New Year, New Law –
a contract law update

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1. INTRODUCTION

Contracts are the cornerstone of the commercial enterprise. They regulate relationships between the business and its customers, suppliers, financiers and employees.

The written contract is there to record the agreed commercial terms. This should be simple but, as some of the following cases will show, it is not always straightforward. When negotiating a contract you will also want to ensure that you get the best possible position. To assist you in this, and in avoiding some of the pitfalls, we set out a consideration of some cases from the last twelve months, together with a brief look at a European development on choice of law. In particular, we will address:

> Pre-contractual negotiations: important or not?
> When does an oral “agreement” constitute a binding contract?
> Standard exclusion clauses – how wide can you go?
> Contractual discretion – absolute or reasonable?
> Damages – at what date should they be assessed?
> Can you choose the law of non-contractual obligations?

In each case we look at practical ways to address the issues raised.
2. PRE-CONTRACTUAL NEGOTIATIONS: IMPORTANT OR NOT?

As ever, the answer to this question is that it depends on the context. As set out below, the Courts have in the last 12 months given judgments which place starkly different levels of importance on pre-contractual discussions.

2.1 First context: contractual construction

The traditional view ([Prenn v. Simmonds [1971]]) is that pre-contractual negotiations and discussions are not ordinarily admissible to aid construction of a concluded agreement. However, this concept has had considerable judicial doubt placed upon it, particularly in such cases as [ICS v. West Bromwich [1998]] where the Court stressed the importance of construing contracts within the relevant “factual matrix”. In 2005 Lord Nicholls stated in an extra-judicial article that the rule was too rigid and it received further criticism from the Court of Appeal in [Proforce Recruit v. The Rugby Group [2006]].

*Great Hill Equity Partners II LLP v. Novator One LP & Ors*

It is perhaps surprising, given this background, that the recent decision in *Great Hill Equity Partners* confirmed the orthodox view that pre-contractual negotiations are inadmissible. In this case GHP (the claimant) and FLS (the defendants) were rival bidders for a takeover target. Shortly before a Takeover Panel deadline, and in return for dropping its own bid, GHP entered into an option deed with investors in FLS. The option deed contained an anti-dilution provision, which was conditional on FLS’s bid succeeding. Unexpectedly, FLS’s bid failed.

GHP claimed that the anti-dilution provision applied to certain loans to, and share subscriptions in, FLS made prior to the date when FLS’s bid lapsed. If correct, this would have entitled GHP to a valuable stake in FLS. In support of its interpretation of the anti-dilution provision, GHP relied on evidence of pre-contractual discussions and draft heads of terms. However, the Court excluded this evidence, following the rule above, and reiterated that there are only limited circumstances in which such evidence will be admitted; in particular where it was contended on proper grounds that:

(i) there was an estoppel by convention;

(ii) the parties had used a term without defining it (referred to as the “private dictionary exception”); or

(iii) the contract should be rectified.

For now, at least, the rule in *Prenn v. Simmonds* remains good law. In practical terms this means:

(i) care must be taken to ensure contractual documents are clear and free-standing. Parties cannot overcome lack of clarity by relying on correspondence, Heads of Terms or earlier drafts to show what was meant – the idea that the answer will emerge from that mass of material will not work;
(ii) parties to litigation will need to continue to find creative ways to ensure that the judge sees pre-contractual material which could influence the outcome of the construction issue; for example a plea of rectification – provided it can properly be made – will enable the party to put what may be persuasive material before the Court.

2.2 Second context: pre-contractual statements

The position is the Global Equity case may be contrasted with that in the Quest 4 Finance Ltd case.

*Quest 4 Finance Ltd v. Maxfield & Ors*

It is common for agreements to contain declarations that neither party has relied on any statement or representation by the other that is not contained in the contract itself. This case explored how far a party making a pre-contractual statement can rely upon such a clause.

The defendants were directors of a company which needed further funds. The claimant was a finance company that provided short-term funds based on the borrower’s monthly wage bill (a product marketed as “Wageroller”). The company obtained financing from the claimant.

The claimant’s marketing brochure contained a clear statement that personal guarantees were not required from directors, although a warranty would be required to cover fraudulent acts being knowingly committed. However, the claimant required the directors to enter into a warranty agreement, under which the directors indemnified the claimant against losses suffered as a result of a breach by the company of the warranties in the financing agreement. In effect, the directors guaranteed the company’s compliance.

