

# 1 Introduction

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Free and fair competition is a basic tenet of a free enterprise economy.<sup>1</sup>

## Business conduct issues

1.1 The terms of reference required the Committee to examine the main business conduct issues arising out of commercial dealings between firms.

1.2 The Committee took evidence on a wide range of business conduct damaging to small business. The major areas of conduct brought to the Committee's attention, each of which forms a separate chapter in this report, were:

- disputes between retail tenants and their landlords [Chapter 2];
- disputes between franchisors and franchisees [Chapter 3];
- the misuse of market power by large firms competing with small businesses [Chapter 4]; and
- harsh conduct by banks and other financial institutions towards small business clients [Chapter 5].

1.3 There is a common theme underlying the types of unfair business conduct raised by all areas of small business, namely an inequality of power. The complaints cover:

- unfair contract terms arising from a refusal of big business to negotiate the terms and conditions of contracts;
- complexity of documentation/lack of standard form 'plain English' contracts for small business dealings;
- lack of pre-contract disclosure, resulting in the inability of small businesses to make informed decisions about the viability of an enterprise;
- the inadequacy of advice and education for small businesses and the poor quality of much of the legal and/or accounting advice provided to small businesses during contract negotiations in many cases; and
- the prohibitive costs of, and the long delays involved in, legal action, inhibiting small business access to justice.

1.4 These issues bias business dealings in favour of powerful companies with the financial resources to engage in lengthy litigation. The consequence has been that small business in its many dealings with big business often has to accept unfair terms and conditions on a 'take-it-or-leave-it' basis. Small business people are then open to subsequent arbitrary or opportunistic conduct with associated heavy economic and social costs to society.

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1 The then Minister for Business and Consumer Affairs, the Hon John Howard, introducing the Trade Practices Amendment Bill 1976, *Parliamentary Debates*, H of R 98, p. 1011.

1.5 The capacity of some small businesses to grow is being inhibited because of unfair terms and conditions. Many small business operators unfairly lose their homes and livelihoods because such conduct induces the failure of their businesses. The heavy social costs are highlighted throughout the report in the accounts of specific submissions received while the economic impact is considered later in this chapter.

## **Small business in Australia**

1.6 This Committee has previously defined small businesses as:

- being independently owned and managed;
- being closely controlled by owner/managers who also contribute most, if not all, of the operating capital; and
- having the principal decision making functions resting with the owner/managers.<sup>2</sup>

1.7 This can be qualified by a size component serving as a functional addition, as follows, but this addition should not overshadow that definition:

- non-manufacturing organisations employing fewer than 20 people; and
- manufacturing organisations employing fewer than 100 people.

1.8 Helping small business to grow, employ, export and invest in Australia's future has been a high priority for all recent Australian Governments. As Australia's largest employment sector and the main source of employment growth in recent years, the economic health of the small business sector is critical to the well being of the Australian economy. In particular, it is a key to employment growth:

- in the decade to 1994-95, the small business sector accounted for almost all the 1.2 million net increase in jobs, increasing its workforce by an estimated 1.1 million compared to 270 000 for large business and a decline in public sector employment of 150 000;
- in 1994-95 (the latest year for which data is available) the small business workforce increased by 6.4 per cent, compared with 3.9 per cent for total employment; and
- small businesses accounted for almost half of total employment in 1994-95.<sup>3</sup>

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2 House of Representatives Standing Committee on Industry, Science and Technology, *Small Business in Australia: Challenges, Problems and Opportunities* (AGPS, Canberra, January 1990), p. 9.

3 Statistics from: *More Time for Business*, Statement by the Prime Minister, the Hon John Howard MP, 24 March 1997, Section 1.

1.9 In 1994-95, small business accounted for 32 per cent of the goods and services sold in Australia, with small business playing a particularly significant role in the construction, manufacturing, retail trade and property and business services sectors. Small business is also becoming a major contributor to Australia's export performance. As at February 1995, 11 per cent of small businesses exported a proportion of their output, with another 5 per cent planning to export in the near future. In manufacturing, 19 per cent of small businesses export and a further 11 per cent were planning to export.

