DLA PIPER

CONTRACTING HINTS AND TIPS

HISCOX

Contents

1. Contract formation

When is a contract formed?

A contract is formed between two parties when the basic principles of offer, acceptance, consideration (payment, in any form, not necessarily in money) and an intention to create a relationship have been met.

When negotiating a contract, it is important to keep in mind the four basic principles so as not to bind yourself to terms which you had not intended to agree to.

What is an offer and what is acceptance?

- An offer is a promise by one party to enter into a contract on certain terms. An offer must be specific, complete, capable of being accepted by another party and made with the intention of being binding if it is accepted (in other words, there should be no further bargaining required if accepted).
- Acceptance is the final agreement to the offer and must correspond exactly with the terms of the offer. It must also be communicated to the party making the offer.
- If a party attempts to accept an offer but the acceptance does not match the offer exactly, no contract will be formed. Instead, it will be treated as a counter-offer, which the other party can accept (provided it accepts all the terms).

Whose terms and conditions apply?

When parties are negotiating the terms of a contract with each using their own standard terms and conditions, it can be difficult to establish whose terms apply at the time the contract is formed. This is often referred to as the ‘battle of the forms’.

If you as a supplier try to form a contract on your own terms and your customer accepts but tries to impose its own standard terms, then no contract will have been formed. Instead, your customer will have made a counter-offer which can be accepted unequivocally by you or by carrying out the contract. In practice, this means that the last set of standard terms delivered before acceptance of the contract or the carrying out of the contract will be the terms that apply.

To avoid a ‘battle of the forms’ you could try to negotiate directly with your customer and agree any variations to your standard terms. Alternatively, you could try to include your standard terms in as many pre-contractual documents as possible and not raise the issue of standard terms with a customer; seeking instead to ensure that your terms appear on the last document passing between you before work begins.

Other considerations and risks

There must be certainty of the terms for a contract to be formed, therefore it is important to include clear and unambiguous wording while ensuring that you haven't forgotten to include an essential term to avoid the risk of a contract being unenforceable.

If using heads of terms or heads of agreement it may be sensible to ensure that these are not legally binding as parties can be bound by such documents. To try to prevent this risk you should expressly state that the provisions are not intended to be binding while specifying that they are 'subject to contract'.

A contract does not have to be signed to be effective. Even if you have agreed that a draft contract must be signed, if both parties act in accordance with the contract terms so that they effectively agree that such a formality is no longer necessary, then the contract may be binding.

2. Entire agreement clauses

What is it?

Including an 'entire agreement clause' in a contract helps to ensure that the written contract agreed between you and your customer sets out the full extent of your responsibilities; reducing the possibilities of future dispute.

What are the potential risks?

The legal basis for such a clause is complicated and careful drafting is required. Without an effective entire agreement clause there is a risk that statements and representations made, but not expressly stated in the written contract, may form part of the contract between you and your customer; meaning your customer may have additional rights against you.

What are the key components?

The three main areas to include within an entire agreement clause are as follows.

1. A statement that the written contract is the entire agreement made between you and your customer.

   The contract itself may not always constitute the entire agreement. For example, side letters can create legally binding terms, or a previous agreement made might cover the same subject but on different terms. A clear statement aims to avoid this risk by making sure that the written contract contains all of the relevant contractual terms.

   The statement however will usually only apply to issues that come up before the actual date of the signed contract itself. Such a statement can also be ineffective if the contract does not accurately reflect what was actually agreed or if it can be interpreted so as not to capture specific, external arrangements.

2. A statement that neither party is relying on any statement or representation which is not set out in the contract.

   To be able to exclude liability for pre-contract misrepresentations, the exclusion must be explicit and clear. For this reason it is common to include a statement that you and your customer have not relied upon any statements which are not repeated within the contract as specific contractual terms.

3. Agreement that the only remedies available will be those set out in the contract or will be a claim in damages (for breach of contract).

The basis for a claim for misrepresentation (for a precontractual misrepresentation which is incorporated into a contract) is different to a claim for breach of contract and may include the potential to set aside the contract and put the innocent party in a position as though the contract was never made. As such, it is preferable to seek to exclude remedies for misrepresentation.

Must be reasonable

Contract terms which seek to exclude or restrict liability for misrepresentation are only enforceable if they are reasonable. To reduce the risk of the entire agreement clause being considered unreasonable, it should make it very clear that the parties are not trying to exclude liability for fraudulent misrepresentation.

