



Royal Commission into Misconduct in the Banking,
Superannuation and Financial Services Industry

Credit for Small Business – An Overview of Australian Law Regulating Small Business Loans

Background Paper 10

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The views expressed are the authors' views and are not to be understood as
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CREDIT FOR SMALL BUSINESS

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CREDIT FOR SMALL BUSINESS

AN OVERVIEW OF THE AUSTRALIAN LAW REGULATING SMALL BUSINESS LOANS*

1. Introduction

1.1. The importance of lending to small business

Small business performs a central role in the Australian economy. Statistics issued by the Australian Treasury for 2016 indicate:¹

- There were over 2 million small businesses in Australia;
- 97 percent of all businesses were small businesses;
- 62 percent of small businesses were non-employing businesses;²
- 75 percent of employing small businesses employed 1 to 4 employees;
- Small business accounted for around \$380 billion worth of industry value added; and
- Small business provided employment for around 4.7 million people.

The Australian Bankers' Association has reported that about half of small businesses have a business loan facility other than a credit card. Further, bank loans to small businesses (where the loan amount is under \$2 million) totalled \$261 billion in December 2015.³

Small businesses occupy a unique space in the Australian regulatory landscape, which is primarily focused on providing protection for individual borrowers and consumers of goods and services generally. Small businesses are subject to some but not all of the statutory protections that apply to individual consumers.⁴ Thus, they are both inside and outside the regime and the coverage is not consistent. Part of the reason for this uneven regulatory coverage of small businesses in the consumer protection landscape is that there are competing considerations in defining the boundaries of this kind of protection.

Access to credit is centrally important to the flourishing of small businesses and in supporting innovation in the market. This credit needs to be provided at a reasonable cost to be accessible to small business, which means that small business lending has been allowed to operate without undue restrictions or regulatory hurdles.

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¹ Australian Treasury's Small Business Data Card, 4 August 2017, available at https://static.treasury.gov.au/uploads/sites/1/2017/09/SB_data_card.pdf.

² The term 'non-employing' business refers to sole proprietorships and partnerships without employees. See Australian Bureau of Statistics, 'Small Business in Australia' (Catalogue number 1321.0, available at <http://www.abs.gov.au/ausstats/abs@.nsf/mf/1321.0>

³ Australian Bankers' Association, 'The small business sector in Australia – Economic Report' (May 2016), available at

https://www.ausbanking.org.au/images/uploads/ArticleDocuments/134/ABA-126420_Economic_Report__Small_business_sector_in_Australia_-_May16.pdf.

⁴ For the regulatory regime providing credit to consumers see BP4.

1.1.1. Inequality of bargaining power

Nonetheless, as noted in Part 2.1 below, a balance needs to be struck between facilitating access to credit on the part of small businesses and imposing restrictions on banks and other lenders to ensure that the interests of small businesses are appropriately protected. Small businesses are often in a similar position to individual consumers in seeking credit, as well as contracting for other goods and services. Small business may be operated by individuals or a collection of individuals who may lack specialised expertise in negotiating for credit and have limited resources to seek financial and legal advice to assist in this process.⁵ These factors mean that there are often considerable inequalities of bargaining power, arising primarily from information asymmetry, between small businesses and the financial institutions from whom they may seek credit.⁶

1.1.2. Balancing regulatory objectives

Achieving a balance between encouraging a market that provides reasonably priced credit to small businesses with fair and reasonable safeguards is a challenging task. The challenge is reflected in the ways in which both the general or judgment law and legislation have responded to small business lending. As we shall see in some cases the relevant law draws no distinction between small and large business while in other respects small businesses are treated as being in a similar position to consumers.

1.2. The scope of this paper

This paper complements, and draws on information from, ‘Everyday Consumer Credit – Overview of Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans’ (‘BP4’).⁷ In some areas, such as the generic consumer law in the ASIC Act and the Code of Banking Practice, small business credit is treated in either the same or substantially the same way as consumer credit. Given the overlap between small business and consumer credit in these areas, some of the information in BP4 is repeated in this paper with relevant modifications.

The scope of this paper is limited to small business credit in the form of loans, both secured and unsecured. It does not consider other banking facilities, financial products or financial services. It is intended to provide an overview of the relevant issues and does not purport to be comprehensive.

⁵ See Aviva Freilich and Eileen Webb, ‘Small Business: Forgotten and in need of protection from unfairness’ (2013) 37 *University of Western Australia Law Review* 134, 138-139; *Treasury Legislation Amendment (Small Businesses and Unfair Terms) Bill 2015 Explanatory Memorandum* [1.1]-[1.7].

⁶ Productivity Commission Inquiry Report, *Review of Australia’s Policy Framework Vol II* (2008) p 318.

⁷ See <https://financialservices.royalcommission.gov.au/Pages/default.aspx>.

1.3. Structure

The paper covers the following topics:

1. Introduction;
2. Perspectives on regulating small business credit;
3. Overview of the law applying to small business credit;
4. The parties involved in a small business credit transaction;
5. Guarantees and security;
6. The Australian Securities and Investments Commission Act; and
7. The Code of Banking Practice and Other Industry Codes.

The Appendix sets out the abbreviations used in this paper.

2. Perspectives on regulating small business credit

2.1. Why regulate small business credit?

The case for providing legal protection for small businesses in credit transactions arises from the observation that many of the justifications for protecting consumers (see BP4) also apply to the circumstances of small businesses, as effectively a collection of individual consumers with an information asymmetry in their dealings with lenders, and also the important role of small business in the Australian economy. Many small businesses are undertaken by sole traders, under which the business is owned and run by one person. In such circumstances, the sole trader is personally responsible for the debts of the business and there is no legal distinction between the sole trader and the business. In other circumstances, small businesses are undertaken through a company in which one person is the sole shareholder or in which all of the shares are held by members of one family.

Although undertaking a business in a corporate form means that the owners of the business are legally separate from the entity undertaking the business and confers on the owners the benefit of limited liability protection in respect of the debts of the business, the shareholders (particularly those who are directors) are often exposed to personal liability as a result of guarantees or security that they have given to banks and other creditors in support of the debts of the business. In many cases, the security is granted over personal assets such as the family home.

Irrespective of the legal form in which a small business is undertaken, small business is qualitatively different from 'big' business or big corporate groups as they have much less bargaining power vis-à-vis creditors such as banks and also much less knowledge and access to resources when negotiating commercial contracts such as loan agreements. Small businesses usually enter into loan agreements on a standard-form basis; namely, the terms are not subject to negotiation and they are offered to the small businesses on a 'take it or leave it' basis. Banks themselves usually recognise the distinction between small business and big business by referring to the loans to the former as 'business lending' and loans to the latter as 'corporate lending'.

Although standard form business loan contracts reduce both the transaction costs that are incurred in negotiating the terms of an agreement and also the time that is required to review the terms,⁸ they are often very one-sided in favouring the interests of the banks or other creditors and granting them broad rights to protect those interests. Most (if not all) of the risks are shifted from the lender to the borrower. In addition, there is a concern that the terms allow the lender ‘increased flexibility and opportunity beyond what is reasonably necessary for the protection of [the lender’s] legitimate interests and to the detriment of the [borrower].’⁹

As a result of the limited knowledge and resources that small businesses possess, they do not enjoy a level playing-field when procuring commercial finance and negotiating the terms of the finance with banks. For this reason, the relatively weak position of small businesses is often considered to be analogous to that of consumers and in similar need of the general consumer protections provided under the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act) against unfair contract terms, unconscionable conduct and false or misleading representations.¹⁰

It is generally recognised, however, that a balance needs to be struck between facilitating access to credit on the part of small businesses and imposing restrictions on lenders to ensure that the interests of small businesses are appropriately protected. This balance is particularly relevant in the case of start-up businesses where there is no established track record in terms of cashflow or profit.¹¹ In such cases, banks and other lenders would be reluctant to lend if they were unable to reduce the credit risk on the loans by taking guarantees and security and by lending on terms that protect their own interests.

In addition, it has been recognised that businesses’ interactions through contracts are different in a number of ways from consumer interactions, including greater diversity of transactions, increased likelihood of repeat transactions and large variation in transaction size.¹² Accordingly, not all legal protections that are extended to consumers in credit transactions may be relevant or appropriate in the case of small business credit. For example, small business lending is not subject to the extensive disclosure regime that applies to consumer credit, primarily through the *National Consumer Credit Protection Act 2009* (Cth) (NCCP Act) and the National Credit Code (NCC), and those who are involved in providing credit to small business are not subject to the licensing regime, with its extensive conduct and responsible lending obligations in the NCCP Act.¹³

⁸ Small business owners often do not review the terms of loan agreements and, even if they did, would not understand the terms or their legal significance.

⁹ The Australian Treasury, ‘Extending Unfair Contract Term Protections to Small Businesses’ (Consultation Paper, May 2014), 1.

¹⁰ See further Part 6 below.

¹¹ See the Khoury Review, 49. See Part 2.4.4 below.

¹² The Australian Treasury, ‘Extending Unfair Contract Term Protections to Small Businesses’ (Consultation Paper, May 2014), 1.

¹³ See BP4.

One question that has been the subject of debate in recent years is whether the responsible lending regime in the NCCP Act should be extended to small businesses.¹⁴ Under this regime, a bank is required to make reasonable inquiries about a consumer's credit requirements, take reasonable steps to verify the consumer's financial situation and make a 'not unsuitable' assessment.¹⁵ Proposals to extend the responsible lending regime to small business credit have previously been considered but have not been adopted or recommended,¹⁶ mainly due to concerns that such a move would restrict flexibility on the part of lenders and thereby limit access to credit.¹⁷

2.2. What is a small business?

As this paper will explain, the definition of a 'small business' is relevant for various purposes, including the applicability of legislative protections and certain dispute resolution mechanisms to small business credit contracts. There are differences in the way in which the term is defined, particularly in relation to the thresholds for employee headcount and lending amounts that determine whether a business is a small business for the relevant purpose. It has been suggested that the differences are confusing and increase the complexity of navigating the regulation in this area.¹⁸ The following four contexts are relevant to the issues discussed in this paper.

2.2.1. *The Corporations Act*

As noted in Part 3.2.2 below, in the case of financial products and services other than credit (for example, banking, insurance and investment), a detailed, specific consumer protection regime is found in Chapter 7 of the Corporations Act and applies to the provision of a financial product or a financial service to a 'retail client'. In certain circumstances, a small business can be a 'retail client',¹⁹ and will then have access to these protections. For these purposes, section 761G(12) defines the term 'small business' as follows:

small business means a business employing less than:

- (a) if the business is or includes the manufacture of goods—100 people; or
- (b) otherwise—20 people.

¹⁴ As noted in BP4, 32, the NCCP Act applies where, among other things, the debtor is a natural person or a strata corporation and the credit is provided wholly or predominantly for personal domestic or household purposes or to purchase, renovate or improve residential property for investment purposes or to refinance credit used for such purposes.

¹⁵ See BP4, 48-49. This assessment requires the bank to determine that the credit contract would meet the consumer's requirements and objectives and that the consumer would be able to comply with the contract without substantial hardship. See the comments of Davies J in *ASIC v The Cash Store* [2014] FCA 926 [28].

¹⁶ See, for example, the *Amendment (Credit Reform Phase 2) Bill 2012*, which was not adopted. This amendment would have meant that providers of small business credit contracts would have been subject to modified responsible lending obligations under the NCCP Act. Further obligations would have applied to 'protected small business credit contracts'.

¹⁷ See the Khoury Review, 49-50.

¹⁸ *Ibid*, 47.

¹⁹ See also definition of retail client in Corporations Act, ss 761G(5) (for general insurance products), 761G(6) (for superannuation and retirement savings account products), and 761G(7) (for all other financial products and services).

2.2.2. *The Australian Securities and Investments Act (the ASIC Act)*

For the purpose of implying the conditions and warranties of quality in contracts for financial services in s 12ED, section 12BC(2) defines ‘small business’ as follows:

Small business means a business employing less than:

- (a) if the business is or includes the manufacture of goods—100 people; or
- (b) otherwise—20 people.

By contrast, for the purpose of applying the unfair contract terms provisions of the *ASIC Act* to small business contracts,²⁰ section 12BF defines a ‘small business contract’ as follows:

- (4) A contract is a ***small business contract*** if:
 - (a) at the time the contract is entered into, at least one party to the contract is a business that employs fewer than 20 persons;
and
 - (b) either of the following applies:
 - (i) the upfront price payable under the contract does not exceed \$300,000;
 - (ii) the contract has a duration of more than 12 months and the upfront price payable under the contract does not exceed \$1,000,000.
- (5) In counting the persons employed by a business for the purposes of paragraph (4)(a), a casual employee is not to be counted unless he or she is employed by the business on a regular and systematic basis.

As a result, for the purposes of applying the unfair contract terms provisions, the employee threshold is narrower in the definition of a ‘small business contract’ as it does not depend on falling below a 100-person headcount in the case of the manufacture of goods.

