
TECHNOLOGY CONTRACTS – CHANGING TIMES AND
CHANGING POSITIONS: NEGOTIATE OR SUE?



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A. INTRODUCTION

1. In the current economic climate the following scenario is becoming increasingly common: your company entered into an agreement a while ago which at the time was commercially satisfactory for both parties. However, for one reason or another, times and positions have changed and either your company is no longer happy with the other party's performance or you are concerned that the other side wants to get out of the contract or renegotiate terms.
2. Stresses can build in any commercial arrangement for a variety of reasons. Perhaps the other party is not performing completely in accordance with the contract, for example by proving to be late in completing obligations. Or their enthusiasm has waned as the project is costing them more than they anticipated. Alternatively, you may be the supplier and have experienced problems delivering on time and in accordance with the budget. Perhaps the contract or project may no longer be commercially viable, or the revenue share agreed at the outset is no longer a good deal. Maybe your company would now prefer to use a different supplier/provider. In these situations, what are your options and can you get out of the contract?
3. Analysing your company's position and the approach that should be taken with the other side is incredibly important, as if this is not done correctly there could be severe consequences. For example, when faced with a counter-party who is in breach, there is a high risk in terminating. If you seek to do so in circumstances where there is no contractual right, this could be taken by the other side as a repudiation of the contract, resulting in a claim against your company. Effectively, you will have transformed your position from having the possibility to extract value from the other side's breach, to being in danger of having a claim made against you.
4. You will need to consider what the contract says, whether there are ambiguities and how the parties' obligations are likely to be interpreted. Importantly, it is necessary to ascertain whether the contract provides a mechanism for resolving disputes and if so, such a mechanism must be followed. On a commercial level it is worth considering whether it might be possible to negotiate your way out and the possible cost of doing so. If there has been a serious breach by the other side, does that give rise to a right to terminate or only a right to claim damages? Finally, could you use the other side's breach as leverage to secure better terms?
5. The purpose of this note is to address the kind of legal issues that a company is likely to face when the possibility of a contractual dispute arises and to offer practical guidance on how to analyse those issues. The key is to assess, so far as possible, the likely outcome if the matter came before a court or arbitral tribunal. That assessment can then assist in the negotiation of a positive outcome, without having to resort to court proceedings.
6. In order to make the above assessment, you will need to analyse: the contract terms (section B), how the contract would be construed (section C), what sort of breach (if any) has occurred (section D), and whether the breach permits termination (section E) and/or other remedies (section F). That assessment should assist in negotiating a resolution (section G).

B. IDENTIFYING THE CONTRACT TERMS

1. What documents embody the deal between the parties?

When a dispute first arises obviously the starting point is to look at the agreed terms governing the relationship between the parties. However, sometimes all of the terms are not set out in one main agreement and it may be necessary to look at other ancillary documents, for example schedules to the main agreement, statements of works, specification documents and terms and conditions of either party (to the extent that they were incorporated into the agreement). Before considering the impact of such ancillary documents, it will be important to assess the scope of the entire agreement clause in the main agreement (see paragraph 4 below).

In the event that there is a contradiction between the terms of the main agreement and an ancillary document, it will be necessary to ascertain which takes precedence. Usually, this will be set out in the relevant documents, however if this is not the case, it can be a point of contention between the parties.

Some companies will seek to contract under their standard terms and conditions and negotiations will proceed with both parties putting their terms forward. When an agreement on commercial terms is subsequently reached, there can be difficulties as to which party's standard terms will prevail. This is referred to as a 'battle of the forms'. As a broad rule, the last set of terms dispatched prior to acceptance or performance will prevail. This was illustrated in *British Road Services Limited v Arthur Crutchley & Co Ltd*¹, where the supplier delivered a consignment to the buyer's warehouse with a delivery note containing the supplier's terms and conditions. Instead of signing the delivery note, the buyer's employee stamped the note, "Received on [the Buyer's] Conditions". The court held that the buyer's terms prevailed.

2. What if they weren't signed?

If parties commence performance under a contract prior to signature, the courts may decide that an agreement was formed on the terms of the last draft of the contract that passed between the parties. The commencement of performance would be deemed to constitute implied acceptance of the terms of such contract². However, in such circumstances, it might be easier to imply other terms into the contract (see paragraph 3 below) which were contained in earlier documentation or negotiations between the parties.

3. Have those terms been varied through a course of dealing?

The general position is that where the parties start to perform the contract in a manner that is different to the terms of the contract, a court is likely to find that the terms of the contract were varied through a course of dealing, providing that the variation was supported by consideration. In order to limit the extent to which contracts can be varied, parties will include a 'no variation' clause³ which prohibits

¹ [1968] 1 All ER 811.

² See *VHE Construction Ltd v Alfred McAlpine Construction Ltd* [1997] CILL 1253.

³ For example, "No variation of this agreement shall be effective unless it is in writing and signed by the parties".

variations to the contract that are not in writing. However, in the case of *I-Way Ltd v World Online Telecom Ltd*⁴, the judge indicated that he thought that a no variation clause could be overridden by the parties' oral agreement; although in this case it is likely that the oral variation was only upheld as it was by way of compromise for a possible claim for misrepresentation⁵. In relation to the variation of deeds, one may think that a deed can only be varied by way of a subsequent deed. However, the case of *Berry v Berry*⁶ is authority that a deed could be varied by a subsequent amendment not made by deed.

4. What is the effect of the entire agreement clause?

An entire agreement clause⁷ is usually included in a contract to prevent the written contents of the agreement being ascertained by reference to prior agreements, representations, negotiations and understandings. However, this does not mean that there is a blanket restriction on adducing pre-contract materials before the court.