The company went into administration. This was a breach of the financing agreement, and as a consequence the directors were liable under the warranty. However, they submitted that the warranty agreement should be set aside on the ground that they had been induced to enter into it by the misrepresentation in the claimant’s marketing brochure, on which they had relied. The directors all gave evidence that they had not read the warranty agreement.

Notwithstanding the declaration in the warranty agreement that they had not relied upon pre-contractual statements, the Court held that the directors were entitled to rescind the warranty agreement on the basis of the statement in the brochure. In essence, the Court took the view that a party attempting to use a declaration of non-reliance in its favour has to show that it believed the declaration to be true and relied on it. The purpose of such declarations is to give certainty that the rights of the parties are governed by the written contract. However, a Court may look further into the background to the transaction. Where a party has made pre-contractual representations intending that the other side rely on them, it may be unconvincing for it to claim that it believed the declaration was true.

This suggests that a non-reliance clause may be of limited use given that the Court appears to indicate that it will be difficult to rely upon it when a pre-contractual statement has in fact been made.
As a practical matter, parties should consider including in their agreements an exclusion of liability for pre-contractual statements as well as a non-reliance clause. It should, however, be noted that section 3 of the Misrepresentation Act 1967 – requiring the clause to be reasonable – will apply to such an exclusion (though it does not apply to non-reliance clauses).
3. WHEN DOES AN ORAL “AGREEMENT” CONSTITUTE A BINDING CONTRACT?

*Bear Stearns Bank plc v. Forum Global Equity Ltd*

It is standard practice for participants in the financial markets to reach agreement over the telephone, with contractual documentation to be drafted later by the parties’ lawyers. This case provides some indication of how much (or how little) needs to be agreed for this to result in a binding contract.

The parties to the deal were distressed debt traders, selling and buying loan notes in two Parmalat companies. Consistent with market practice, negotiations were conducted over the telephone (usually in taped calls), with the main emphasis on price. Both agreed that the formal documentation would be dealt with by their respective lawyers. When the “deal” was concluded on 14 July (again over the telephone), the parties had agreed the price for the trade but not, *inter alia*, (i) the settlement date, (ii) the mechanism for delivering the benefit of the notes that were the subject of the contract (such as assignment or funded participation), or (iii) what warranties and representations would be given.

By October, circumstances had changed and the seller (Forum Global Equity Ltd) was now making a profit on the relevant notes. As documents had not yet been finalised, it wished to withdraw from the “deal”. Litigation ensued.

The Court held that a contract had been formed on 14 July. There was sufficient certainty as to the terms of that contract, on the following basis in respect of the three issues outlined above:

(i) Settlement date – the parties had agreed to continue discussions either with a view to obtaining a better idea as to when settlement would occur, or to subsequently bind themselves to a settlement date. In any case, they had entered into a contract without an express term as to settlement date. However, the Court held that this was an important but not essential aspect of the contract. In the absence of an express term as to settlement, the Court would imply a term that settlement would occur within a reasonable time.

(ii) Delivery mechanism – the Court held that the parties had agreed on the essence of the contract, which was to transfer the commercial benefit of the notes.

(iii) Warranties and representations – even though only three conditions had been stipulated, the Court held that “the law will imply any terms necessary to give business efficacy to what was agreed.” How this would be done in practice in the context of warranties and representations was not addressed in the judgment save to indicate that warranties and representations (e.g. as to title) would be implied into the contract as necessary.

In summary, the Court held that, even though drafting of documentation had been passed to the parties’ lawyers, the parties had intended to conclude a contract during their telephone conversation. They had gone beyond an agreement to agree: “realistically, the position was that a commercial deal had been concluded and the lawyers were implementing it.” Though it was important to the Court in this case that, in the market in such financial trades, the usual “point of contract” was orally, in a telephone conversation, the case has wider application to any conversations where the parties show the necessary intention to create legal relations.
As a practical matter, parties should ensure that relevant pre-contractual documentation is marked, and pre-contract deal discussion expressly stated to be, "subject to contract" wherever necessary.
4. STANDARD EXCLUSION CLAUSES — HOW WIDE CAN YOU GO?

Regus (UK) Ltd v. Epcot Solutions Ltd

For understandable reasons, there is often a tendency to seek to draft exclusion clauses in standard terms of business as broadly as possible. However, it is important to remember that exclusion and limitation clauses in written standard terms of business are only enforceable if they satisfy the reasonableness test in the Unfair Contract Terms Act 1977. The term will pass this test if it was a fair and reasonable one to have been included in the contract having regard to the circumstances known (or which ought reasonably to have been known) to the parties at the time of making the contract (s.11(1) UCTA). Schedule 2 of UCTA sets out a non-exhaustive list of factors to be taken into account. This case provides a useful indication of how a court may approach this issue.

