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## **SMEs and Cross Border Contracting – The New Zealand Pilot: Background Paper**

Submitted by: Victoria University of Wellington



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Particularly Online Dispute Resolution  
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# SMEs & Cross Border Contracting – the New Zealand Pilot\*

## Background Paper

### 1. Introduction

As Fiske already observed in 2004:<sup>1</sup>

Without a neutral, efficient, and fair dispute resolution process that is legally enforceable, many businesses would not contract abroad for fear of foreign litigation.

Research, undertaken by the IMF/World Bank, the European Commission and a pilot study in New Zealand, seem to confirm that international litigation is an unsatisfactory vehicle for providing access to justice for many SMEs.<sup>2</sup> The European Commission's study into intra-EU trade by small and medium sized businesses found that one third of respondents felt that the resolution of cross-border conflicts stifled their cross-border trade.<sup>3</sup> The World Bank and the International Finance Corporation in their 2012 co-published study, *Doing Business 2012*, reported that efficiency and transparency in dispute resolution were pivotal in encouraging cross border trade.<sup>4</sup>

In addition, SMEs generally lack the knowledge, inclination, resources or bargaining power to incorporate either a favorable jurisdiction clause or alternative dispute resolution processes (such as arbitration or mediation) into their contracts.<sup>5</sup>

The unsatisfactory solution for many SMEs seems to be to “self-hedge”, restricting their cross-border trade, thereby restricting the potential growth and benefits such trade could generate. Alternatively, SMEs potentially expose themselves to the serious risks of cross-border litigation, often resulting in unfair and catastrophic results for small enterprises.

Research on the contractual realities for SMEs is scarce; if not non-existent. Some of the assumptions in regard to the unsuitability of international litigation as the default dispute resolution mechanism are based either on anecdotal evidence, on surveys conducted among large businesses<sup>6</sup> and/or quantitative surveys<sup>7</sup>. What existing surveys have not tested is whether there is a better alternative to cross border litigation for SMEs. How do SMEs actually contract? And what alternative might exist? A pilot empirical study and survey conducted in New Zealand confirmed on the one hand the anecdotal evidence of the lack of sophistication in cross border

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<sup>1</sup> William Fiske “Should Small and Medium-Size American Businesses ‘Going Global’ Use International Commercial Arbitration?” 18 (2004) *Transnat'l Law* 455, 459.

<sup>2</sup> Compare European Commission, *European contract law in business-to-business transactions: Summary* (2011); World Bank and the International Finance Corporation *Doing Business 2012* (2012). The Bar Council of Ireland's findings in “Are you an SME with a dispute against a trader in another EU Member State?” draw the same conclusion in regard to Ireland: “Unfortunately going to court is not an option for most businesses as it can be expensive, stressful and time-consuming, and this is even more likely to be true when different languages and differing legal systems are involved.” Hanneke van Oeveren, Hanneke van Oeveren, “*It hurts my head to think about it*”- SMEs and the Legal Framework for International Commercial Contracts, Victoria University, LLM research paper (2016).

<sup>3</sup> European Commission, *European contract law in business-to-business transactions: Summary*, 2011

<sup>4</sup> World Bank and the International Finance Corporation *Doing Business 2012* (2012).

<sup>5</sup> See findings Hanneke van Oeveren, “*It hurts my head to think about it*”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016).

<sup>6</sup> See Queen Mary University of London School of Arbitration surveys on <http://www.arbitration.qmul.ac.uk/research/international-arbitration> (last accessed 8 Jan 2017).

<sup>7</sup> European Commission, *European contract law in business-to-business transactions: Summary* (2011); World Bank and the International Finance Corporation *Doing Business 2012* (2012).

contracting by SMEs; on the other found that the extent and magnitude of the issue is underestimated and/or ignored.<sup>8</sup>

## **2. The New Zealand Study**

The New Zealand pilot study interviewed twelve New Zealand businesses from different areas, from manufacturing to IT, located all around the country<sup>9</sup>.

### *a. Lack of single contract document*

The study found that SMEs generally do not have one contract document. Contracting is done in a piecemeal fashion often through a mixture of emails and phone calls.<sup>10</sup> There was a recurring theme of a mistrust of contractual documents. There was some reluctance to require contractual counterparts to sign legalistic-looking documents, perceived as using verbose clauses to contemplate everything that has the potential to go wrong with a particular transaction. The importance of maintaining a relationship between the parties substituted for any contractual document. As one participant emphasized<sup>11</sup>

Good relationships are important to me; I am not really interested in doing deals just for the sake of a deal...I would much rather work on relationships than signing documents and working at a level of distrust.

