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Your contract - more or less than you bargained for?

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Company Commercial partner Richard Cowan considers some recent court decisions in relation to commercial contracts.

Do you have an enforceable contract or not?

With some exceptions (such as contracts for the sale of land, guarantees and consumer credit agreements) a contract does not need to be in writing. However, without a written contract it can be difficult to establish when (if at all) during the contract negotiations the parties reached an agreement which they both intended to be a legally binding contract and the exact terms of that contract. Although the parties' intention to create legal relations will be assessed by considering their objective conduct as a whole (not their subjective states of mind), a signed document which is expressed to be binding contract will normally avoid the need to establish this intention.

However, even if the terms of an agreement are recorded in a signed document, you may not have a binding contract if any important terms are left open for agreement by the parties at a later date.

Each case has to be decided on its own facts. The Court of Appeal (when considering this fundamental issue in the case of MRI Trading AG V Erdenet Mining Corporation LLC) recently confirmed some general principles:

- where no contract exists, using an expression such as "to be agreed" may prevent a contract from coming into existence as the courts will not enforce an "agreement to agree"
- where no contract exists, the absence of agreement on essential terms may prevent any contract coming into existence
- if a term of a contract is left open for subsequent agreement, there may be no enforceable contract at all- the more important the term, the more likely it is that the entire contract (or just the relevant provision) is not enforceable
- in commercial dealings between parties who are familiar with the relevant trade the courts are willing to imply terms (where possible) to enable the contract to be carried out, particularly where the parties have acted in the belief that they had a binding contract
- where the contract involves performance over a period and the parties desire or need to leave

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matters to be adjusted in the working out of the contract, the courts will assist the parties to do so on the basis that "what can be made certain is itself certain" (particularly where one of the parties has had the benefit of some performance in the context of a long term relationship or has made investment premised on that relationship)

- an express stipulation for a reasonable measure or price will be a sufficient criterion for the court to act on and the presence of a mechanism for resolving the issue (such as an arbitration clause) may assist the court to decide that a contract is sufficiently certain or can be made so

The court will not imply a term which is inconsistent with what it concludes that the parties have agreed or should be taken to have intended. If the parties must have intended to leave a matter for future agreement on the basis that either party is free to agree or disagree about the unresolved matter (as his own perceived interest dictates), the court will not imply a term that the matter is determined by some objective criteria (such as fairness or reasonableness). If the parties intended that any matter on which they could not agree should be determined by reference to some objective criteria, the court will provide its own machinery for determining what needs to be determined if the contract contains no mechanism for this.

In this case, a settlement agreement in relation to an earlier dispute between the parties provided for 3 new contracts between the parties for the supply of copper concentrate. Although the contract in dispute (due to be performed in 2010 - the "2010 contract") had not been performed at all, the other 2 contracts had been fully performed. The 2010 contract stated that the shipping schedule, treatment charge and refining charge were each to "be agreed during the negotiation of the terms for 2010". The 2010 contract also contained an arbitration mechanism. The Court of Appeal held that the 2010 contract was enforceable on the basis that:

- although the 2010 contract had not been performed at all, it was part of an overall agreement (comprising the settlement agreement and the 2 other contracts) which had been performed
- the language of the settlement agreement and the 2010 contract strongly indicated that the parties did not intend that a failure to agree these outstanding issues should destroy their bargain, particularly where all other aspects of the contract (including quality specification and price) had been agreed and the contract provided for arbitration of disputes by a market tribunal.

The case might have been decided differently, if there had been no settlement agreement or the other contracts had not been performed. The lesson to be drawn from this is that, whenever important terms of a contract have to be left open, the contract should make it clear that the parties must act reasonably in agreeing any outstanding points and/or include an express mechanism for resolving any disagreement.

Incorporation of standard terms

The parties may attempt to incorporate their standard terms in a contract. Disputes frequently arise as to whether or not standard terms have been effectively incorporated into a contract.

This issue is neatly illustrated by a case concerning a maintenance agreement between the owner of an aircraft and an operator under which the operator was responsible for repairing and maintaining the aircraft (Rooney and another -v- CSE Bournemouth Ltd [2010]). It was the operator's practice to require the owner to sign a work order before starting any repair and maintenance work. Over 50 work orders had been submitted prior to the work order in dispute. 40 of these work orders (including the one in dispute) set out at the foot of the page, just below the signature box, the words "terms and conditions available upon request".

