consumer action law centre

20 February 2012

By email: icareview@treasury.gov.au

Manager
Financial Services Unit
The Treasury
Langton Crescent
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Dear Sir or Madam

Unfair terms in insurance contracts - Draft regulation impact statement

The Consumer Action Law Centre (**Consumer Action**) welcome the opportunity to comment on the draft Regulation Impact Statement on unfair terms in insurance contracts (**the draft RIS**).

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action provides free legal advice and representation to vulnerable and disadvantaged consumers across Victoria, and is the largest specialist consumer legal practice in Australia. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

We also operate MoneyHelp, a not-for-profit financial counselling service funded by the Victorian Government to provide free, confidential and independent financial advice to Victorians experiencing financial difficulty.

1. Overview

1.1 Objects of reform

We approve of the Government's stated objective to:

> ...ensure that consumers who purchase insurance have an equivalent level of protection as that which currently applies to other financial products and financial services, and are

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thus, insofar as is reasonably possible, protected from actual or potential disadvantage or loss as a result of insurance contracts containing terms that are harsh and/or unfair.[1]

In our view, it is clear that options A (retaining the status quo), B (enhancing existing remedies in the *Insurance Contracts Act 1984* (Cth) (**the IC Act**) without creating any unfair terms provisions) and E (industry self regulation) will not achieve this objective and so should be eliminated from consideration.

1.2 Preference for options in the discussion paper

We strongly support option C, which would extend the operation of the unfair contract terms provisions in the ASIC Act to insurance contracts.

This is the only option which aligns with the findings of the Productivity Commission in its 2008 review of Australia's consumer policy framework which argued for a single, generic consumer law to apply across all sectors of the economy finding "little reason for any variation" in its content.[2] The Productivity Commission also recommended that that law include a prohibition on unfair contract terms in standard form contracts. Since then the Senate Economics Committee in 2009 found that consumers are not provided with adequate protection in insurance contracts under existing law, and that the onus was on those who do not believe these provisions should cover insurance contracts to prove their case.[3]

Despite these findings, the Government has allowed for insurance contracts to be exempted from the unfair contract terms laws without providing a clear rationale for doing so. The insurance industry has argued that it should be exempted from these laws due to existing consumer protections in the IC Act, and that the provisions will create uncertainty leading to increase costs (particularly of reinsurance). As demonstrated in this submission, existing provisions in the IC Act do not adequately protect consumers from unfair terms. We also believe that uncertainty can be reduced through the provision of substantial industry guidance about the application of the prohibition on unfair terms to insurance contracts (see further below).

We do not believe that it is necessary to clarify the meaning of 'main subject matter' in section 12BI of the ASIC Act.

As with other types of consumer contract, we do not believe that courts will find it difficult to determine what is (and what is not) the main subject matter of an insurance contract. There is no reason provided in the draft RIS or elsewhere justifying why insurance contracts should be treated differently to other types of consumer contracts in this regard.

However, if the Government decided to clarify the definition of 'main subject matter', we strongly support option 2a which would clarify that policy exclusions are not considered to be the 'main subject matter' of an insurance contract (and so can be found by a court to be an unfair contract term). As outlined further below, such an approach is similar to that which has taken in relation

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[1] Draft RIS, Paragraph 3.1.

[2] Productivity Commission (2008) *Review of Australia's Consumer Policy Framework,* Inquiry Report No 45. See for example, Volume 2, p 58-61 and Volume 2, p 327.

[3] Senate Economics Legislation Committee, *Trade Practices Amendment (Australian Consumer Law) Bill 2009*, Recommendations at para 10.11

to the additional exclusion of 'upfront price' in section 12BI which excludes contingent fees and charges from the meaning of 'upfront price'. Moreover, this approach will ensure that "consumers who purchase insurance have an equivalent level of protection as that which applies" to other financial products and services.

We strongly oppose options A, B and E.

Options A (the status quo), B (enhancing existing remedies in the the IC Act without creating any unfair terms provisions) and E (industry self regulation) will not achieve the Government's objective of ensuring "consumers who purchase insurance have an equivalent level of protection as that which currently applies to other financial products and financial services".

To retain the status quo would preserve a number of small consumer protection provisions which, as the draft RIS notes, "do not cover the same breadth of circumstances as the UCT laws".[4] Enhancing existing IC Act remedies would build on those provisions which (while well-intentioned) have been shown to be poorly understood, cumbersome and impractical to enforce. Even if amended, existing provisions (such as section 14 which imports a duty of good faith) are not directed at addressing systemic or market-wide unfair terms in standard form contracts, which is one of the principal drivers of unfair contract terms regulation. Finally, we do not believe that the industry can effectively self-regulate given its long term opposition to the need for unfair contract terms regulation. The industry has made no attempts to address this issue using existing self-regulatory processes, despite widespread debate and dialogue about the issue.

We oppose option D.

In our view, option D (extending IC Act remedies to include unfair contract terms provisions) is highly unlikely to provide an equivalent level of protection from unfair contract terms for insurance consumers, and will create inconsistencies in regulation of unfair terms. However, this option is superior to A, B and E.

2. Responses to consultation questions

2.1 Consultation Question 1

A. In practical terms, is the current consumer protection provided in relation to the use of unfair terms in the Insurance Contract Act 1984 adequate?

No. As we have discussed in previous submissions, the consumer protections in the IC Act have been shown to not operate in the way they were intended and are inadequate.[5] Most notably:

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[4] At 2.51.

[5] See National Legal Aid (2010) Submission to Unfair Terms in Insurance Contracts: Options Paper pp 9-12 (http://icareview.treasury.gov.au/content/_download/submissions_options_paper/NLA_Submission.pdf) and Consumer Action Law Centre (2010) submission to the same inquiry, pp 6-8 (http://www.consumeraction.org.au/downloads/SubmissiononUnfairInsuranceContractTermsOptionsPaperMay10.pdf).

- despite having no shortage of examples of unfair contract terms in insurance contracts, consumers and regulators rarely bring cases based on the 'utmost good faith' provision at section 14 of the IC Act because it is cumbersome and difficult to use;

- the 'standard cover' and 'unusual terms' provisions at sections 35 and 37 of the IC Act do not provide consumers with adequate notice of significant exclusions or unusual terms. Insurers satisfy the requirements of these provisions by simply given written notice of terms, usually buried within the policy's fine print or a complex and wordy product disclosure statement.

B. Besides the provision of an additional legal avenue for consumers to explore if they are a party to a contract that has potentially unfair terms (if UCT provisions are introduced), are there any practical benefits for consumers?

Fundamentally, the prohibition on unfair terms allows the regulator (in this case, ASIC) to take a proactive approach to reviewing insurance policies for unfair terms and taking steps to have these terms amended or removed where it is appropriate to do so. This is the most important practical benefit for consumers, as such an approach can avert consumer harm and improve contracts throughout the industry. It is also more efficient and less costly than the arbitrary, ad-hoc removal of unfair terms that would result if only individual consumers were able to use unfair contract terms regulation as an additional legal avenue. While we acknowledge that individual court decisions about unfair contract term provisions will assist interpret the law in the future, not relying on this avenue alone will ensure that consumers will not have to experience detriment from potential unfair terms that may be reviewed by ASIC in the meantime.

C. Is there a reason for treating contracts of insurance different from other contracts relating to other financial products?

No, and many of the arguments that are commonly made to support the idea that insurance is a 'special case' are baseless. Again we have covered this in previous submissions, but briefly:

- The suggestion that the IC Act is currently the sole source of regulation for insurers is incorrect. Section 15 of the IC Act states that insurance contracts of acts cannot be the subject of relief pursuant to other legislation which prevents the operation of the unfair contract term provision in the ASIC Act applying to insurance. However, this does not mean that the other consumer protection provisions of the ASIC Act are incapable of applying to insurance. As we have explained in the past, a plain reading of the IC Act and at least one judicial decision demonstrate that insurers can be subject of claims for misleading and deceptive conduct, and unconscionable conduct.[6]

- The argument that applying ASIC Act requirements to insurers will create 'dual pleadings' is related to the point above and is similarly baseless[7].

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[6] For details, see Consumer Action Law Centre (2010) Submission to Unfair Terms in Insurance Contracts Options Paper, p 9. See *Australian Competition & Consumer Commission v IMB Group Pty Ltd (ACN 050 411 946) (in liq)* [2002] FCA 402 (5 April 2002)

[7] See Consumer Action Law Centre (2010) Submission to Unfair Terms in Insurance Contracts Options Paper, p 13.