When asked whether he thought customers read the business' terms and conditions another participant said<sup>12</sup>

No...and I hope that they don't because it can only be damaging for the relationship.

### *b. Lack of awareness of legal issue and lack of engagement of/with legal services*

SMEs lack resources to engage legal advice or to deal with the associated processes on top of the day job of trying to sustain and to grow their business.<sup>13</sup> In addition, SMEs generally lack awareness of the complexity of the potential legal issues- illustrated by the comment of one of the participants<sup>14</sup>

If someone comes to us to do business, then I guess my gut feeling would be that whatever law we work in always applies. So if somebody rings me from the US and wants to buy something from me then I assume that they came to us so our law must apply. The moment we call them instead, then US law might apply.

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<sup>8</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016).

<sup>9</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016).

<sup>10</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016).

<sup>11</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 27 fn 104.

<sup>12</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 27 fn 105.

<sup>13</sup> Hanneke van Oeveren, *"It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts*, LLM thesis (Victoria University Law Faculty, Wellington, 2016). The New Zealand findings are echoed by the UK Federation of Small Businesses in its study "Tied Up- Unravelling the Dispute Resolution Process for Small Firms" (London, November 2016) a quantitative survey which looked at the domestic use of dispute resolution mechanisms by SMEs.

<sup>14</sup> Hanneke van Oeveren, *"It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts*, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 40 fn 155.

In particular, they are often not aware that in cross border contracting additional issues might arise. As one participant stated<sup>15</sup>

For a layman like myself, even reading a legal document is already something, you have a bit of an idea of what it says, but what it really means you don't really know.

Sometimes a “down-to-earth” approach prevails which echoes perceptions maybe gained by watching US legal drama<sup>16</sup>

No...because America you know, don't kid yourself. The Americans are not going to sue me, I could poison and kill an American [with my product] and they wouldn't sue me because the lawyers would not make enough. They could take me to the cleaners, they could take my business, they could take my wife and children and sell them into slavery and they still would make enough to pay their fee.

However, even if SMEs seek legal advice the advice they are receiving often does not satisfy their needs. As participant explained<sup>17</sup>

.a ten-minute discussion with my solicitor, we sent a machine to the UK which I owned. I had known the dealer for a long time and there was mutual trust but once I sent the machine it was effectively out of my hands, he had it but I owned it. I had a ten minute discussion with my solicitor but he said it was a complicated thing *so I said we will forget it and go with the handshake.* (emphasis added)

Traditional academic writing on international commercial contracts often assumes the involvement of lawyers in the contract drafting stage.<sup>18</sup> However, in many cases the value of the individual transactions will mean that the involvement of a lawyer is not a commercially viable option. One participant clarified

For us the amounts are just too small, if we are doing a deal worth 50,000 the profit margin might only be 10%, if we use a lawyer “poof” half the profit is gone.

Furthermore, in relation to international matters, an SME's usual lawyer might not have a broad knowledge of the best practice for key clauses in an international commercial contract. This may be particularly true for smaller firms located in regional areas of New Zealand with lawyers who engage in a broad range of legal services for both private and commercial clients. Many small businesses will customarily refer all their legal queries and issues to the same lawyer.<sup>19</sup> When asked about the use of drafted documents for international transactions, one participant reported that<sup>20</sup>

I wouldn't have a clue where to start and I also probably would fear that if I went to my usual lawyer  
He wouldn't have a clue either...

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<sup>15</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 27.

<sup>16</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 49 fn 201.

<sup>17</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 28 fn 108.

<sup>18</sup> See, for example, William Fox, *International Commercial Agreements* (3<sup>rd</sup>ed, Kluwer Law International, The Hague, 1998) 87.

<sup>19</sup> Elio F Martinez Jr “Representing a Small Business” (2009) 26 GPSolo 28, 29.

<sup>20</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 30 fn 124.

c. *(perceived) Ingenuity of SMEs*

An interesting slightly counter-implication of the multi-tasking SME management is their involvement with, and understanding of the day-to-day performance of contracts, as well as the negotiation thereof. In general, smaller businesses will also have fewer customers and fewer individual transactions than larger firms. Where a firm has fewer customers and fewer transactions, it is possible for the management to “hold the reins” and be personally in control and assess the risk of individual transactions. Smaller businesses may hereby have an increased ability to be selective in whom they deal with and operate on the basis of relationships rather than formal procedures. When asked whether documents for sale to a distributor included anything about dispute resolution or applicable law, one participant said<sup>21</sup>

No... Eventually we will have to go there but at the moment the relationships are really personal and I deal personally with all these people, and when you're sitting across the table face-to-face you work it out. But if we get bigger and employ salespeople then we need more detail. As I own the business I can see the big picture, but for a salesperson that is much harder to do.