1.10 While small business has a vital role to play, as the Minister for Small Business has acknowledged, it is 'doing it tough in a number of areas'.<sup>4</sup> Some of those difficulties are detailed later in this report. The large number of claims that small businesses are not adequately protected against unfair conduct in their dealings with larger firms raise important policy issues.

1.11 The Government's small business statement, *More Time for Business*, placed great emphasis on the need to make it easier for small business to deal with government. This report complements that emphasis by seeking to ensure small businesses do not suffer from unfair conduct in their dealings with big business.

1.12 Importantly, the Committee's recommendations will not involve any unnecessary increase in compliance costs for small business and will significantly improve their access to redress.

## **Social and economic implications**

1.13 The terms of reference further required this Committee to report on the social and economic implications of the business conduct issues identified.

### ***Social outcomes***

1.14 While it is widely believed that the small business sector experiences a high failure rate, and that most of these failures occur in the early years of operation, reliable and comprehensive information on small business failures is not currently available. The need for better research in this area has already been recognised and the Office of Small Business within the Department of Industry, Science and Tourism is funding a longitudinal study by the Australian Bureau of Statistics to repair this deficiency. However, this research does not extend to an examination of the social impact of those failures. No formal research of this nature was tendered in evidence.

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4 Statement by the Hon Geoff Prosser MP, Minister for Small Business and Consumer Affairs, Minister Responsible for Customs, 69/97, 24 March 1997.

1.15 The Committee took evidence at public hearings around Australia providing many small business people with an opportunity to present their views in person. The Committee was impressed by the courage and tenacity of these witnesses and at the depth of their concern to ensure others do not suffer from similar experiences. Similarly, the Committee was impressed by the level of concern expressed by professional advisers and counsellors who dealt with the consequences of unfair conduct in their practices. The Committee was also struck by the anger, frustration and bitterness that surfaced as some witnesses recounted their experiences at the hands of unscrupulous companies.

1.16 The Committee heard many distressing stories. Many witnesses had 'lost everything' including homes, family farms, superannuation payouts and savings. As a result some were unemployed and with little prospect of finding alternative employment. All had experienced hardship and trauma that had affected their health and the lives of their families.

1.17 The common theme was the very real sense of desperation. Small business people were united in their message that, in the commercial environment in which they struggle to survive, they believe everything is stacked against them and they need help now.

1.18 It is difficult to quantify the profound social impact of such conduct; but the words of the witnesses are eloquent testimony to the depth of individual suffering. As a former experienced specialty retailer (name suppressed) said:

*I once had a thriving business in an industry few could match my enthusiasm for ... [What the retail leases tribunal could not consider] is the devastating effect the past five traumatic years have had on me and my family, which not even our once rock solid 27 year marriage could survive. We were once confident, positive thinking go-getters but now we're broken dispirited relics of our former selves with several stress related health problems, not the least being acute depression, insomnia, nervous tension and obesity. I went through premature menopause and my once cheerful workaholic, loving partner is now an angry, aggressive alcoholic. Our children suffer too, helplessly watching both their parents fall to pieces before their eyes, and their quality of life diminish. At 50 years of age, we've been left with a massive business debt which we have insufficient earning power to repay and ... we now face the real prospect of being homeless as well.*

*The chains have been allowed to gobble us up and the landlords allowed to trample us down. Our pleas to politicians fall on deaf ears and the legal system treats us with contempt. The end result is the tragedies exposed almost daily on the national news. Why must it be so? We too are entitled to our place in the sun. [The Fair Trading inquiry] has it within its power to recommend that justice is done and if I believed in God anymore, I'd pray that you will ensure it is.<sup>5</sup>*

1.19 It is perhaps inevitable that in a competitive economic environment many will fail and the personal consequences of failure can be severe. That does not remove the necessity of examining individual business failures in order to determine whether they are:

- an indication of some kind of market failure;
- the result of conduct by another party which a decent society simply should not tolerate;
- the lack of adequate preparation of small business entrants; or
- the result of fair competition.