2.2.3. *The Code of Banking Practice (COBP)*

As noted in Part 7 below, the provisions in the Code of Banking Practice (‘COBP’) apply to ‘banking services’ offered by subscribing banks to their individual and small business customers. ‘Banking services’ is defined to mean ‘any financial service or product provided by [a subscribing bank] in Australia to [an individual or small business customer]’.²¹

²⁰ See further in Part 6.6 below.

²¹ COBP clause 42 (definitions of ‘banking service’, ‘you’ and ‘small business’). Note that as it relates to a ‘financial product’ or a ‘financial service’ for the purposes of Chapter 7 of the *Corporations Act*, the COBP applies just to a ‘retail client’ as defined in Chapter 7 and not to a small business as defined by clause 42 of the COBP. This does not affect lending products to small business, to which the COBP applies.

Clause 42 of the COBP defines ‘small business’ as follows:

small business means a business having:

- (a) less than 100 full time (or equivalent) people if the business is or includes the manufacture of goods; or
- (b) in any other case, less than 20 full time (or equivalent) people, unless the **banking service** is provided for use in connection with a business that does not meet the elements of (a) or (b) above.

The effect of the qualification in Clause 42 above (i.e. the qualification starting with the word ‘unless’) is that the COBP does not apply where a borrower meets the elements of subclauses 42(a) or (b) but the banking service is provided for use in connection with a business that does not meet those elements. This would occur, for example, where credit is provided to a small business in connection with the financing arrangements for a large corporate group.

2.2.4. Jurisdictional thresholds for the Financial Ombudsman Service (FOS)

Under section 4.1(d) of its Terms of Reference, FOS may consider a dispute if, among other things, the dispute is between a Financial Services Provider and a Small Business (each as defined). Section 20.1 defines the term ‘Small Business’ as follows:

“Small Business” means a business that, at the time of the act or omission by the Financial Services Provider that gave rise to the Dispute:

- a) if the business is or includes the manufacture of goods: had less than 100 employees; or
- b) otherwise: had less than 20 employees.

Although this is along similar lines to the definitions above, section 5.1 of the Terms of Reference set out the exclusions from FOS’s jurisdiction and provides that the circumstances in which FOS may not consider a dispute include (1) where the value of the applicant’s claim in the dispute exceeds \$500,000;²² (2) where an applicant is a member of a group of related bodies corporate and that group has in excess of 20 employees (or 100 employees in the case of a manufacturing group);²³ and (3) where the dispute is about debt recovery against a small business where the contract provides for a credit facility of more than \$2,000,000.²⁴

FOS is currently working with ASIC on a review of its small business jurisdiction.²⁵ As noted in Part 3.5 below, FOS will have its jurisdiction taken over by the new Australian Financial Complaints Authority, which will have jurisdiction to consider small business disputes. AFCA will apply a new definition for small business (any business with fewer than 100 staff) and will have a monetary limit of \$5m and a compensation cap of \$1m for small business credit facility disputes.

²² Section 5.1(o)

²³ Section 5.1(p).

²⁴ Section 5.1(r).

²⁵ See FOS, ‘Our small business jurisdiction’, available at <https://www.fos.org.au/small-business/our-small-business-jurisdiction/>.

2.2.5. *Calls for change*

There have been various calls for changes to the definition of ‘small business’ as it relates to small business loans, primarily for the purpose of expanding the scope of small businesses that fall within the definition. These calls have been made by the Carnell Inquiry²⁶ and the Khoury Review.²⁷ Some of the recommendation of the Khoury Review are extracted in Part 7.5 below.

2.3. *Types of small business credit*

In a small business context, individuals, firms and companies raise credit for a variety of purposes, including the acquisition of land, plant and machinery, the construction of buildings and the financing of new business ventures.

Banks offer a broad range of facilities, including overdraft facilities, term loans for working capital purposes, trade finance facilities, vehicle and equipment loans, construction loans and acquisition loans. Some loans are provided on an unsecured basis (i.e. the bank does not take any security over assets such as a mortgage over residential property). Some loans are secured in the form of a mortgage or all-asset security.²⁸ Some loans are supported by guarantees from directors or shareholders.

2.4. *Inquiries and reviews concerning small business credit*

Since the Global Financial Crisis, the banking and financial sector in Australia has been the subject of several inquiries and reviews. These have been conducted by a range of actors, including the Federal Parliament, the Australian Government, regulators such as the Australian Securities and Investments Commission (ASIC) and industry associations such as the Australian Bankers Association (ABA). These have been far-reaching and include extensive coverage of challenges and issues concerning small businesses and small business credit. An outline of the recent inquiries and reviews as they relate to small business credit appears below.

2.4.1. *ABA six-point plan (21 April 2016)*

In April 2016, the ABA announced that Australia’s banks would ‘begin to implement comprehensive measures to protect consumer interests, increase transparency and accountability and build trust and confidence in banks.’²⁹ In the industry statement, the banks committed to six actions, including bringing forward the review of the ABA Code of Banking Practice. This review, known as the Khoury Review, is referred to in paragraph 2.4.4 below.

2.4.2. *Parliamentary Joint Committee (PJC) on Corporations and Financial Services inquiry into the ‘Impairment of Customer Loans’ (4 May 2016)*

Under its terms of reference, the PJC was required ‘to consider the practices of banks towards borrowers who they judge may be in financial difficulty and may have breached the terms of their loan contracts.’³⁰ The main focus of the PJC was on small business and

²⁶ See Part 2.4.3 below.

²⁷ See Part 2.4.4 below.

²⁸ See Part 5 below.

²⁹ ABA, ‘Banks act to strengthen community trust’ (ABA Media Release, 21 April 2016), available at <https://www.ausbanking.org.au/media/media-releases/media-release-2016/banks-act-to-strengthen-community-trust>.

³⁰ Parliamentary Joint Committee on Corporations and Financial Services, ‘Impairment of Customer Loans’, Executive Summary, ix.

commercial loans. In its report, the PJC noted that many borrowers were ‘small family businesses...run by an individual, family or partnership that has significant personal exposure due to the use of personal assets such as the family home as security.’³¹ The PJC recommended that the Australian Small Business and Family Enterprise Ombudsman be given powers to carry out its role and that it ‘work with the banking industry to develop nationally consistent standardised loan contracts.’³² It also recommended that responsible lending protections be extended to small business loans.³³

2.4.3. Australian Small Business and Family Enterprise Ombudsman (ASBFEO) Small Business Loans Inquiry (Carnell Inquiry) (12 December 2016)

On 6 September 2016, the ASBFEO was tasked by the Minister for Small Business ‘with undertaking an inquiry into the adequacy of the law and practices governing financial lending to small businesses.’³⁴ The recommendations of the report, which was issued on 12 December 2016, led to commitments by the big four banks in August 2017 to improving the terms of their small business loans. The changes made by the banks are detailed in ASIC Rep 565 (Unfair contract terms and small business loans, March 2018).

2.4.4. Independent Review of the COBP (Khoury Review) (31 January 2017)

On 7 July 2016, Phil Khoury was tasked by the ABA to undertake an independent review of the COBP to ensure, among other things, that the COBP was ‘effective in enhancing banks’ capacity to serve consumer interests and to building trust and confidence in banks.’³⁵ The report notes that small business issues were a primary issue for the review. These issues included ‘better information for businesses applying for credit, more time to respond to changes imposed by banks, extending protections to small businesses in financial difficulty or whose loans are in default, access to valuers and accountants reports and improvements in access to dispute resolution.’³⁶ The report of the Khoury Review was issued on 31 January 2017. Its recommendations³⁷ informed the preparation of the revised COBP, which has been provided to ASIC for approval.³⁸

2.4.5. Review of the financial system external dispute resolution and complaints framework (Ramsay Review) (3 April 2017)

Pursuant to its original terms of reference dated 8 August 2016,³⁹ the Ramsay Review examined the current dispute resolution and complaints arrangements to consider whether

³¹ Ibid.

³² Ibid, x.

³³ Ibid, xviii.

³⁴ Australian Small Business and Family Enterprise Ombudsman, ‘Inquiry into small business loans’, 12 December 2016.

³⁵ Phil Khoury, ‘Independent Review – Code of Banking Practice’ (31 January 2017).

³⁶ Ibid, 7.

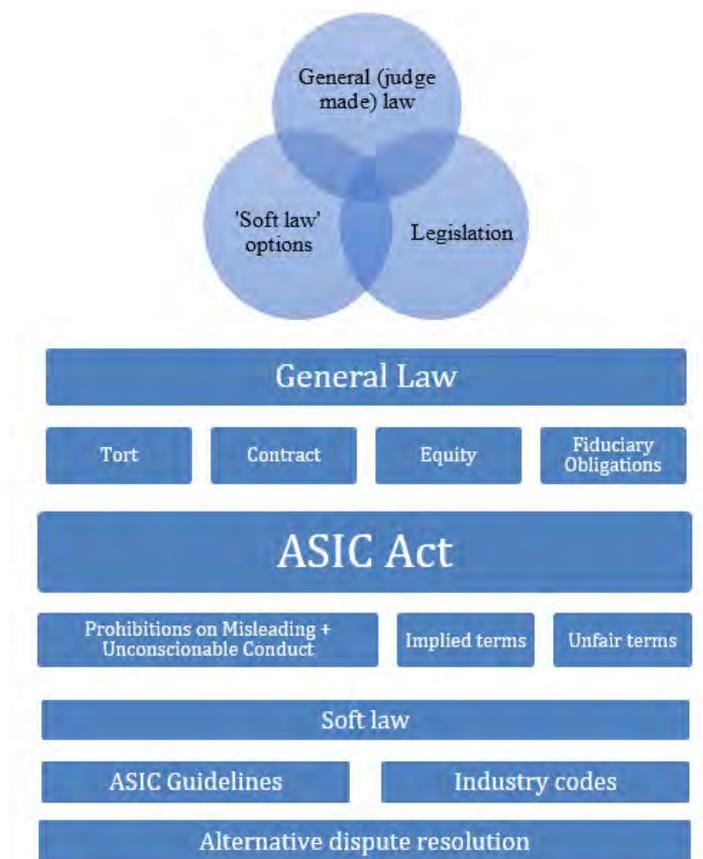
³⁷ See Part 7.5 below for extracts of some of the recommendations that are relevant to the issues discussed in this paper.

³⁸ See Part 7 below for a discussion about the current Code of Banking Practice.

³⁹ On 2 February 2017, the Government amended the Terms of Reference to ask the review panel to make recommendations on the establishment, merits and possible design of a compensation scheme of

changes to current dispute resolution and complaints schemes in the financial sector are necessary to deliver effective outcomes for users in a rapidly changing and dynamic financial system.⁴⁰ On 9 May 2017 the Government accepted all 11 recommendations of the Ramsay Review concerning the financial system external dispute resolution and complaints framework, including the establishment of a one-stop shop for all financial disputes, including superannuation disputes.⁴¹ Legislation establishing the Australian Financial Complaints Authority (AFCA) was enacted in February 2018.

3. Overview of the law applying to small business credit



last resort and to consider the merits and issues involved in providing access to redress for past disputes.

⁴⁰ Ramsay Review, 5.

⁴¹ The Australian Treasury, 'External dispute resolution and complaints framework', available at <https://treasury.gov.au/consultation/external-dispute-resolution-and-complaints-framework/>.

According to ASIC:

The law provides the highest level of protection to individual consumers borrowing for household and domestic purposes (for example, personal loans for renovations or holidays, car loans, credit cards and pay day loans). This also includes loans to consumers to buy residential properties (including investment properties). For these types of consumer and personal loans, the law regulates what lenders need to disclose, how interest can be calculated, how the loan can be enforced, and limits on default charges.

The law provides the lowest level of protection to commercial loans, including loans to small businesses. Commercial loans are loans provided to companies and business owners. They are used to fund the running of a business and the purchase of goods or services used in the business. For example, commercial loans may be used to fund purchases of supplies used in manufacturing, new machinery or premises.⁴²

As noted in BP4, consumer credit disputes are commonly resolved by reference to statute law, including the provisions of the NCCP Act and the ASIC Act.⁴³ The NCCP Act and the NCC apply only to ‘consumer’ credit. Business (including small business)⁴⁴ credit and investment credit (other than credit for residential property investment)⁴⁵ are expressly excluded from their scope.

In the case of small business loans, the ASIC Act applies to provide protection against misleading and unconscionable conduct, as well as providing substantive protection through a regime of implied terms and through the regime rendering void unfair contract terms. However, given that there is no comprehensive legislative framework that applies in respect of small business loans (such as applies under the NCCP Act in respect of consumer credit), such loans are commonly resolved by reference to the general law, particularly contract law.