- Suggestions that the ASIC Act unfair contract terms provisions will be difficult to apply to insurance contracts because of the 'main subject matter' exclusion are also unfounded, as is discussed later in this submission.

We note that insurers have argued that unfair contract terms law should not apply to them (or should only apply partially) because they will be required to monitor their practice to manage compliance and this may increase costs. However, this will also have been the case with every other industry in Australia which are now subject to the unfair contract terms under either the ACL or the ASIC Act. The cost of monitoring legal compliance is a normal cost of business and is not a justification for a regulatory carve-out.

The only unique risk faced by insurers noted by the draft RIS is that, if an exclusion in one of their standard form contracts is found to be unfair and declared void by a court, this may leave them open to risks across a large number of policies for which they have not collected any premiums. This may ultimately affect the ability of insurers to access reinsurance, which will have effects on availability and price of cover.[8] However, we believe that steps can be taken to limit the likelihood of this occurring.

In particular, it is our view that the regulator may produce substantial guidance as to how the unfair contract terms provisions might apply in relation to insurance. While not definitive, this guidance would provide strong indication to insurers about the types of terms that may be unfair. We note that Consumer Affairs Victoria, as the Victorian regulator in relation to unfair terms, has developed such guidance for health and fitness centres, mobile phone operators, carpet and curtain businesses, and vehicle hire businesses.[9] Such guidance can be developed in consultation with industry, drawing on actual terms in relevant consumer contracts. This guidance can be used to address uncertainty and risk concerns.

Further, the application of unfair terms provisions will not prevent insurers using exclusion clauses to manage their risk exposure. It will only prevent them from using exclusions (or other terms) which are both unfair and unnecessary to protect their legitimate commercial interests. This gives considerable room to insurers—exclusions required to protect their legitimate interests cannot be struck out under these provisions. Further, those that are not necessary to protect those interests can only be struck out if they are unfair, that is, they cause a significant imbalance in the rights and obligations of the parties, and they would cause detriment if applied or relied upon.

D. Will equivalent protection in respect to unfair contract terms lead to beneficial outcomes for consumers? If possible can you outline any situations where these benefits can be clearly identified?

Yes. Extending an equivalent level of protection in relation to unfair contract terms to insurance consumers will create an accessible avenue to challenge unfair terms which consumers do not currently have.

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[8] See draft RIS, paragraph 6.6.
[9] See: http://www.consumer.vic.gov.au/businesses/fair-trading/contracts/unfair-contract-terms

The Panel Chair's Report in the 2004 Annual Review for the Insurance Enquiries and Complaints Scheme (now the Financial Ombudsman Service) set out a number of instances where the Panel was forced to make decisions which "*whilst legally correct, may be viewed as unfair or harsh."*[10] These matters included

- An applicant who lost a $50,000 car damage claim because he did not disclose one speeding offence prior to policy renewal.
- A landlord was not covered by his policy when the tenant burned down the home. This is because of an exclusion for damage caused by an invitee.
- The injured worker who could not claim disablement benefits as the policy provided cover only if disablement occurred within 12 months of the incident giving rise to the claim.
- The travel insurance policy that only covers injury sustained at the departure terminal subject to his establishing he travelled to the point of departure by public conveyance.

As was pointed out by our colleagues in the Insurance Law Service, this report shows that not only do problems with the use of unfair terms exist in the insurance industry, but the current law (including the duty of utmost good faith in the IC Act) do not address this problem.[11] Extending unfair contract terms provisions to insurance contracts will mean that consumers (and dispute resolution bodies) are less likely to have to make decisions which are legally correct, but unfair.

E. What percentage of insurance contracts and types of insurance contracts are likely to be standard form contracts in accordance with section 12BK of the ASIC Act?

It is likely that all consumer insurance contracts will be standard form contracts for the purposes of section 12BK of the ASIC Act. In our experience, consumer insurance policies do not:

- give consumers any bargaining power over terms or opportunity to negotiate;
- give consumers any choice other than to accept or reject the contract as presented; or
- allow a contract to be drawn up during negotiation, rather than being drafted by the insurer beforehand.

2.2 Consultation Question 2 (regarding option A)

A. Please provide details of any additional costs or benefits of the status quo—if possible, please state the magnitude (either in dollars or qualitatively) of the costs and benefits?

As discussed above, we do not see any consumer benefit in maintaining the status quo. This option is unacceptable for consumers, as it would simply allow the current problems to continue, and will not achieve the Government's objective of providing the same level of protection that is available to consumers of other financial products and services.

Maintaining the status quo may also create costs to consumers flowing from under participation in the insurance market generally. Dr Rhonda Smith[12] has argued that consumers are unlikely

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[10] At page 25. Cited in Insurance Law Service (2009) Submission to Senate Economics Legislation Committee Inquiry into the Trade Practices Amendment (Australian Consumer Law) Bill 2009.

[11] Insurance Law Service (2009) Submission to Senate Economics Legislation Committee Inquiry into the Trade Practices Amendment (Australian Consumer Law) Bill 2009, pp 3-4.

[12]

to be fully aware of non-core contract terms (in any market) when making purchasing decisions. As a result,

> ...even if initially suppliers offer different terms, lack of competition on non core terms, is likely to mean that the non core terms of contracts within an industry become standardised to the least favourable terms for consumers.[13]

Smith goes on to argue that, where a product is purchased repeatedly or regularly, a consumer that is unsatisfied with one supplier can switch when they next buy the product, and so exert competitive pressure. However,

> …in the case of unfair contract terms, even if there is competition in relation to core terms (price/quality attributes), generally there is little or no competition with respect to non core terms, as noted above. Although there are alternative suppliers, this confers market power on suppliers (similar to the effect of a cartel on price) and so the allowance for risk associated with particular contingencies is not reflective of the likely cost associated with those events if they occur and this represents a misallocation of resources. *Consumers have the choice of accepting contracts that contain unfair terms or not purchasing the particular good or service at all* [our emphasis].[14]

Finally, maintaining the status quo imposes costs upon individual consumers who pay for insurance but are still required to absorb losses that they reasonably thought they were covered for. Where a loss is significant (for example, a natural disaster) these losses flow onto the community at large which then has to react to dampen the impact of the loss which may otherwise have been covered by insurance.

2.3 Consultation Question 3 (regarding option B)

A. Would you support changes to section 14 of the IC Act as a viable means to address the issue of unfair contract terms in insurance?

No. This option would result in consumers continuing to lack an accessible legal avenue to challenge unfair terms in insurance contracts.

This option is premised on a belief that a duty of utmost good faith is capable of protecting consumers from unfair terms. As National Legal Aid have argued in the past,[15] the key weakness of this provision is that it relies on consumers—the weaker party—to proactively challenge the decision of insurers using a poorly understood and cumbersome process. While there are no shortage of consumers who have been harmed by unfair terms in insurance contracts,[16] section 14 is rarely used by either consumers, (even in low cost jurisdictions like the Financial Ombudsman Service)[17] or ASIC, suggesting this mechanism is either inaccessible, ineffective, or both.

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[13] Smith (2008) p 6 (see Appendix).

[14] Smith (2008) p 6 (see Appendix).

[15] National Legal Aid (2010) *Unfair Terms in Insurance Contracts: Options Paper* (Submission).

[16] For example, see submissions by Consumer Action and the Insurance Law Service to the Senate Economics Legislation Committee inquiry into the Trade Practices Amendment (Australian Consumer Law) Bill 2009 and submissions from Consumer Action and National Legal Aid to the Government's Unfair Terms in Insurance Contracts options paper.

[17] For example, National Legal Aid's previous analysis of decisions from the Financial Ombudsman Service over the 18 months to May 2009 found that good faith was used sparingly as a basis for relief.

Among other problems, the duty of utmost good faith is a relatively vague concept and (even if the onus of proof were reversed to require insurers to prove they acted in utmost good faith[18]) it will likely remain a complex and unworkable tool for consumers. In particular, even if modified, it is not directed at addressing systemic or market-wide unfair terms in standard contracts, but rather looks at the nature of conduct between the parties. A systemic or market-wide approach to dealing with unfair terms is one of the principal drivers and benefits of unfair contract terms regulation.

Further, it is simply inefficient to address unfair terms in standard form contracts through a series of individual actions by consumers, as use of section 14 would require. If an identical term appears in across standard form contracts with multiple consumers and is considered unfair, the efficient response is to rule it out of all contracts at once (assuming there are no reasons why this should not occur under the circumstances). The alternative as required by section 14 is that every consumer that suffers detriment because of the unfair term would need to spend the time and money required challenge the term individually. The further cost of this approach is that many (if not most) consumers would simply bear the cost of the unfair term without challenging it because of a lack of awareness of their rights and the uncertainty and potential costs involved in taking legal action. This leads to poor outcomes for consumers (the unfair term may continue to be included in future contracts) and for the competition (insurers who retain unfair terms may have an advantage over those who do not).