1.20 There are measures which governments can take to address market failure and these can be justified on economic as well as social grounds. Action against certain commercial practices that result in small business people being exploited, abused and destroyed should need no justification other than the principles of justice and decency which the vast majority of people in our society would endorse. Usually, economic arguments can be made as well against the toleration of such practices. They frequently result in distortions of the market system reducing fair competition, or reflect the existence of such distortions.

1.21 Even in cases of business failure as a result of legitimate competition, there may well be grounds for action – such as encouraging better preparation by people before entering business, or improving the flow of information about matters affecting business risks. This can be justified not only in terms of the likely reduction in the massive and widespread personal suffering from business failure but also in economic savings by reducing the enormous resources wasted as a result of the collapse of so many small business ventures.

1.22 As indicated above, the social impact alone is sufficient to justify action.

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5 Name withheld, *Submission No. 185*.

## **Economic outcomes**

1.23 The Committee was specifically asked to report on whether certain commercial practices might lead to ‘sub-optimal’ economic outcomes. The Committee has concluded that many of the business conduct issues drawn to its attention do lead to sub-optimal outcomes and consequently are not in the best interests of the Australian economy. The exact extent of the economic cost is hard to estimate as the effects of unfair conduct are disguised by being very wide spread at a micro level across many sectors. Consequently, such problems are not amenable to formal benefit cost analysis, which has a well recognised bias towards easily measurable data. Indeed, it became clear during the public hearings that the responsible Departments – the Department of Industry, Science and Tourism, and the Treasury – have not attempted that sort of analysis, nor have any of the major business groups who made submissions.

1.24 On the basis of the evidence it has received the Committee believes that unfair conduct is a serious problem and the costs to the economy are very significant. As a consequence the capacity of small business to grow, to employ, to export and to invest in Australia’s future has been reduced. No convincing argument was presented to the Committee to suggest that the unfair conduct complained about would provide economic benefits which would, even in a theoretical sense, outweigh the costs involved.

1.25 In a market economy it is expected that businesses will seek to maximise their profits. However, the pursuit of individual self-interest does not always automatically result in the best economic outcome for the society as a whole. All economists recognise the existence of the potential for market failure where there is less than perfect competition, for example, because of the presence in the market of some participants who have inordinate power and who exercise that power either to eliminate competitors or to coerce their suppliers or their customers. One instance where market failure may occur is where there is a wide disparity in the information available to different participants in the market. Market players with inordinate power quite clearly, in certain cases, use that power to prevent those with whom they deal (as competitors or in a business relationship) from having access to the information they need.

1.26 The evidence presented to the Committee clearly indicates the existence of great disparities of power in many business relationships. This is clearly the case in many landlord-tenant relationships in large shopping centres, in some franchisor-franchisee relationships, and in some dealings between financial institutions and small business clients.

## Economic efficiency and fairness

1.27 The Business Council of Australia (BCA) claimed in its submission that the Trade Practices Act is primarily concerned with ‘economic efficiency’.<sup>6</sup> The Business Council drew attention to the comments of the Blunt Committee in 1979 to the effect that the Trade Practices Act is directed primarily at enhancing competition and should not deal with the ‘moral’ issues involved in business conduct.<sup>7</sup> The Business Council went on to argue there should only be regulatory intervention when ‘economic efficiency’ is lessened by distortions in a market which hinder the movement of resources to their most valuable and efficient use.

1.28 Competition is not something that is valued simply for itself.<sup>8</sup> Rather, competition is valued as an instrument promoting economic efficiency, which in turn is valued in so far as it increases the welfare of society as a whole. As the Hilmer Report says:

*Competition policy is not about the pursuit of competition per se. Rather, it seeks to facilitate effective competition to promote efficiency and economic growth while accommodating situations where competition does not achieve efficiency or conflicts with other social objectives.*<sup>9</sup> [emphasis added]

1.29 Consequently, there is no underlying inconsistency involved in the dual aims of the Trade Practices Act. It is clear that the competitive provisions of the Trade Practices Act set out to control various facets of market power: its acquisition, its extension and its abuse.

