that the whole of the contract must be in identical and immutable terms on each occasion it is used rather than there being variations in the terms.*
>
> *Here, the contracts for each of the applicants were not in identical terms, although the Terms & Conditions formed part of each contract.*

[1] *Australian Securities and Investments Commission Act*, subsection 12BK(2); *Competition and Consumer Act*, schedule 2, subclause 27(2).

[2] Ferme & Ors v Kimberley Discovery Cruises Pty Ltd [2015] FCCA 2384

However, the point was not the subject of argument and I pass from it without further comment."

To constitute a term of the contract there must be some promissory element to it.[3] Without that promissory element, the words used would merely constitute a statement or representation.

In a typical franchise case, whether a document forms part of the franchise agreement or not will depend upon:

(a) the language used in the franchise agreement to incorporate or reference the other document - is it intended, assessed objectively, that the other document form part of the promise;

(b) the language of the other document - does its terms convey the necessary promissory intent. Look for words like "agree", "guarantee", "I will"; and

(c) whether the document has been signed - a party executing a written agreement is bound by it, subject to non est factum, rectification rights4 and now, the application of the UCT.

This process will call upon well settled common law principles of contract formation and interpretation.

Having identified what constitutes the terms of the contract, it falls upon the party asserting that it is not standard form to discharge the onus.

In many cases it will be clear that a document is likely to be used as a standard form contract. At this point in time, however, the bounds of what may constitute a "standard form contract" are still unclear.[5] The outcome in respect of the more marginal cases will largely centre on what the courts eventually determine constitutes an "*effective opportunity to negotiate*".[6]

(a) Will simply stating that a party can negotiate a term but then not allowing for negotiation in practice be enough - unlikely;

(b) Will it be good enough to merely give opportunity to obtain independent legal advice - unlikely;[7]

(c) Will being prepared to negotiate key terms (e.g. the upfront price or subject matter of a contract) but not other terms constitute effective negotiation sufficient to take it out of the realms of a standard form contract?

(d) Do you need to be prepared to change negotiation strategies?

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[3] Hospital Products Ltd v United States Surgical Corp (1984) 156 41

[4] Equuscorp Pty Ltd v Glengallan Investments Pty Ltd (2004) 218 471 at 482

[5] Diab Pty Ltd v YUM! Restaurants Australia Pty Ltd [2016] FCA 43 the Federal Court noted that the international franchise agreement to which Yum and the franchisees were parties, was a "standard form" contract

[6] Section 27(2) ACL sets this out as one of the matters that the court may take into account in determining whether the contract is a standard form contract.

[7] UK Housing Alliance v Francis (2010) EWCA Civ 117

In *Ferme v Kimberley Discovery Cruises Pty Ltd*, the court determined that the contract between a travel business and consumer of the travel business was a standard form contract on the grounds that the consumer did not have an effective opportunity to negotiate the terms of the contract. In reaching this decision, the court noted the absence of:

(a) material to suggest that the consumer could negotiate with the travel business about the content of that contract;

(b) material to suggest that the content of the contract might in any way be varied;

(c) evidence that the contracts, and specifically, the terms and conditions were negotiated and the terms settled separately with each consumer;

(d) evidence that the travel business had ever negotiated in the past with a consumer on a case by case basis to see if some mutually agreeable arrangement could be made; and

(e) evidence that the travel business had ever communicated to potential consumers, their willingness to negotiate.

3 Application of "Small Business" test

A party to a *small business contract* is able to seek relief under the UTC.

A contract will be a *small business contract* where:

(a) the contract is for the supply of goods or services8, or a sale or a grant of interest in land; and

(b) at the time of entering into the contract:

  (i) at least one of the parties to the contract employs less than 20 persons (assessed on a head count basis at the time the contract is entered into, varied or renewed and includes casual employees employed on a regular and systematic basis) (**Small Business Test**); and

  (ii) the upfront price of the contract is no more than $300,000, or $1 million if the contract is for more than 12 months.

It is therefore an important threshold issue to determine whether the party asserting the unfairness of a term is eligible to access the relief under the UTC. Where the question becomes difficult is in circumstances where large corporate groups (e.g. BHP), which could not be considered in any way as vulnerable, structure themselves for a particular transaction or enterprise, so as to have less than 20 employees. Having entered into a contract, can that subsidiary/SPV of the large corporate group assert, post contract, that a particular term they agreed to is unfair and seek relief under the UTC?

