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MAST C03: LAW FOR MANAGERS

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ASSESSMENT Nr.2:

CONTRACT LAW

Question 1: Implied Terms and Exclusion Clauses

When two parties enter into a contract, no matter how large the companies and how encompassing the issues they are contracting for, it will always be impossible to include every intention and eventuality into the contract, since contracting is subject to what economists call *contracting costs*, which is a term that stands for all the costs involved in contracting, such as the human capital and the time involved.

It is for this reason that the concept of *implied terms* is one of great importance to ensure that contracts can serve their proper *function.* In other words, if implied terms were completely disregarded, an infinite number of loopholes could be sought that could render most contracts useless.

There are two sources of terms being implied into contracts, the one being *the courts,* the other being *statute.* In the first two sections I shall analyse what kinds of terms are implied for what reasons by the courts and statute respectively. In the third section I shall consider the possibility of parties expressly excluding terms that would be implied if no explicit mention of them was made in the contract.

Terms implied by the courts

The basic underlying reasons, why courts decide to imply terms into contracts, is one of ensuring proper *functioning* of business contracts on the one hand, and one of *protecting* customers on the other hand.[1] It is important to see that the courts are thereby taking the principle of *freedom of contract* as a starting point, and thereupon imply terms to constrain this principle from being exploited against the public good (a so-called top-down approach). It is not a question of courts taking a 'bottom-up' approach of laying down terms which

[1] Harrison et al. 1997:332

contractors are allowed to use. Thus in general 'it is not the *task* of the courts to insert new terms into contracts, but rather to interpret those that already exist'[2]. Nonetheless, courts will sometimes imply terms in order to give contracts *business efficacy.*

What are the motivating drives behind courts implying terms? I shall distinguish three kinds:

1. Terms implied by fact
2. Terms implied by law
3. Terms implied by custom.

Terms implied by fact are the most obvious: these are terms the courts imply that would seem natural to a third - neutrally onlooking - party to have been intended in the contract from the outset. In other words, if this third party was asked if the term was intended in the contract, she would answer: 'Oh, of course!'[3]. Terms implied by fact are an obvious need for *business efficacy*.

However, it is not merely enough for terms implied by fact to be *reasonable*[4], but also to be *necessary.* For although implied terms may be reasonable to ensure business efficacy, they need not be necessary[5] and thus 'although the test of reasonableness may be used in *interpreting* express terms, the court will not normally undertake the task of improving the contract by implying new terms into it'. [6]

On the other hand, there are implied terms that would not necessarily live up to the 'Oh, of course' test of necessity and reasonableness, but which have evolved as implied terms in the evolution of the common law. These are the *terms implied by law.* These terms are still

[2] Ellison et al. 1997:334
[3] As put by MacKinnon LJ in *Shirlaw v. Southern Foundries Ltd. 1939*
[4] as Lord Denning held
[5] Smith, 1993:124
[6] Treitel 1995:69

based on necessity, but this necessity is established by the courts, and not by looking for 'evidence of common intention'[7] between the two parties. Examples of such implied terms would be suppliers of services carrying out his services with reasonable care and skill or employers taking care that his employee's health is not endangered.[8]

The third kind of term implied by courts is that implied by *custom.* It is reasonable to assume that various areas of trade through long-established custom have rules and implicit standards of conduct that can be seen as implied terms. The best example for this is *The Moorcock 1889* where a firm of wharfingers was held to be liable for damage made to a ship at its wharf due to it resting on a ridge of hard ground when the tide ebbed. The term was implied through custom that the wharfinger would take reasonable steps to ensure that no such ridges existed, which they obviously didn't.[9]

Terms implied by statute

Since the second world war, parliament has sought to create Acts that imply terms into contracts in order to *counter-balance* inequalities in bargaining situations and thus these terms have become a vehicle for 'effecting profound social and economic change', as well as being an efficient codification of 'judicially recognised mercantile custom'.[10] Thus, as in common law, we also have the functions of ensuring proper *functioning* of businesses and *protection* of consumers and other potential victims of 'unfair' contracts.

[7] ibid. p.70
[8] 'Two fields in which the courts have been active in implying terms are in the employment and in the landlord and tenant relationship' (Ellison et al. 1997:334)
[9] Note, however, that it is sufficient to take reasonable care, and that the company probably wouldn't have been held liable for the damage had they thoroughly investigated the bed of the Thames but not found a ridge. In other words, it was not an implied term that the wharfingers would simply be liable for any damage to the ship caused by ridges. (Smith 1993:126)
[10] Ellison et al. 1997:335

Two examples of parliament clearly stating terms to be implied into all contracts of the relevant nature are the Sale of Goods Act 1979 and the Health and Safety at Work Act 1974.