6 BCA, *Submission No. 31*, p. 5.

7 Trade Practices Consultative Committee (the Blunt Committee), *Small business and the Trade Practices Act*, (AGPS, Canberra, 1979). In the event, the Blunt Committee considered a law prohibiting ‘unfair’ business conduct as going further and not being compatible with the provisions of Part IV of the Act. However, the Blunt Committee felt there was great merit in exposing the proposal to debate and discussion and considered it a worthwhile area for the Government to keep under active examination.

8 The Treasury acknowledged this in its evidence to the inquiry into competition law conducted by the House of Representatives Standing Committee on Legal and Constitutional Affairs. The Committee reported: ‘Treasury argued that competition is not an end in its own right, but rather a means to an end. It stated: The pursuit of competition cannot ... be an absolute objective ...’. (House of Representatives Standing on Legal and Constitutional Affairs, *Mergers, Takeovers and Monopolies: Profiting from Competition* (AGPS, June 1989), p. 17).

9 National Competition Policy Review, *National Competition Policy: Report by the Independent Committee of Inquiry* (AGPS, August 1993), p. xvi. Similarly, the Treasury submitted to the Review that, ‘Efficiency is a fundamental objective of competition policy because of the role it plays in enhancing community welfare’ (Treasury, Submission to the National Competition Policy Review, *Treasury Economic Papers*, Number 16, 1993, p. 3).

1.30 As Professor Helen Hughes has pointed out:

*The effectiveness of markets depends on moral precepts that make cheating and lying unacceptable implicitly in social behaviour and explicitly in law that is enforced across all strata of society.<sup>10</sup>*

1.31 In this regard Mr James Starkey on behalf of the Australian Institute of Petroleum (AIP) said in evidence:

*The AIP and its member companies fully support the concept of fair trading. Indeed, we believe it is a central plank of a flourishing economy. AIP supports the concept of generic legislation to underpin fair trading.<sup>11</sup>*

1.32 The hazards associated with any transaction vary not only with the nature of that transaction but also with the trading environment of which it is a part. The danger of opportunistic behaviour on the part of one party to a transaction can increase the perception of risk attached to all transactions and thus the costs of doing business generally. It follows that an exploitative business culture is likely to be less economically efficient than one in which there is a greater degree of honest dealing, fairness and trust.

1.33 The Better Business Conduct Discussion Paper of 25 October 1995 by the Department of Industry, Science and Technology relied on reasoning related to the ‘contestability’ of markets and ‘economic ransom’ to provide a justification for proposed amendments to the Trade Practices Act to outlaw ‘harsh or oppressive’ conduct within an existing commercial relationship. The Department went on to point out that gaining an adequate return on sunk costs is important for small businesses, as they often use finance borrowed against the family home to enter a market. The sunk costs of a business then create a barrier to market exit which restricts the owners’ commercial flexibility and leaves them open to exploitation. The abuse of relative bargaining power, in such a way as to remove choice in a commercial arrangement from one party, impacts negatively on contestability. The Department concluded that situations of ‘economic ransom’ are a problem which requires attention.<sup>12</sup>

1.34 More generally, the Trade Practices Commission and its successor, the Australian Competition and Consumer Commission (ACCC), have consistently argued that ‘economic efficiency’ would be enhanced by action directed against ‘unconscionable’ conduct in commercial transactions. In its submission, the ACCC expressed such a view in the following terms:

*From an economic viewpoint, economic efficiency and consumer welfare are maximised when resources are allocated to those uses in which the value to the consumer*

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10 Hughes, Helen, ‘Markets, efficiency and ethics’, in *Can we afford to be efficient?* (St James Ethics Centre, Sydney, 1995).