2.4 Consultation Question 4 (regarding option C)

A. What are the potential benefits to consumers (both monetary and non-monetary) of adopting this option - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

See response to question 1D.

B. From an industry perspective, what would be the potential compliance costs (both monetary and non-monetary) associated with this option - if possible please provide the magnitude of the costs and a breakdown of categories?

While we cannot speak for the costs that will be faced by industry, it is important to note that all other industries currently regulated by unfair contract terms law will have faced compliance costs in 2011 and that (according to the analysis of the Productivity Commission) such costs will have been one off expenses and "likely to be small" relative to turnover.[19] The mere presence of compliance costs for insurers should not be a relevant consideration unless the insurance industry can make a compelling argument that their compliance costs will be significantly higher than any other industry which has had to comply with these provisions.

[18] As suggested at pages 26-27 of the draft RIS.
[19] Productivity Commission (2008), Volume 2, p 434-435.

2.5 Consultation Questions 5 (regarding option D)

A. If UCT laws were extended to include insurance, is it preferable for these laws to sit within the IC Act or ASIC Act?

The unfair contract terms in the ASIC Act should be extended to apply to insurance contracts. We oppose option D, that is, that new unfair contract terms could be created in the IC Act.

Such an approach would lead to the development of a separate body of law in relation to unfair contract term regulations for insurance, compared with financial services generally. This has the potential to create increased costs and uncertainty, which was a concern of the Productivity Commission in its suggestion that a single, generic consumer law should apply across all industry sectors.

D. What are the potential benefits to consumers (both monetary and non-monetary) - if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

This option could bring some limited benefits for consumers and is a better option than options A, B or E (which will bring no consumer benefit). However, as noted above, we do see inefficiencies and costs arising from the development of a separate body of unfair contract terms law that applies to insurance, compared to that which will apply to other financial services and products. If the same law (in the ASIC Act) applied to all financial services generally, including insurance, this would have significant benefit to all stakeholders in terms of consistency and understanding of the law in practice.

2.6 Consultation Question 6 (regarding Option E)

Option E proposes to "encourage the insurance industry" to adopt self-regulation to limit the use of unfair contract terms. We strongly oppose this option.

As we said in our response to the March 2010 round of consultation, self regulation is simply not an option while significant portions of the industry oppose unfair terms regulations or refuse to accept that the problem exists.[20]

We note that some in the insurance industry have begun to show a willingness to address unfair contract terms. Despite this, we still oppose this option. Consumer Action and other consumer advocates have many years of experience dealing with the insurance industry and its self regulatory tool, the General Insurance Code of Practice. We have frequently found the insurance industry to be unresponsive to consumer concerns and unwilling to satisfactorily address non-compliance with the Code of Practice and systemic consumer issues with insurance.[21] While we have seen some improvements in recent times, negotiations regarding amendments to the Code of Practice are still lengthy and can lead to 'lowest common denominator' outcomes—a real risk in this case given significant industry opposition.

[20] See for example page 7 of the draft RIS.
[21] For more detail on this point see National Legal Aid (2010), p 16.

Further, we are not convinced that the Code of Practice is well suited to the level of detail and guidance that would be necessary to properly address unfair terms. In our view, there are no indications that the industry is capable of addressing the problem of unfair insurance contract terms via self-regulation.

A. What would be the costs and benefits to consumers (both monetary and non-monetary) of adopting option E—if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

We believe option E is likely to create costs but no benefits for consumers. Option E would likely put pressure on insurers to make some kind of response (creating costs which would be passed onto consumers), but as we suggested above, we doubt such a response will create any consumer benefit. We are dubious that the possible consumer benefits identified in Table 6.5 of the draft RIS[22] would eventuate under this option, or indeed whether any substantial change would occur.

In relation to unfair terms, the most substantial consumer benefit will arise where there is a well-resourced regulator which can adequately review contract terms, develop industry guidance and ultimately take enforcement action where required. A self-regulatory approach would be unlikely to provide monitoring and compliance functions to an independent regulator that can place this role effectively.

2.7 Consultation Question 7

A. Do you agree that main subject matter should be clarified in the context of insurance policy exclusions?

We do not agree that it is necessary to include any clarification in the law of what is or is not the main subject matter of an insurance contract. In our view, a court will have little trouble distinguishing between:

- clauses which genuinely describe the subject matter of an insurance policy (not subject to review as unfair contract terms); and
- exclusion clauses which limit insurer liability from cover described by the main subject matter, or clauses which set out conditions precedent making a successful claim (which would be subject to review)

However, we would support clarification of the law through regulatory guidance, such as an ASIC regulatory guide. This could have the effect of encouraging compliance with the unfair terms provisions without limiting their application.

In general, attempting to define the main subject matter creates the risk that terms will be deemed to be non-reviewable for completely arbitrary reasons even if they do not deal with the 'main subject matter' of the contract. It is important to note that insurance contract terms are capable of evolving over time—what may be dealt with through three separate clauses (one outlining cover, one outlining exclusions and one outlining pre-conditions to accessing cover)

[22] The benefits identified were "possible benefits from changes in insurer's conduct in drafting and administering contract terms" and "access to potentially more appropriate level of cover".

can be re-drafted as one single clause. This demonstrates the danger of a blanket carve-out of particular types of insurance terms—a term may change from being reviewable to non-reviewable through contractual drafting techniques, when the intention is that the term is reviewable for unfairness.

If Government feels that clarification of the meaning of 'main subject matter' is necessary, the definition should be as narrow as possible to ensure that exclusion clauses can be reviewed under unfair terms provisions.

Further, the wording of any definition should be clear that, when courts are considering whether a term is part of the main subject matter, the decision should be based on the substance rather than the form of the term, as viewed in context of the contract as a whole.

B. Do you consider terms that seek to limit liability genuinely constitute main subject matter of an insurance contract?

No. Pursuant to common law, the main subject matter of the contract is the fundamental understanding conveyed to the consumer about which property, liabilities etc are covered from harm caused by particular events. According to one text:

> a contract of insurance insures the interests of insured against the subject-matter of the insured. The subject-matter of the insurance may be a physical item such as a house or car; it may be a chose in action (which is a contractual or proprietary right enforceable by action) such as debt, contractual right or licence; it may be a potential legal liability such as one road-user's potential liability to other road-users for damage or injury caused by the former's negligence; or, as in the case of life, accident or sickness insurance, it may be a person.[23]

As such, the main subject matter of an insurance contract cannot be considered to be the scope of cover and thus any terms which exclude particular property, liabilities, circumstances or events from coverage, or that place conditions precedent on accessing coverage are not the main subject matter of the contract.

This view is consistent with the purpose and plain reading of the unfair contract terms provisions and also the rationale for extending unfair contract terms protections to insurance contracts.

The explanatory memorandum to the Australian Consumer Law explains the 'main subject matter' exemption as follows:

> ***Main subject matter of the contract***
> 5.59 The exclusion of terms that define the main subject matter of a consumer contract ensures that a party cannot challenge a term concerning the basis for the existence of the contract.
>
> 5.60 Where a party has decided to purchase the goods, services, land, financial services or financial products that are the subject of the contract, that party cannot then challenge the fairness of a term relating to the main subject matter of the contract at a later stage, given that the party had a

[23] CCH Limited, *Australian & New Zealand Insurance Commentary*, (2010) at [¶1-410]

> choice of whether or not to make the purchase on the basis of what was offered.
>
> 5.61 The main subject matter of the contract may include the decision to purchase a particular type of good, service, financial service or financial product, or a particular piece of land. It may also encompass a term that is necessary to give effect to the supply or grant, or without which, the supply or grant could not occur.

Although the discussion above concerns section 26 of the ACL, the exclusion operates in the same way at section 12BI of the ASIC Act and so the same reasoning applies. Essentially, the main subject matter exclusion recognises that certain parts of a contract are necessarily up for negotiation—the consumer "had a choice of whether or not to make the purchase on the basis of what was offered". A consumer will not enter into an insurance contract if it clearly will not cover a particular risk for which a consumer seeks protection. The explanatory memorandum is clear that what is meant by the 'main subject matter' of the contract is the basic parameters of the product that are clearly obvious as understood at the point of sale—the "particular type of good, service financial service or financial product".