Exclusion Clauses

Obviously being aware of the possibility that the courts or statute would imply certain terms in the case of a dispute, parties have over the ages sought to avoid such terms through inserting so-called *exclusion clauses* into the contracts, which specifically state that their liability is excluded or limited in certain cases. Exclusion clauses are an accepted fact by the courts and the statute, but not all exclusion clauses are upheld by the courts and certain types of exclusion clauses have specifically been banned by statute in Acts such as the Unfair Contract Terms Act 1977.

The courts usually require such clauses to have been properly incorporated into the contract by either

- signature

or

- notice.

In the case of a contract including an exclusion clause being signed by a party, the courts will be very strict in asserting that the party has consented to the exclusion clause, and therefore he / she will find it hard to convince the courts of not knowing about the clause at the time of signature.

If an exclusion clause is put up by notice, the courts strictly require this to be done in such a way, that it clearly comes to the attention of the contractor *before* or *during* the formation of a contract. Thus in *Olley v. Marlborough Court Hotel 1949,* a sign posted in the hotel room excluding the management's liability for loss or theft of personal belongings was

said to be unenforceable, since the contract was made when the guest checked in, i.e. before he saw the sign. Similarly, in *Thornton v. Shoe Lane Parking 1971,* exclusion clauses printed on the back of a ticket issued at the entry of the car park were held to be unenforceable, since the contract had come into existence when the money was put in the machine issuing the tickets, before the ticket was issued.

In addition, the courts will be very strict in their interpretation of the exclusion clause: they must be drafted very carefully and must contain the precise nature of the breach from which the party wishes to have its liability excluded. Usually, the courts will interpret an ambiguous exclusion clause in favour of the party *against* which it is being used[11]

The most notable statutory limitations on exclusion clauses were imposed by the Unfair Contract Terms Act in 1977. They specifically referred to clauses excluding *contractual* liability (S.2) and clauses excluding liability in *negligence* (S.2&5).

Exclusion clauses excluding contractual liability are only valid if they pass the 'requirement for reasonableness'. The UCTA 1977 included guidelines for a *reasonableness test,* that identified factors such as the relative bargaining power of the parties, knowledge of existence of exclusion clauses, possibility of insuring oneself and particular circumstances of the case, basically a catchall. There are however two main exceptions, i.e. cases where exclusion clauses are automatically invalidated: where the *safety* of a product is involved[12], and, in the case of contracts between businesses and consumers, where the *quality* of a product is at issue. In the case of contracts between two businesses a term excluding liability for the quality of a supplied good or service is subject to the reasonableness test.

[11] known as the *contra preferentem* rule

[12] i.e. liability cannot be excluded for dangerously defective goods

Where clauses exclude liability in *negligence,* similar rules apply. Thus, there is no way in which a party can exclude liability relating to negligence resulting in death or injury, and in the case of other damages, the reasonableness test applies again.

Conclusion

Thus, to conclude, it is fair to say that the U.K. has the luxury of the principle of *freedom of contract*. However, social policy and proper market efficiency also require a minimum of regulation, which takes the form of implied terms coming from both the common law and statute, as well as restrictions on the use of exclusion clauses.

Section 2: Report to Fashions Ltd re Machines Ltd and Retail Ltd.

The problems we are facing at Fashions Ltd in relation to trying to recover money from both Machines Ltd and Retail Ltd goes to show to what extent we are an active participant in a long economic chain, and that failure in one link of the chain - in our case Machines Ltd, or possibly even their suppliers - causes further links to suffer great financial detriment. It is obvious, that in our weak financial situation, we are keen to minimise the financial losses arising from this unfortunate situation, and that there is an obvious incentive to try and recover money from both companies. I shall, however, take a close look at the situations as they apply to each individual company, and I will argue that we indeed have a claim against Machines Ltd, but that our claim against Retail Ltd is likely to fail.

Machines Ltd

In order to assess the situation with Machines Ltd we have to ask ourselves a number of precise questions relating to the formulation of the actual contract:

- Did either company use a standard form contract, and if so, which one?
- Was one of the terms in the contract an express condition of prompt delivery being of utmost importance?
- If no such term was expressly written, is there any indication of past reliance on Machines Ltd, part of which included prompt delivery?