The operator carried out some maintenance work on the aircraft as set out in a work order signed by the owner. The work was carried out negligently, resulting in damage to the aircraft. The owner claimed damages.

The operator claimed in its defence that it carried out the work on its standard terms and relied on a

number of those terms. It argued that the absence of the word "standard" in the reference on the works order form was not significant since the evidence showed that the operator had only ever had one set of trading terms. The owner argued that the work order was not a contractual document and that the reference to "terms and conditions being available" did not mean that they were incorporated in the contract. These words did not identify the terms and conditions or say that they were to apply to the work.

The court held that the ultimate question was whether reasonable people in the position of the parties would understand the words used as referring to contractual terms upon which the operator agreed to do the work. It decided that the work order (which was signed by the owner and activated work being done under the maintenance agreement) was intended to be a contractually binding order within the contractual framework of the maintenance agreement rather than a form of pre-contractual negotiation. The court decided that it would be commercially odd to have a contract for the performance of services where, instead of it containing any detailed commercial terms (for example regarding payment) the operator devised such terms but included them only at the owner's request.

As the appeal was from an order striking out part of the defence, the issue was only whether the operator's construction of the words was reasonably arguable. The court held that it was the more likely construction, subject to further evidence on the underlying contractual framework. The court decided only on the issue as to whether or not the terms were incorporated, not whether they reasonable.

The case illustrates that the courts will consider the overall factual background when determining whether terms have been incorporated or not, even if the language is not clear. It also highlights the importance of using clear language to incorporate separate terms of business into a contract.

Who are the contracting parties?

If it is impossible to identify a party to a contract as a matter of construction, the contract will fail for uncertainty unless the court is prepared to grant a rectification order. It should be straightforward to ensure that a contract correctly identifies the contracting parties (by, among other things, including the relevant registration number where a party is a company or LLP). However, in a recent case involving a contract for consultancy services, the identity of both of the contracting parties (the "client" and the "consultant") was in dispute. The relevant letter of engagement referred to a company called "Climate Change Group Ltd" as the "client" and to "ERA" as the "consultant". Climate Change Group Ltd (a dormant company) was part of a group of companies consisting of a holding company ("Climate Change Holdings Ltd") and 18 subsidiaries one of which ("Climate Change Capital Ltd") was the chief operating company of the group. It was not clear whether the consultant was ERA UK Ltd (the UK arm of a worldwide franchise operation called Expense Reduction Analysts) or a franchisee of this franchise called Zuckra Ltd (operating under the trading name ERA). The court decided, from an objective standpoint, that the written contract was between the chief operating company (as the client) and Zuckra Ltd (as the consultant). The court noted that, although the parties had probably not considered which member of the Climate Change group was to be the contracting party, when considering the question objectively in the light of the factual background known to both parties, the chief operating company was the obvious contracting party, given that it was authorised and regulated by the FSA and provided advisory services to clients.

In another recent case, the issue was whether a person signing a letter of engagement was acting personally or as agent for his company. The signatory's name was printed on the letter below his signature together with the trading name of a company owned by him. The court determined that the approach to deciding this issue was what a reasonable person with the relevant information would have concluded. It held that the person signing the contract will be regarded as contracting in his own name unless the document make clear that he signs as agent for a sufficiently identified principal or extrinsic evidence establishes that both parties knew he was signing as agent or company officer. In this case, the court determined the signatory was not acting as agent as the other party had not been told that the trading name on the letter was the trading name of a limited company and there was no

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reference in the letter to the proper company name or to the signatory signing as a director.

Is the purchaser under the contract a consumer?

What type of customer you hold yourself out to be when entering a contract was the focus of a recent high court case. (Overy v Paypal (Europe) Ltd [2012])).