Two recent cases have highlighted that the courts could, despite the existence of an entire agreement clause, admit evidence as to communications between the parties prior to the making of a written contract. In *Lloyd v Sutcliffe*⁸ the court found that the entire agreement clause did not bite where a party was seeking to adduce pre-contract negotiations/agreements in order to interpret or clarify the true terms relating to matters which were not dealt with in the written agreement⁹. In relation to ambiguities in the meaning of words used in a contract, the case of *ProForce Recruit Limited v The Rugby Group*¹⁰ provided that an entire agreement clause may not be sufficient to prevent the court from referring to pre-contract materials. The court was prepared to look at extrinsic evidence when seeking to ascertain the parties' intended meaning for words or phrases used in the contract which did not have an obvious natural or ordinary meaning. Such words could only be properly determined in the context of the agreement when read as a whole in accordance with the surrounding circumstances. The Court of Appeal referred to the judgment of Kerr J in *The Karen Oltmann*¹¹ where he suggested

⁴ [2002] EWCA Civ 413.

⁵ In *I-Way*, prior to the parties entering into a telecoms agreement the defendant had made representations as to expected take up the service. On the basis of those representations, the parties agreed that the rebate from BT should be split 80% to the defendant and 20% to the claimant. Following signature of the agreement, it transpired that the profile of utilisation was different to that represented by the defendant and as a result the agreement was not commercially viable for the claimant. Accordingly, the claimant sought to renegotiate the terms and at a meeting between the parties, the defendant reluctantly agreed to a revision of the rebate share so that the defendant would receive 70% and the claimant 30%. In a slightly contradictory decision, the judge held that the parties had entered into an enforceable agreement at the meeting by way of compromise of potential claims for misrepresentation, whereby the contract was varied to allow the claimant to receive 30% of the rebate. However, the judge also said that this conclusion rendered it unnecessary to consider the defendant's contention that the variation was ineffective as it was not executed by way of addendum as per the terms of the contract.

⁶ [1929] 2 K.B. 316.

⁷ For example, "*This agreement constitutes the entire agreement and understanding of the parties and supersedes any previous agreement, understanding or arrangement between the parties relating to the subject matter of this agreement*".

⁸ [2007] EWCA Civ 153.

⁹ In this case the matter not dealt with in the main agreement was a profit share arrangement.

¹⁰ [2006] EWCA Civ 69.

¹¹ [1976] 2 Lloyds Rep 708 at 712.

that evidence of pre-contract negotiations/agreements could be considered where: (i) the words used in the contract are capable of having more than one meaning; and (ii) it is alleged that the parties negotiated on an agreed basis that the words bore only one of two possible meanings. However, *ProForce* and *Sutcliffe* are exceptions to the general rule that an entire agreement clause would render evidence of pre-contract negotiations and discussions inadmissible where a party is attempting to persuade the court that one interpretation of the contract is to be preferred to another¹², or that a prior oral¹³ or written¹⁴ agreement had effect.

Another situation where pre-contract discussions/documents can be adduced before the court is where one of the parties is making a claim for rectification, mistake or misrepresentation¹⁵.

However, in relation to implied terms, the case of *Exxonmobil Sales and Supply Corp v Texaco Ltd*¹⁶ is authority for the proposition that an appropriately worded entire agreement clause could be effective to exclude implication of terms based on custom or usage. In this case, the entire agreement clause read: “*This instrument contains the entire agreement of the parties with respect to the subject matter hereof and there is no other promise, representation, warranty, usage or course of dealing affecting it.*” The judge found that:

*“(i) Although entire agreement clauses come in different forms (see *Inntrepreneur Pub Co v East Crown Ltd* [2000] 3 EGLR 31 at 33, [2000] 2 Lloyd’s Rep 611 at 614) they generally constitute a binding agreement that the terms of a contract are to be found in the document or documents evidencing the contract.*

*(ii) ‘Usage or course of dealing’ are two methods by which a term might be implied in a contract; see *Chitty vol 1*, pp 652–653 (paras 13-018–13-021). It was not suggested that usage and custom in this context were other than synonymous.*

(iii) Thus the agreement that ‘there is no usage’ is a clear indication that the parties intended that terms based upon usage or custom were not to be implied into the sale agreement.”

However, it is important to note that an implied term re usage and custom was only excluded in this case because the entire agreement clause specifically referred to “usage or course of dealing”. Notwithstanding this the judge also expressed the view (strictly obiter) that it was arguable that an

¹² See *Prenn v Simmonds* [1971] 1 WLR 1381 and *Arrale v Costain* [1976] Lloyds Rep 98.

¹³ For example, see *Reed Solicitors and Another v Norwich Union Limited and Others* [2005] All ER (D) 258 (Jan), *Inntrepreneur Pub Co v East Crown Ltd* [2002] 2 Lloyd’s Rep 611 and *SERE Holdings Ltd v Volkswagen Group UK Ltd* [2004] EWHC 1551 (Ch).

¹⁴ For example, *Ravennavi SpA v New Century Shipbuilding Co Ltd* [2006] EWHC 733 (comm.), *Fertilisers and Petrochemicals Corp v ICI* [1999] 1 All E.R. (Comm) 69, *Inntrepreneur Pub Co v East Crown Ltd* [2002] 2 Lloyd’s Rep 611 and *Exxonmobil Sales and Supply Corp v Texaco Ltd* [2003] EWHC 1964 (Comm).

¹⁵ For example, *Thomas Witter Ltd v T.B.P. Industries Ltd* [1996] 2 All E.R. 573, *Deepak Fertilisers and Petrochemicals Corp v ICI* [1999] 1 All E.R. (Comm) 69 and *South West Water Services Ltd v International Computers Ltd* [1999] Build L.R 420.