The statutory and general law regimes are further complemented by various forms of soft law options that may provide a resolution to the dispute without having the formal force of law. These soft law options include codes of conduct (such as the COBP), ASIC guidelines and external or alternative dispute resolution opportunities, such as through ombudsman services. As noted in Part 7 below, the COBP is a legally enforceable set of principles and rules that is incorporated into the contract between the bank and its small business customer.

3.1. General law and small business credit



⁴² ASIC Information Sheet 207: Disputes about commercial loans.

⁴³ Background Paper, 11.

⁴⁴ NCC s 5(1).

⁴⁵ NCC ss 5(1), (3).

There are a number of general law doctrines and principles that may apply to govern the relationship between small business borrowers and the entities involved in a small business credit transaction and also between those entities themselves.

- The relationship between small business borrowers and lenders (e.g. banks, credit unions, finance companies) and intermediaries such as commercial finance brokers will usually be based on a contract and therefore subject to the law of contract. Equally there will usually be contractual relationships between the different business entities involved in credit transactions, including between lenders and intermediaries such as commercial finance brokers.
- Equitable doctrines operate to supplement the law of contract. In particular, they may provide relief against conduct that has impaired the consent of a small business borrower or a guarantor to an abuse of power by a lender.⁴⁶ They also operate to impose duties on banks in exercising their powers, such as the duty to take reasonable care in the exercise of the power of sale under a mortgage.⁴⁷ These duties exist alongside statutory duties in both State and Commonwealth legislation.
- Tort duties may apply to require lenders to perform their services with reasonable care and impose liability for negligent or fraudulent conduct.⁴⁸
- In special circumstances, fiduciary duties may apply to commercial finance brokers and even lenders (if they provide advice or assistance) in their dealings with small businesses to prohibit the party who is a fiduciary from making an unauthorised profit or acting with a conflict of interests or duties.⁴⁹ As O’Donovan and Priskich have noted, however, ‘the ordinary relationship of banker and customer or lender and borrower does not give rise to a fiduciary duty even if it is a warm, valued and prolonged association.’⁵⁰ A commercial lender is entitled to prefer its own interests and does not have a duty to provide advice⁵¹ and therefore has no duty to advise a small business borrower on whether a loan product is suitable or whether there are other products that would be more suitable. The circumstances in which a bank will assume a fiduciary duty are rare.⁵²

⁴⁶ E.g. *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.

⁴⁷ See Part 5.2 below.

⁴⁸ E.g. *Lloyd v Citicorp Australia Ltd* (1986) 11 NSWLR 286 in which it was held that a lender had a duty to monitor a foreign currency loan and to exercise the ‘skill and diligence which a reasonably competent and careful foreign exchange adviser would exercise having regard to the [relevant] market’ (Rogers J, 288).

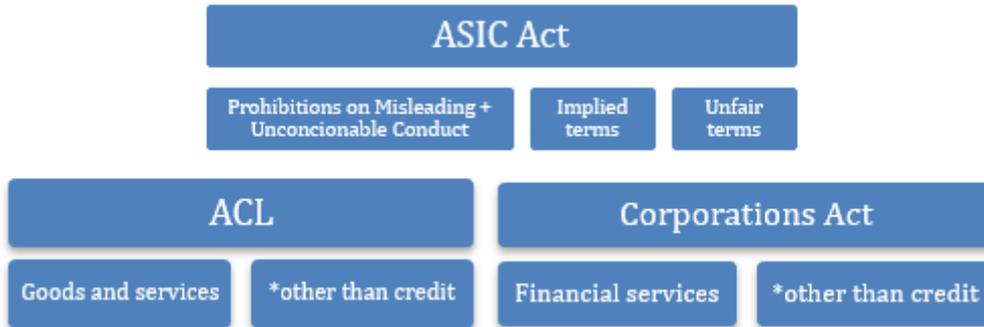
⁴⁹ E.g. *Hurstanger Ltd v Wilson* [2007] 1 WLR 2351; *McWilliam v Norton Finance (UK) Ltd (in liquidation)* [2015] EWCA Civ 186; [2015] 1 All ER (Comm) 1026.

⁵⁰ James O’Donovan and Vicky Priskich, *Lender Liability* (Lawbook Co. 2016), para [1.440].

⁵¹ See *Timms v Commonwealth Bank of Australia* [2004] NSWSC 76.

⁵² *Timms v Commonwealth Bank of Australia* [2004] NSWSC 76 at para 169. For a case in which a bank was held to assume a fiduciary duty in respect of the acquisition of a business, see *Commonwealth Bank of Australia v Smith* (1991) 102 ALR 453.

3.2. Legislation



3.2.1. General legislation – small business credit

The ASIC Act applies to suppliers of credit products and services, including suppliers of business credit and investment credit, and it imposes (in Part 2, Division 2) largely equivalent provisions to those found in the Australian Consumer Law (ACL). These include prohibitions against misleading or deceptive conduct, unconscionable conduct, and unfair contract terms.⁵³

The Competition and Consumer Act 2010 (CCA) provides that, with the exception of Pt 5.5 of the ACL (linked credit providers), the ACL enacted as schedule 2 of that Act, does not apply 'to the supply, or possible supply, of services that are financial services, or of financial products'.⁵⁴ The definitions of 'financial service' and 'financial product' in the CCA adopt the definitions used in the ASIC Act, so that there are no gaps in the application of these general consumer protection provisions.⁵⁵ In other words, if a product falls within the ASIC Act definition of financial product it will be subject to the general consumer protection provisions in the ASIC Act. If it does not, it will be subject to the general consumer protections in the ACL.

Part 6 below provides an outline of the ASIC Act as it applies to small business credit.

3.2.2. Other financial products and services (non-credit)

In the case of financial products and services *other than credit*⁵⁶ (for example, banking, insurance and investment), a detailed, specific consumer protection regime is found in Chapter 7 of the Corporations Act and applies to the provision of a financial product or a financial service to a 'retail client'. Under section 761G(5), a financial product is considered to be provided to a retail client if the financial product is a general insurance product and 'the insurance product is or would be for use in connection with a small business'.⁵⁷ For

⁵³ See Part 6 below.

⁵⁴ CCA s131A. Interestingly, State and Territory laws applying the ACL do not contain a provision equivalent to s 131A of the CCA.

⁵⁵ See ACL s2(1) (definitions of 'financial product' and 'financial service').

⁵⁶ Corporations Act s 765A(1)(h)(i) and Corporations Regulations 2001 reg 7.1.06 (for the purposes of the Act financial product does not include credit). The exception is that margin lending is subject to regulation under the Corporations Act and not the NCCP Act, despite being a form of credit. See NCC s 6(12) – the Code does not apply to the provision of credit by way of a margin loan; and s Corporations Act s 764A(1)(l) – a margin lending facility is a financial product.

⁵⁷ See Part 2.2.1 above for the definition of 'small business' in this context.

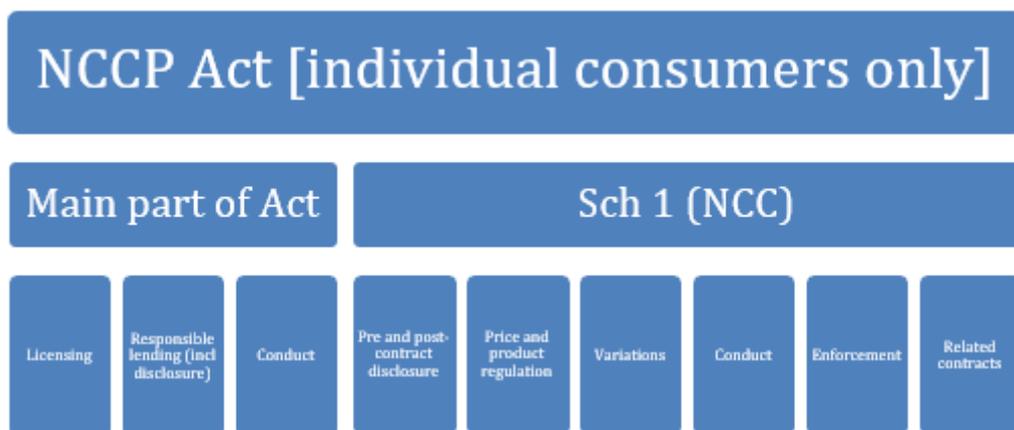
other financial products and services (other than superannuation and retirement savings accounts), a business can be treated as a retail client if the price or value of the product or service does not exceed the specified amount (currently \$500,000) and the product or service is provided in connection with a small business.⁵⁸

The consumer protections in the ASIC Act also apply to other financial products and services, including banking, superannuation, insurance and investment.⁵⁹

3.2.3. Goods and services (other than financial products and services)

In the case of goods and services *other than* financial products and services, the general protections in the ACL apply to both consumer contracts and small business contracts. Industry specific consumer legislation or other regulation may also apply for some products and services.⁶⁰

3.3. Regimes that do NOT apply to small business credit (in contrast with consumer credit)



As noted above, the NCCP Act and NCC apply only to ‘consumer’ credit – they do not have application to business (including small business)⁶¹ credit or investment credit (other than credit for residential property investment).⁶² The exception in the case of credit for residential property investment does not cover a mortgage that is given over residential property in support of a business loan.

⁵⁸ See Corporations Act s761G(7). For the definition of retail client in the context of superannuation or retirement savings accounts, see Corporations Act s761G(6). Other provisions defining retail client are not applicable when the product or service is provided in connection with a business (see Corporations Act ss 761G(7)(c) and 761GA).

⁵⁹ See the definitions of ‘financial product’ and ‘financial service’ in ASIC Act ss 12BAA and 12BAB. Note that the definition of ‘financial product’ in the Corporations Act (see ss 763A – 765A) differs from the definition of financial product in the ASIC Act (see s 12BAA). Most relevantly, a ‘credit facility’ is specifically excluded from the definition of ‘financial product’ in the Corporations Act, see s765A(1)(h)(i).

⁶⁰ See e.g. Telecommunications Act 1997 (Cth), part 6 (Industry Codes and Industry Standards).

⁶¹ NCC s 5(1).

⁶² NCC ss 5(1), (3).

This means that in seeking and obtaining credit, small businesses are not subject to the regimes in the NCCP that provide:

- a licensing regime for those engaging in credit activities and their representatives;
- general conduct obligations;
- mandatory disclosure requirements; and
- responsible lending obligations

Nor are small businesses protected by the provisions in the NCC providing for:

- pre-contractual disclosure;
- content obligations for credit contracts and related mortgages and guarantees;
- price regulation;
- unilateral and agreed changes to credit contracts;
- hardship variations to credit contracts;
- unjust transactions and unconscionable interest and charges;
- ending and enforcement of credit contracts and related mortgages and guarantees.

3.4. 'Soft law'



3.4.1. Industry codes

The banking and finance industry has adopted a number of voluntary industry codes which apply to the relationship with relevant consumer customers. These include the Code of Banking Practice (COBP), the Customer-Owned Banking Code of Practice and the Mortgage and Finance Industry Association Code of Practice. This paper primarily focuses on the COBP.

The COBP is published by the Australian Bankers' Association and the most recent version (2013) has been adopted by most banks offering retail products in Australia,⁶³ although there is no industry or legislative requirement that they do so.⁶⁴ For subscribing banks, the provisions of the Code apply to their 'banking services', which are defined as 'any financial service provided in Australia' to the bank's individual and small business customers.⁶⁵ The

⁶³ In information provided to the most recent review of the Code of Banking Practice, the Australian Bankers' Association advised that over 95% of banking services in Australia are provided by banks that subscribe to the Code of Banking Practice: Khoury Review, p 10.

⁶⁴ This contrasts with the legislative obligation imposed on credit businesses to belong to an external dispute resolution scheme: NCCP Act s 47. However, note that the recent review of ASIC's enforcement powers has recommended that financial services entities should be required to subscribe to relevant ASIC-approved codes: The Australian Government the Treasury (2018) *ASIC Enforcement Review Taskforce Report*, xv (recommendation 19).

⁶⁵ COBP cl 42 (definitions of 'banking service', 'you' and 'small business').

COBP also applies to products or services provided by a subscribing bank through an intermediary.⁶⁶ The COBP will therefore apply to subscribing banks when they provide consumer loans and small business loans, as well as other credit products.

As discussed in BP4, if a subscribing bank fails to comply with the COBP:

- the bank can be subject to an investigation by the Code Compliance Monitoring Committee,⁶⁷ although the Committee has no powers to award compensation;⁶⁸
- the customer may bring legal proceedings for breach of contract (as the COBP applies as a matter of contract between a bank and its customers⁶⁹); and/or
- redress for non-compliance can be sought through the Financial Ombudsman Services FOS' - the relevant External Dispute Resolution (EDR) Scheme for most banks).⁷⁰ Note, however, that the definition of 'small business' for FOS is narrower than the definition of 'small business' in the COBP.