3. Warranties and indemnities

What is a warranty?

In English law, a warranty is a contract term which, if breached, may give the innocent party the right to claim damages. It does not usually allow the innocent party to treat the contract as if it had ended.

The Sale of Goods Act 1979 defines a warranty as "an agreement…collateral to the main purpose of [the] contract, the breach of which gives rise to a claim for damages, but not to a right to reject the goods and treat the contract as repudiated."

A term can be a warranty if it is provided by statute (e.g. under The Sale of Goods Act), or as expressly agreed between the parties, or sometimes a term can be a warranty by implication.

In reality, the word 'warranty' is used more commonly and more loosely than set out above.

In IT contracts for example, it is often used as a guarantee, for instance where a licensor of software 'guarantees' the functions of its software.

What are the potential risks?

Calling a term a 'warranty' will not necessarily mean that it is treated as such in law. If the contract does not specify what will happen in the event of a breach of the warranty, there is a risk that the term may be interpreted as one which is so important to the contract that a breach of the term could trigger the right to terminate the contract.

As such, if a term is expressed to be a 'warranty' it is preferable to set out in the contract the consequences of a breach of that term.

What is an indemnity?

An indemnity is a promise made by one party to compensate another party for a specific loss, often related to a third party claim. For example, it is typical for the seller of computer software to give a contractual indemnity to the licensee against any claims made by a third-party that the use of the software infringes that third-party's intellectual property rights.

What are the potential risks?

It can be easier for an indemnified party to recover its losses under an indemnity than it could recover for a breach of contract (although it cannot make a profit from the indemnity).

Firstly, depending on the wording of the indemnity, the indemnified party may be able to recover both direct and indirect losses.

Secondly, it is commonly claimed that there is no duty to mitigate (or moderate the loss) in indemnity actions.

Finally, it is easier to prove an indemnity claim than a breach of contract claim. Breach of contract claims involve proving the breach and showing that the losses flowed from the breach. An indemnity claim is easier, as (subject to the terms of the indemnity) it simply requires proving that the trigger event occurred and quantifying the losses.

4. Time of the essence

What is its purpose?

Including a 'time of the essence' clause in a contract makes performance of contractual obligation within a specified period of time a 'condition' of the contract (this means it is an essential element of the contract which must be complied with).

What are the potential risks?

If you enter into a contract which makes time for contractual performance 'of the essence', there are potentially significant consequences for failure to perform on time. Your customer will have a number of legal options available which may include termination of the contract and a claim for damages.

What are the key principles?

The words 'of the essence' do not expressly need to be used. Time can also be made 'of the essence' by expressly stating in the contract that meeting a deadline is a 'condition' of the contract or that the deadline must be strictly complied with; or by expressly stating the effect of a delay in the contract (i.e. if the deadline is missed the innocent party can terminate).

That 'time is of the essence' may also be implied where the nature of the contract or the subject of the relevant obligations indicate that the deadline must be met.

Consequences of breach of a 'time of the essence' obligation

If you are late delivering a contractual obligation and the contract states time is of the essence, the effect is as if a contract condition has been breached. This allows the customer to terminate the agreement immediately without notice and claim damages.

Making time 'of the essence' after an obligation has been missed

Where a party has delayed in the performance of a contractual obligation, the innocent party may be able to make time of the essence 'after the event' by requiring performance within a reasonable time (provided of course that the party giving notice is ready to perform any related obligations within that period). This gives notice to the party in default that the failure to comply would go to the root of the contract i.e. would effectively deprive the innocent party of substantially the benefit of the contract and allow it to terminate.

For such a notice to be effective, it should include a sufficient grace period (what is reasonable will depend on upon the circumstances) and also include a warning of the intention to terminate. To rely on this right the party issuing the notice should not itself be in breach.

5. Contract variation

What is a variation?

A contract variation can be spoken or in writing (unless it is required by law to be in writing).

Any agreement which varies the terms of an existing contract must either be supported by consideration (payment in any form, not necessarily in money) - or be executed as a deed.

Consideration can take various forms and a benefit or a detriment to either party will suffice as consideration. Where consideration is given, the variation can be recorded in a simple contract. However, in the absence of consideration, a variation should be executed as a deed (which includes ensuring that the document states clearly that it is intended to be a deed, is sealed and delivered)

Alternatively, parties to a variation can agree to a nominal payment to provide for consideration. In practice, it may be sensible to provide for payment of a small sum even where there appears to be consideration, to avoid the risk of a future argument that there was not valid consideration in return for the variation agreement.