[8] distinguish from contracts that terminate the supply of goods or service such as Deeds of Consent entered into when a franchisee leaves the system.

Whether the party satisfies the Small Business Test for the purposes of determining whether the UTC applies, will ultimately turn on the court's interpretation as to what constitutes the 'business'. Is the analysis of the 'business' limited to the corporate entity entering into the contract or will the courts consider whether other corporate entities within the corporate group can be taken into account? Legal opinions on the issue vary.

In a franchising context, this issue may be relevant when analysing contracts with franchisees that are sophisticated multi-unit operators. If these businesses are structured so that each individual franchised business is contained within a separate entity, each of them individually might qualify as a small business.

Where a 'business' is conducted across more than one company in a corporate group, it seems likely that the reference to "*business*" in the definition of "*small business contract*" is intended to allow the number of employees across all of those entities to be taken into account to reach the 20 employees threshold. This conclusion draws upon basic statutory interpretation principles:

(a) Had Parliament intended otherwise, it would presumably have used the terms 'corporation' or 'person' as used in all other provisions of the ACL or *Competition and Consumer Act (Cth)* 2010; and

(b) The ACL, which includes the UTC, is beneficial legislation and will likely be interpreted by the court to give effect to its legislative intent[9] - the protection of those considered to be vulnerable including "*time-poor small businesses entering into contracts for day-to-day transactions*".[10]

Unless and until further judicial clarification is provided to the contrary (or the legislation is changed), there remains a risk that contracts with individual entities within large corporate groups could nevertheless constitute 'small business contracts', if that individual entity doesn't employ more than 20 people, and access relief under the UTC to avoid their contracted bargain. In practice, this may not turn out to be a significant issue given that the “standard form contract” test takes into account the equality in bargaining power of the parties.

4 Thresholds

In order to be considered a contract with a ‘small business’, one party must employ less than 20 employees (as noted above, this includes full-time, part time and casual employees employed on a regular and systematic basis and is assessed at the time the contract is entered into, renewed or varied) and:

(a) the duration of the contract is less than 12 months and the upfront price payable under the contract is less than $300,000; or

[9] West v AGC (Advances) Ltd (1986) 5 NSWLR 610 at 631 per McHugh JA

[10] 2015 Exposure Draft, Treasury Legislation Amendment , (Small Business and Unfair Contract Terms) Bill 2015

(b) the duration of the contract is more than twelve months and the upfront price payable is less than $1 million.

The upfront price is the consideration (which may comprise a number of different types of payments) to be provided for the supply, sale or grant under the contract, that is disclosed at or before the time the contract is entered into (or varied or renewed). For the purpose of assessing whether the small business contract monetary thresholds are satisfied, any amounts that cannot be calculated with certainty at the time are unlikely to be included in the calculation of the upfront price payable. This is particularly relevant in franchise agreements where royalties and marketing levies are often calculated by reference to the performance of the business.

Payments that are not referable to the supply, sale or grant under the contract are not part of the upfront price payable. For example, early termination fees or transfer fees are unlikely to be included.

5 Terms that are likely to be considered "unfair"

For a term in a contract to be considered unfair, all of the following must be satisfied:

(a) the term must cause a significant imbalance in the parties' rights and obligations under the contract;

(b) the term is not reasonably necessary to protect the legitimate business interests of the party advantaged by the term; and

(c) operation of the term would cause detriment (whether financial or otherwise) to the weaker party if it were to be relied on.

Importantly, the legislation raises a rebuttable presumption that a term of a contact is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by that term, unless the party can prove otherwise.[11] It is also not necessary that the term actually cause detriment, or indeed that the term is even relied on (or likely to be relied on based on past practice).

Terms that will be excluded from these provisions, and not liable to be declared unfair or void, include clauses that define the subject matter of the contract, set the upfront price payable or are required, or those expressly permitted by other laws.[12]

Some examples of unfair terms include:

(a) Unconstrained right to unilaterally vary franchise agreement or operations manual

(b) Broad restraints of trade

[11] *Australian Securities and Investments Commission Act*, subsection 12BG(1); *Competition and Consumer Act*, schedule 2, subclause 24(4).