¹⁶ [2004] 1 All ER (Comm) 435.

implied term based on business efficacy could not be excluded by the entire agreement clause. The judge stated that:

“The entire agreement clause was also relied upon by Exxonmobil in seeking to defeat the argument that a term should be implied based upon business efficacy. I have not, on that account, rejected Texaco's argument that a term should be implied on the grounds of business efficacy. It seems to me arguable that where it is necessary to imply a term in order to make the express terms work such an implied term may not be excluded by the entire agreement clause because it could be said that such a term is to be found in the document or documents forming part of the contract. The same cannot be said of an implied term based upon usage or custom.”¹⁷

In summary, it is possible that an entire agreement clause would not prevent a party adducing pre-contract materials: (i) in order to interpret or clarify the true terms relating to matters which were not dealt with in the written agreement, (ii) to ascertain the parties' intended meaning for words or phrases used in the contract, (iii) in claims for rectification, mistake or misrepresentation, (iv) in the implication of terms into the contract (though perhaps not re usage or custom, depending on the wording of the clause).

¹⁷ [2004] 1 All ER (Comm) 435 at 441.

C. CONSTRUING THE CONTRACT

1. **How would a court decide what the contract terms mean?**

The House of Lords decision in *Investors' Compensation Scheme (ICS) v West Bromwich*¹⁸ is still the leading authority for the way in which the courts should interpret commercial contracts. Lord Hoffman set out five key principles:

Interpretation – the ascertainment of the meaning which the document would convey to a reasonable person, having all the background knowledge reasonably available to the parties.

Background – i.e. the “matrix of fact”. Anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

Exclusion from the admissible background previous negotiations of the parties – they are admissible only in an action for rectification, misrepresentation or mistake (although the courts appear to have become more flexible in applying this rule, see for example *Lloyd v Sutcliffe*) - see section B.4 above.

The meaning of a document to the reasonable man is not the same thing as the meaning of its words – the meaning of words is a matter for dictionaries, whereas the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean.

Words should be given their “natural and ordinary meaning” - The general position is that a court will find that people do not generally make linguistic mistakes in formal agreements. However, if it is clear that a mistake has been made with the language, the law does not require judges to attribute to the parties an intention which they clearly could not have had¹⁹.

In effect, the court is required to objectively consider the meaning of words as used in their particular context, while taking account of the factual matrix and not preferring a literal interpretation over a purposive one. Where there is ambiguity in a contract, the courts will normally interpret the words against the party who insisted on its inclusion, or against a party who insisted on using its own standard form contract. This is the *contra proferentem* rule.

2. **Purposive construction**

It is now well established that in construing a commercial contract the court will normally adopt a practical and flexible approach in order to ascertain the true meaning of a clause. It will attempt to assess the commercial purpose of the transaction and construe the words used in the light of that purpose and in accordance with what a reasonable person would understand the words to mean. So, as stated in *Schuler AG v Wickman Machine Tool Sales Limited*: “*The fact that a particular*

¹⁸ [1998] 1 WLR 896.

¹⁹ In the *Antaios Compania Neviera S.A. v Salen Rederierna A.B.* [1981] A.C. 191, Lord Diplock said, “...if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense”.

*construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result, the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they shall make that intention abundantly clear.”*²⁰

3. When can terms be implied?

Despite the existence of an entire agreement clause and/or the contract appearing to be complete, the courts will be prepared to imply terms into a contract where it is clear that they must have intended such terms to govern their relationship in the following circumstances:

Where it is necessary to give business efficacy to the contract, i.e. something without which the contract would not be able to work in the way that it was intended and that “*must obviously have been the intention of the parties...with the object of giving efficacy to the transaction*”²¹. For example, where there is a clause which can only be fulfilled with the co-operation of both parties, the courts will imply a duty on the parties to co-operate²². The courts went further in *Anglo Group Plc v Winther Brown & Co Ltd*²³ and suggested that in relation to a contract for the supply of a computer system the implied duty of co-operation would involve: (i) the purchaser communicating any special needs to the supplier at the earliest opportunity; (ii) the purchaser taking reasonable steps to ensure the supplier understands those needs; (iii) the supplier communicating whether those precise needs can be met and if not, offering an alternative option; (iv) the supplier taking reasonable steps to ensure the purchaser is trained in the system; (v) the purchaser devoting reasonable time to understand how to operate the system and (vi) the parties working together to resolve problems that will almost certainly occur. This is an important case as it highlights that the existence of an entire agreement clause may not prevent additional obligations being implied into the contract where necessary to give effect to the intended business relationship between the parties.

Where the term is obvious, i.e. the officious bystander test. To be implied under this test, the term needs to be so obvious at the time the parties entered the contract (rather than the time when the dispute arose) that its inclusion in the contract goes without saying. The test was formulated by MacKinnon L.J in *Shirlaw v Southern Foundries*²⁴. However, the courts may be unwilling to imply terms into a contract in this way where two commercial parties have entered into long and considered agreement²⁵.

²⁰ [1974] AC 235 at 251 per Lord Reid.

²¹ *The Moorcock* [1889] 14 P.D. 64.

²² In *Mackay v Dick* [1881] 6 App Cas 251, it was held that: “*where in a written contract it appears that both parties have agreed that something shall be done, which cannot effectively be done unless both concur in doing it, the construction of the contract is that each agrees to do all that is necessary to be done on his part for the carrying out of that thing, though there may be no express words to that effect*”.

²³ [2000] All ER (D) 294.

²⁴ *Shirlaw v Southern Foundries (1926) Ltd* [1939] 2 KB 206 – When the parties were formulating their contract, if an officious bystander said to the parties “*why not include it in the contract*” they would agree and both say, “*oh of course, that goes without saying*”.

²⁵ *Philips Electronique Grand Public SA & Anor. v British Sky Broadcasting Ltd* [1995] EMLR 472.

Where it is the unexpressed intention of the parties, i.e. both parties must have intended the term to be part of the contract. However, in recent years, the courts have shied away from implying terms into contracts on this basis, particularly where the parties are both sophisticated commercial entities and where a contract exists between them which contains comprehensive terms. In *Jones v St John's College Oxford*²⁶ it was said that a court would be slow to imply terms “*where the parties have entered into a carefully drafted written contract containing detailed terms agreed between them*”.