However, 'main subject matter' does not include the terms which modify those basic parameters. In a standard form contract, such terms are not up for negotiation but are presented on a "take it or leave it" basis. It is quite possible that a consumer who buys the product either grudgingly agrees to these other terms or is completely unaware of them.

The wording of the ASIC Act leads to a similar conclusion. In particular it is instructive that the 'main subject matter' exclusion is in the same section of the ASIC Act as the exclusion that the up-front price of a product also cannot be an unfair term (section 12BI). They are both matters that the consumer is necessarily aware of at the point of sale and can make a choice about. If the consumer believes that the up-front price is unfair, they need not make the purchase. There is no room for surprise or power imbalance.

By contrast, a contingent fee is not necessarily the subject of negotiation, in the same way that an insurance policy exclusion is not. This is why contingent fees can be considered an unfair contract term under subsection 12BI(2) even though upfront cost cannot.

D. What benefits are there for consumers (both monetary and non-monetary)—if possible, please state the magnitude (either in dollars or qualitatively) of these benefits?

As discussed above, we do not believe any clarification is necessary in the Act to assist courts to identify contract terms which make up the main subject matter of the contract. That being so, we do not believe there is any real consumer benefit to making this kind of clarification.

There will be no consumer benefit to defining 'main subject matter' broadly, as suggested by option 1 in the draft RIS.[24] On the contrary, we believe this option will cause consumer detriment because it will arbitrarily prevent consumers from challenging some contract terms which would otherwise meet the definition of an unfair term under section 12BF.

[24] See pages 42-43 of the draft RIS..

2.8 Consultation Questions 8

A. Are there any major obstacles (either legal or practical) preventing a narrow definition for main subject matter?

A narrow definition of 'main subject matter' (which would not allow policy exclusions to be challenged as unfair under section 12BF), as proposed by option 2a,[25] is our preferred option if Government feels that this point needs any clarification.

In our view, there are no legal obstacles to defining this term narrowly, and as discussed above, the intent of the protection supports a narrow definition.

C. What benefits are there for consumers (both monetary and non-monetary)—if possible, please state the magnitude (either in dollars or qualitatively) of the benefits?

The main benefit for consumers from option 2a (compared to options 1 and 2b) is that they or ASIC will be able to challenge unfair exclusion clauses in insurance contracts when they are in dispute with their insurer.

We should note that this does not mean that all exclusion clauses will be struck down for unfairness—this will only occur where the term is unfair by the definition in section 12BF, that is:

- it would cause a significant imbalance in the parties' rights and obligations;
- it is not reasonably necessary to protect the insurer's legitimate interests; and
- it would cause detriment to the consumer.

It follows that insurers will be free to use exclusion clauses to limit their risk under option 2a. This option simply gives consumers the opportunity to challenge those terms if they are unfair and application or reliance upon them would cause detriment.

D. If main subject matter was to be defined narrowly, what types of policy exclusions/ limitations should be excluded?

If Government chooses to clarify the meaning of 'main subject matter', the clarification should make clear that a court may review all exclusion or limitation clauses in insurance contracts for unfairness under section 12BF. Framing the clarification in this way will ensure that courts are not arbitrarily barred from finding that a term is unfair. As noted above, this will not mean that all exclusion or limitation clauses are eligible to be struck down, as a term will still need to meet the other requirements of section 12BF and the other unfair terms provisions.

Framing the clarification in this way will also not prevent a court from finding that an exclusion term is actually part of the main subject matter of the contract—it will merely prevent a court from refusing to review the term at all for compliance with 12BF.

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[25] See pages 44-46 of the draft RIS

2.9 Consultation Questions 9

A. Do you consider it necessary (or desirable) to restrict remedies to be exercised solely by the regulator if UCT laws were extended to include insurance?

And

B. Will individual consumers have the same level of protection (as provided in the ACL and the ASIC Act) if the regulator is the only party that can seek remedies in relation to UCT?

It would be very undesirable to only allow the regulator (and not consumers) to seek remedies for unfair contract terms. Under this proposal, consumers have one less avenue for redress when dealing with an insurer than when dealing with any other industry, and so will not have "an equivalent level of protection as that which currently applies to other financial products and financial services".

We of course welcome ASIC having powers to challenge unfair contract terms in insurance. In doing so, ASIC creates benefit for all consumers (particularly the most disadvantaged and vulnerable consumers, who may be less able to challenge unfair terms on their own motion) and has the ability to prevent disputes before they arise.

However, consumers also need to be able to challenge unfair terms on their own motion as part of a dispute with an insurer. Family homes, other significant assets and considerable amounts of money are often at stake when a consumer challenges a decision of an insurer. If an insurer comes to a decision by relying on a contract term which is patently unfair, the law should not arbitrarily close avenues of redress.

We do not accept the reasoning that consumers do not need access to unfair contract terms protections because court actions on this basis are rare.[26] This suggestion ignores that most consumer disputes will be settled well before they reach court, and when they settle in a consumer's favour it is because the consumer has demonstrated that they have a strong case which the business is not willing to risk defending.

To illustrate, a brief look through Consumer Action's records for the last 12 months finds that at least 94 inquiries were made through our advice lines which appeared to involve unfair contract terms. Twenty-nine cases in that period were considered at our legal practice's case intake meeting (which considers more significant cases and refers some to our solicitors for ongoing support). When cases are taken on through our intake process, they will still usually be resolved before proceeding to a court or tribunal hearing. So although we may rarely bring unfair contract term cases to courts or tribunals, the threat of action provides a valuable negotiation tool for consumers. Extending unfair terms protection to insurance contracts will almost certainly increase the number of consumers achieving just outcomes from disputes with insurers even if they are rarely raised in courts.

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[26] As suggested by the draft RIS at paragraph 6.3.

2.10 Consultation Question 15

If UCT provisions were applied to insurance, would a 2 year transition period be adequate for industry and consumers?

While we accept that it will take time for insurers to review their contracts and processes, this reform is already overdue and we would strongly oppose a transition of longer than two years. To our knowledge, most consumer insurance contracts are renewed each year, and any necessary changes to contract terms could be made through the renewal process. Two years is the absolute maximum time required.

Please contact David Leermakers on 03 9670 5088 or at david@consumeraction.org.au if you have any questions about this submission.

Yours sincerely
CONSUMER ACTION LAW CENTRE

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CONSUMER ACTION LAW CENTRE

Supplementary Submission

Unfair Contract Terms*

Costs and Benefits of Intervention in Relation to Unfair Contract Terms

Competitive markets, free from regulatory intervention will perform efficiently and this will benefit not only producers but also consumers – the market will supply the products that consumers most value at prices that reflect the value of the resources used to produce them and producers will be responsive to changes in demand and supply conditions. In such markets buyers and sellers are free to enter into contracts relating to the supply of goods and services and they will do so where such arrangements are mutually beneficial and so those contracts will be efficient. Contract provisions are legally enforceable by either party and this is important to ensure efficient outcomes.

Thus, Vickers observes:

'…with symmetric information between a buyer and a seller…freedom of contract should lead to an efficient outcome – the gains from trade should be maximised. Sellers would have every incentive to offer terms that deliver value for money to consumers as efficiently as possible. If a sales contract contained a term that benefited the consumer less than it cost the seller – or harmed the consumer more than it benefited the seller – then the term would be inefficient and would go. Without the inefficient term the seller would be able to offer a deal that would be better both for the seller and the consumer. Likewise there would be every incentive to include efficient terms. In short, deals would be tailored efficiently by unfettered market participants.'[27]

As noted in the original submission by the Consumer Action Law Centre to the Productivity Commission, standard form contracts, as a process, are efficient and may benefit consumers because in competitive markets reduced transaction costs will be reflected in lower prices or other improvements in sales terms. Thus,

'Standard form contracts can have advantages to both supplier and purchaser provided that a fair chance is achieved between both parties to the contract. They reduce transaction costs for the supplier which would otherwise be passed on to the purchaser. They allow for lengthy and detailed contracts to be finalised with the

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* This paper was prepared by Rhonda Smith, Economics Department, University of Melbourne at the request of , and with participation from, the Consumer Action Law Centre. It forms part of a broader research task which examines Part V of the Trade Practices Act and considers whether it has kept pace with developments around the world and within other Australian jurisdictions.