ASIC does not have any powers to take enforcement action in relation to conduct that breaches the COBP or another industry code, unless that conduct also breaches a provision of the legislation that ASIC administers, such as the unconscionable conduct provisions. However, reference to the requirements of an industry code is one of the factors that a court may have regard to in assessing whether there is unconscionable conduct under the ASIC Act.⁷¹

3.4.2. ASIC Guidelines

The limited amount of litigation on consumer and small business credit means there may be little judicial interpretation of the relevant legislative provisions. In some contexts, ASIC has sought to fill this interpretative gap by providing guidance on its view of the law in the form of regulatory guidelines. These guidelines might be described as 'soft law'.⁷² They do not have formal legal status but nonetheless influence the conduct of those regulated by the relevant law. In addition, the Administrative Appeals Tribunal has given some weight to ASIC Regulatory Guides in reviewing ASIC decisions.⁷³

The following ASIC regulatory documents are relevant to small business lending:

- ASIC Information Sheet 54: Receivership: a guide for creditors
- ASIC Regulatory Guide 165: Licensing: Internal and external dispute resolution
- ASIC Information Sheet 207: Disputes about commercial loans
- ASIC Information Sheet 211: Unfair contract term protections for small businesses
- ASIC Report 565: Unfair contract terms and small business loans.

⁶⁶ COBP cl 42 (definition of 'banking service').

⁶⁷ COBP cl 36(b).

⁶⁸ See Code Compliance Monitoring Committee *Our investigations* (2018) <<http://www.ccmc.org.au/about-us/what-we-do-2/our-investigations/>>.

⁶⁹ See COBP cl 12.3.

⁷⁰ E.g. FOS Terms of Reference (as amended 1 January 2018), cl 8.2(b). There is also a second ASIC-approved external dispute resolution scheme – the Credit and Investments Ombudsman. It takes a similar approach to industry codes in dispute resolution: see CIO Rules (10th edition, in force from 15 August 2016), cl 12.

⁷¹ ASIC Act ss 12CC(1)(h), (2)(h), (3).

⁷² See E Bant and J Paterson, 'Statutory interpretation and the critical role of soft law guidelines in developing a coherent law of remedies in Australia' in R Levy et al (eds), *New Directions for Law in Australia: Essays in Contemporary Law Reform* (ANU E Press 2017).

⁷³ See eg *Vissenjoux v ASIC* [2015] AATA 98 [13]-[14]; *Coshett v ASIC* [2014] AATA 677 [16].

3.5. External dispute resolution (EDR) schemes



According to ASIC:

Commercial loans may have terms of many years and disputes can often arise during the course of the relationship between the borrower and the lender. This is particularly true if the borrower gets into difficulty making repayments on a loan. Disputes may relate to fees (including fees paid to finance brokers to prepare loan applications), repayment arrangements, valuations, consequences of default, rights under the loan agreement or other terms of the loan agreement. For example, the borrower may have concerns that the lender did not adequately disclose the terms of the agreement, or that the conduct of the broker or lender is unfair in some way. Disputes may also arise if a lender appoints a receiver to deal with an asset that a borrower has used as security for a loan.⁷⁴

As with consumers, many disputes between small businesses and lenders are resolved by alternative dispute resolution, such as that offered by the Financial Ombudsman Service (FOS) and the Credit and Investments Ombudsman (CIO).⁷⁵ Farming businesses may also have access to farm debt mediation schemes under State and Territory Law. Unlike in the case of a consumer credit provider, a lender who only provides commercial credit is not required to have a credit licence and is not legally required to be a member of an EDR scheme. They may, however, join an EDR scheme on a voluntary basis.⁷⁶

In 2018, FOS and CIO will have their functions taken over by the new Australian Financial Complaints Authority, designed to be a one-stop shop for financial services disputes.⁷⁷ As is currently the case with FOS and CIO, the new AFCA will have jurisdiction to consider small business disputes. AFCA will apply a new definition for small business (any business with fewer than 100 staff) and will have a monetary limit of \$5m and a compensation cap of \$1m for small business credit facility disputes.

⁷⁴ ASIC Information Sheet 207: Disputes about commercial loans.

⁷⁵ See generally the discussion of dispute resolution and the different schemes in the financial services sector in Cth Treasury *Review of the financial system external dispute resolution and complaints framework* (Final Report) (2017).

⁷⁶ See ASIC Information Sheet 207: Disputes about commercial loans, which recommends that small business seek private legal advice if the lender is not a member of FOS or CIO.

⁷⁷ See *Treasury Laws Amendment (Putting Consumers First – Establishment of the Australian Financial Complaints Authority) Act 2018*. The new organisation will also encompass the functions currently being carried out by the Superannuation Complaints Tribunal.

3.5.1. Dispute resolution at FOS

As noted above,⁷⁸ FOS can accept disputes about credit services up to an amount of \$500,000. The monetary limit on awards is \$323,500 for most disputes.⁷⁹ EDR schemes receive large numbers of disputes each year from small business customers. For example, FOS (the larger scheme⁸⁰) accepted 1,067 business finance disputes in 2016-17. Two-thirds of business finance disputes related to business loans, followed by business credit cards (9%). Financial services providers (FSPs) decision (29%) and financial difficulty (24%) were the main issues within business finance disputes. Banks were involved in almost three-quarters (71%) of disputes relating to business finance.⁸¹

3.5.2. Process of dispute resolution

As with consumers, EDR schemes aim to resolve disputes informally and efficiently, with a focus on negotiation. For example, FOS explains that it aims to resolve disputes in a timely manner with ‘minimum formality and technicality’ and ‘as transparently as possible, taking into account our obligations for confidentiality and privacy’.⁸²

More on the dispute resolution process by EDR schemes generally and FOS specifically can be found in BP4.

4. The parties involved in a small business credit transaction

ABC Pty Ltd is a small family company that operates a commercial cleaning business and is owned and managed by a married couple, who are the sole shareholders, directors and employees of the company. The company has managed to cover its operating costs to date through the revenue that it generates and a small, unsecured overdraft facility with its account bank. In response to increasing customer demand, the company would like to expand its business, including by employing four additional employees and purchasing two additional vans. For this purpose, the company decides to obtain a vehicle acquisition loan and a working capital loan from a bank. Because it has been operating on a small scale and does not have any expertise in relation to negotiating bank loans, ABC Pty Ltd engages a commercial finance broker to identify and negotiate a small business facility with one of the big banks. The bank identified by the broker assesses the company’s financial information, confirms the amount that it is willing to lend to the company and offers a facility with competitive interest rates. To support the company’s borrowings, the bank requires the directors to give personal guarantees secured by a second mortgage over the family home.

⁷⁸ See Part 2.2.4.

⁷⁹ Financial Ombudsman Service *What we do* (2018) <<https://www.fos.org.au/about-us/what-we-do/>>.

⁸⁰ In 2015-16, FOS received almost 88% of the disputes lodged at the two ASIC-approved EDR schemes: Cth Treasury *Review of the financial system external dispute resolution and complaints framework* (Final Report) (2017), p 48.

⁸¹ FOS *Annual Review 2016-17* (2017) p 71.

⁸² Financial Ombudsman Service *What we do* (2018) <<https://www.fos.org.au/about-us/what-we-do/>>.

4.1. Contractual relationships

A small business credit transaction will be structured by a series of contractual relationships involving the small business borrower and the lender and other parties who may be involved such as commercial finance brokers. These may include contracts between:

- small business and commercial finance brokers;
- small business and the lender, such as a bank or non-bank lender, for the provision of the credit;
- a guarantor and the lender;
- a security-provider such as a mortgagee (which may be the small business borrower or a third party) and the lender.

A general outline of each of these parties is set out below.

4.2. Small business borrowers

As noted in Part 2.1 above, a small business borrower may take a variety of forms, including a sole trader, who carries on business in his or her own name, or a company in which one person is the sole shareholder or in which all of the shares are held by members of one family. A small business borrower may also take the form of a partnership consisting of two or more partners, as is typical in the area of professional services such as accounting and law.

4.3. Small business lenders

There is a broad range of possible lenders in small business loans, including banks and non-bank entities such as finance companies. Finance companies include general financiers and pastoral finance companies.⁸³ In addition, finance for small business purposes may be sourced from individual lenders.

4.4. Intermediaries (commercial finance brokers)

A finance intermediary is usually understood to be somebody who acts as an intermediary between a borrower and a lender for the purpose of securing finance. Unlike under the NCCP there is no specific regulation of intermediaries and brokers acting for small businesses. In the context of small business, commercial finance brokers commonly assist borrowers to obtain finance for business purposes and also assist with debt restructuring when a business encounters financial difficulty. Unlike credit assistance providers under the NCCP Act, commercial finance brokers are not subject to specific regulation and are not required to hold either an Australian Credit Licence or an Australian Financial Services Licence in order to act as a commercial finance broker. Many commercial finance brokers are accredited by the Mortgage & Finance Association of Australia (MFAA), which requires them to abide by the MFAA Code of Practice.⁸⁴

⁸³ Neither general financiers nor pastoral finance companies are prudentially regulated by APRA, but they are required to meet disclosure, licensing and conduct requirements that ASIC administers in respect of all financial companies. See Reserve Bank of Australia, 'Main Types of Financial Institutions', available at <https://www.rba.gov.au/fin-stability/fin-inst/main-types-of-financial-institutions.html#fn3>. However, as explained in Part 3.3 above, there are no specific licensing and disclosure obligations imposed in relation to providing credit or credit advice to business (including small businesses).

⁸⁴ See Part 7.5.2 below.

In helping to identify and negotiate small business loans, commercial finance brokers act as agents for their small business clients pursuant to the terms of engagement entered into with their clients. Brokers often have sub-brokerage relationships with other brokers and are accredited by banks and other lenders. As part of the accreditation process, standard commission terms between the brokers and the lenders are agreed. In some cases, they engage in lending activities themselves or are owned by a lender (although this is not as widespread as in the case of home mortgage brokers).⁸⁵

5. Guarantees and security

5.1. Guarantors and protections

There are extensive provisions within the National Credit Code (NCC) that protect a guarantor of consumer credit. By contrast, there are no equivalent legislative provisions that apply to guarantors of small business loans. Given the findings of a 2003 report that most third party guarantees are undertaken to support small business borrowing, and that in many of these cases, the guarantor had no real control over the company,⁸⁶ the NSW Law Reform Commission recommended in 2006 that the statutory protections for third party guarantors should apply in the case of small business credit.⁸⁷ However, this recommendation has not been acted upon.

Instead, the legal framework is governed by the general law, including equitable doctrines that have been applied in circumstances where:

- it is unconscionable for a lender to enforce a guarantee against a guarantor who was at a ‘special disadvantage’⁸⁸ or
- the principles in *Yerkey v Jones* apply to provide special protection for a wife who enters into a guarantee of her husband's debts.⁸⁹

Under equitable principles, outlined in *Amadio*, unconscionability will arise where a ‘special disadvantage’ adversely affects the guarantor’s ‘ability to make a judgment as to [his or her] own best interest’ and is sufficiently evident to the creditor, who takes unfair advantage of that ‘special disadvantage’ by entering into the transaction. Factors to be taken into account in determining whether it is unconscionable for a creditor to rely on a guarantee include the following: (1) the guarantor’s understanding of English; (2) whether the guarantor had the benefit of independent advice; and (3) whether the guarantor was advised as to whether there was a limit on his or her liability under the guarantee. A statutory basis for unconscionability exists in the ASIC Act, which is discussed in Part 6 below.

⁸⁵ On the vertical integration between mortgage aggregators and banks see Productivity Commission Draft Report *Competition in the Australian Financial System Overview & Draft Recommendations* (Jan 2018) pp 213-4; ASIC Report 516 *Review of Mortgage Broker Remuneration* (2017) pp 59-60. For a media report on the extent of ownership of mortgage brokers by banks, see Leisa Goddard, ‘Broking bad: Who really owns your mortgage broker?’ (7NEWS Investigations, 24 February 2014), available at <https://au.news.yahoo.com/a/21674710/big-banks-own-majority-of-mortgage-brokers/>.

⁸⁶ Jenny Lovric and Jenni Millbank (2003) *Darling, please sign this form: a report on the practices of third party guarantees in New South Wales* (NSW Law Reform Commission and University of Sydney, Research Report 11), xiii - xiv.

⁸⁷ NSW Law Reform Commission (2006) *Guaranteeing someone else’s debts* (Report 107), 92.

⁸⁸ See *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.

⁸⁹ See *Garcia v National Australia Bank* (1998) 194 CLR 395.

Under the principles in *Yerkey v Jones*, as affirmed in *Garcia v National Australia Bank Limited*, there are two bases for relief in transactions where a wife guarantees the debts of her husband.