Where it is implied from usage or custom, i.e. where there is an invariable, certain and general usage or custom in a particular trade or place and which does not create an inconsistency with the terms of the contract. To be binding, the usage must be notorious, certain, reasonable and not contrary to law²⁷. However, as set out in section B.4 above, the case of *Exxonmobil Sales and Supply Corp v Texaco Ltd*²⁸ is authority that an appropriately worded entire agreement clause could exclude terms based on usage or custom.

Where it is implied from a previous course of dealing, i.e. where there is no express term in the contract but the parties have dealt with each other previously on similar contracts and they have consistently gone about things in a certain way, therefore it must have been the reasonable expectation of the parties that the term would apply to the transaction in question.

Where implied by statute, i.e. pursuant to the Sale of Goods Act 1979 (“SGA”) and the Supply of Goods and Services Act 1982 (“SGSA”). The SGA sets out implied terms where the seller sells goods in the course of business, for example title/right to sell and that the buyer will have quiet possession²⁹, correspondence with description³⁰, satisfactory quality of goods³¹ and that the goods will be fit for purpose³². However, with the exception of the implied term as to title/right to sell, these terms can be negated by an exclusion clause in the contract providing that it does not fall foul of the Unfair Contract Terms Act 1977 (although it does not apply to international supply contracts). In addition, where the contract is silent on particular matters, the SGA will imply further terms, for example that the goods will be reasonably priced. Additionally, sections 3 and 4 of the SGSA implies the same terms as the SGA into contracts for works and materials, while section 13 implies a further term that services will be carried out with reasonable care and skill.

4. **Are negotiations, heads of terms or pre-signing terms ever relevant?**

Heads of terms or pre-signing terms are not legally binding, although they do create an understanding between the parties as to the main commercial terms and a moral obligation to honour those terms.

²⁶ [1970] L.R. 6 QB.

²⁷ *Yates v Pym* (1816) 6 Taunt 446.

²⁸ [2003] EWHC 1964 (Comm).

²⁹ Section 12.

³⁰ Section 13.

³¹ Section 14(2) (a).

³² Section 14(3).

Where there is an entire agreement clause, clearly heads of terms or pre-contract negotiations will generally not be relevant. This is particularly the case in relation to oral negotiations, where the parol evidence rule renders evidence of oral representations inadmissible where they contradict, add or vary the terms of the contract. However, there are circumstances where heads of terms or pre-contract negotiations can be adduced to construe the terms of a contract – these were discussed in section B.4 above.

D. BREACH & TERMINATION

1. General issues

Having identified the scope of the contract and assessed how its terms might be interpreted, any contractual dispute will involve two key issues:

- (i) identifying whether a breach has occurred and the nature of the contractual obligations that have been breached; and
- (ii) deciding what rights the innocent party has as a result of that breach, including whether they give rise to a right to terminate.

Most commonly the contract itself will identify specific rights that arise as a result of a breach, trying to categorise the breach by reference to terms such as “*material breach*”, “*remediable breach*” or variations, like “*substantial breach*”. This means the innocent party needs to be able to establish what category of breach has occurred (if any) in order to assess its rights.

In addition, the actions of one party may constitute a *repudiatory* or *fundamental* breach, which (unless effectively excluded under the contract) gives the innocent party certain additional rights under the common law.

So, the analysis should be conducted as follows: Has a breach occurred? What sort of breach is it? What can the innocent party do as a result of that breach?

2. What is a breach?

A contract is breached by one party’s failure or refusal (without lawful excuse) to perform some or all of the obligations of the contract, or where a party performs an obligation in a defective manner or puts himself in a position where he cannot perform.

3. When does the breach arise?

The breach can be said to have occurred once performance of an obligation falls due but has not taken place, or if the obligation performed was defective. In addition, the breach may occur in advance of when the relevant obligation is due, if a party makes it clear that it will not perform all or some of its obligations under the contract, or does something to make it impossible to perform them. This is an **anticipatory breach**. Depending on the nature of the obligation in issue, an anticipatory breach may be repudiatory or a material breach under the contract terms.

4. What are the consequences of the breach?

Any breach entitles the innocent party to claim damages (we deal with remedies in more detail in section F below) although the extent of those damages would depend on the loss suffered. In addition, depending on the nature of the breach and/or the contract terms, the innocent party may also be entitled to demand that the breach is remedied or to terminate the contract. When considering the consequences of a particular breach, there are potentially two types: (a) breaches that give rise to rights under common law and (b) breaches identified and specifically dealt with under the contract.

For a specific breach, the rights conferred under the contract may be broader than those that would exist under the general law, meaning that a party may be able to terminate under the terms of the contract but not under the common law.

(a) **Breaches under the common law.**

The law will recognise a party's rights to claim damages in the event of a breach of contract. In addition, the innocent party may be entitled to terminate a contract but only in the event of a **repudiatory breach**.

What constitutes a repudiatory breach? A breach of *a condition* is a repudiatory breach. A condition is a stipulation which the parties have agreed (expressly or impliedly) to be, or which the common law regards as, a term which goes to the root of the contract so that any breach of that term may at once and without further reference to the facts and circumstances give the injured party the right (but not the obligation) to terminate.

So, a breach will be repudiatory if it so serious that it deprives the innocent party of a whole "*or substantially the whole*" of the benefit of the contract³³.

A party will also have committed a repudiatory breach if it renounces the contract, making it clear (by words or conduct) that it is no longer willing or able to perform its obligations under the contract.

What is a fundamental breach? "Fundamental breach" is a term often used as an alternative to a repudiatory breach but has been described by the courts as "*no more or less than the well-known type of breach which entitles the innocent party to treat it as repudiatory and to rescind the contract*"³⁴. Similarly, a "fundamental term" appears to be no more than a condition.

Despite the different terminology that is used, the principle is the same: a particular breach or breaches may be such as to go to the root of the contract and entitle the other party to treat such breach or breaches as a repudiation of the whole contract.

What is the effect of a repudiatory breach? The innocent party, faced by a repudiatory breach has a choice (or "election"): either to treat the contract as continuing (*affirmation*) or bring it to an end (*acceptance of the repudiation*).