If a person purchases goods or services, he/she will have a greater degree of statutory protection if he/she purchases "as a consumer ". The case decided that a buyer of electronic payments services was not a consumer for the purposes of the Unfair Terms in Consumer Contract Regulations 1999 ("UTCC Regulations"). The buyer had a photographic business and, although he opened a business account with Paypal, his main purpose in opening the account was to hold an online competition to sell his house. Paypal suspended the payment service on the basis that this was in breach of its gambling and lottery policy. The suspension resulted in the failure of the buyer's sale competition and he sued Paypal for breach of contract. The court held that:

- an individual will normally be regarded as acting for purposes outside his trade business or profession if, and only if, the purpose is to satisfy the individual's own needs in terms of private consumption
- if an individual is acting for more than one purpose, the UTCC Regulations will only apply if the business purposes are negligible or insignificant
- if the individual is, in fact, acting for purposes wholly outside his trade business or profession, he may not be entitled to the protection of the UTCC Regulations if he has given the other contracting party the impression that he was acting for business purposes so that the other party was and could reasonably have been unaware of the private purposes.

Contractual discretion- how is it qualified?

A party to a contract may have a right or power which is stated to be exercisable at its discretion. In a case where a bank had power to value securities which were volatile and illiquid (with no qualification that the bank would act reasonably in doing so), the court implied a term that this power should not be exercised in an arbitrary or irrational manner (a lower threshold than "reasonable"). Amplifying a Party's discretionary right or power by adding the words "sole" or "absolute" is unlikely to override this requirement to act rationally and not in an arbitrary manner when exercising the discretion.

However, the Court of Appeal in Mid Essex Hospital Services HHS Trust v Compass Group UK and Ireland Ltd (trading as Medirest) [2013]) decided that this qualification will not be implied where the discretion only involves a decision whether or not to exercise an absolute contractual right rather than making an assessment or choosing from a range of options. The contractor claimed that the Trust, when exercising its contractual right to award service failure points and to make deductions, was subject to an implied term that it would not exercise this right in an arbitrary, capricious or irrational manner. However, the court held that there was no such implied term. The contract contained precise rules as to how service failure points and deductions should be calculated. The Trust had no discretion as to the calculation; it simply had discretion whether or not it would exercise this right to award service failure points. If the calculation was wrong, it could be challenged.

The court will not normally imply a term that a discretionary right or power is to be exercised reasonably.

The summary in the following table gives a brief indication as to how contractual discretion is likely to be interpreted.

Is the discretion qualified?	What does this mean in practice?

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No express qualification	The court will generally imply a term that the discretion must be exercised "rationally - ie in a manner which is not arbirary capricious, perverse or irrational
"Sole" or "absolute" discretion	These words on their own are unlikely to prevent the court from implying a term that the discretion must be exercised rationally
Discretion must be exercised "reasonably"	This is an objective standard which will generally involve the application of the principles discussed below in the section headed "withholding of consent"

Do the parties have to act in good faith?

The High Court has recently implied an overarching duty of good faith in a distributorship contract using the interpretation technique of the "presumed intention" of the contracting parties. The duty was expressed as a test of "good faith and fair dealing" to emphasise that it was an objective standard as to whether specific conduct in the particular context would be regarded as commercially acceptable by reasonable and honest people. However, the Court of Appeal in the Mid Essex Hospital Services case (referred to above) confirmed that there is no general doctrine of "good faith" in English contract law and that, if the parties wish to impose a duty of good faith, they must do so expressly. The Court of Appeal recognised that the duty may be implied by law in employment contracts and where parties owe a fiduciary relationship to each other. The contractor had claimed that the Trust's conduct was a breach of its contractual obligation to co-operate in good faith. The clause in question (which imposed a mutual duty to co-operate in good faith) was unclear and was capable of being construed as either imposing a duty to co-operate in good faith generally in relation to the contract or only in relation to defined purposes (which included the efficient transmission of information and instructions). The court found that the express contractual duty of good faith was limited to these particular defined purposes.

Implying terms into the contract

Construing (or interpreting) a contract is the process, in relation to any point at issue, of ascertaining the meaning which the words used in the contract document would convey to a reasonable person having all the background knowledge which would have reasonably been available to the parties in the situation they were in at the time the contract was made. The implication of terms is part of this process where the express wording of the agreement makes no provision.