- 1 If the wife's consent is procured by the husband's undue influence, the wife will be entitled as against the lender to have the mortgage or guarantee set aside unless the lender can show that she received independent advice.²⁷ The reason for granting relief in these circumstances is that “to enforce that voluntary transaction against her when in fact she did not bring a free will to its execution would be unconscionable”.⁹⁰
- 2 If the wife fails to understand the effect of the document and the significance of giving a guarantee, she may be entitled as against the lender to have the transaction set aside unless the lender took steps to inform her about the transaction and reasonably supposed she understood.²⁷ In these circumstances it would be unconscionable for the lender to enforce the guarantee:

if the lender took no steps itself to explain the purport and effect to her or did not reasonably believe that its purport and effect had been explained to her by a competent, independent and disinterested stranger.⁹¹

In *Garcia v National Australia Bank Limited*⁹² the High Court left open the possible future application of principles in *Yerkey v Jones*⁹³ to other long-term and publicly declared relationships short of marriage, between members of the same or opposite sex.⁹⁴ It now appears the principle extends beyond marital relationships but its precise scope remains uncertain.⁹⁵

Clause 31 of the COBP contains guarantee-related obligations on the part of banks. These obligations are incorporated into guarantee contracts in respect of consumer and small business loans⁹⁶ and reflect both the NCC requirements (in respect of consumer credit) and also case law.

The COBP extends to guarantors of small business loans contractual protections that may not otherwise apply. For this reason, the COBP is an important source of protections for guarantors in respect of small business loans. As noted in Part 2.2.3 above, the COBP defines ‘small business’ as a business having (a) less than 100 full time (or equivalent) people if the business is or includes the manufacture of goods; or (b) in any other case, less than 20 full time (or equivalent) people.

²⁷ *Yerkey v Jones* (1940) 63 CLR 649, 678; Duggan, *Undue Influence* in Parkinson, *Principles of Equity* (2nd ed, 2003), p 420.

⁹⁰ *Garcia v National Australia Bank Limited* [1998] HCA 48; (1998) 194 CLR 395, 408.

²⁷ *Yerkey v Jones* (1940) 63 CLR 649, 683; Duggan, *Undue Influence* in Parkinson, *Principles of Equity* (2nd ed, 2003), p 420.

⁹¹ *Garcia v National Australia Bank Limited* [1998] HCA 48; (1998) 194 CLR 395, 408–9.

⁹² *Garcia v National Australia Bank Limited* [1998] HCA 48; (1998) 194 CLR 395.

⁹³ *Yerkey v Jones* (1940) 63 CLR 649.

⁹⁴ *Garcia v National Australia Bank Limited* [1998] HCA 48; [22]; (1998) 194 CLR 395, 404.

⁹⁵ *Kranz v National Australia Bank Ltd* [2003] VSCA 92; (2003) 8 VR 310, [24]–[31]; *Agripay Pty Limited v Byrne* [2011] QCA 85, [4]; *McIvor v Westpac Banking Corporation* [2012] QSC 404, [104]. Cf *McIvor v Westpac Banking Corporation* [2012] QSC 404, [14].

⁹⁶ COBP 31.3: “A **Guarantee** must include a statement to the effect that the relevant provisions of this Code apply to the **Guarantee** but need not set out those provisions.”

The protections include the following:

- Liability under the guarantee must be limited to, or be in respect of, a specific amount plus other liabilities (such as interest and recovery costs) or be limited to the value of a specified security at the time of recovery;⁹⁷
- The bank must give a prominent notice in relation to various matters before the guarantee is taken, including that the guarantor ‘should seek independent legal and financial advice on the effect of the guarantee’;⁹⁸
- The bank must tell the guarantor about certain matters, such as the service of a notice of demand on the debtor,⁹⁹ and provide copies of the credit contract and other documents.¹⁰⁰

For guarantors of a small business credit facility, clause 31.15 of the COBP provides that certain requirements do not apply where the guarantor is a commercial asset financing guarantor, sole director guarantor or trustee guarantor (all as defined in clause 42) as distinct from other small business guarantors.

There is some case law concerning the interpretation and application of the COBP as it relates to guarantees. In *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351, in which an earlier version of the COBP was considered, it was held that the equivalent of clause 27¹⁰¹ was a relevant provision under the equivalent of clause 31.3¹⁰² and was therefore incorporated into the terms of the guarantee.

In *National Australia Bank Ltd v Rose* [2016] VSCA 169, which also considered an earlier version of the COBP, it was held that the failure of the bank to give a prominent notice under the equivalent of clause 31.4(a)(i) of the COBP resulted in five guarantees being set aside.

5.2. Security-providers and protections

In the context of small business lending, a lender may be prepared to extend credit facilities without requiring the borrower to provide security. This means that in the event of default by the borrower, the only remedy available is a personal action for repayment of the loan. An unsecured overdraft afforded by a bank and a monthly credit account opened by a retailer are examples of unsecured loans. Often, however, the lender is prepared to lend only on the basis that the loan is secured. A secured loan has the advantage that, in the event of payment default by the borrower, the lender has recourse to the property over which it holds security to recover the debt. In addition, the lender enjoys priority in respect of the secured property over other creditors, except for any creditor that has a higher-ranking security over the same property. If the secured property is worth as much as or more than the debt, the lender will be paid in full and the balance after payment of the loan will be returned to the borrower (or be available for general distribution to creditors in the event of insolvency). If

⁹⁷ COBP 31.2.

⁹⁸ COBP 31.4(a)(i).

⁹⁹ COBP 31.4(b)(i).

¹⁰⁰ COBP 31.4(d).

¹⁰¹ COBP 27: “Before **we** offer, give **you** or increase an existing, credit facility, **we** will exercise the care and skill of a diligent and prudent banker in selecting and applying **our** credit assessment methods and in forming **our** opinion about **your** ability to repay the credit facility.”

¹⁰² COBP 31.3: “A **Guarantee** must include a statement to the effect that the relevant provisions of this **Code** apply to the **Guarantee** but need not set out those provisions.”

the value of the secured property is less than that of the debt, the lender's claim is secured only to that extent and any claim to the balance of the debt is unsecured and must be enforced through a personal action against the borrower. In general, the remedies available to a secured creditor in common law jurisdictions do not require the intervention of a court and may be exercised swiftly and with a minimum of formality. Security transactions take many forms and the remedies available to the lender and the rights of the borrower depend on the form selected.¹⁰³

Two forms of security that are common in the case of small business loans are a mortgage over real estate and a general security agreement, under which all of the assets of a corporate borrower serve as security for the loan. The duties of banks and other lenders that hold security in the form of mortgages and general security agreements are governed by statute and by case law.

In the case of a mortgage, default by the borrower entitles the lender holding the mortgage (i.e. the mortgagee) to exercise various powers against the party who provided the mortgage (i.e. the mortgagor). The most commonly exercised power is the power of sale. In the event of a sale, the mortgagee is subject to certain duties that derive from statute and equity. The statutory duty differs between the relevant States in Australia. In Victoria and Tasmania, for example, the mortgagee must proceed with the sale 'in good faith and having regard to the interests of the mortgagor'.¹⁰⁴ By contrast, the provision in New South Wales requires a mortgagee exercising a power of sale to 'take reasonable care to ensure that the land is sold for...not less than its market value'.¹⁰⁵

In the case of a corporate mortgagor, s 420A of the Corporations Act 2001 (Cth) provides that a 'controller' exercising a power of sale over the corporation's property must 'take all reasonable care' to sell the property for not less than its market value. If the property has no market value, it must be sold for the 'best price reasonably obtainable'. A 'controller' includes a person who has control of the property for the purpose of enforcing a security such as a receiver or mortgagee.

In the case of a general security agreement, the most common remedy in the event of default by the corporate borrower is the appointment of a receiver. According to ASIC, the receiver's role is to:

- collect and sell enough of the charged assets to repay the debt owed to the secured creditor (this may include selling assets or the company's business);
- pay out the money collected in the order required by law; and
- report to ASIC any possible offences or other irregular matters they come across.¹⁰⁶

The receiver's primary duty is to the secured creditor that appointed them. The main duty owed to unsecured creditors is an obligation to take all reasonable care to sell the property for not less than its market value or, if there is no market value, the best price reasonably obtainable. The security document generally provides that a receiver is the agent of the debtor company, which alone is responsible for the acts and defaults of the receiver and also

¹⁰³ The information in this section is drawn partly from Brendan Edgeworth, Christopher Rossiter, Pamela O'Connor and Andrew Godwin, *Sackville & Neave Australian Property Law* (Tenth Edition, 2016), Chapter 11.

¹⁰⁴ Transfer of Land Act 1958 (Vic), s 77; Land Titles Act 1980 (Tas), s 78(1).

¹⁰⁵ Real Property Act 1900 (NSW), s 111A(1)(a). See also Property Law Act 1994 (Qld), s 85(1).

¹⁰⁶ ASIC Information Sheet 54, 'Receivership: a guide for creditors'.

for paying the receiver's costs and remuneration. A receiver may, however, become the agent of the secured creditor if the receiver acts on the secured creditor's instructions or at the secured creditor's direction in exercising the receiver's powers.¹⁰⁷

The security document also generally excludes any liability on the part of the secured creditor or the receiver for any conduct or negligence or breach of duty in respect of the exercise of any power, except in the case of fraud or wilful misconduct. Consequentially, debtor companies have little protection against the acts of the receiver or the secured creditor that appointed the receiver.

In a small business credit context, banks and other lenders appoint independent property valuers at various stages, including when assessing loan applications, when undertaking periodic reviews and also when enforcing security such as mortgages. Banks use qualified valuers who are members of the Australian Property Institute (API) or other organisations that abide by industry codes of practice and undertake valuations in accordance with the relevant standards. Although the valuers are independent of the banks, they are engaged by the banks, to whom they owe a duty of care, and respond to their specific instructions in relation to issues such as the valuation method to be used or the basis on which the property should be valued (e.g. fire sale, normal market conditions). Small business borrowers have little (if any) say in the process and have traditionally not had full access to the valuation reports and valuation instructions, even though they are required to pay for the valuations.

In its inquiry into the 'Impairment of Customer Loans',¹⁰⁸ the PJC called for the provision of valuation reports to borrowers to be written into the COBP, failing which the government should bring forward appropriate legislation or regulation to require banks to provide copies of valuation reports and valuation instructions to borrowers. In line with this call, the Carnell Inquiry¹⁰⁹ recommended that 'all banks must provide borrowers with a choice of valuer, a full copy of the instructions given to the valuer and a full copy of the valuation report.'¹¹⁰ Similarly, the Khoury Review recommended that the COBP be amended to require signatory banks' processes in relation to expert valuations and investigating accountants' reports to be fair and transparent.¹¹¹

¹⁰⁷ See *Standard Chartered Bank Ltd v Walker* [1982] 1 WLR 1410.

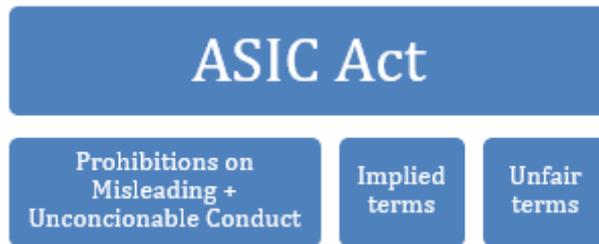
¹⁰⁸ See Part 2.4.2 above.

¹⁰⁹ See Part 2.4.3 above.

¹¹⁰ Australian Small Business and Family Enterprise Ombudsman, *Small Business Loans Inquiry Report*, 12, December 2016, Recommendation 8.

¹¹¹ Khoury Review, recommendation 29.

6. The Australian Securities and Investments Commission Act (ASIC Act)



Following the States' referral of powers to the Commonwealth under the Corporations Agreement 2002, financial services and financial products are regulated by the Commonwealth under the ASIC Act, with the ASIC as the national regulator. Section 131A of the CCA provides that the ACL does not apply 'to the supply, or possible supply, of services that are financial services, or of financial products.' In most relevant respects, the consumer protection provisions of the ASIC Act, which apply to small businesses and small business contracts, have been amended to maintain consistency with the ACL.¹¹²

6.1. To whom does the ASIC Act apply?

The consumer protection provisions of the ASIC Act are found in Division 2. They apply, primarily, to conduct in relation to the supply of financial services and financial products. Extensive definitions of a financial service and a financial product are found in ss 12BAB and 12BAA respectively, and include credit products.¹¹³

The identity of who is protected under the ASIC Act varies according to the protection in question: the prohibitions on misleading and unconscionable conduct apply to almost all conduct in trade or commerce, while the implied conditions and warranties have an extension to financial services acquired by consumers in connection with a small business¹¹⁴ and the unfair terms regime applies to small business contracts.¹¹⁵

6.2. Main consumer protection provisions of the ASIC Act

The primary protections for consumers of financial services under the ASIC Act are:

- prohibitions on misleading conduct;
- prohibitions on unconscionable conduct;
- statutory implied terms;
- a regime rendering void unfair contract terms in standard form contracts.

¹¹² There is no equivalent to the ACL consumer guarantee regime in the ASIC Act.