[27] John Vickers (2003), Economics for consumer policy, p.8, available at www.oft.gov.uk/shared_oft/speeches/spe0503.pdf. See also Russell Korobin (2002), Bounded Rationality, Standard Form Contracts, and Unconscionability, *University of Chicago Law Review, Vol 70, pp1203- 1295* for a discussion of how market structure and willingness of purchasers to acquire information influences the presence of unfair contract terms.

minimum of time and by lay persons who only need to negotiate the specifics such as price, description of goods and services and delivery times. Over a period of time, people become familiar with the contracts because they are standard and may encourage a general understanding of trading practice.'[28]

Arguably, those who desire and are willing to pay the extra costs of non standard contracts, are free to do so and it might be assumed that under competitive conditions firms would respond to such requests. Frequently, it seems that, for various reasons, the reality is otherwise. It is not unusual for purchasers to enter into contracts into which they have had little or no input and frequently these contracts contain terms that are not necessarily fair and may not produce efficient outcomes.[29] Although the discussion of unfair contract terms typically relates to standard form contracts, it may be more appropriate in the present context to consider more generally contracts that are not negotiated between the parties. This is because word processing enables suppliers to customise contracts for particular purchasers quickly and at very little cost but the purchaser still has no input in to the contract terms.

Although many contracts contain unfair terms whether as a consequence regulatory intervention of some sort is necessary or justified requires that the benefits from intervention exceed the cost that intervention imposes on various parties. This in turn raises a question of the welfare standard against which such an assessment is to be made.[30] Having resolved this issue, if the cost of unfair contract terms is likely to exceed any benefits from non intervention, there are two other issues to be considered. The first is whether there are already adequate provisions in place to address the problem and, if not, what form should any intervention take, recognising that the costs and benefits associated with intervention are likely to be influenced by the particular policy instruments selected. This paper focuses on the costs and benefits of addressing unfair contract terms, and only briefly considers the form that such intervention might take.

The Costs Resulting From Addressing Unfair Contract Terms

Clearly there are costs associated with regulatory intervention in relation to contract terms. They include:

i. an increase in transaction costs - standard form contracts are efficient as they reduce the transaction costs of buyers and sellers associated with negotiating

[28] Standing Committee of Officials of Consumer Affairs (2004), Unfair Contract Terms, A Discussion Paper, January, p.16. (hereafter SCOCA)

[29] The Consumer Action Law Centre submission to the Productivity Commission.

[30] In the context of an exemption from Part IV of the Trade Practices Act, the Australian Competition Tribunal canvassed the issue of the relevant welfare standard to apply in the Qantas-Air New Zealand matter. It concluded that the appropriate standard was a modified total welfare standard, a standard that could just as well have been described as a modified consumer welfare standard. In the present context the aim of the proposed intervention is to ensure consumer sovereignty and to avoid certain detriments to consumers. Therefore a consumer welfare standard would appear to be appropriate. However, this should be modified to recognise that the impact on consumer welfare of producer conduct may be indirect rather than direct (for example, efficiency increases free up resources for other uses and so benefits consumers even when there is no direct pass through of benefits in the form of lower prices or improved quality).

and drawing up a sales contract. In discussing unfair contract terms it seems that often the counterfactual is incorrectly assumed to be ceasing to use standard form contracts so that contracts must be individually negotiated. However, the issue is not standard form (or non negotiated) contracts, it is the terms that are inserted into them. If these contracts do not contain unfair terms, they may still be used;

ii. adjustment costs, that is, the cost of amending and re-negotiating existing contracts. The extent of such costs depends on whether there are unfair terms in the contracts, the length of time before the contract expires and the time allowed for the removal of such terms. Word processing facilities mean that these contracts can be readily altered and at little cost so compliance costs and future transaction costs should not be as significant as they may have been in the past;

iii. a one-off cost to amend contracts offered in future so that they will be compliant (see ii above), as well as the costs associated with monitoring the firm's own compliance in future;

iv. the monitoring and enforcement costs of the regulator. The extent of the former depends in part on whether an existing body is charged with this responsibility as there are likely to be economies from shared overheads and even from better/fuller use of staff.

The costs associated with addressing unfair contract terms are affected by whether such regulation replaces some existing requirements (such as disclosure requirements). If so, the relevant cost is the cost of the new provisions net of the costs of existing, but now redundant, requirements. In addition, in determining the cost of new regulation, the cost savings of having a national regime for firms that operate nationally should be netted out. Further, to the extent that new regulation causes changes that avoid litigation under the existing, but perhaps not very satisfactory, provisions, the consequent saving of enforcement costs should be taken into account.

In his oral evidence to the Productivity Commission Inquiry, Professor Field discussed the costs associated with addressing unfair contract terms.[31] In particular he argued that remedying the problem may deprive consumers of benefit, at least in part because it may reduce competition between rival suppliers. He stated:

'...there's a potentially much more significant cost that's involved than compliance costs and its around the interference with what I would call the complex balance of the contractual bargain. Put simply, the deletion of one term as unfair may see another term which the consumer values affected adversely. What, of course, then seems on its face attractive, which is the protection of powerless consumers from the excessive power of business, may in fact upset the complex balance of the contractual bargain in a way that's harmful to consumers.'[32]

[31] Productivity Commission, Transcript
[32] Productivity Commission, Transcript.

However, reference to the contractual bargain is hardly relevant in that essentially the issue of unfair contract terms arises where purchasers lack input into those terms and, as a consequence, the terms unduly favour the supplier. It is indeed the market power of the business with respect to those terms which is the problem.

Professor Field illustrates his comments with an example relating to contracts containing a term that creates a cost disincentive to discourage consumers from changing from one telecommunications supplier to another early in the contract. He states:

'The pricing offered to consumers to enter into those contracts is premised on the fact that consumers will stay in that contract for a period of time…If you take that clause out, they'll probably act rationally and that is, two months after they've entered that contract they may well find the next contract offered in the market at a cheaper price and they'll move to that.'

He concludes that this may lessen competition in the market.

There may be circumstances where removal of a particular term from a contract has implications for the commerciality of the contract. Nevertheless, the example provided is not appropriate on a number of levels and the conclusions drawn from it are not valid. Thus,

i. a customer who signs up to a contract generally does so for a specified period and so is committed for this period without any need for penalty clauses. Indeed the suggested outcome can be avoided by offering the potential purchaser alternative contract periods with corresponding adjustments to the price;

ii. ignoring (i) and accepting that customers could legally terminate contracts early,[33] it is exactly that risk of losing customers that is the essence of what makes a competitive market work. That risk forces a firm to 'sharpen its pencil', to offer the best possible deals and to engage in innovation to achieve that outcome;

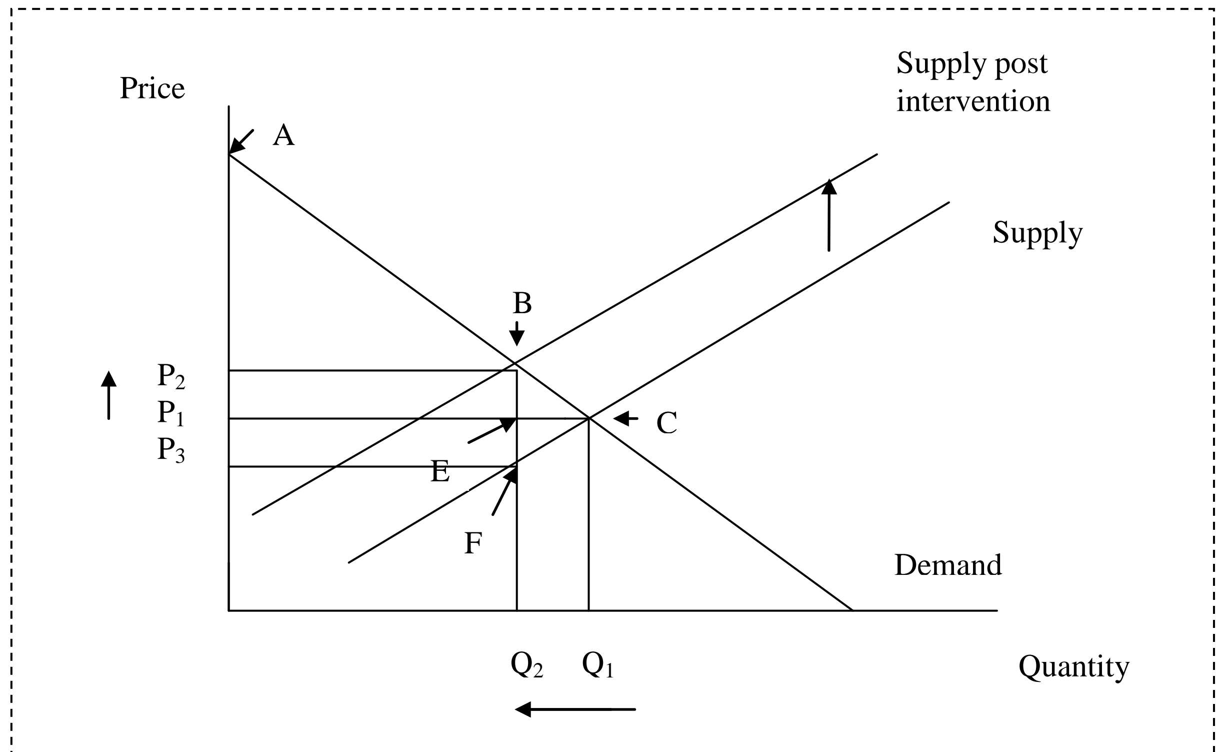
iii. although the statement seems to accept that the penalty clause in the contract is unfair, it implies that if correcting it means additional changes then it should not be changed. One might think that at the very least the relative costs and benefits of the two scenarios would be relevant.