[12] *Australian Securities and Investments Commission Act*, subsection 12BG(1); *Competition and Consumer Act*, schedule 2, subclause 26(1).

(c) Excessive liquidated damages

(d) Unreasonable termination rights

Set out below is a number of common scenarios from the franchising industry that have been listed for discussion. A definitive view as to whether the term is in fact fair or unfair within the meaning of the UCT is unable to be provided. To reach such a conclusion requires an analysis of the contract as a whole, whether the term is balanced by other provisions in the agreement and whether there is a legitimate right to be protected and if so, whether the extent or the protection is properly qualified or proportionate.

This may mean that the same term is considered unfair in some contracts or franchise networks but not in others, depending on the industry and the relationships between the parties.

(a) Operations Manuals:

(i) A term that allows the franchisor to introduce an Ops manual during the term and oblige the franchisee to comply with it - fair or unfair?

(ii) A term that allows a franchisor to issue a breach notice / terminate the franchise agreement if a franchisee fails to comply with the terms of an Ops manual - fair or unfair?

(iii) A term that allows a franchisor to vary the Ops manual at any time and in any manner without the consent / consultation of the franchisee - fair or unfair?

(b) Clauses that retain the right to increase fees:

Whether a term that allows the franchisor to increase fees or impose new fees during the term - fair or unfair;

(i) royalties;

(ii) advertising fund;

(iii) expenses such as software costs to third parties where the relevant term is merely an obligation imposed on Franchisee to take up any IT and where there has been a software upgrade.

(c) Renewals, options, transfers:

(i) A term that requires the franchisee to enter into "the then current agreement" which may change the terms to something materially different to the original agreement - fair or unfair?

(ii) A term that allows the franchisor to transfer its interests without the need for the franchisee's consent but the franchisee cannot transfer their interest without the franchisor's consent - fair or unfair?

(iii) What if the agreement is pre 12 Nov 2016 but the assignment occurs after 12 November 2016 - will the UTC apply to the new agreement and if so, to what extent?

(d) Indemnities and disclaimers:

(i) A term that requires the Franchisee to indemnify the Franchisor for all liabilities howsoever caused (including through the Franchisor's negligence).

(e) Termination and step in rights:

(i) A term that provides for the breach in one agreement to constitute grounds for terminating all ancillary agreements associated with that site - Franchise Agreement, Licence to Occupy, GSA etc;

(ii) A term that provides for the breach in one agreement to constitute grounds for terminating all agreements for that site and other sites;

(iii) A term that allows the Franchisor to step in and manage a business where there has been a breach; and

(iv) A term that provides for liquidated damages.

(f) Restraint of trade:

(i) A restraint of trade where no compensation or consideration given - fair or unfair;

(ii) A non solicitation clause - not solicit customers or employees etc fair or unfair;

(iii) A non entice clause - fair or unfair;

(iv) Does it matter if there is a linked term giving consideration (or genuine compensation for goodwill) for the restraint (clause 23 of the Code)?

(g) Maintaining the ability to unilaterally vary franchise agreements or operations manuals.

6 ACCC's powers in respect of an "unfair term"

The ACCC may seek a declaration that the term or terms in question are unfair and void. Other remedies will be available subsequent to this declaration.

The remainder of the contract will continue to bind the parties to the extent it is capable of operating without the unfair term(s).

Importantly, other conduct may come to light in the course of the ACCC's investigation and claims such as misrepresentation and unconscionable conduct may be argued. These claims may carry larger penalties than those imposed for unfair terms.

7 Avoiding the application of the regime

The manner in which the regime operates provides some options for parties seeking to avoid the application of the regime. These options include:

(a) managing the contractual process to fall outside the definition of a 'standard form contract';

(b) structuring the contract to exceed the applicable threshold in terms of the 'upfront price'; and

(c) drafting the contract to take advantage of the exemptions to the regime.

7.1 Contracting process

The contracting process is critical when assessing whether a contract is caught by the regime. The factors to be assessed when making a determination in relation to whether a contract is 'standard form' relate more to the process itself, rather than the terms of the contract. While the court is free to consider a range of factors, court must have regard to:

(a) whether one of the parties has all or most of the bargaining power in the transaction;

(b) whether the contract was prepared by one party before any discussion occurred between the parties about the transaction;

(c) whether the other party was, in effect, required to either accept or reject the terms of the contract in the form in which it was presented;

(d) whether the other party was given an effective opportunity to negotiate the terms of the contract; and

(e) whether the terms of the contract take into account the specific characteristics of the other party or the particular transaction.