What constitutes affirmation? Affirmation in the face of a repudiatory breach may be express or implied. Importantly, it will be implied if the innocent party does some unequivocal act from which it may be inferred that they intend to go on with the contract regardless of the breach. So although mere inactivity after the breach does not in itself amount to affirmation, the innocent party needs to be careful in the way that it responds to learning about a repudiatory breach.

³³ Per Lord Diplock in *Hong Kong Fir Shipping Co v Kawasaki Kisen Kaisha* [1962] 2 QB 26.

³⁴ Lord Reid in *Suisse Atlantique Societe d'Armement Maritime SA v N.V. Rotterdamsche Kolan Centrale* [1966] 1 Lloyd's Ref. 529.

Affirmation will always be conditional on the innocent party having knowledge of (i) the facts giving rise to breach; and (ii) its legal right to choose between the alternatives available.

Affirmation is irrevocable. If the innocent party elects to affirm the contract it cannot subsequently reverse that decision. However, if the breach is repeated, the innocent party will normally be able to treat that further breach as a separate act of repudiation, giving it the right to terminate.

Can the innocent party delay the decision and see if the breach is remedied? If the innocent party does nothing for too long, there may come a time when he is treated as having affirmed the contract³⁵. However, if he maintains the contract for the time being while expressly reserving his right to treat it as repudiated if the counter-party persists in his repudiation, then he has not yet elected.

Contacting the other party and asking them to change their mind and perform the contract will not, in itself, amount to an affirmation. In such circumstances, the courts are “slow” to accept that an innocent party has committed itself to irrevocably going on with the contract³⁶.

What about anticipatory breaches? Can the innocent party “wait and see”? Yes, provided no affirmation is made, but there is a risk that the party in breach will resume performance of the contract and end any continuing right that the innocent party may have to elect to accept the former repudiation as terminating the contract.

Can you affirm but still claim damages? Yes – it is important to remember that the party that elects to affirm only abandons its rights to treat the contract as repudiated; the innocent party can still claim damages for the loss suffered as a result of the breach. The contract will continue and remain in existence for the benefit of the wrongdoer as well as the innocent party.

This is in contrast to a “total waiver”, whereby the innocent party foregoes not merely their right to terminate the contract but also any claim for damages for the breach.

Exclusion of right to terminate for repudiation. Subject to the application of the statutory test of reasonableness, the consequences of a repudiatory breach (including the right of the innocent party to terminate the contract) can be expressly excluded by the contract. Disputes can arise as to whether the words used in the contract mean such rights have in fact been excluded³⁷.

(b) **Breaches dealt with under the contract: material, substantial and remediable breaches.**

The contract will commonly identify different categories of breaches and specify the consequences of each. For example a right to terminate may be stated to arise upon:

³⁵ In contrast, inaction or failure to perform obligations will not be taken as acceptance of the repudiation – see *Vitol SA v Norelf Limited*, *The Times Law Report* 2nd June 1995.

³⁶ “*The law does not require an innocent party to snatch at repudiation and he does not automatically lose his right to treat the contract as discharged merely by calling on the other to reconsider his position and recognise his obligation.*” *Yukong Line Ltd v Rendsberg Investments Corp of Liberia* [1996] 2 Lloyd’s Rep 604.

³⁷ For example, “*the contract may only be terminated in the following circumstances*” would imply exclusion of the right to terminate for repudiatory breach, as opposed to “*the termination provisions of this contract are without prejudice to any other rights and remedies*”.

“material and irremediable breach or if a remediable breach was not remedied within 28 days of a notice to do so.”³⁸

Disagreements between the parties most often arise as to (i) whether a breach has taken place at all; and (ii) given the different possible consequences, what category of breach has occurred.

The categorisation of breaches under the contract is considered in more detail below:

What if the contract doesn’t categorise breaches? Some contracts specify the consequences of “any breach”, for example permitting one party to terminate in the event of any breach. What does this mean in practice? The courts have approached this issue with common sense, rejecting arguments that such provisions should be interpreted literally thereby permitting the innocent party to terminate no matter how minor the breach may be. Instead “any breach” has been interpreted as meaning a repudiatory breach only³⁹.

What is a “material breach”? It is important to bear in mind that “material breach” is not an established common law concept – its meaning comes only from the way in which it is used in a contract. As a consequence the term has no set definition although over the years the courts have given guidance, summarised by Neuberger J, in *Glolite Limited v Jasper Conran* as follows:

“Whether a breach of an agreement is “material” must depend upon all of the facts of the particular case, including the terms and duration of the agreement in question, the nature of the breach, and the consequences of the breach”.

and

“One is concerned here with a commercial contract, and when judging what the parties meant when they referred to a breach having to be “material” and “remediable”, it seems to me that they must have had in mind, at least to some extent, the commercial consequences of the breach”.

What also seems clear is that in most instances “material breach” need not be construed as a reference to something as serious as a “repudiatory breach”, although the party in breach will often argue that this is the case⁴⁰.

What is a “substantial breach”? Contracts sometimes refer to certain rights arising as a consequence of “substantial breach”. Here, unlike the line of decisions in relation to “material breach” the courts have held that a “substantial breach” needs to be akin to a repudiatory breach. Stating, for example, that they:

³⁸ As in *Glolite Limited v Jasper Conran* [1998] *The Times*, 28 January.

³⁹ See for example *The Antios* [1981] AC 191 and *Rice (t/a The Garden Guardian) v Great Yarmouth Borough Council* [2000] All ER (D) 902.

⁴⁰ See for example *National Power plc v United Gas Company* and Colman J’s comments that *“to confine the application of the clause to repudiatory would lead to further improbable consequences...In other words [the clause] would provide the innocent party with nothing more than its rights at common law”.*

*“doubt whether there is any distinction to be drawn between the “substantial” breach required by that clause and a breach of condition or repudiatory breach. “Substantial” deprivation of the intended contractual benefit is after all one way in which the test of repudiatory breach is often expressed.”*⁴¹

What is an “irremediable breach”? Often a contract will permit termination for an irremediable material breach or a remediable breach that is not remedied within a specific period. This raises the issue as to what is an irremediable breach. Mostly, it will be clear whether the party in breach can rectify the situation and comply with its obligations, for example making a late payment or fixing faulty service.