As a consequence of these costs Professor Field's line of reasoning leads to the conclusion that regulatory intervention in relation to the terms of standard form or non negotiated contracts will reduce the net efficiency with which markets operate, resulting in misallocation of resources (including the deadweight loss associated with responding to, complying with, and enforcing the regulation) and reducing the incentive to innovate and respond to changing market conditions due to any increase in uncertainty/risk and reduced profitability. However, regulation of unfair contract

[33] Perhaps because there is a 'meet the competition' clause in the contract. This is unlikely in a 'take-it-or-leave-it' contract as it is in the interests of the purchaser rather than the supplier.

terms is unlikely to have such effects if contract terms are mutually beneficial and hence efficient rather than unfair.

The effect of regulatory intervention in relation to unfair contract terms is illustrated in Diagram 1.[34] From the initial equilibrium C, the introduction of regulatory measures in respect of unfair contract terms increases the costs incurred by suppliers (implementation and compliance costs), represented by P_3FBP_2, and this has the effect of shifting the supply curve to the left. The share of that cost passed through to consumers is P_1EBP_2. The result is reduced supply and assuming that the demand curve is unchanged,[35] increased prices for consumers and a reduction in consumer surplus (by P_2CBP_1) and in producer surplus (by P_3P_1CF). In addition, a deadweight loss of BCE is created. This represents an overall loss of P_1P_2BCF. The significance of these responses from a policy perspective depends largely on the extent of the increase in costs to suppliers, the impact of this on quantity and price (which depends on the relative elasticity of supply and demand) and the size of the deadweight loss. Further, it assumes that currently there is no exercise of market power in relation to the unfair contract terms (see below). If this is not the case, then account must be taken of the reduction or elimination of monopoly rents through regulatory intervention, and the net impact of intervention on the size of the dead weight loss. In addition to the changes represented on the diagram, there may be adverse effects on the incentive to invest (dynamic efficiency), as well as increased costs for government of implementing the regulatory provisions and enforcing them.



[34] An issue is whether the cost associated with regulatory intervention is an additional variable cost or an additional fixed cost. The diagram and discussion could be taken to assume that it is a variable cost. Nevertheless, in the long run (the relevant time period) if the market is competitive the additional cost may result in some smaller firms (or firms with more favourable alternatives) exiting the industry, thereby restoring normal profits but causing the supply curve to shift to the left (as in Diagram 1).
[35] This assumption is relaxed below.

Diagram 1

Whether the above scenario is realistic depends on whether certain conditions are satisfied. The first of these is that:

'...the parties are able to negotiate on an equal footing, have equal bargaining power, are equally able to look after their own interests and have a full understanding of the consequences of their actions and the terms of the contract. In reality, this is not always the case.'[36]

In order to assess the implications of regulating unfair contract terms, the relevant 'price' is not simply the 'ticket price' but the price that takes into account all of the terms and conditions associated with supply, including any that may come into effect in the future. The second condition is that efficient outcomes are conditional on the absence of significant market failures. Yet, in reality, this is rarely if ever the case and so, even when markets are highly competitive, competition may not result in a market that operates efficiently. In relation to unfair terms in contracts, neither of these conditions may be satisfied.

Unfair Trading Terms and Consumer Sovereignty

Ensuring consumer sovereignty is an accepted justification for consumer protection policy.[37] Informed consumer choice is the distinguishing feature of consumer sovereignty, and it is a necessary condition for markets to function effectively.[38] Consumer sovereignty requires that the market offers a range of options to consumers, and that consumers are able to formulate preferences and choose effectively between the options available.[39] For various reasons (see below), consumers often fail to account fully for non core contract terms[40] when making purchase decisions. Consequently, even if initially suppliers offer different terms, lack of competition on non core terms, is likely to mean that the non core terms of contracts within an industry become standardised to the least favourable terms for consumers – this is analogous to bad products driving out good products as explained by Akerlof.[41] Thus, this has the effect of reducing consumer options and it means that there is little incentive for innovation in respect of the risk resulting from the contingencies to which these terms relate. Unfair contract terms may impair consumer sovereignty.

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[36] SCOCA, p.16

[37] For a discussion of this issue see Rhonda L. Smith and Stephen King (2007), 'Does Competition Law Adequately Protect Consumers?' *European Competition Law Review*, Vol 28, No 7, July, pp 412-424, at pp 413-414.

[38] Michael Waterson, "The Role of Consumers in Competition and Competition Policy", *Warwick Economic Research Papers*, No. 607, Dept of Economics, University of Warwick, 2001, p.2.

[39] Averitt, Neil W. and Robert H. Lande, "Consumer Sovereignty: A Unified Theory of Antitrust and Consumer Protection Law", *Antitrust Law Journal*, Vol 65, 1997, p 713-756, at pp. 713.

[40] Core terms are price and quality attributes; non core terms are all other contract terms such as the terms and conditions of cancellation, quality guarantees, provision for refunds and the like.

[41] George A. Akerlof (1970), `The Market For Lemons: Quality Uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, Vol 84, pp488-500. This may hurt the producers of good products as well.

Although in many situations consumers face a price which they do not negotiate, in imperfectly competitive markets consumers generally are able to choose between suppliers who may offer different price/quality bundles. In many cases these are products that are purchased repeatedly, if not regularly. Consequently, if the consumer is not satisfied with a particular purchase, subsequent purchases may be made from a different supplier. However, in the case of unfair contract terms, even if there is competition in relation to core terms (price/quality attributes), generally there is little or no competition with respect to non core terms, as noted above. Although there are alternative suppliers, this confers market power on suppliers (similar to the effect of a cartel on price) and so the allowance for risk associated with particular contingencies is not reflective of the likely cost associated with those events if they occur and this represents a misallocation of resources. Consumers have the choice of accepting contracts that contain unfair terms or not purchasing the particular good or service at all.

From the perspective of individual buyers, the cost associated with unfair contract terms is not, and indeed cannot, be accurately factored into the price of the product. While the probability of a particular event occurring is relevant for firms when determining their risk exposure and may be objectively available, it is not of much assistance to individuals in relation to consumption decisions – they are unlikely to be aware of the probability of such an event occurring, and even if they are, they cannot know the probability of it occurring in relation to themselves. The inherent problems of predicting and assigning a value to the risk of a particular contingency are illustrated by the use of unilateral variation clauses to fundamentally alter the nature of the supply conditions. For example, Telstra offered 'unlimited' download of its Big Pond product but later imposed a download limit on existing customers without providing consumers with an opportunity to exit the contract. Similarly, Citibank marketed a fee free credit card but subsequently introduced a one off fee of $165 on existing customers (the fee could be avoided by spending money on the card). It was not until ASIC intervened that consumers were offered the option to exit the contract (though even this was imperfect given that the offer had enticed consumers to make balance transfers to the Citibank card from other cards, so they had to pay out the balances to achieve exit.

In circumstances where these probabilities and costs are unknown (and unknowable), individuals are likely to discount the likelihood that such an event will occur in relation to their own purchase, especially when it has a low probability of occurring, and so triggering a clause in a contract that may be detrimental to them.[42] This can be illustrated with respect to the inclusion of penalty fees in banking products. Assume that there are 6 million bank accounts, and that each account holder incurs one penalty fee per annum of $20 (this may be fairly conservative as fees can be as high as $50 in the mainstream banking market and much higher in some fringe markets). This represents a cost of $120 million to consumers per annum and is likely to hugely exceed the costs to the bank of the conduct that resulted in the penalty. If these types of terms are being ignored, the product price is underestimated and consequently consumers overbuy the product relative to the position if there were no unfair contract

[42] See for example the discussion of hyperbolic discounting in the Consumer Action Law Centre's Submission to the Productivity Commission Inquiry.

terms. The significance of the failure to take non core contract terms into account is shown in Diagram 2.