¹¹³ The definition of 'financial service' in ASIC Act s12BAB(1) includes providing financial product advice and dealing in a financial product, and a 'financial product' is defined to include a 'credit facility' (see s12BAA(7)(k)). Note that the definition of 'financial product' in the Corporations Act (see ss 763A – 765A) differs from the definition of financial product in the ASIC Act (see s 12BAA).

¹¹⁴ ASIC Act s 12BC.

¹¹⁵ ASIC Act s 12BF.

6.3. Misleading conduct

The ASIC Act contains a simple and categorical prohibition on a business, in trade or commerce, engaging in conduct that is misleading or likely to mislead¹¹⁶ supplemented by prohibitions on specific forms of misleading conduct.¹¹⁷ While the prohibition applies widely to conduct in trade or commerce and does not differentiate between the types of parties protected, it is worth noting that in assessing whether conduct is misleading, the court may take the identity of the plaintiff into account and may demand high standards of self-responsibility and care from parties engaged in business,¹¹⁸ although this is not always the case.¹¹⁹

6.4. Unconscionable Conduct

The ASIC Act contains prohibitions on unconscionable conduct under the ‘unwritten law’¹²⁰ and on unconscionable conduct in connection with financial services.¹²¹ The ASIC Act also contains a statement of interpretative principles relevant in determining whether a person has engaged in unconscionable conduct¹²² and contains a list of matters that a court can take into account in determining whether a person has engaged in unconscionable conduct under the statute.¹²³

In interpreting the statutory prohibitions courts have indicated that a high degree of ‘moral obloquy’ is required.¹²⁴ An open textured prohibition such as unconscionable conduct is necessarily incapable of being confined to a narrow or fixed definition. ‘Put simply, unconscionable conduct is conduct against conscience by reference to the norms of society that are in question’.¹²⁵

Courts have been clear about what will *not* amount to unconscionable conduct. Mere inequality of bargaining power does not make the conduct of the stronger party in promoting its own interests unconscionable.¹²⁶ This was emphasised by the High Court in *Paciocco* holding that

¹¹⁶ ASIC Act s 12DA. On this prohibition see further BP4.

¹¹⁷ ASIC Act ss 12DB, 12DC and 12DF.

¹¹⁸ See e.g. *Butcher v Lachlan Elder Realty Pty Ltd* [2004] HCA 60; 218 CLR 592; *Miller & Associates Insurance Broking Pty Ltd v BMW Australia Finance Ltd* [2010] HCA 31; 241 CLR 357.

¹¹⁹ See e.g. *Westpac Banking Corporation v Lee* [2013] NSWCA 375.

¹²⁰ ASIC Act s 12CA.

¹²¹ ASIC Act s 12CB. Listed public companies cannot take advantage of this prohibition: ss 12CB(1)(a) and (b).

¹²² ASIC Act s 12CB(4).

¹²³ ASIC Act s 12CC(4).

¹²⁴ *Attorney-General (NSW) v World Best Holdings Ltd* (2005) 63 NSWLR 557, 583; [2005] NSWCA 261, [121] (Spigelman CJ). Also, *Violet Home Loans Pty Ltd v Schmidt* (2013) 300 ALR 770, 785–6; [2013] VSCA 56, [58] (Santamaria JA, with whom Neave and Osborn JJA agreed). Also, *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28, [188] (Gageler J). Cf *Kobelt v Australian Securities and Investments Commission* [2018] FCAFC 18, [193] (emphasising the need to focus on the words of the prohibition).

¹²⁵ *Australian Competition and Consumer Commission v Woolworths Limited* [2016] FCA 1472, [129] (Yates J).

¹²⁶ *Director of Consumer Affairs Victoria v Scully* (2013) 303 ALR 168, 181; [2013] VSCA 292, [43].

While a disparity in bargaining power may be necessary to attract the operation of the provision, the mere existence of the disparity is not sufficient to do so. The existence of a disparity in bargaining power, which is an all-pervading feature of a capitalist economy, does not establish that the party which enjoys the superior power acts unconscionably by exercising it.¹²⁷

Similarly, the exercise of express contractual powers¹²⁸ and the occurrence of an outcome that is less than favourable for the weaker party to the transaction¹²⁹ are not on their own sufficient to support a finding of unconscionable conduct contrary to statute. Something more is required.

In business to consumer transactions courts have shown a particular concern with conduct by a trader that takes advantage of a consumer's 'vulnerability or lack of understanding'.¹³⁰ In business-to-business transactions unconscionable conduct has been found in comparable situations, where one party is clearly in a position of potential vulnerability, which is then exploited by the other party to the transaction.¹³¹ Unconscionable conduct in business-to-business transactions has also been found in one party exploiting a position of superior bargaining power in a manner that goes beyond what is acceptable in even a commercial transaction.

In *Australian Competition and Consumer Commission v Coles Supermarkets Australia Pty Ltd*¹³² Coles admitted contraventions of the ACL in making claims for additional payments and rebates from its suppliers. Coles, the second largest retailer of grocery products in Australia, had significantly greater bargaining power than the relatively small suppliers.¹³³ This factor alone did not make the conduct unconscionable. The key factors relevant to the contravention were that Coles had no reasonable basis for its claims and did not provide information to the suppliers that adequately established a basis for the claims. Coles then threatened the suppliers with negative commercial consequences if its demands were not met, to which the suppliers were vulnerable because of the commercial commitment involved in undertaking to supply a supermarket the size of Coles.

By contrast, *Australian Competition and Consumer Commission v Woolworths Limited*¹³⁴ Yates J held that the design and implementation of a 'mind the gap' scheme introduced by Woolworths to require its suppliers to pay for various shortfalls in the expected or targeted profit on the sale of their products did not involve the exercise of unconscionable conduct. This was a commercial transaction and each party could be assumed to be committed to furthering its own commercial interests.¹³⁵

¹²⁷ *Paciocco v Australia & New Zealand Banking Group Ltd* [2016] HCA 28, [293] (Keane J)

¹²⁸ See e.g. *Automasters Australia Pty Ltd v Bruness Pty Ltd* [2002] WASC 286, [376]; *Body Bronze International Pty Ltd v Fehcorp* (2011) 34 VR 536; [2011] VSCA 196, [82] and [84] (Macaulay AJA).

¹²⁹ *Director of Consumer Affairs Victoria v Scully* (2013) 303 ALR 168; [2013] VSCA 292, [39]. Also *Commonwealth Bank of Australia v Kojic* [2016] FCAFC 186, [60] (Allsop J).

¹³⁰ *Tonto Home Loans Australia Pty Ltd v Tavares* [2011] NSWCA 389, [291].

¹³¹ *Australian Competition and Consumer Commission v Dukemaster Pty Ltd* [2009] FCA 682; See also E Webb, 'Unconscionable Conduct in *Australian Competition and Consumer Commission v Dukemaster Pty Ltd* – A Recognition of "Acoustic Segregation" in Retail Leasing Transactions?' (2010) 18 *APLJ* 48.

¹³² [2014] FCA 1405.

¹³³ [2014] FCA 1405, [102].

¹³⁴ [2016] FCA 1472.

¹³⁵ See also *Virk Pty Ltd (in liq) v YUM! Restaurants Australia Pty Ltd* [2017] FCAFC 190.

6.5. Implied terms

The ASIC Act s 12ED(1) implies a number of terms into contracts for the supply of financial services. The implied term regime contrasts with the ACL approach of providing statutory rights guaranteeing basic standards of quality in the supply of goods and services to consumers.¹³⁶

These terms are only implied in ‘consumer’ contracts as defined in the ASIC Act. However, this category is, somewhat confusingly, defined to include an extension to protect small businesses.¹³⁷ In other words, even though small business contracts are not *per se* consumer contracts, the implied terms are extended to apply to small business loans by operation of an extended definition in s 12ED. Under this approach, a person is a consumer if:

- the price of the services did not exceed \$40,000, or,
- where the price exceeded \$40,000, the goods were of a kind ordinarily acquired for personal, domestic or household use or consumption, or
- where the price exceeded \$40,000, the services were acquired for use or consumption in connection with a small business, and the services were of a kind ordinarily acquired for business use or consumption.¹³⁸

The terms implied under the ASIC Act into contracts for the supply of financial services are mandatory warranties (in the form of contract terms) that:

- the services will be rendered with ‘due care and skill’, which is similar to the duty of care in tort;¹³⁹
- that the services (and any materials in connection with the services) will be reasonably fit for any purpose or required result made known to the supplier by the consumer.¹⁴⁰

The implied terms cannot be excluded from a contract,¹⁴¹ however, it is possible for the parties to limit liability to resupply (or the costs of resupply) if the services are not ‘services of a kind ordinarily acquired for personal, domestic or household purposes.’¹⁴²

6.6. Unfair Contract Terms

A small business enters into a loan contract. Under a term of the contract, the lender has the right to vary any term or condition of the contract, including interest or fees, if notice is given in writing. The small business does not have the right to end the contract, even if the lender increases its fees significantly (e.g. by 20%).¹⁴³

The ASIC Act, like the ACL, contains a regime rendering void (ineffective) unfair terms in

¹³⁶ ACL Pt 3-2.

¹³⁷ ASIC Act s 12ED(1), (2).

¹³⁸ ASIC Act s12BC(1), (3).

¹³⁹ ASIC Act s12ED(1).

¹⁴⁰ ASIC Act s12ED(2).

¹⁴¹ ASIC Act s 12EB.

¹⁴² ASIC Act s 12EC.

¹⁴³ Extracted from ASIC Information Sheet 211, ‘Unfair contract terms protections for small businesses’.

standard form consumer and small business contracts for financial services and financial products.¹⁴⁴ The regime initially only applied to consumer contracts but was extended to standard form small business contracts from November 2016. The extension was based on a recognition of the substantial hurdles to small businesses in trying to negotiate contracts with larger suppliers and the impact of onerous, one-sided or otherwise unfair terms on those businesses.¹⁴⁵ The new regime will apply to standard form small business contracts entered into, renewed or varied on or after 12 November 2016.

6.6.1. *Small business contracts*

A small business contract for the purposes of the regime is defined by reference to the upfront price and number of employees. Section 12BF defines a ‘small business contract’ as follows:

- (4) A contract is a *small business contract* if:
 - (a) at the time the contract is entered into, at least one party to the contract is a business that employs fewer than 20 persons;
 - and
 - (b) either of the following applies:
 - (i) the upfront price payable under the contract does not exceed \$300,000;
 - (ii) the contract has a duration of more than 12 months and the upfront price payable under the contract does not exceed \$1,000,000.
- (5) In counting the persons employed by a business for the purposes of paragraph (4)(b), a casual employee is not to be counted unless he or she is employed by the business on a regular and systematic basis.

6.6.2. *Standard form contracts*

The unfair contract terms regime applies only to standard form consumer or small business contracts.¹⁴⁶ The regime creates a rebuttable presumption that a contract is a standard form contract in circumstances where a party alleges that the contract is of such a kind.¹⁴⁷ In determining whether a contract is a standard form contract, the unfair terms regime states that a court ‘may take into account such matters as it thinks relevant but must take into account’ the following list of specified factors:

- (a) whether one of the parties has all or most of the bargaining power relating to the transaction;
- (b) whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties;
- (c) whether another party was, in effect, required either to accept or reject

¹⁴⁴ ASIC Act s 12BF(1). See further BP4 ASIC Information Sheet 211 (‘Unfair contract term protections for small businesses’).

¹⁴⁵ *Treasury Legislation Amendment (Small Businesses and Unfair Terms) Bill 2015 Explanatory Memorandum* [1.1]-[1.7].

¹⁴⁶ ACL, s 23(1)(b); ASIC Act, s 12BF(1)(b).

¹⁴⁷ ASIC Act, s 12BK(1).

- the terms of the contract ... in the form in which they were presented;
- (d) whether another party was given an effective opportunity to negotiate the terms of the contract ...;
- (e) whether the terms of the contract ... take into account the specific characteristics of another party or the particular transaction;
- (f) any other matter prescribed by the regulations.¹⁴⁸

6.6.3. *Contracts and terms to which the unfair contract terms regime does not apply*

The unfair contract terms regime does not apply to terms that are ‘required, or expressly permitted, by a law of the Commonwealth, a State or a Territory’ or that define ‘the main subject matter of the contract’ or set ‘the upfront price payable under the contract’.¹⁴⁹ The upfront price payable under a contract is ‘the consideration that’:

- (a) is provided, or is to be provided, for the supply, sale or grant under the contract; and
- (b) is disclosed at or before the time the contract is entered into;
- (c) but does not include any other consideration that is contingent on the occurrence or non-occurrence of a particular event.¹⁵⁰

The regime also does not apply to certain shipping contracts or to contracts that are constitutions of companies, managed investment schemes or other kinds of bodies.¹⁵¹ Section 15 of the *Insurance Contracts Act 1984* (Cth) has the effect that the unfair contract terms regime will not apply to those terms that are regulated by that Act.