The comment is illustrative of the (perceived) ability the management of a SME to avoid the need for legal recourse by retaining oversight and by being directly in control of all aspects of their business' involvement in international commercial transactions. Being required to sign a contractual document or requiring the other party to agree to and sign a drafted contract may induce a sentiment of the agreement no longer being a flexible agreement in the hands of the negotiators, but instead being constricted into a paper straightjacket requiring interpretation by lawyers.

The ingenuity of SME management, an illustration of the potential advantages of SMEs but also of their relationship to written formally negotiated contracts is illustrated by one New Zealand SME. An SME that frequently deals with much larger overseas companies, explained<sup>22</sup>

They are dealing with one person –me. I'm dealing with their finance department and their legal department, like 30, 40 or even 50 people... so you're dealing with 50 people and they have lawyers on tap that are on payroll and they want to keep those guys busy. And that's why we say, yeah you can go down that track [changing our standard contract] *but you're gonna be paying our legal fees as well.* (emphasis added)

Small businesses find alternative ways to minimise the risk they take on in entering into an international transaction, which reduce the perceived importance of legal recourse. One of the most obvious, and frequently recommended, methods to minimize risk for a seller of goods or services is to require full payment before delivery or provision of the services.<sup>23</sup> One participant's response is illustrative<sup>24</sup>

Well obviously you mitigate it, you approach it differently, but the risk would be that it is much harder, or at least I perceive it to be much harder to enforce any payment. We just don't go there, it is sort of accepted in international transactions that there is a lot more cash on delivery, pay before it leaves.

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<sup>21</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 29 fn 117.

<sup>22</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 31 fn 126.

<sup>23</sup> US Department of Commerce, *International Trade Administration Finance Guide: A Quick Reference for US Exporters*, 4.

<sup>24</sup> Hanneke van Oeveren, “It hurts my head to think about it”- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 16 fn 55.

This view was echoed by another participant who said<sup>25</sup>

...our credit terms are payment before delivery, so we would never ship without the payment being complete or at the very least a letter of credit. So, no I would not say they are more risky but maybe that is just because we have mitigated against the risks.

Both participants considered the risk of international transactions, at least to a significant extent, to be mitigated by requiring full payment before delivery.<sup>26</sup>

*d. Concluding observations*

The study revealed that the extent of the SMEs' unsophistication and the lack of resources are generally underestimated. Allocation both in time and energy to the various tasks and responsibilities a SME management has to be perform mean that often even awareness of a potential legal issue is not raised neither is information sought, should awareness be present, in regard to even relative simple, let alone complex, legal issues.<sup>27</sup> The lack of time and the multiple tasks SME management has to fulfill means that no time or money is spent on preventory measures, such as drafting contracts<sup>28</sup> since time dedicated to contractual drafting is inevitably time that cannot be spent on other tasks or duties.<sup>29</sup>

However, many small businesses, including the majority of those interviewed in the course of the New Zealand research, have been highly successful in their international endeavors, with little concern about questions of applicable law or dispute resolution. Where current conditions and practices appear to be meeting commercial needs, the sentiment can arise among the businessmen themselves that, "if it aint broke, why fix it?"

It also has to be noted that SME lobby groups so far have not demanded any change in the legal landscape to date. However, the New Zealand research suggests that SMEs are so unaware in regard to issues of contracting that "they not even know what they do not know". Therefore, risk management regarding potential disputes generally occurs through faith in the relationship, by "front-ending" the obligation, ie demanding purchase price payment before delivery, or by riding off any losses made. The risks for SMEs are potentially very high. As one SME stated which found itself in parallel proceedings: "We learned it the hard way and got out of it lucky- with just one black eye."

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<sup>25</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 16 fn 56.

<sup>26</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 16.

<sup>27</sup> Hanneke van Oeveren, "It hurts my head to think about it"- SMEs and the Legal Framework for International Commercial Contracts, LLM thesis (Victoria University Law Faculty, Wellington, 2016) 28; see also Elio F Martinez Jr "Representing a Small Business" (2009) 26 GPSolo 28, 29.

<sup>28</sup> Elio F Martinez Jr "Representing a Small Business" (2009) 26 GPSolo 28, 29.

<sup>29</sup> Wyatt McDowell and Lyle Sussman "Alternative Dispute Resolution: How Small Businesses Can Avoid the Courts in Resolving Disputes" (2004) 69 SAM Advanced Management Journal 32, 32.