However, one situation causes particular debate, namely when milestones with a specific deadline are missed. The courts have shown a willingness to be flexible in such circumstances and have generally been reluctant to declare any missed dates as comprising an irremediable breach. Remedy has been taken to mean putting right for the future rather than making good any damage done in the past. So missed deadlines may well be considered remediable and *“the breach of a promise to do something by a certain time could for practical purposes be remedied by the thing being done, even out of time”*⁴².

⁴¹ Mance LJ in *Crane Co v Wittenborg A/S* Court of Appeal (Civ:/Division) 21/12/1999 – reported on New Law Online, ref: 2991222304.

⁴² Court of Appeal in *Expert Clothing Service and Sales Limited v Hillgate House Limited* [1986] Ch 340. See also the House of Lords’ decision in *L Schuler v Wickman Machine Tools Sales Limited* [1974] AC 235 (*“To restrict the meaning of remedy to cases where all damage past and future can be put right would hardly leave any scope at all for this clause”*) and *Peregrine Systems Ltd v Steria Ltd* [2005] WL 753207.

E. TERMINATION FOR BREACH – ADDITIONAL COMMENTS

As we have discussed above, certain breaches will give the innocent party a right to terminate the contract, either under the terms of that contract or through the acceptance of repudiation. Parties should bear in mind that any attempt to terminate the contract brings with it certain risks – the other party may claim wrongful termination and bring its own claim for damages for breach of contract and/or repudiation, particularly if the party attempting to terminate ceases to comply with its own obligations under the contract.

The stakes can be high. Consider the following scenario: Party A alleges that the non-performance of certain obligations by Party B constitutes an irremediable material breach under the contract and/or a repudiatory breach. Party A ceases to perform its obligations under the contract and informs Party B that the contract is terminated, claiming damages. Party B responds by suing Party A claiming damages on the basis that the termination was wrongful, itself constituted repudiation and/or breach of the contract. Which party succeeds will largely depend on whether Party B was, or was not, in irremediable material breach and/or repudiatory breach of the contract – it would not be enough for Party A to prove a breach; the breach must be severe enough to give rise to a right to terminate (as discussed above). In effect, Party A has risked all on its assessment of breach being right and turned a situation in which it had a right to claim damages for Party B's breach into one where it is being sued itself for wrongful termination.

With these risks in mind it is frequently better for a party believing there to be a breach to demand that it is remedied within the time specified under the contract and engage in an attempt to negotiate a resolution, while specifically reserving its rights under the contract so as to avoid any allegation of waiver or affirmation. If the wrongdoer does not remedy the breach and/or persists in failing its obligations, the innocent party will be on safer ground in terminating and seeking damages.

F. REMEDIES

Any negotiated resolution of a contractual dispute requires an assessment of the innocent party's remedies, in particular what damages or other relief a court might award an innocent party. In this section we provide an overview of those remedies.

1. Damages

Damages are almost always at the heart of any breach of contract claim. Bringing a claim for breach of contract may have little commercial purpose if the innocent party has not suffered any loss as a result of the breach.

General principles. Damages can be claimed for losses flowing from breach of contract. To be awarded damages the innocent party must show that the loss suffered was not too **remote** and was **caused** by the breach. The general rule is that damages are assessed at the date of the breach and are intended to put the claimant in the position in which it would have been had the contract been performed according to its terms.

Most damages claims seek compensation for “**expectation loss**” and commonly include claims for cost of replacement⁴³ or repair, loss of profits, loss of anticipated future savings⁴⁴, additional expenditure and costs incurred and expenditure spent on preserving customer goodwill.

Alternatively claims may focus on “**reliance loss**” – the cost to the innocent party of his actions in reliance on performance on the contract. Claims may include money paid to a supplier or third parties in relation to the contract, expenditure incurred in connection with the contract⁴⁵, including consultancy fees as well as management and staff costs.

Whatever the basis of the damages claim, it is important to bear in mind that the court will not permit an overlap between the different heads, so expectation and reliance loss are mutually exclusive to prevent double recovery.

Remoteness. Losses need to be foreseeable to be recoverable. The principles were laid out in *Hadley v Baxendale*⁴⁶, which established that the claimant can recover:

- I. losses arising naturally, according to the normal course of things, from the breach of contract itself; and
- II. such losses as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as a probable result of the breach.

⁴³ The claimant's entitlement to the full cost of replacement will not be assumed. The claimant will need to show that such an assessment is reasonable.

⁴⁴ For example, staff reductions, lower financing and running cost or space savings and lower maintenance costs.

⁴⁵ A claimant may be able to recover pre-contract expenditure, so long as it was reasonably within the contemplation of the parties as likely to be wasted if the contract was broken.

⁴⁶ (1854) 9 Ex 341.

The first limb is objective, referring to “general damages” and the second covers knowledge of special circumstances outside the ordinary course of things; what could have reasonably been contemplated by the party in breach. Where the term consequential loss is used in the exclusion clause of a contract, it refers to damages recoverable under the second limb.

For the purpose assessing remoteness, it is the date of making the contract and not the date of breach which is relevant for applying the test.

Causation. Losses will only be recoverable if they were caused by the breach. The claimant must prove on a balance of probabilities that the breach caused the loss. The courts sometimes apply a “but for” test; i.e. but for the breach, would the claimant have suffered the loss?

Liquidated Damages. Contracting parties may seek to avoid the cost and unpredictability of damages claims and agree that a certain fixed sum should be paid in the event of breach. To make a claim under an enforceable liquidated damages clause the innocent party need only prove breach, not whether there has been any actual loss.