RGL provided serviced offices to Epcot. RGL negligently failed to maintain the air conditioning system in those offices, which damaged Epcot’s business. Epcot subsequently moved to another office provider, leaving fees owed to RGL. When RGL sued Epcot for the unpaid fees, Epcot counter-claimed for breach of contract on the basis of the defective air conditioning.

RGL attempted to rely on the following exclusion clause:

"we will not in any circumstances have any liability for loss of business, loss of profits, loss of anticipated savings, loss of or damage to data, third party claims or any consequential loss."

The Court held that in principle it was reasonable to restrict liability for loss of profits and consequential loss. Loss of profit was a classically insurable loss, the risks of which were best known to RGL’s customers. Epcot was not in a weak bargaining position, as there were similar serviced offices nearby and that had allowed Epcot to negotiate the contract terms and price.

However, the Court considered that the breadth of the exclusion clause effectively deprived Epcot of any remedy at all for failure to provide a basic service in what was the business equivalent of a hotel. Such a broad exclusion clause was therefore not reasonable. It was unfair for no remedy at all to be available to corporate customers of RGL for serious failures in service over what could be a contract for a significant period.

Although the reasoning in the judgment is questionable (in particular because the clause does not in fact appear to exclude all remedies as direct losses – such as costs incurred on a replacement – seem to be recoverable) the case is helpful in highlighting some of the issues when drafting standard exclusion and limitation clauses. In practical terms:

(i) the temptation to keep adding exclusionary categories to a clause should be avoided as this will make it more likely that it will be found to be unreasonable. The drafting should be as focussed as possible;

(ii) care should be taken to draft limitations into separate clauses. The Court will strike out clauses in their entirety and so such an approach will make it more likely that some limitations will be upheld.
5. CONTRACTUAL DISCRETION — ABSOLUTE OR REASONABLE?

_Lymington Marina v. McNamara & Ors_

Where a contract provides for any matter to be subject to the approval or consent of one of the contracting parties, then, unless the contract gives absolute discretion to the decision-maker, a degree of reasonableness and good faith may be required when decisions are made. However, the public law concept of “Wednesbury unreasonableness” (i.e. no person acting reasonably in the position of the decision maker would have made that decision) is not an appropriate test in the construction of a commercial contract.

In _Lymington Marina_, the claimant owned a marina, and the first defendant had been assigned a licence to berth his yacht in it. The first defendant wished to grant successive, or rotational, sub-licences to his two brothers. This was permitted by the terms of the licence, subject to the marina operator’s prior approval of the proposed sub-licensee. This provision contrasted with the provision for assignment of the whole of the licence, under which the marina operator had absolute discretion to refuse assignment.

A dispute arose in respect of the marina operator’s refusal to approve the proposed grant of successive, or rotational, sub-licences to the two brothers of the first defendant.

The Court of Appeal held that the marina operator’s discretion in respect of such approval could only be exercised on the basis of an objection to the particular proposed sub-licensee and his proposed use of the marina. This followed the construction of the relevant clause. Further, the discretion was not absolute; it had to be exercised in good faith and could not be exercised arbitrarily. The Court of Appeal held that these implied terms were necessary for the business efficacy of the licence. However, there was no requirement that the exercise of the discretion had to be on objectively justifiable grounds, nor did the marina operator have an obligation to seek out other facts once the application for approval of a sub-licensee had been made to it. Its only obligation was not to act arbitrarily – i.e. it need only have some basis for its decision, genuinely held, even if not correct.

It is helpful that the Court of Appeal has confirmed that the public law “Wednesbury unreasonableness” test is inappropriate in the context of the construction of commercial contracts. Other practical implications arising from the judgment:

(i) Be specific when drafting approval / consent provisions – if the giving of an approval / consent is to be at the absolute discretion of the relevant decision-maker, say so explicitly. Otherwise, limits may be implied on the exercise of such discretion (i.e. to act in good faith and not arbitrarily or capriciously);

(ii) Be consistent in the drafting of approval / consent provisions in a contract – especially when, as is often the case, different sections of an agreement are drafted by different parties, be certain to conform the drafts of the approval / consent provisions, unless the intention is for them to operate differently. If one approval / consent “may be withheld at a party’s absolute discretion”, but another is silent on the point, as a matter of construction limits (as above) are likely to be implied in the latter.
6. DAMAGES — AT WHAT DATE SHOULD THEY BE ASSESSED?