In the case of a franchise agreement itself, the mandatory disclosure process and cooling off period dictated by the Franchising Code of Conduct already provide some justification for why a franchise agreement should not be considered a standard form contract. However, this process itself is not enough on its own, particularly given the presumption that a contract is a standard form contract unless the party relying on the term proves otherwise.

Some practical tips to avoid the regime by managing the contractual process include:

(a) Preliminary meetings – conduct initial meetings with the other party at which the proposed terms of the contract are discussed prior to presenting a draft contract.

(b) Opportunity for negotiations – make it clear to the other party and its advisors that any comments or queries will be given due consideration. This might include providing the other party with a template contract and giving them the opportunity to provide comments

and conduct negotiations before a proposed final contract is circulated. It also needs to involve a proper review and assessment of requests for changes.

(c) Tailored contracts – similar to the previous point, ensuring that contracts are tailored to the particular circumstances and the particular party before they are circulated.

(d) Balanced terms – ensure that the contract takes into account the interests of both parties and does not include any unnecessary or onerous terms. This does not mean all clauses need to be mutual, but departures from mutual clauses should be justified.

(e) Mandatory legal advice – require the other party to seek legal advice and not accepting the position where the other party elects not to take advice.

(f) Clear and consistent communications – ensure that all representatives (including external advisers) are consistent in the manner in which they communicate with the other party, particularly in relation to requested changes. If changes are not accepted, or not accepted in their entirety, commercial justification for the position being taken should be given.

(g) Record-keeping – ensure that records of all meetings, communications, negotiations and draft contracts are retained on file for future reference if required.

While each of these steps may be appropriate in the context of the franchise agreement itself, they may not be appropriate in respect of each ancillary agreement. Even in the context of the franchise agreement itself, it is likely that extensive negotiation of the terms of a franchise agreement to avoid being considered standard form.

7.2 Upfront price

The thresholds which determine whether or not a contract is subject to the regime can be problematic in a franchising context where a range of fees are linked to the performance of the business (for example, royalties linked to gross revenue). The franchisee's anticipated payments over the duration of the contract may well exceed the applicable thresholds but this might not be able to be calculated with any certainty up-front. Some options to structure the arrangement to try and exceed the relevant thresholds include:

(a) requiring the franchisee to pay the fit out costs for a new store to the franchisor, on the basis that the franchisor will then pay the contractors conducting the fit out;

(b) if the franchisor holds the head lease for any fixed premises, including an obligation to pay the rent for the premises under the franchise agreement;

(c) imposing fixed minimum royalties and marketing levies to enable these amounts to be taken into account when calculating the up-front price; and

(d) specifically identifying quantifiable costs that are intended to be taken into account in determining the up-front price. A number of sophisticated landlords have been using

similar techniques in their standard leases where certain payments are deemed to constitute part of the up-front price.

Whether any or all of the above techniques will be effective if challenged remains to be seen, but they are likely to make it harder for a claim under the new regime to be successful.

7.3 Exemptions

The unfair contract terms laws do not apply to:

(a) terms that define the main subject matter of a contract;

(b) terms that set the 'upfront price'; or

(c) terms that are required or permitted by law.

There is also case law to suggest that the laws might not apply to terms that have been negotiated. Reference is made in the ACCC's guide to the unfair contract terms laws to a decision of the Victorian Civil and Administrative Tribunal where it was stated that:

> *"[T]erms of a consumer contract which have been the subject of genuine negotiation should not be lightly declared unfair. This legislation is designed to protect consumers from unfair contracts, not to allow a party to a contract who has genuinely reflected on its terms and negotiated them, to be released from a contract term from which he or she later wishes to resile."*

While there is little influence a party can have over the terms that are required or permitted by law, there may be an opportunity to test the scope of the first 2 exemptions through contractual drafting. For example:

(a) Specifying particular clauses or concepts as being part of the 'main subject matter of the contract'.

(b) Specifying various payment obligations as forming part of the 'upfront price'.