Before considering Diagram 2 (and 3), certain qualifications in relation to the diagrammatic representation should be made explicit. First, the implications of regulatory intervention for price and quantity, for the deadweight loss and so on, depend in part on the absolute shifts of the supply and demand curves. Second, while the implications of these changes for quantity are unambiguous, this is not the case for price, and the new equilibrium values post intervention will be influenced by the relative price elasticity of demand and supply. Not withstanding these qualifications, the general result that intervention to address unfair contract terms is likely to lessen inefficiency is justified. The appropriate comparisons are the pre-intervention equilibrium and the post intervention equilibrium that reflects the actual price rather than the ticket price.

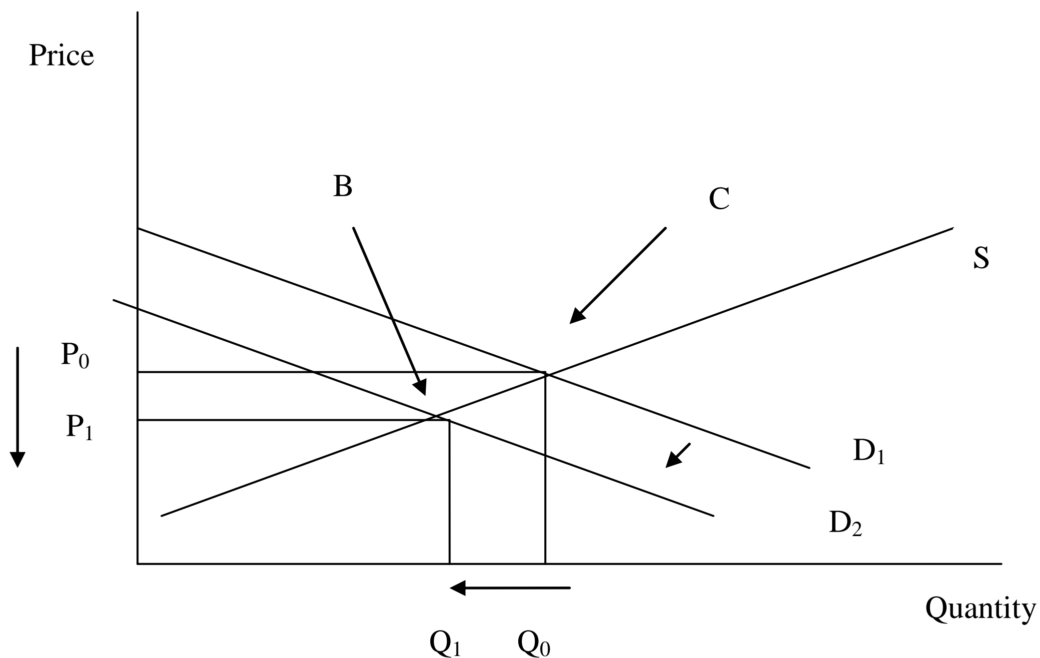

Diagram 2

If consumers fail to account fully for the cost to them of unfair contract terms, then the demand curve in Diagram 1 while representing actual willingness to buy based on the ‘ticket price’, overstates what that willingness would be if consumers took account of those costs, that is, it misrepresents consumer preferences. As shown in Diagram 2, the true demand curve consistent with consumer preferences is D_2 rather than D_1. As a consequence with demand represented by D_1, the product price is lower than it would otherwise be (it fails to take account of the non core terms) and the equilibrium quantity traded is greater. The efficient equilibrium is B rather than C with Q_1 rather than Q_0 and P_1 rather than P_0.

Given this correction, Diagram 3 re-introduces regulatory intervention to address unfair contract terms, thereby shifting the supply curve to the right (S_1). As a result of reducing or eliminating unfair contract terms, the 'correct' demand curve D_3 will be to the right of D_2 but to the left of D_1, its exact position depending on the cost to consumers of fairly addressing the relevant contingencies. The new equilibrium would be C (the intersection of D_3 and S_1, although if consumers still fail to take account of these costs the actual equilibrium will be the intersection of S_1 and D_1, that is, at B. Nevertheless, this is an outcome that is more efficient than if the unfair contract terms were not regulated in some way. At B, quantity exceeds the efficient level by Q_1Q_2 whereas without intervention quantity exceeds the efficient level by Q_0Q_2. The effect on price is uncertain as the supply response tends to increase price (reflecting increased costs) but the demand response puts downward pressure on price.

In addition, but not shown in the Diagram, regulatory intervention may make buyers more aware of non core contract terms and this may stimulate competition in respect of those terms which will further increase efficiency.

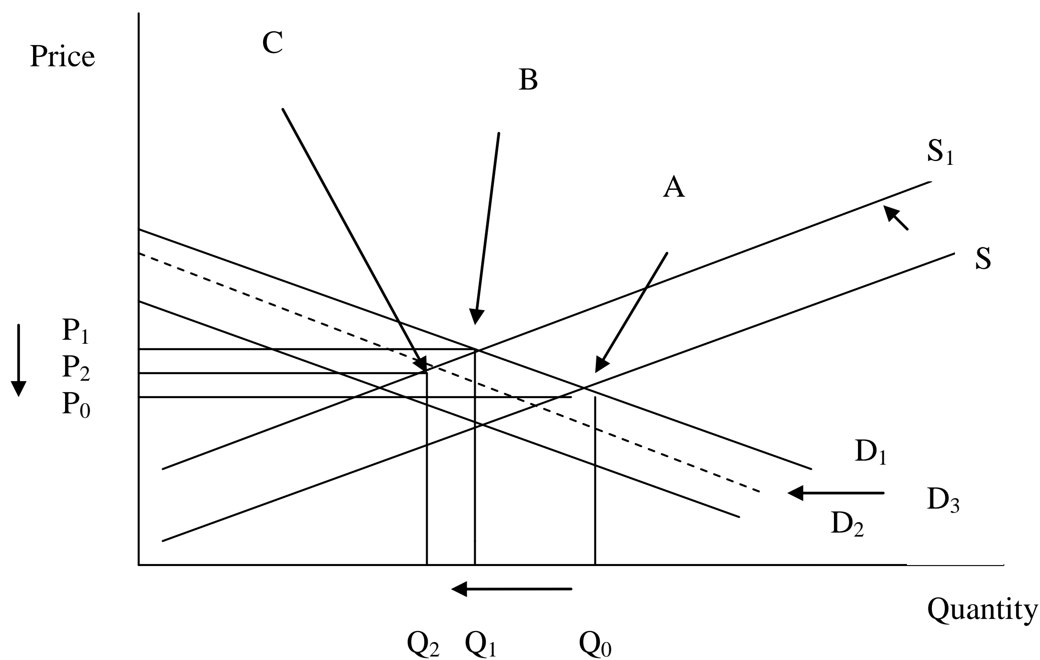

Diagram 3

Some additional considerations

First, publicity may alert consumers to the existence of problems resulting from unfair terms in contracts in particular industries (such as in relation to mobile phone contracts), although they may be only vaguely aware of the specific nature of the problem. In relation to that market at least a proportion of consumers will be more wary than they otherwise would be and may over-invest in seeking information about

the nature of the contract in that specific market. The effect will be to move the demand curve to the left of D_1. To the extent that the concern is unwarranted or overstated, the relevant demand curve will be to the left of D_2, resulting in under-consumption compared to a situation where no such uncertainty exists.

However, the adverse effects of unfair contract terms may not be confined to the market in which the contracts exist. Concern about contracts in one market, such as mobile phones, may spillover into other markets, such as those for the supply of electricity or gas. This may mean over-investment in seeking information in these markets as well and/or failure to respond to welfare-enhancing offers available from alternative suppliers. Further, the consequence may be to dampen competition in these markets not just in relation to the non core terms of the contract, but also in relation to core terms. This is because uncertainty makes consumers reluctant to switch suppliers even when an alternative supplier actually offers a better deal.[43]

Second, if businesses are able to reduce their costs by the use of unfair contract terms, they may be able to offer a lower price for a given product quality than can competitors that operate with fairer contracts.[44] As a consequence consumers may find themselves locked into a supplier for a considerable period because to switch to another supplier will trigger those terms and significantly increase the effective purchase price post purchase.[45] Examples of such terms include penalties for early re-payment of a loan, and terms stating that there will be no refunds in relation to cancellation of pre-booked holiday packages. Consumers often fail to realise that post purchase the contract terms convert the bargain into a rip-off. Awareness of such an outcome may cause at least some consumers to accept a somewhat higher price in exchange for greater flexibility in responding to changes in the market. As noted above, supplier conduct of this type tends either to result in all suppliers offering unfair terms or to drive out those offering fair terms. While the former reduces competition in relation to non core terms, the latter reduces competition in relation to core terms. Thus, removal of unfair contract terms protects competition and more efficient outcomes may result.