6.6.4. *The test for an unfair term*

A term will be unfair if:

- a. it would cause a significant imbalance in the parties' rights and obligations arising under the contract; and
- b. it is not reasonably necessary in order to protect the legitimate interests of the party who would be advantaged by the term; and
- c. it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.¹⁵²

Attention should be paid to each of these elements in assessing whether a term is unfair – a impressionistic argument will not suffice.¹⁵³ The relevance of considering the legitimate interests of a party relying on the term is an opportunity for them to justify why the term is needed to protect their legitimate interests. The onus is on the party who would be

¹⁴⁸ ASIC Act, s 12BK(2).

¹⁴⁹ ASIC Act, s 12BI(1).

¹⁵⁰ ASIC Act, s 12BI(2).

¹⁵¹ ASIC Act, s 12BL.

¹⁵² ASIC Act, s 12BG(1).

¹⁵³ For a particularly thorough analysis of these elements see *Australian Competition and Consumer Commission v Chrisko Hampers Australia Limited* [2015] FCA 1204 (Edelman J). Also *Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224 (Moshinsky J)

advantaged by the term to prove that it is reasonably necessary in order to protect the legitimate interests of that party.¹⁵⁴

6.6.5. *Matters relevant in determining whether a term is unfair*

The unfair contract terms regime provides that in determining whether a term of a standard form consumer contract is unfair, ‘a court may take into account such matters as it thinks relevant, but must take into account the following’:

- a. the extent to which the term is transparent;
- b. the contract as a whole.¹⁵⁵

A term is transparent if the term is:

- expressed in reasonably plain language; and
- legible; and
- presented clearly; and
- readily available to any party affected by the term.¹⁵⁶

Transparency requires that terms should be drafted in plain language and should not be presented as a ‘densely packed page of small print terms and conditions’.¹⁵⁷ It has yet to be determined whether transparency may create of itself an imbalance in the rights and obligations of the parties. However it is clear that a lack of transparency may mean that any imbalance in the substantive rights of the parties is ‘significant’.¹⁵⁸ Conversely,

The legislation proceeds on the assumption that some terms in consumer contracts, especially in standard form consumer contracts, may be inherently unfair, regardless of how comprehensively they might be drawn to the consumer’s attention.¹⁵⁹

6.6.6. *The grey list of unfair terms*

The unfair contract terms regime sets out a list of ‘examples of the kind of terms of a consumer contract that may be unfair’.¹⁶⁰ The examples are expressed in general language and are only illustrative. Any term under review must still be assessed with regard to the tests specified in the unfair contract terms regime. A type of term not included in the list may still be found to be an unfair term.¹⁶¹

ASIC and the Australian Small Business and Family Enterprise Ombudsman (ASBFEO) have done considerable work in identifying terms in standard loan contracts that may impact

¹⁵⁴ ASIC Act, s 12BG(1).

¹⁵⁵ ASIC Act, s 12BG(2).

¹⁵⁶ ASIC Act, s 12BG(3).

¹⁵⁷ *Australian Competition and Consumer Commission v Chrisco Hampers Australia Limited* [2015] FCA 1204, [90] (Edelman J).

¹⁵⁸ *Australian Competition and Consumer Commission v Chrisco Hampers Australia Limited* [2015] FCA 1204, [74] (Edelman J).

¹⁵⁹ *Australian Competition and Consumer Commission v JJ Richards & Sons Pty Ltd* [2017] FCA 1224, [19] (Moshinsky J).

¹⁶⁰ ASIC Act s 12BH.

¹⁶¹ See e.g. *Australian Competition and Consumer Commission v Chrisco Hampers Australia Limited* [2015] FCA 1204, [44] (Edelman J); *Ferme v Kimberley Discovery Cruises Pty Ltd* [2015] FFCA 2384.

harshly on small business and be unfair.¹⁶² The changes negotiated with “big four” banks to their small business loan contracts, in order to comply with the unfair contract terms law’ are set out in ASIC Report 565 (‘Unfair contract terms and small business loans’). The terms identified as particularly problematic in this context include:

- entire agreement clauses;
- broad indemnification clauses;
- material adverse change event of default clauses;
- financial indicator covenants; and
- unilateral variation provisions.

While the unfair terms regime will prompt the removal or modification of many of the terms in standard form loan contracts impacting on small business borrowers, importantly, the unfair contract terms regime does not apply to regulate the upfront price of a credit product nor does it ensure the substantive suitability of the product for a business.

7. The Code of Banking Practice Obligations and Other Industry Codes

The Code of Banking Practice (COBP) is a voluntary code that has been adopted by most banks offering retail products in Australia,¹⁶³ although there is no industry or legislative requirement that they do so.¹⁶⁴ Many small businesses may be more likely to rely on enforcing their obligations under the COBP through negotiation or through the FOS than to pursue litigation through courts. The Code of Banking Practice is a legally enforceable set of principles and rules that is incorporated into the contract between the bank and its small business customer.

The current COBP was published in 2013 and was independently reviewed in 2016-17. The Australian Bankers' Association has announced that a revised Code has been provided to ASIC for approval.¹⁶⁵ However, this revised Code has not yet been published. The discussions in this paper therefore refer to the 2013 COBP.

The provisions in the Code of Banking Practice (‘COBP’) apply to the ‘banking services’ offered by subscribing banks to their individual and small business customers. ‘Banking services’ is defined to mean ‘any financial service or product provided by [a subscribing bank] in Australia to [an individual or small business customer]’.¹⁶⁶

¹⁶² ‘ASIC reports on changes to small business loan contracts by big four banks’ (ASIC Media Release 18-073MR, 15 March 2018), available at <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-073mr-asic-reports-on-changes-to-small-business-loan-contracts-by-big-four-banks/>.

¹⁶³ In information provided to the most recent review of the Code of Banking Practice, the Australian Bankers’ Association advised that over 95% of banking services in Australia are provided by banks that subscribe to the Code of Banking Practice: Phil Khoury *Independent Review of the Code of Banking Practice* (2017), p 10.

¹⁶⁴ However, see The Australian Government the Treasury (2018) *ASIC Enforcement Review Taskforce Report*, xv (recommendation 19).

¹⁶⁵ Australian Bankers’ Association ‘Customers set to benefit from new Banking Code’ (Media Release, 20 December 2017).

¹⁶⁶ COBP cl 42 (definitions of ‘banking service’, ‘you’ and ‘small business’).

There are several provisions in the COBP that impose obligations on banks when they provide credit products. Unlike the NCCP Act / NCC, the provisions in the COBP apply to both consumer and small business customers.¹⁶⁷

7.1. Disclosure

Under the COBP, subscribing banks must provide a copy of the terms and conditions applicable to a banking service (including a credit product), and these terms and conditions must include information on the applicable fees, charges and interest rates.¹⁶⁸ Other disclosure obligations require banks to:

- provide copies of the terms and conditions and other documents on request and within certain timeframes;¹⁶⁹
- provide notification of unilateral changes to the terms and conditions;¹⁷⁰
- provide regular statements of account;¹⁷¹ and
- give prospective guarantors certain information about the guarantee and the debtor.¹⁷²

7.2. Responsible lending

The COBP requires a subscribing bank to ‘exercise the care and skill of a diligent and prudent banker in selecting and applying [the bank’s] credit assessment methods and in forming [the bank’s] opinion about [the customer’s] ability to repay the credit facility.’¹⁷³ Clause 27 provides as follows:

Before **we** offer, give **you** or increase an existing credit facility, **we** will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and forming **our** opinion about **your** ability to repay the credit facility.

The predecessor clause in the Banking Code (clause 25.1 in the 2004 Code) had the same wording, and was considered in *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351. In this case, it was held that the clause obliged a subscribing bank to take care in forming its opinion about the customer’s capacity to repay, but did not proscribe the steps to be taken once the opinion was formed. The clause did not require a bank to refuse to provide a loan if it formed the opinion that the customer did not have the ability to repay.¹⁷⁴ Other factors, including other financial resources that may be available to the bank in the event of default, may be relevant to the bank’s decision in relation to the loan.¹⁷⁵

¹⁶⁷ COBP cl 42 (definitions of ‘you’ and ‘small business’).

¹⁶⁸ COBP cl 12.1.

¹⁶⁹ COBP cl 12, 13.

¹⁷⁰ COBP cl 20.

¹⁷¹ COBP cl 26.

¹⁷² COBP cl 31. See Part 5.1 above.

¹⁷³ COBP cl 27.

¹⁷⁴ *Doggett v Commonwealth Bank of Australia* [2015] VSCA 351 [163] – [164].

¹⁷⁵ *Ibid* [163].

The scope of this obligation, as interpreted by the VSCA, contrasts with the more prescriptive obligations in the NCCP Act, which are not applicable to loans provided for business purposes. As discussed in more detail in BP4, the NCCP Act obligations direct the lender to make reasonable inquiries about particular matters, take reasonable steps to verify certain information, and to assess the suitability or otherwise of the loan. If, after following the prescribed steps, the credit provider determines that the loan is unsuitable for the customer, then it is prohibited from providing the loan, or providing credit assistance with the loan.¹⁷⁶ A loan will be unsuitable if the borrower cannot comply with the obligations under the contract, or can only comply with substantial hardship, or if the contract does not meet the consumer's requirements or objectives.¹⁷⁷ Further, if the consumer can only comply with the obligations by selling their principal place of residence, there is a presumption of substantial hardship.¹⁷⁸

The CCMC and FOS have both released guidance on how they will approach disputes about responsible lending in the context of consumer and small business lending.

The CCMC has explained that its assessment of compliance with clause 27 may examine whether a bank has exercised the care and skill of a diligent and prudent banker in:

- selecting the credit assessment method;
- applying the chosen credit assessment method; and
- forming its opinion on the customer's ability to repay.¹⁷⁹

The CCMC has also noted that, although the NCCPA obligations do not apply in the case of small business lending, the principles may provide guidance when assessing compliance in relation to a small business customer.¹⁸⁰

In making decisions about compliance with this clause, the CCMC may consider relevant publications by FOS, the NCCP Act, and ASIC regulatory guides.¹⁸¹ The CCMC will make assessments on a case-by-case basis, but it expects banks to:

- make reasonable inquiries about the customers' circumstances objectives and financial situation, including any known vulnerability or disadvantage of the consumer;
- make reasonable inquiries to verify the customer's financial situation;
- make further inquiries where needed (e.g., if the customer has a history of late payments); and
- assess information about the customer from its own records, information from other accounts held by the customer at that bank, the purpose and size of the facility, and records about credit (e.g., credit reports), bankruptcy and other personal insolvency administrations.¹⁸²

¹⁷⁶ See NCCP Act s 123(1) (for credit assistance providers), s 133(1) (for credit providers).

¹⁷⁷ See NCCP Act s123(2) (for credit assistance providers), s 133(2) (for credit providers).

¹⁷⁸ See NCCP Act s 123(3) (for credit assistance providers), s 133(3) (for credit providers).

¹⁷⁹ Code Compliance Monitoring Commission *Guidance Note 9: Provisions of Credit (Version 1, December 2014)*, 2.

¹⁸⁰ Code Compliance Monitoring Committee *Own motion inquiry: provision of credit (2017)*, p 9.

¹⁸¹ CCMC *Guidance Note 9 (Provision of credit)*, p 2.

¹⁸² *Ibid* 2-3.

In its guidance documents, FOS has noted that the Code provisions apply to small business lending, and that it expects all financial service providers (FSPs) to make sure their lending standards are consistent with the relevant Code obligations, even if a FSP does not subscribe to the Code.¹⁸³ This reflects FOS's view that the industry codes represent 'good industry practice' and can therefore be taken into account in decision making.¹⁸⁴ In determining disputes about responsible lending, FOS will focus on the assessment of the customer's ability to repay;¹⁸⁵ if it determines that it was inappropriate for the FSP to lend the money, it can find in favour of the applicant. This is the case for both consumer and small business lending. However, in the case of small business lending, it is not necessary for a business to demonstrate that a new loan can be repaid based on existing income; as the new funds may be used to purchase an income-producing asset, or otherwise be used to increase the business's income.¹⁸⁶

The contrast between the obligations of a credit provider when lending to small business compared to lending to a consumer is illustrated by the two scenarios below.

Scenario 1: Diedre wants to borrow \$400,000 from a bank to purchase an investment property for \$500,000. She intends to secure the loan with a mortgage over the property. As the bank is a subscriber to the COBP, it must comply with the obligations in cl 27 of the COBP and the responsible lending obligations in the NCCP Act. The bank makes several enquiries and verifies Diedre's financial situation. If, after making the relevant enquiries and taking the required steps to verify Diedre's financial information, the bank determines that the only way that Diedre could repay the loan would be by selling the property, it will be presumed that she could only comply with her obligations with substantial hardship. Unless the bank could rebut this presumption of substantial hardship, the bank would be prohibited from lending the funds to Diedre.