What is the effect of a 'no-variation' clause?

A contract may contain an express 'no-variation' clause. Usually this will prevent variation of the contract unless the parties follow a specific procedure, such as documenting the variation in writing which must be signed by both parties. Such a clause is intended to exclude the possibility of informal or accidental spoken variations being agreed.

What are the potential risks?

If your contract does not contain a clause which provides for a formal variation process, then there is a risk that spoken variations may happen. This is particularly risky where operational and commercial teams are operating separately to each other, and one part of the business agrees an informal variation without informing the other.

However, even if your contract does contain a 'no variation' clause, a spoken variation might still take effect if one party has acted in a way that makes it clear it has agreed to the variation and a reasonable person would believe that he should act on the variation, and the other party has acted on it.

Despite this risk, oral variations are generally difficult to prove where there is also a 'no-variation' clause. The party which claims the contract has been varied will have to show firstly that there had been an oral agreement to amend the 'no-variation' clause, and then show that there had been an oral agreement to vary the contract itself.

6. Exclusion and limitation clauses

What are exclusion and limitation clauses?

Exclusion and limitation clauses are simply clauses in a contract that seek to limit the rights of parties to that contract by restricting the liability of one party should the other party make a claim.

Exclusion clauses attempt to exclude any loss whereas limitation clauses restrict or 'cap' claims. For example, a party may limit how much money the other party can claim.

How do they affect me and my business?

The most serious effect of not having exclusion and limitation clauses is leaving your business open to unlimited claims. This means the amount sought by the other party is unknown until a claim is brought or a court decides the amount due.

What are the risks?

Just having exclusion and liability clauses included in your contract does not necessarily mean you are protected by them. When seeking to rely on exclusion and limitation clauses it is worth remembering that:

- it is for the supplier to show that the claim brought comes within the exclusion of liability based on its actual meaning
- the court will be reluctant to allow terms which effectively absolve one party from all duties and liabilities
- contract terms for a consumer have stricter rules than for business to business terms.

The Unfair Contract Terms Act 1977 ('UCTA') prevents exclusion and limitation clauses which are 'unreasonable'. What is reasonable will depend on the facts of each contract.

Avoiding the risks

The key ways to avoid exclusion and limitation clauses being invalid are as follows.

Make it clear what is excluded or limited

Ensure a clause is as simple and clear as possible, both in terms of the language used and in terms of the understanding between the parties to the contract:

- when dealing with a consumer, you should expect a lesser degree of understanding on their behalf and simpler terms being included as a result;
- when entering into inter-business contracts, which are viewed on a more commercial understanding, the terms can be more sophisticated.

Be particularly careful, when listing the types of claims that are being excluded (e.g. loss of profit), not to leave out important types of claims.

It is a common misconception that loss of profits is an 'indirect' or 'consequential' loss. In fact, loss of profits (and any other kind of financial loss) can be a direct or indirect loss. You must ensure that if you want to exclude both direct and indirect loss of profit that this is separated from the reference to indirect/ consequential loss in the clause.

In a recent case the courts gave a very narrow interpretation to exclusion clauses which appeared to be widely drafted. As your clause may be open to interpretation it is important that it is very carefully and precisely drafted.

What is the level of exclusion?

Consider whether the terms imposed are trying to remove liability altogether and whether that is reasonable in the circumstances.

Check terms that are sought are not automatically excluded

For instance, UCTA will automatically void clauses which attempt to exclude or restrict liability for death or personal injury resulting from negligence, irrespective of their context, and these should not be included in any contract.

Who are you trading with?

Take the most care when dealing with consumers, particularly on standard terms and conditions. If a term is unreasonable, it cannot be relied on. Factors taken into account when deciding this include:

- the strength of the bargaining positions of the parties as compared to each other;
- whether the customer received an inducement to agree to the term, and whether it had an opportunity of entering into a similar contract elsewhere without having to accept a similar term; and
- whether the goods were manufactured, processed or adapted to the special order of the customer.

7. Exercising contractual rights and termination

What rights are available under your contract?

It is important to be familiar with the terms of your contracts and understand what rights and remedies are available to you and your customer in the event that problems arise.

Typical clauses in an IT contract include:

- a right for your customer to claim liquidated damages if you fail to deliver on time or if services drop below a specified standard
- a right for you to seek an extension of time for delivery or performance if you are unable to deliver because of a default by your customer
- a process for formal notices to be served in the event of a breach (often known as 'breach notices') and a prescribed timescale in which those notices must be responded to and/or breaches remedied.