Equity benefits from intervention

Although competitive markets can be expected to operate efficiently, absent market failure, there is no reason to expect that they will produce equitable outcomes. Economists are prone to respond to concerns about equity by arguing first that competition should be unimpeded by concerns about equity because other policies such as taxation and welfare are superior instruments to address distribution issues. Second, they may suggest that if markets are efficient they will result in a higher level of economic activity and so everyone will be better off and there will be more wealth to redistribute.

Irrespective of whether these arguments are valid in competitive markets, the counterfactual to intervention to address unfair contract terms is not about interfering with such markets so that contracts contain unfair terms and markets are less

[43] However, the adverse effects of unfair contract terms may not be confined to the market in which the contracts exist.
[44] See for example, Centre for Credit and Consumer Law, submission to SCOCA March 2004, p.8.
[45] See earlier discussion of Professor Field's evidence to the Productivity Commission.

competitive in relation to core terms and not competitive in relation to non core terms, so that they do not operate efficiently. Further, redistribution policies frequently focus on redistribution of income from high income to low income groups, although some policies such as education and health, attempt to address the cause of inequity. In relation to unfair contract terms exposure to such terms is not determined by income level, but rather by the desire to purchase a particular product, that is, by being a purchaser.[46] If intervention is justified in these circumstances, it should be preventative and pro-active rather than reactive.[47]

Lack of consumer response to unfair contract terms

In the face of unfair contract terms, consumers typically continue to base their purchase decisions primarily on core terms and fail to take account of non core terms, although as noted above purchase decisions may be affected when there is awareness of the potential for unfair terms; and do not utilise existing means of redress. These responses (or the lack of them) could be taken to indicate that consumers do not consider unfair contract terms as significant enough to cause them to respond. However, the actual position seems to be otherwise. In order to understand the lack of consumer response it is important to consider why these unfair terms exist (this is also important for determining the nature of any regulatory intervention) and to understand the likely cost of remedial action.

Just as consumer protection problems were, and still are, often attributed to a lack bargaining power on the part of consumers, so too is the presence of unfair contract terms. Consequently, this is a problem that is assumed to arise in markets characterised by limited competition. In such markets consumers have little or no choice of supplier and so have limited bargaining power. The solution is therefore aggressive competition policy.[48]

In perfectly competitive markets consumers are protected because they have plenty of choice of supplier and are they fully informed. This same choice constrains suppliers, depriving them of market power. Thus, perfect competition prevents an imbalance of bargaining power between buyers and sellers, and so competition is perceived by many as the best form of consumer protection, including protection from unfair contract terms. However,

i. although markets may be competitive, few are perfectly competitive, and in such markets competitive pressure may result in consumer exposure to risk, including in relation to unfair contract terms (see discussion of switching costs);

ii. nor are consumers fully informed. Information deficiencies, including asymmetry of information, confer power on the party possessing information, and lack of access to relevant information or the cost of

[46] All purchasers of the product are exposed to risk and it may be that those who are time poor, but income rich, can afford to engage in less search and so are more likely to realise the consequences of unfair contract terms.
[47] See, for example, Frank Zumbo (2007), ‘Promoting fairer consumer contracts: Lessons from the United Kingdom and Victoria, *Trade Practices Law Journal* , vol 15, pp 84-95, at p.88.
[48] For a discussion of this see Smith and King, supra note 10, pp 418-420.

obtaining it, may prevent consumers responding so as to avoid or reduce the impact of unfair contract terms. Consumers may make inappropriate choices because the costs of acquiring information and/or using it are too great relative to the expected benefits likely to result.[49]

iii. The findings of behavioural economics indicate that quite frequently consumers fail to acquire and/or to use fully relevant information about transactions. Apparently irrational consumer behaviour may result from inertia, incapacity to process the complex information required to make the decision to switch or, faced with choice, the fear of making the wrong choice.[50] Thus, even when consumers are aware of the potential for consumer detriment as a result of unfair contract terms, frequently they do not respond to that risk but this does not mean that the cost is insignificant. In such circumstances, addressing information deficiencies is not likely to overcome consumer problems of this sort.

Addressing consumer detriment from unfair contract terms

It may be argued that if individual consumers are aggrieved in relation to contract terms, they already have avenues of redress and so specific regulation directed at unfair terms simply duplicates regulatory costs. However, to the extent that there may be avenues that individual consumers can currently pursue, the cost incurred by an individual as a consequence of the terms is unlikely to justify the legal costs of seeking redress. In the context of consumer protection policy generally and as applied to the US but equally applicable to unfair contracts terms:

'...for consumer transaction going to court is usually not economically feasible. When disputes involve small losses to consumers, private lawsuits will not work. Nor have class actions evolved to provide adequate enforcement. Further, small claims courts do not sufficiently reduce the costs of litigation. Thus, government consumer protection agencies have become part of the process to enforce the basic rules as well as to provide modification and amplification.'[51]

Yet collectively, the cost to consumers of unfair contract terms may be very large (or to put it slightly differently, the benefit derived by business from such terms may be very substantial). Regulation against such terms provides the basis for collective action that may improve the position of consumers affected by the terms and may reduce the incentive to impose such terms by necessitating that the costs associated

[49] Smith and King, supra note 10, pp 415-416.
[50] Eldar Shafir (2006), A behavioural perspective on consumer protection, paper presented to OECD Rountable On Demand-side Economics For Consumer Policy: Summary Report, 2006, available at www.oecd.org/dataoecd/31/46/36581073.pdf. Griggs points out that 'Increasingly the good or service being purchased encompasses the contract as an essential feature of the product or service.'[50] For example, the firm supplying Pay TV supplies the installation services, and associated equipment under a single service contract. Consequently, '…the rational consumer does not and cannot be expected to fully appreciate the embedded contractual complexity…'(Lynden Griggs (2005), 'The [ir]rational consumer and why we need national legislation governing unfair contract terms, CCLJ, Vol 13, pp 51-72, at p.52.)
[51] Timothy J. Muris (1991), 'Economics And Consumer Protection', *Antitrust Law Journal,* vol 60, no 1, pp 103-121, at p.105.

with such actions (after factoring in the probability of being caught) be taken into account by firms when determining a course of action.

Unlike the labour market where there are concerns about unfair employment terms in contracts, there is little potential for effective collective action in relation to consumer acquisitions (and possibly not even in relation to businesses purchasing inputs). Other potential remedies also appear flawed or incomplete[52] – for example, it seems that the Australian courts are not prepared to interpret unfair terms in contract as unconscionable conduct; while Victoria's prohibition on certain unfair contract terms has limited cover (it excludes the financial sector) and, of course, is confined to Victoria.

A Proposal to Address Unfair Contract Terms

It is apparent that the actual costs and benefits resulting from addressing unfair contract terms depend in part on the nature of the process to be employed. Victoria introduced regulation in respect of these terms in 1999 and through the SCOCA process other states are involved, at least to some extent, in consideration of the issue. An outcome likely to result in more significant compliance and administrative costs is for each state to introduce slightly different provisions. A more cost effective outcome is a national approach. This might involve inclusion in the Trade Practices Act of a new provision (for examples 51AAA) which prohibits unfair contract terms and it would apply not only to business dealings with consumers but also with large business dealings with small businesses. This might identify certain types of terms as unfair, while providing a basis for assessing whether other terms are unfair. Assessment of whether a particular term is unfair could be undertaken by the ACCC (or some other body) either at its own instigation or in response to complaints by purchasers. Alternatively, a company could request an administrative decision from the regulator in respect of a particular clause/s or for an entire contract, in a process akin to notification. An appeal process in relation to these administrative decisions should be available (as for authorisation and notification decisions). On legal issues this would be to the Federal Court but otherwise to a tribunal.[53] The remedy for unfair contract terms would be to void those terms in the contract, but not the entire contract. Only where the supplier failed to comply with this requirement would a pecuniary penalty be imposed.

[52] This issue has been explored in detail in numerous submissions to the Productivity Commission and in oral presentations and so is not elaborated here.
[53] Although this role could be filled by the Australian Competition Tribunal, it would need to be differently constituted when considering cases relating to unfair contract terms, that is, its membership should include a consumer representative.