Given the imprecise manner in which the Act is drafted and the lack of judicial consideration, whether any of these approaches is effective is inherently uncertain but they will at least create a basis for a franchisor to dispute the application of the regime if necessary.

8 Meeting the "fairness" test

As noted above, for a term in a small business contract to be considered unfair, each of the following elements needs to be satisfied in respect of the term:

(a) it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and

(b) it is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and

(c) it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

In determining whether a term is unfair, the court must also take into account:

(a) the extent to which the term is transparent; and

(b) the context of the term in the contract as a whole.

Each of these factors provides guidance to franchisors that are seeking to ensure terms in their contracts are not at risk of being declared void on the basis that they are "unfair".

8.1 Transparency

A term will be transparent if it is expressed in reasonably plain language, legible, clearly presented and readily available to any party affected by the term. Transparency itself is not a cure to unfairness (a term may be transparent, but still be declared unfair), but is an important practical consideration to take into account when drafting small business contracts (or contracts at risk of being deemed small business contracts).

Some practical tips to enhance transparency through drafting are:

(a) Always use plain English drafting. Ensure that contracts are drafted in a simple and clear manner, without the use of legal jargon.

(b) Steer away from long and convoluted sentences or paragraphs. Break up lengthy clauses with sub-paragraphs or dot points, to make clauses easier to read and understand.

(c) Ensure the document is ordered logically and use appropriate headings and a table of contents (for longer contracts). Do not try to 'hide' one-sided terms at the end of the contract or in external documents.

(d) Consider the use of an executive summary to emphasise key commercial issues.

(e) Draft in the active tense rather than the passive tense.

From a process perspective, transparency requires full disclosure of all relevant terms and conditions before the contract is entered into. In the context of a franchise agreement, the mandatory disclosure period is an example of a transparent process, but consideration should be given to what is disclosed before or as a part of this process. Ideally, franchisors should provide ancillary documents such as occupancy licences, trading terms, software licences, general security agreements, policies and procedures and operations manuals as part of the disclosure process.

8.2 Context

When assessing whether a particular contract term is unfair, the court is expressly directed to consider the particular term in the context of the contract as a whole. Some terms may be appear to be unfair on their face, but may well be commercially justifiable when considered in the context of the broader relationship.

To this end, it may be appropriate in certain circumstances to include some context in the clause itself as evidence of the justification for the clause. This is often seen in restraint clauses where the restrained party is required to make certain acknowledgements which are intended to explain why the restraint is required, but also why it is reasonable in the circumstances.

8.3 Commercial justification

When reviewing a clause that is necessarily one-sided and has the potential to cause detriment if relied upon, consideration needs to be given to the commercial justification for the clause. If a claim is made alleging an unfair contract term, the burden of proof is on the party advantaged by the term to prove the term is reasonably necessary to protect their legitimate interests.

Firstly, this involves an analysis of the legitimate interests of the party. This requires an understanding of the risk that the clause is seeking to protect against and the potential loss or damage that could flow if the risk is not mitigated. From a franchisor's perspective, regard should be had to financial impacts on the franchisor and franchise network as well as reputational impacts on both the franchisor and other franchisees.

Secondly, once the risk itself is understood it is necessary to consider whether the clause itself protects against the risk and goes no further than what is required to address the risk.

As noted above, in certain circumstances it might be appropriate to highlight the commercial basis for the clause within the clause itself. If this is not appropriate in the circumstances, consideration should be given to:

(a) Creating an internal document that explains the basis for each clause (or at least every clause that is 'at risk'). This may be useful in assisting internal staff to understand the contract and negotiate more effectively with counter parties. It also serves as a contemporaneous record of the contracting party's position at the time the contract was entered into.

(b) Re-drafting clauses to isolate 'at risk' components of a clause into a separate sub-clause that is capable of being severed if found to be unfair.

(c) Ensuring that all communications with prospective franchisees and their advisers are consistent and that commercial reasons are provided when rejecting proposed variations to an agreement.

9 Next steps

If a relevant contract meets the criteria, franchisors need to review the contracts to identify significant imbalances and determine if all clauses are reasonably necessary for their legitimate business interests. To avoid noncompliance with the regime it may be necessary to redraft borderline clauses or include additional clauses to provide greater clarification within the agreement.