Generally terms are implied by law, because the contract is of a certain type (e.g. contracts of employment or landlord and tenant) or by the courts on an adhoc basis applying the interpretation technique of imputing an objective intention to the parties from the wording of the contract document and against the factual background in which the contract was made.

The courts will only imply a term (other than a term implied by law) where this is necessary. The starting point is the wording of the contract and the principle that commercial parties intended the words used in the document to mean what they said in setting out their rights and obligations. This test of "necessity" has been expressed in different formulations including the necessity to give business efficacy to the contract. If there are two possible constructions of an ambiguous clause, the courts can apply the interpretation which is more consistent with business common sense.

In a recent Court of Appeal case (Dear and Another v Jackson [2013]) a shareholders agreement entered into in 2008 provided that the shares of the holding company would be voted on so as to continue to appoint the claimant to the board of the subsidiary company (except in the case of a termination event as defined). Some years later the claimant was removed as a director by the directors of the subsidiary in accordance with its articles of association. The directors included 2 individuals who were parties to the shareholders agreement. The court held that it was not necessary to imply a term that this power of the directors under the articles to remove a director should be restricted (in the same way as the shareholders agreement) so as not to allow the claimant to be removed as a director except in a termination event (as defined). The court relied on earlier court

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decisions which indicate that where the parties have made express provision for a matter, it is difficult to argue that there should be a further implied term in the contract as to that matter. In particular, the court noted that although the 2 shareholders (who had agreed to the restriction in the shareholders agreement) had joined in the exercise of the directors' power, the exercise of this power required the concurrence of the other independent directors.

In reaching its decision, the court asked, if a term was not implied, would the consequences contradict what 'any reasonable person' would understand the contract to mean. This seems to be a departure from the test of 'a reasonable person'. The new test means that the question posed is 'would all reasonable people agree that the implied term should be included in the commercial terms of the contract?'

Withholding of consent

Commercial contracts often provide that one party is required to obtain the other party's consent in relation to one or more specified matters and that this consent will not be unreasonably withheld.

In Porton Capital Technology Funds and Others v 3M UK Holdings Ltd and 3M Company [2011], the court applied, in a commercial context, various principles which were taken from landlord and tenant decisions as to whether or not consent had been unreasonably refused. The principles included:

- the burden is on the party seeking the consent to show that the other party had unreasonably withheld its consent
- the party whose consent is required does not have to show that their refusal was right or justified, only that it was reasonable in the circumstances
- in determining what is reasonable, the party whose consent is required is entitled to have regard to its own interests and is not required to balance its own interests with those of the other party

The case involved a contract for the sale of shares in a company where the majority of the share purchase price consisted of an earn-out payment based on net sales of the company for the calendar year 2009. Both the seller and the buyer had estimated that the sales would be in excess of US$ 20 million. Under the contract the buyer could not terminate the company's business without the seller's consent (which was not to be unreasonably withheld). After completion of the sale, the buyer indicated to the seller that the business was failing and was only estimated to generate sales of $1.7 million during 2009. The buyer sought the seller's consent to terminate the business because of the expense of continuing to operate it. When the seller refused, the buyer terminated the business in December 2008 with the result that there were no sales during 2009. The court held that, in the circumstances, the seller was entitled to dispute the buyer's assertions and had not unreasonably withheld its consent.

This approach has recently been adopted in a financial transaction dispute (Barclays Bank plc v Unicredit Bank AG and another [2012]). The facts were that Barclays provided long term guarantees to Unicredit so that it could meet its regulatory capital requirements. Unicredit had the contractual right to terminate the guarantees early if there was a regulatory change, subject to obtaining Barclay's consent which was to be determined in a commercially reasonable manner. Unicredt exercised this termination right but Barclays refused to grant its consent unless it received 5 years fees under the guarantee. The court held that Barclays acted in a commercially reasonable manner by refusing to grant consent. The court re-iterated the following principles:

- "commercially reasonable" was to be assessed objectively- it was not sufficient for Barclays to show that its decision was made in good faith and was not arbitrary, capricious or irrational
- the question was not whether the decision was justified but whether a reasonable commercial man in Barclays' position might have reached such a decision
- in determining what is commercially reasonable, Barclays' commercial interests (i.e. earning the