However, if the liquidated damages clause is not a genuine pre-estimate of loss it may be viewed as an invalid penalty clause⁴⁷.

Mitigation. A party cannot recover damages for any part of its loss which it could have reasonably avoided – that party has a duty to mitigate its loss, both by taking reasonable steps to minimise losses and by not taking unreasonable steps to increase losses. Where losses have been avoided they cannot be recovered as damages. What is “reasonable” needs to be assessed in the specific circumstances, but generally the claimant need not risk damaging its commercial reputation or its money.

The party seeking damages will need to demonstrate to the court it has considered and taken reasonable steps to mitigate. A failure to do so can often severely curtail the amount of damages that may be recovered. In seeking damages, the performance of a replacement product or service may in fact be the best evidence of the cost savings and increased profits that would have resulted from proper performance of the contract.

Exclusion clauses and limitation of liability. Commonly parties will seek to exclude or limit their liability under the contract. Such clauses will be interpreted in accordance with the principles laid out in *Investors’ Compensation Scheme*⁴⁸ and need to be considered carefully in assessing any possible award of damages. Issues regarding the effect and enforceability of such clauses are outside the scope of this note, but needless to say any attempt by the wrongdoer to rely on limitation of liability clauses will often be met by a challenge to their validity.

⁴⁷ The test remains as set out in *Dunlop Pneumatic Tyre Limited v New Garage & Motor Co Ltd* [1915] A.C. 79, in particular whether the sum is “*extravagant and unconscionable*” in comparison to the loss. There is a presumption that if the same sum is stated to apply to different types of breach of contract, some of which are serious and some not, then it will be viewed as a penalty clause.

⁴⁸ See section C.1 above.

2. **Specific Performance**

Where a court agrees that damages are not an adequate remedy, it may be prepared to make an order for specific performance, thereby compelling one party to perform its contractual obligations. Although the court has made exceptions, it is a general rule that specific performance will not be ordered if the contract requires performance or constant supervision over an extended period of time and/or the obligations of the party are not clearly defined⁴⁹.

3. **Injunctions**

The court may also exercise its discretion and award an injunction, either banning one party from continuing to breach the contract (prohibitory injunction) or forcing that party to perform a positive contractual obligation (mandatory injunction). As with specific performance, the court will only make such an order if damages will not adequately compensate the innocent party and will apply the balance of convenience test⁵⁰ to ascertain whether an injunction should be granted.

⁴⁹ See *Co-Op Insurance v Argyll Stores* [1997] 3 All ER 297.

⁵⁰ The test was formulated in *American Cyanamid Co v Ethicon Ltd* [1975] AC 369 where the House of Lords found that the court must have regard to the detriment to the claimant's business that would occur if it refused to grant the injunction, as against the detriment that the defendant's business would suffer if the injunction was granted.

G. NEGOTIATING A RESOLUTION

1. Following dispute resolution clauses in the contract

Once a dispute has arisen and you have conducted an assessment of your position, it is imperative that attempts made to resolve the dispute are conducted strictly in accordance with the dispute resolution clause (if any) contained in the contract. Recent cases have highlighted that if parties fail to do so, there could be disastrous consequences, particularly for claimants. For example, in *Douglas Harper v Interchange Group Ltd*⁵¹ the claimant (Harper) failed to follow the dispute resolution mechanism set out in the contract and the court therefore barred him from bringing court proceedings. The mechanism in question related to the dealing with disputes regarding the level of commission payable to Harper. In particular, Harper had 28 days following receipt of the statement setting out the fees due to him to dispute the statement. Harper did dispute one of the statements rendered by the defendant, but outside the 28 day time limit and not in the form prescribed by the contract. Harper sought to argue that the wording of the clause did not stipulate that if it was not complied with, any right of action was barred. However, the judge found that Harper was not entitled to bring an action as he had not invoked the contractual machinery for dealing with such disputes.

In terms of a defendant's failure to follow a dispute resolution clause, the consequences may not be so severe. In *Sunrock Aircraft Corporation v Scandanavian Airlines System Denmark-Norway-Sweden*⁵², the contract between the parties stated that certain disputes should be resolved by expert determination. A dispute arose that came within the clause, however the defendant refused to appoint an expert. At first instance the claimant won damages in relation to the breach of the dispute resolution clause for the amount that the expert would have awarded had the determination proceeded. However, the court of Appeal overturned this decision on the basis that it did not think the claim for damages would succeed. Therefore, the court only awarded nominal damages for the defendant's breach.

2. Notices

Where a party wishes to serve a notice of breach (or a notice of termination), it must take care to ensure that such notice is drafted and served in accordance with the dispute resolution clause and the notices clause contained in the contract. For example, the dispute resolution clause may provide that a notice of breach must set out the clause that has been breached and provide a period for remedy. Also, the notices clause may provide, for example, the method by which a notice must be served under the contract (e.g. by fax only) or the address or person on which the notice must be served.

If notices are not served in accordance with the dispute resolution and notices clause in the contract, they may be invalid. The position is that prima facie, the validity of the notice depends on the precise observance with the specific contractual provisions⁵³. However, the prima facie rule may be

⁵¹ [2007] EWHC 1834.

⁵² [2007] EWHC Civ 882.

⁵³ *Tradax Exports SA v Dorada Compania Naviera SA* [1982] 2 Lloyd's Rep. 140.

dispensed with when regard is had to the underlying commercial purpose of the termination clause⁵⁴. Also, a consideration of the notice requirements of the contract as a whole and regard to general considerations of law may show that a stipulated notice requirement was intended by the parties to be an intermediate term, the non-observance of which would not invalidate the notice (unless the other party was seriously prejudiced) but would give rise to a claim for damages only⁵⁵.

3. Without Prejudice

Once a dispute has arisen, it is important that any negotiations/correspondence aimed at resolving the dispute are marked “without prejudice”. This will prevent any statements/correspondence made in a genuine attempt to settle a dispute (whether made verbally or in writing) from being put before the court as evidence against the party who made them⁵⁶. The rule allows parties to freely and openly explore the prospect of settlement without worry that the discussions could be used against them in formal proceedings.