11 James Starkey, Australian Institute of Petroleum, *Transcript of evidence*, p. 360.

12 Department of Industry, Science and Technology, *Better Business Conduct Discussion Paper* (25 October 1995).



*is highest. However, the attainment of economic efficiency is affected by distortions in the market (such as misuse of market power and misleading information) which prevent or hinder the free movement of resources to their most valuable and efficient use. In other words, the market may fail in important respects. Measures such as those in the Trade Practices Act to lessen or remove the underlying market distortions are economically justifiable.<sup>13</sup>*

1.35 The Treasury suggested that there are two primary reasons for government intervention:

- market failure; and
- equity/fairness.

1.36 The Treasury went on to argue that inadequate information, high transaction costs and substantial market power may give rise to ‘market failure’. This ‘failure’ can result in efficient small businesses being discouraged from entering the market or forced out of business, thereby producing a sub-optimal allocation of the community’s resources. It can also lead to other social costs, such as increased bankruptcies and social dislocation. The Treasury acknowledged that inadequate information, transaction costs and market power may be problems.<sup>14</sup>

1.37 A further form of analysis was provided by Access Economics in early 1995 to the Small Business Forum Working Party on Section 51AA of the Trade Practices Act. Access Economics advised:

*If it is accepted that individuals as consumers can require legal protection against unconscionability in transactions with businesses, it seems sensible, a priori, to conclude that similar protection should be available to individuals as producers of goods and services as well.*

*At the end of the day, the type of damage done to individuals as consumers as a result of unconscionability in transactions (loss of income, capital, reduced living standards, etc) is economically indistinguishable from damage done to businesses and the individuals that own those businesses - as a result of unconscionability in commercial transactions.*

*People are hurt in the same way in both cases. In both cases, similar remedies should be available.*

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13 ACCC, *Submission No. 62*.

14 It was concerned, however, that general legislative action to deal with these issues, and to deal with the equity considerations, may have adverse consequences on business certainty and the competitive process. Treasury, *Submission No. 168*.

*This principle suggests the same basic rules in relation to unconscionability in commercial transactions should apply to all parties to economic transactions, whether they be people as consumers, as employees, as principals of businesses, or as representatives of governments.*<sup>15</sup>

1.38 In regard to this argument Mr Phillip Noonan, First Assistant Secretary, Office of Small Business and Federal Consumer Affairs Division, Department of Industry, Science and Tourism said:

*It is not realistic to expect the average small business person to have the skills and expertise of a large company.*<sup>16</sup>

1.39 It was for this reason that the Swanson Committee in 1976 was strongly of the view that the definition of a consumer should be sufficiently broad to provide protection to a range of business transactions, particularly purchases by small businesses.<sup>17</sup> In the view of the Swanson Committee, one important function of the consumer protection provisions of the Act was to redress, between supplier and customer, inequalities in the technical expertise required to recognise, and the bargaining power to negotiate, a fair bargain. These inequalities are not necessarily limited either to 'traditional' consumers or to transactions involving what might be termed 'consumer' goods, in a narrow sense.

1.40 What this means in practice is that unfair business conduct results in a transfer of income from the small business sector to the big business sector, a reduction in employment opportunities in the small business sector, and the misallocation of resources generally. For example the retail trade is the largest employer in Australia accounting for over 1.1 million people in 1993-94.<sup>18</sup> Any shift from labour intensive small business to capital intensive big business, such as is alleged by the Council of Small Business Organisations of Australia (COSBOA) to have happened, could significantly reduce employment (or the growth of employment) in that sector.<sup>19</sup>

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15 cited by the Motor Trades Association of Australia (MTAA), *Submission No 118*, pp. 63-64.

16 Phillip Noonan, Department of Industry, Science and Tourism, *Transcript of evidence*, p. 652.

17 Trade Practices Act Review Committee (Swanson Committee) *Report* (August 1976), para 9.40.

18 *Exhibit No. 179*.

19 COSBOA, *Submission No 105*. The Property Council of Australia submitted, however, that Access Economics had reported that the retail trade has generated an increasing proportion of the jobs available over the last decade, and that the Prices Surveillance Authority had suggested that the information on profitability provided no grounds for the conclusion that shop rentals constitute a limit on retailing profitability (*Exhibit No 70*).