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guarantee fees) took precedence over Unicredit's interests (in this context terminating the guarantees which no longer gave rise to capital relief)

- Barclays was not obliged to carry out a balancing exercise between its interests and Unicredit's interests unless the nature or amount of the fee income protected was so disproportionate to Unicredit's obligation to continue to pay it that no commercially reasonable man in Barclays position could have reached such a decision

The lesson to be drawn from these cases is that the party, which has to obtain the consent of the other party, will need to consider whether the qualification that the consent will not be unreasonably withheld gives it sufficient protection in the context of the commercial transaction in question. Given that the party granting the consent will not be required to balance its interests against those of the other party (unless wholly disproportionate not to do so), the party which has to obtain consent would be well advised to ensure that the contract expressly provides for the party granting the consent:

- to "balance both parties interests" when reaching a decision whether to grant consent (either in general terms or limited to specific interests of the party seeking the consent)
- not to unreasonably delay in giving its decision
- to be subject to the onus to show that it had acted reasonably in refusing consent and to specify its reasons for the refusal

Is the clause unenforceable because it is a penalty?

A penalty clause is usually described as a clause which provides for the payment of a sum of money on breach with the predominant purpose of discouraging a party from deliberately breaching its contractual obligations. This doctrine applies not just to the payment of a sum of money but also to withholding a sum of money or to the mandatory transfer of property. A penalty clause is unenforceable to the extent that the payment (or value of the mandatorily transferred property) exceeds the actual loss suffered by the innocent party.

A contract may specify the damages payable on a particular breach as this has the advantage of avoiding the potentially difficult task of quantifying the damages for breach of contract. As Blackburn Rovers found out to the cost when they exercised a right to terminate the manager's contract before its fixed term had expired, a sum which is payable under a contract for reasons other than breach of contract will not be a "penalty". The Court held that it was not realistically arguable that the provisions of the early payment clause which required the Club to pay compensation of £2.25 million for the early termination was a penalty.

Even if the contract describes the payment or transfer of property as "liquidated damages" (which are enforceable), the court will make its own assessment as to whether the payment stipulated is a penalty or liquidated damages. This question is decided by reference to the terms and inherent circumstances of each particular contract, judged as at the time the contract is made (not at the time of the breach). To assist in deciding this issue, the courts have traditionally considered whether the liquidated damages (as stipulated in the contract) are a genuine pre-estimate of the loss suffered by the claimant (recognising that it is not a bar to the operation of a liquidated damages clause that a precise pre-estimation of loss is impossible).

A recent case has used the test of 'commercially justifiable' to decide whether a clause was a penalty or not. This is in contrast to the more conventional 'genuine pre-estimate of loss' test (Cavendish Square Holdings BV and another v El Makdessi [2012]).

The case concerned a share purchase agreement, which imposed a restrictive covenant on the seller of the shares. The agreement stipulated that, if the restrictive covenant was broken, the purchaser would not be liable for any future instalments of the purchase price for the shares and the seller could be required to sell the remainder of their shares to the purchaser for a price based on net asset value.

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The seller argued that the provision was not a genuine pre-estimate of the purchaser's loss since it was the company (and not the purchaser) which suffered loss as a result of the seller breaching the restrictive covenant. However, the court held that there was no longer the need for the dichotomy between liquidated damages and genuine pre-estimate of loss, so the relevant questions were simply:

- was there a commercial justification for the provision?
- was the provision extravagant or oppressive?
- was the predominant purpose of the provision to deter breach?
- if relevant, was the provision negotiated on a level playing field?

In this case the commercial purpose was to achieve a speedy separation of the parties (so that the defaulting seller ceased to be a minority shareholder in the company) rather than to deter a breach of the restrictive covenant. The adoption of a net asset valuation of the shares (which ignored the goodwill of the company) was not disproportionate since a breach of the restrictive covenant was likely to have a substantial adverse impact on the goodwill of the company.

However, because the target company had already received damages for breach of fiduciary duty by the seller, enforcing the clause would give rise to a penalty as the purchaser would have double recovery. The court therefore asked the purchaser to credit the amount paid by the company, so it could enforce the clause.

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