However, in some situations it might be better to conduct negotiations on an open basis, particularly where you think that the other side might be unreasonable in their demands. The advantage of open correspondence is that it can be put before the court in order to show faith in your position and as evidence that you made a legitimate attempt to settle, but this was not possible due to the other side’s unreasonable approach. Also, correspondence can be marked “without prejudice save as to costs”. The benefit of such correspondence is that it cannot be put before the court on the issue of liability, but it can be adduced on the issue of costs. Accordingly, you might be able to claim a higher proportion of your costs if you can show that the other side unreasonably turned down a settlement offer, or refused to enter settlement discussions. Alternatively, if defending and in the event you lose the case, you could adduce such evidence to reduce your liability to pay the claimant’s costs on the basis that they unreasonably refused to settle.

It is important to note that merely marking a document “without prejudice” does not guarantee it cannot be used in evidence. Use of the label will suggest that the document was intended to be used for the purposes of negotiation⁵⁷, however, it is not conclusive. In assessing the situation, the court will look at substance over form. Therefore, a document which is marked without prejudice but is not a genuine attempt to settle the dispute will not attract protection. Conversely, omitting to mark a document without prejudice will not prevent the rule applying if it is a genuine attempt to settle⁵⁸.

⁵⁴ Ellis Tylin Ltd v Co-operative Retail Services Ltd [1999] B.L.R. 205.

⁵⁵ Bremer Handelsgesellschaft mbH v Vanden Avenne – Izegem P.V.B.A [1978] 2 Lloyd’s Rep 109.

⁵⁶ However, note that while without prejudice documents are not admissible in court, the rule is not a bar to disclosure of the documents in that stage of proceedings. Therefore, when preparing the lists of documents, the parties must alert each other as to the existence of the without prejudice documents, i.e. disclose them. However, the documents need not to be made available for inspection.

⁵⁷ Schering Corporation v Cipla Ltd [2005] FSR 25.

⁵⁸ In *Rush v Tompkins* [1989] 1 A.C. 1280 it was held: “...the application of the rule is not dependent upon the use of the phrase, “without prejudice” and if it is clear from the surrounding circumstances that the parties were seeking to compromise the action, evidence of the content of those negotiations will, as a general rule, not be admissible at the trial and cannot be used to establish an admission or partial admission”.

One should also bear in mind that there are exceptions to the without prejudice rule. Accordingly, without prejudice documentation may be admissible in court in the following circumstances: (i) to show that an agreement should be set aside for fraud, undue influence or misrepresentation; (ii) where a clear statement was made giving rise to an estoppel, without prejudice documents may be adduced to prove the statement was made; (iii) if the without prejudice documents would act as a cloak for perjury, blackmail or other impropriety; (iv) to explain an apparent delay or acquiescence; (v) to evidence the terms of a settlement agreement; and (vi) without prejudice save as to costs – see above.

4. Retaining Privilege/Without Prejudice.

It is imperative that nothing is done to waive the protection given to without prejudice documents and other privileged material i.e. documents in contemplation of litigation (litigation privilege) and general advice between lawyer and client (legal advice privilege). Where documents are confidential, for the purposes of obtaining legal advice, or in contemplation of litigation, they should be clearly marked as such. Also, documents should not be disclosed to third parties as, in certain circumstances, this may have the effect of waiving privilege⁵⁹.

5. Internal communications/in-house lawyers/3 Rivers⁶⁰

It is outside the scope of this note to fully explore the implications of this complex case. However, in short, the various 3 Rivers judgments have restricted the protection afforded by legal advice privilege, but not the scope of litigation privilege.

The practical effect of 3 Rivers is that only confidential communications between a client and lawyer are privileged from production where the lawyer has been instructed in “a relevant legal context”. However, it is the definition of what constitutes a client that has caused serious difficulties. In 3 Rivers it was held that the three man inquiry team at the Bank was the client, not the Bank itself. Therefore, any documents created by other employees of the Bank, including the Governor, were not privileged even if prepared for the purpose of being sent to the Bank’s external lawyers. This obviously has serious implications for companies when instructing lawyers (whether external or in-house) as the question of who is the client is not always clear and there is a danger that privilege can be lost if advice is shared too widely.

Accordingly, communications with lawyers, whether external or internal, should be tightly managed to restrict dissemination within the client organisation. When instructing external lawyers, it is imperative to keep the internal client group with responsibility for managing the instruction clearly defined and to a minimum. Further, the client group should ensure that anyone outside the group does not create documentation relating to the advice sought.

⁵⁹ Note that this is particularly the case in relation to legal advice privilege, rather than litigation privilege (which will allow the documents to be sent to third parties (for example, witnesses of fact/expert witnesses) without privilege being waived).

⁶⁰ The litigation involved proceedings brought by the liquidator and depositors in the collapsed BCCI bank against the Bank of England, alleging bad faith in the performance of its supervisory duties vis-à-vis BCCI. The Bank had set up a 3-man team to deal with all communications in the enquiry and had instructed solicitors to advise them.

6. Documenting a resolution

Once the parties have agreed on a resolution, this should be documented, if possible by way of a formal settlement agreement which clearly identifies the agreed terms of settlement and is signed by both parties and expressed to be in full and final settlement of any claim either party may have resulting from the dispute. The agreement will be contractually binding and therefore, if one party breaches the terms of settlement, the other party would have a claim against them for breach of contract.

The above paragraph assumes that no proceedings have been issued and the dispute was resolved at the pre-action stage. However, where proceedings have been issued and the parties then enter into a settlement agreement, this may give the opportunity to have the settlement agreement annexed to the court order that discontinues the claim, as evidence of the terms of settlement. In such circumstances, a breach of the settlement agreement would constitute a breach of the court order and the party in breach could be held in contempt of court.

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These materials were prepared for a Kemp Little seminar and do not constitute legal advice