## Options and strategies to address business conduct issues

1.41 The Committee was asked to report on whether ‘the impact of the business conduct issues identified by the Committee is sufficient to justify Government action taking into account existing legislative protection for small business’.

1.42 Much of the debate on this issue focused on the adequacy of the Unconscionable Conduct provisions of the Trade Practices Act (Part IVA). The Committee is proposing a significantly strengthened provision to deal with the general problem of unfair conduct, but the Committee is strongly of the view that this recommendation should only be seen as part of a broad strategy to deal with the problem. As Mr David Parker, Assistant Secretary, Competition Policy Branch, the Treasury, said:

*As a general point, in our view it is better to focus on remedies which alter the environment in which a business relationship is formed in order to help businesses conserve their own interest.<sup>20</sup>*

1.43 It is also necessary to alter the environment in which business relationships are sustained. In this regard Mr Allan Asher, the Deputy Chairman of the ACCC, said that it was a mistake to simply seize upon some change to the unconscionable conduct provisions of the Act as the whole solution. The Commission has consistently argued right back to the Swanson Committee in the 1970s that what is required is a new approach overall to the resolution of disputes between small and large businesses. It is the whole package, including the use of effective industry codes, conciliation systems, and information disclosure that is important, rather than a simple focus on changes to the sections of the Trade Practices Act which deal with unconscionable conduct. The Committee agrees that improving the above provisions of the Trade Practices Act alone, without also addressing the costs and delays involved in litigation, would be an inadequate solution. As Mr Asher said:

*... in my view, it is a cruel hoax to give people a legal provision that is not enforceable. By enforceable, I do not just mean that there is a legal right but that there is some real capacity to be able to use it.<sup>21</sup> [emphasis added]*

20 David Parker, Treasury, *Transcript of Evidence*, p. 872.

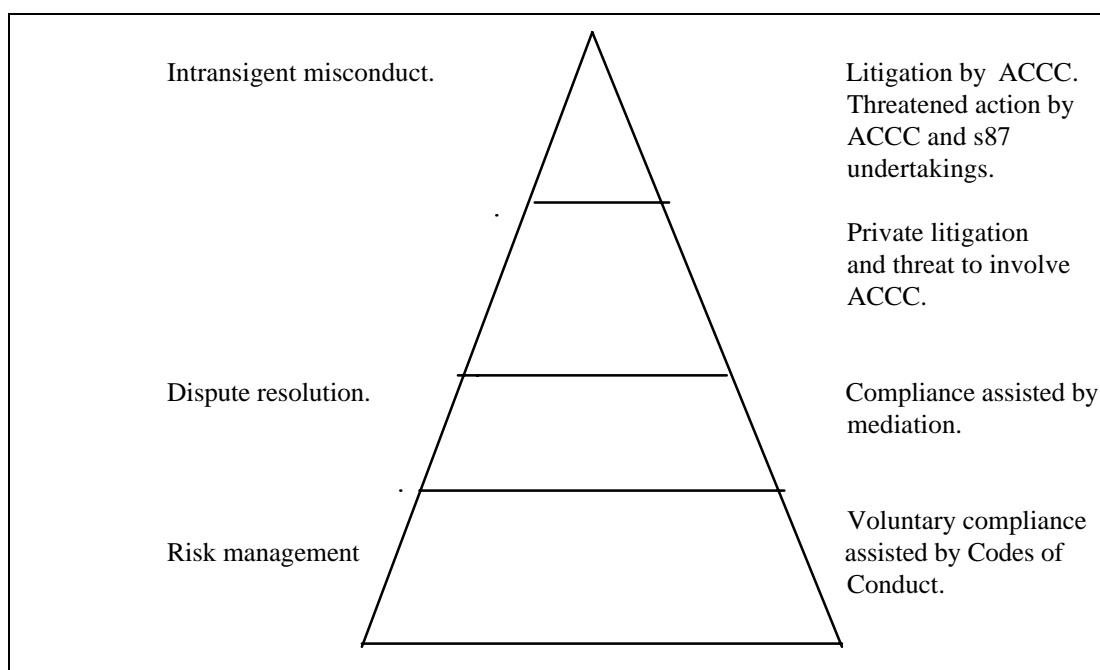
21 Allan Asher, ACCC, *Transcript of evidence*, pp. 374-75.