The ordinary rule is that where a party has breached a contract, the damages for the non-breaching party will be assessed at the date of breach. In cases where the breaching party has repudiated the contract and that repudiation has been accepted, the ordinary rule is that damages will be assessed on the date of that acceptance. A recent case has considered the extent to which events which occur after an accepted repudiation can be taken into account when assessing damages.

Golden Strait Corp. v. Nippon Yusen

The Defendant repudiated a charterparty and this repudiation was accepted by the Claimant. The following were the relevant dates:

> 17 December 2001 – the claimant accepted the repudiation
> 6 December 2005 – the end date of the contract
> 20 March 2003 – the start of the second Gulf war

Applying the ordinary rule, it appeared that the Claimant would be entitled to damages for the remaining unperformed period of the contract – almost four years from December 2001 to December 2005. However, the Defendant contended that the outbreak of the second Gulf war would have given it the right to terminate the contract pursuant to its terms and that it would have exercised the right on that date. Indeed, by the time the case came to the House of Lords, both these propositions were accepted. Accordingly, it contended that it should only be liable for damages up to 20 March 2003.

The question which arose for consideration by the House of Lords was the extent to which the outbreak of the second Gulf war – being an event which occurred after the date the repudiation was accepted (and therefore after the date upon which damages would ordinarily be assessed) – should be taken into account. There were competing views in the House of Lords in what turned out to be a three-two majority decision. Some Law Lords stressed the importance of certainty, finality, and the settlement of cases and, therefore, indicated that the ordinary rule of assessing damages at the date of the repudiation should be accepted as this would exclude taking into account subsequent events, such as the outbreak of war. However, the majority view emphasised the compensatory principle – that a party should only be compensated for losses in fact suffered – and indicated that if the contract contains a termination event then this should be taken into account, even if it takes place after the date the repudiation is accepted, the Law Lords taking this view indicated that to do otherwise would compensate the claimant for more than he would have received if there had been no repudiation.

This conclusion gives rise to some concern that parties to litigation may seek to string out such litigation in the hope that events may materialise which could give rise to determination which would place a temporal limit on the damages which may be claimed. However, the position appears to go even further. Each of the majority decisions contains statements indicating that the chance of a contingency occurring must also be valued. For example one of them stated:
“Damages can be assessed at the date of repudiation by valuing the chance that the contingency would occur ... That value might lie anywhere on the scale between extreme unlikelihood, which would give the deduction a minimal value, to virtual certainty, which would mean that it would be assessed at a figure very close to that which would be reached if one made the definite assumption that the contingency would occur.”

This appears to open up wide areas for dispute between parties where a long-term contract which has been repudiated contains (as will often be the case) a list of events which would allow the contract breaker to terminate the contract. Indeed, it appears that even if such events are less likely than not to happen in the future, some value may need to be placed upon them. For example, it is common for contracts to contain a clause allowing parties to terminate if the other becomes insolvent. One impact of this judgment may be that repudiating parties will seek to have a percentage deduction from the damages awarded against them on the basis that there is at least some prospect (albeit that it may be less than 50%) that the other party would have become insolvent at some future date within the term of the contract. Plainly, this is an area which will require some clarification in further case law.
7. ROME II — CHOICE OF LAW CLAUSES

“Rome II” is the name given to the EU Regulation on the law applicable to non-contractual obligations. Rome II will be directly applicable in the UK from 11 January 2009 without the need for further implementing legislation. It will apply in relation to events giving rise to damages which occur after that date.

Among other things, Rome II includes a provision allowing commercial parties to agree in advance the law which is to apply to their non-contractual obligations. Although it will apply only to events occurring after it comes into force, these may arise in the context of a contract entered into before that date.

The types of claim in relation to which commercial parties may exercise this choice of law are likely to include those based on fraud, pre-contractual misrepresentation, unjust enrichment or breach of fiduciary duty, although the precise meaning of the term “non-contractual obligation” in Rome II has not yet been tested and will not necessarily reflect an English law classification of “contractual” and “non-contractual”. Parties are not able to exercise choice of law in relation to certain categories of claims, in particular competition or intellectual property rights claims.

Where contracts are currently being negotiated, it may be advisable, in appropriate circumstances, to extend the choice of law clause to cover non-contractual as well as contractual obligations.
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