Scenario 2: Diedre is a small business and wants to borrow \$400,000 from a bank to invest in her fledgling business. She intends to secure the loan with a mortgage over her investment property (worth \$500,000). As the loan is for a business, the obligations in the NCCP Act will not apply. However, as the bank is a subscriber to the COBP, it must take the steps of a diligent and prudent banker in, among other things, assessing the business's ability to repay the loan. However, there is no presumption that a loan would be inconsistent with the Code obligations merely because it could not be repaid from current income. Also, there is no direct proscription in the Code preventing lending if the customer does not have the ability to repay. Instead, if an allegation of maladministration in lending was made, FOS would examine whether it was, in all the circumstances, appropriate for the bank to lend the funds.

¹⁸³ Financial Ombudsman Service, *The FOS Approach Responsible Lending Series, 3 How we approach responsible lending disputes taking into consideration legal principles, industry codes and good industry practice* (Version 1, July 2014), [32].

¹⁸⁴ See Financial Ombudsman Service Terms of Reference (1 January 2010, amended 1 January 2018), cl 8.2(c).

¹⁸⁵ Above note 183, [34].

¹⁸⁶ For example, see Financial Ombudsman Service, *Recommendation, Case no 425366, 2*.

7.3. Financial difficulty assistance

Clause 28 of the Code of Banking Practice requires a subscribing bank to ‘try to help’ a customer (whether a consumer or a small business) to overcome financial difficulties with any credit facility they have with the bank (for example, by developing a repayment plan). This does not oblige a bank to offer any particular form of help or to agree to a repayment plan or other variation, and the obligations are primarily procedural.

Clause 28 also includes:

- an obligation to deal with a customer’s authorised representative (for example, a financial counsellor) on the customer’s request;¹⁸⁷
- the potential for banks proactively to communicate with customers, so that financial difficulty assistance may be offered even if a specific request is not made by a customer;¹⁸⁸
- an obligation that banks will ‘respond promptly’ and in writing, including with reasons, to requests for financial difficulty assistance;¹⁸⁹
- banks are prohibited from requiring customers to apply for early release of their superannuation to repay a credit facility;¹⁹⁰ something that would otherwise be permissible under the NCC;
- banks are required to promote their financial difficulty assistance programs and to ensure that staff are appropriately trained in the obligations under the Banking Code.¹⁹¹

In the absence of a definition of financial difficulty in the COBP, the CCMC considers financial difficulty to mean:

‘that a customer is willing but unable to meet their obligations under a credit facility. This may be due to a change in circumstances such as illness, unemployment, an increase in living expenses or other cause...It may require assistance such as a variation to a customer’s repayment obligations but is unlikely to include overlooked or late payments, in the absence of evidence that the consumer is unlikely to be able to pay.’¹⁹²

In assessing compliance, the CCMC may have regard to other COBP obligations, including the obligation to act fairly and reasonably towards customers, and will have regard to relevant legislation, ASIC regulatory guides, and the ABA’s industry guideline ‘Promoting understanding about banks’ financial hardship programs’.¹⁹³

Key aspects of the CCMC’s interpretation of clause 28 include:

¹⁸⁷ COBP cl 28.3.

¹⁸⁸ COBP cl 28.4.

¹⁸⁹ COBP cl 28.6, 28.8. This obligation mirrors that in the NCC, but has the effect of extending similar obligations to credit transactions that are not covered by the NCC.

¹⁹⁰ COBP cl 28.9.

¹⁹¹ COBP cl 28.10, 28.11.

¹⁹² CCMC *Guidance Note 13 (Financial difficulty)*, p 2.

¹⁹³ *Ibid* 3.

- banks must give ‘genuine consideration’ to a request for financial difficulty assistance, giving due regard to the customer’s circumstances;
- consider requests on a case-by-case basis;
- consider longer-term assistance where there is evidence that a short-term solution will not contribute to a customer overcoming their financial difficulties;
- if requests for assistance are made, reasons should be given in writing, be clear, and demonstrate that the bank has considered the customer’s individual circumstances.

FOS also takes a similar approach to resolving financial difficulty disputes. FOS also notes that if the available information shows that the customer’s financial difficulties can no longer be overcome, the FSP should provide a reasonable timeframe for the customer to finalise their debt and including time to voluntarily surrender any asset securing the loan or to refinance the loan.

7.4. Other COBP obligations

Other COBP obligations relevant to the provision of small business credit include:

- various key commitments, including to provide information in plain language, and to act fairly and reasonably to customers, in a consistent and ethical manner;¹⁹⁴
- an obligation to provide the terms and conditions of banking services to customers;¹⁹⁵
- special commitments to indigenous consumers in remote communities and customers with special needs;¹⁹⁶
- direct debits and chargebacks;¹⁹⁷
- obligation to provide statements of account;¹⁹⁸
- additional protections for joint debtors,¹⁹⁹ joint accounts and subsidiary cards,²⁰⁰ and guarantees;²⁰¹ and
- internal and external dispute resolution.²⁰²

7.5. Recommendations in the Khoury Review

The following is an extract of certain recommendations in the Khoury Review that are relevant to the issues discussed in this paper.

¹⁹⁴ COBP cl 3. Note that the CCMC cannot investigate an allegation that a key commitment has not been complied with unless there is also a failure to comply with another obligation in the COBP: cl 36(b)(iii).

¹⁹⁵ COBP cl 12. In practice, this overlaps with or duplicates much of what is in the NCC disclosure obligations.

¹⁹⁶ COBP cl 7,8.

¹⁹⁷ COBP cl 21, 22.

¹⁹⁸ COBP cl 26.

¹⁹⁹ COBP cl 29.

²⁰⁰ COBP cl 30.

²⁰¹ COBP cl 31.

²⁰² COBP cl 37, 38, 39.

7.5.1. Definition of ‘small business’

Recommendation 5²⁰³

- a) The Code definition of “small business” (other than for the purposes of financial products or services regulated by the Corporations Act 2001) should be amended to mean a business that employs fewer than 100 full time equivalent employees or, in the case of a business that is part of a group of companies, the group employs fewer than 100 full time equivalent employees.
- b) The provisions of the Code that relate to credit should apply to a small business credit facility only if it is below \$5 million.

7.5.2. Financial difficulty

Recommendation 10

Clause 28 of the Code should be rewritten to separate out more clearly the commitments that signatory banks are making to assist a customer with a small business credit facility below \$5 million in financial difficulty. In redrafting the clause, regard should be had to the language used in the United Kingdom’s *The Lending Code*. The provision should build in relevant protections that apply to consumer credit, including restrictions on signatory banks instituting or continuing with enforcement action.

7.5.3. Responsible lending

Recommendation 16

The Code should rename current clause 27 as “A responsible approach to lending” and redraft it to use clearer, more modern language. The new clause should oblige banks:

- a) to review the applicant’s financial information, situation and requirements carefully and prudently and consider the application on its merits; and
- b) in general, only lend amounts that the bank believes the applicant can reasonably afford to repay.

7.5.4. Guarantors

Recommendation 17

The Code should make explicit that the obligation in current clause 27 is owed to a guarantor not just the borrowing customer.

Recommendation 41

The Code should include a new provision obliging signatory banks to inform a guarantor where the debtor has been in continuing default for more than 2 months or where the debtor’s credit contract has been changed because the debtor has encountered financial hardship.

This provision should only apply to a guarantor of a small business credit facility below \$5 million.

²⁰³ According to the Khoury Review, 47-48, this would ‘better accommodate businesses such as farming enterprises that increase their workforce on a seasonal basis (whilst seasonal workers in the past have often been regarded as independent contractors there is increasing awareness of the breadth of the employment concept).’ The \$5 million threshold was said to be consistent with the view that ‘a credit facility above that amount often takes on a heightened level of complexity.’

Recommendation 56

The Code should be amended to introduce a financial difficulty assistance regime for guarantors of Code customers who are in debt to a signatory bank because the bank has made a demand under the guarantee. The ABA and signatory banks, working with consumer representatives, should develop industry guidance as to the options for assistance.

Recommendation 39

The Code should be amended to prohibit signatory banks from signing a guarantor, who has not been legally advised, until at least the third day after the provision of all required information to the guarantor.

This provision should also apply to a guarantor of a small business credit facility below \$5 million with an exception at the election of a sole director guarantor, a trustee guarantor or a commercial asset financing guarantor.

In its response to the Khoury Review, the Australian Bankers' Association supported most of these recommendations in whole or in principle, however, it did not support Recommendation 39, arguing that the proposal would be unworkable and that customers may be frustrated by the time delay or by the additional expense of legal advice.²⁰⁴

The Australian Bankers' Association (now the Australian Banking Association) subsequently revised this position in a public statement on 20 December 2017 and decided to accept the recommendation to ensure guarantors, who have not received legal advice, will be required to wait three days before signing.²⁰⁵

7.6. Other industry codes

7.6.1. Customer-Owned Banking Code of Practice

Non-bank Authorised Deposit-Taking Institutions, such as credit unions and building societies, do not subscribe to the COBP. Instead, a clear majority of these organisations subscribe to the Customer-Owned Banking Code of Practice (COBCOP). The COBCOP is published by the Customer-Owned Banking Association, representing credit unions, mutual banks and building societies, and was most recently updated in 2018.

The COBCOP covers similar ground to the COBP,²⁰⁶ but varies in some of the detail. Like the COBP, the provisions of the COBCOP protect individual and small business customers, and apply to home loans, personal loans and credit cards, as well as other financial products and facilities issued by subscribing institutions.²⁰⁷

The provisions of the COBCOP are incorporated into the customer-bank contract, and a breach of the COBCOP can therefore be litigated as a breach of contract claim. Compliance with the COBCOP is monitored by an independent Customer-Owned Banking Code

²⁰⁴ Australian Bankers' Association (2017) *Code of Banking Practice: Response by the Australian Bankers' Association to Review Final Recommendations*, 16.

²⁰⁵ <https://www.ausbanking.org.au/media/media-releases/media-release-2017/customers-set-to-benefit-from-new-banking-code>

²⁰⁶ Forerunners of the COBCOP were the Building Society Code of Practice and Credit Union Code of Proactive, which were closely modelled on the original Code of Banking Practice.

²⁰⁷ See Customer-Owned Banking Code of Conduct 2018, Part B.

Compliance Committee,²⁰⁸ and the terms of the COBCCC can be considered by the relevant EDR scheme when resolving disputes.²⁰⁹

7.6.2. Mortgage & Finance Association of Australia (MFAA) Code of Practice

The MFAA Code of Practice is published by the Mortgage and Finance Association of Australia, an industry association that includes credit providers, commercial finance brokers, loan writers, mortgage managers and others in the finance industry.

The MFAA Code is binding on MFAA members who are brokers, managers, servicers or credit providers, although clause 4 (general standards) applies to all MFAA members.²¹⁰ The MFAA Code applies to individual and small business customers.²¹¹ Perhaps reflecting a different type of membership (including many non-ADIs, and credit intermediaries), the MFAA Code has a different emphasis to the COBP and COBCOP, with a greater emphasis on governing the relationships between consumers and intermediaries, rather than between consumers and credit providers.

The MFAA Code includes obligations about contracts with customers, arranging credit, and hardship applications. Complaints about non-compliance with the Code may be considered by the MFAA Investigations Officer²¹² and/or MFAA Tribunal.²¹³ As with the other codes, the terms of the MFAA Code can be considered by the EDR schemes when resolving disputes.

²⁰⁸ See Customer Owned Banking Code Compliance Committee *Building trust in customer owned banking* <<http://www.cobccc.org.au/>>.

²⁰⁹ See discussion above.

²¹⁰ MFAA Code, cl 3.1.

²¹¹ MFAA Code, cl 2.1(a), 14.2 (definition of customer).

²¹² MFAA Disciplinary Rules (effective 14 September 2016), cl 2.1.1.

²¹³ MFAA Disciplinary Rules (effective 14 September 2016), cl 2.1.2, 2.1.3, 2.1.4, 2.1.5.

APPENDIX: Abbreviations

ABA	Australian Bankers' Association
ACCC	Australian Competition and Consumer Commission
ACL	Australian Consumer Law (CC Act Schedule 2)
ASBFEO	Australian Small Business and Family Enterprise Ombudsman
ASIC	Australian Securities and Investments Commission
ASIC Act	Australian Securities and Investments Commission Act 2001 (Cth)
BP4	Everyday Consumer Credit – Overview of Australian Law Regulating Consumer Home Loans, Credit Cards and Car Loans'
CCA	Competition and Consumer Act 2010
CCMC	Code Compliance Monitoring Committee
CIO	Credit and Investments Ombudsman
COBCOP	Customer-Owned Banking Code of Practice
COBP	Code of Banking Practice
EDR	External dispute resolution
FOS	Financial Ombudsman Services
FSP	Financial Services Provider
MFAA	Mortgage & Finance Association of Australia
NCC	National Credit Code (NCCP Act Schedule 1)
NCCP Act	National Consumer Credit Protection Act 2009 (Cth)
PJC	Parliamentary Joint Committee