1.44 To achieve this, the ACCC submission proposed a regulatory strategy described in terms of an enforcement pyramid involving:

- adequate and clear information disclosure (the base of the pyramid);
- early intervention when disputes arise (moving up the pyramid);
- private enforcement (towards the top of the pyramid); and
- public enforcement (at the top of the pyramid).<sup>22</sup>

1.45 The strategy is illustrated by the diagram in Box 1.1.

**Box 1.1 Enforcement pyramid**



1.46 This approach to regulatory policy involves a strong power to deter anti-social behaviour. The effect is to limit the need for either private enforcement or for direct involvement by the regulatory agency as most companies would be induced to comply voluntarily as part of normal risk management. It also requires that those affected by anti-social behaviour have meaningful access to redress. In addition,

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22 ACCC, *Submission No. 62*. In regard to this approach to regulatory policy John Braithwaite argues:

*Instead of institutions that economise on virtue, we need institutions that give actors space to be virtuous. Regulatory institutions can be designed to nurture rather than destroy civic virtue in the business community. At the same time, we need tough-minded regulatory institutions that can shift to a hard-headed approach when virtue fails, as it often will. Hence, I favour regulatory institutions that first attempt to solve problems by persuasion and dialogue, that open regulatory interactions with an assumption of good faith commitment to implement the spirit of the law, even if this involves going beyond the letter of the law. When this fails, regulatory response should escalate to deterrent threats of increasing severity...*

Braithwaite, John, 'Responsive Business Regulatory Institutions' in Coady, C A J, & Sampford, C J G, eds, *Business, Ethics and the Law* (The Federation Press, Leichhardt, 1993).

effective deterrence also requires a willingness on the part of the regulatory authority, in this case the ACCC, to be proactive in pursuing complaints and in bringing serious breaches to the courts. The Committee endorses the broad thrust of this approach to encourage behavioural change on the part of big business in its conduct towards small business.

1.47 The Committee makes specific recommendations later in this report regarding uniform retail tenancy legislation and national franchising legislation as part of that strategy. That legislation will specify in detail what is expected as well as providing for specific redress mechanisms. The Committee also recommends a broad new unfair conduct clause in the Trade Practices Act to deal with unfair conduct more generally. These measures will strongly encourage big business to ensure that its small business partners are adequately informed, and that their interests are properly considered, when decisions affecting them are being made. Importantly, the development of codes of practice codifying what is expected of large business in its dealings with small business will play a significant role in keeping most regulatory action at the base of the enforcement pyramid.

1.48 Providing effective alternative dispute resolution processes will provide small business with an affordable means of resolving disputes, and will complement the other parts of the strategy.

1.49 As indicated above a proactive role by the ACCC is an important part of this strategy. The Committee notes that the ACCC has not been as active in pursuing unfair conduct issues as had been expected following the insertion of Section 51AA into the Trade Practices Act in 1992. In its submission, the ACCC drew attention to its small business program involving strategies covering education, media, liaison, and enforcement.<sup>23</sup> The ACCC also indicated that it is developing a more strategic approach towards compliance and enforcement activities. The Committee expects the ACCC to redouble these efforts.

#### **1.50 Recommendation 1.1**

**The Committee recommends that the Australian Competition and Consumer Commission be proactive in promoting compliance with the proposed new unfair conduct provisions of the *Trade Practices Act 1974*.**

**Due to the ineffectiveness of the Australian Competition and Consumer Commission in small business matters in the past, the Committee believes there is an urgent need to establish a body of precedents under the new provisions as quickly as practicable.**

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23 ACCC, *Submission No. 62*.