As a supplier, there are some practical steps you can take to try to avoid putting yourself in breach or allowing your customer to exercise its rights under the contract. In particular:

- notify your customer promptly if you cannot meet a time deadline because of some act or omission by your customer
- respond promptly to any complaints and if possible set out a programme to remedy any defaults
- follow exactly any procedure for replying to breach notices
- remedy any breaches as fully and as quickly as possible.

Can the contract be terminated?

Your contract might specify what would be considered a 'material' breach, which would allow the other party to terminate the contract on occurrence of such a breach. This is likely to be the case if there is a process in your contract which provides for breach notices to be served.

If your contract doesn't specify what is a 'material' breach, then the contract can only be terminated if the breach amounts to a repudiatory breach (a breach that is sufficiently serious and important to entitle the other to treat the contract as terminated with immediate effect).

Even if the contract allows for termination on occurrence of 'any' breach, a party should not rely on a minor breach as grounds to terminate a contract, as there is a significant risk a court would not endorse the termination.

Can the contract continue after there has been a breach?

The party who has suffered the breach can chose to continue the contract (this is called 'affirming the contract') even if there has been a breach which would have allowed that party to terminate.

If you choose to affirm a contract after a breach it is sensible to reserve your right to claim damages for the breach at a future date (you may still have a claim for damages arising as a result of the breach even if you continue the contract). If there is a risk of the breach recurring, it is also sensible to attach strict conditions.

Other considerations and risks

If you terminate a contract, ensure that any procedures set out in the contract for termination are followed. It is common for a contract to stipulate that a termination notice must be served, in which case you should ensure that the notice is served on the correct person and at the correct address if specified in the contract.

If there is a notice period required under the contract, make sure that the correct amount of notice is given and state when the termination is effective from.

8. Dispute resolution

Is there a dispute resolution clause in my contract?

In the event of a dispute, you should first check your contract to see if it contains a dispute resolution procedure which the parties are required to follow.

Even if the contract has been terminated, most dispute resolution clauses remain and therefore all parties are obliged to comply with them or risk being in breach of contract.

The dispute resolution procedure may contain one or more of the following:

- an **escalation procedure** - this usually involves the dispute being referred to management in the first instance to see if the dispute can be resolved at that level, and then there might be further escalation, for instance to board level
- a provision for **expert determination** - if there is a technical matter which is in dispute between the parties, the contract might allow for the dispute to be referred to an independent third party with expertise in the area. The contract will usually specify what kind of disputes would be suitable and identify an appropriate professional body which could provide an expert
- a requirement for **mediation** before formal proceedings are commenced - a mediation is an informal process involving an independent third party who will help facilitate settlement discussions between the parties. A mediation is conducted on a without prejudice basis and so matters raised in mediation cannot be used in court proceedings
- that the dispute be referred to **litigation or arbitration** - litigation involves court proceedings before a judge; arbitration is a confidential (but binding) formal process before one or a number of arbitrators (an arbitrator may be a solicitor, a barrister or a judge).

If there is no dispute resolution clause in your contract, then it is open to the parties to commence litigation proceedings. The court will expect the parties to try to resolve the dispute prior to proceedings being issued and if either or both parties fail to do so, they may face criticism and even costs sanctions from the court.

In the absence of a dispute resolution process, it is open to the parties to agree any of the steps set out above as an alternative to starting court proceedings.

What can I do to prepare myself for a dispute?

- **Time limits** - if you have already been served with a court document or other formal notification of a claim, check to see whether there is a time limit for acknowledging or responding to the claim. In court proceedings, failure to comply with a time limit could result in a judgment being entered against you.
- **Identify the issues** - identify who is involved in the dispute and contact them to find out more about the allegations raised and understand what lies at the heart of the dispute. If a claim needs to be responded to quickly, it will help your insurers and/or lawyers if you have prepared a summary of the issues and your position.
- **Documents** - once you have identified the issues, devise a strategy for finding the relevant documents. It is very important that any documents which may be relevant are preserved and are easily accessible so that you can provide these to your advisers. They will also help determine the strength of your case.

When should I notify my insurers?

You must notify your insurer of any potential dispute as soon as you become aware of a claim, even if a formal dispute has not yet arisen or if the issue raised appears to have no merit. Failure to do so could result in coverage not being available.

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