The question about which company used a standard form contract is of importance for the reason that the precise term stating the conditions applying to delivery on time may well look different if it was drafted by Machines Ltd than if it was drafted by Fashions Ltd. I assume that a standard form contract of Fashions Ltd would have stated that 'time is of the essence', thereby guaranteeing Fashions the possibility to recover damages in case of a breach. If, however, Machines Ltd used their standard form, which is well possible since they are the

suppliers, then there is a great possibility that the guarantee to deliver on time was formulated merely as a warranty, and that there was an exclusion clause stating that Machines was not liable for any damages resulting from late delivery. If the latter is the case, however, all is not lost, since its validity will depend on a few crucial factors that may well speak against Machines Ltd.

In general, there is no doubt that if time is of the essence and this is recognised either in the contract or impliedly by the courts, then late performance constitutes a breach, which results in Machines Ltd being liable to pay for foregone profits (*Rickards v. Oppenheim 1950*).

The question to be asked here is 'how remote are the damages' from the actions (or rather non-actions) of Machines Ltd. The case of *Hadley v. Baxendale 1854* established the decision that *knowledge of the circumstances* which could produce the damage is a 'crucial factor in determining the extent of the liability for breach'[13]. This principle can well be demonstrated in *Czarnikow v. Koufos 1969,* where a shipowner was successfully sued for damages by the owners of the cargo of sugar which was delivered too late. His knowledge of the fact that the market price of sugar was falling was enough to make him liable for the loss of profit incurred by the owners of the cargo.

There are obvious similarities between our case with Machines Ltd and *Czarnikow*. The question that the courts will have to ask themselves in assessing the case would then be: to what extent was Machines Ltd aware of our dependency on their machines. It is safe to assume that they are very well aware of how important their machines can be to an industry such as ours - no matter if we have dealt with them before or not - since they make them and are thus aware of their advantages compared to comparative machines in the industry.

[13] Ellison et al. 1997:361

Thus, the courts may well have a number of factors to rely on that prove to be for our benefit: Machines may have supplied us with their machines in the past and therefore customary factors would imply the necessity of prompt delivery, and their position in the industry should make them knowledgeable about losses caused through their late performance.

The issue raised above about the possibility of Machines having expressly excluded liability in the contract therefore fades into insignificance, since on the one hand the courts reserve the right to decide which terms are conditions and which are warranties, and since on the other hand, they may well argue against the reasonableness of such an implied term.

Thus, I conclude that there are enough indicators pointing to the fact that Machines Ltd are indeed liable to pay Fashions Ltd for the lost profits of £50,000. This will be the only form of remedy which is of interest to Fashions Ltd: a recission would be useless, there are no other suppliers of these machines. The court will hardly make an order of specific performance[14]In addition, a claim for damages may indeed induce Machines to change their mind and accelerate the production of their sewing machines.

Retail Ltd.

The problem arising with Retail Ltd. is one of *performing existing duties as consideration.*

Fashions Ltd did indeed have an existing legal duty to perform their contract, and - on the face of it - we are not going beyond our existing legal duty if we deliver the goods to Retail Ltd, be it at the old price or at a higher price. In other words, the question is if we at Fashions Ltd are providing consideration for the promise of larger payment for the goods, or not. This

[14] compare with *Société des Industries Metallurgiques S.A. v. Bronx Engineering Co. Ltd. 1975,* where 'the Cout refused to make an order of specific performance in relation to a machine manufactured by the defendant even though another such machine was not available on the market immediately.' (Ellison 1997:393)

issue is indeed a contentious one in common law and recent decisions have created a situation whereby this question cannot be so easily answered.

The orthodox position relating to the provision of existing duties as consideration is obvious: 'performance of an existing duty imposed by law and performance of a contractual duty owed to the promisor do *not* constitute consideration'[15]. Also, performance of an existing contractual duty owed to a promisor is no consideration for a *fresh* promise given by that promisor[16].

The classic case supporting this view is *Stilk v. Myrik 1809,* where the seamen of a ship which had experienced the desertion of two sailors were not entitled to the extra wages promised them by the captain, since they were only performing their existing duties, and thereby provided no consideration.

This case has to be contrasted with two other cases, which point in different directions:
a) *Hartley v. Ponsonby 1857*, where consideration was said to be given, since the performance amounted to work *above* that specified in the contract.
b) *Williams v. Roffey Bros & Nicholls Ltd 1991,* where it was held that performance of an existing contractual duty owed to the promisor *could* constitute good consideration.

In the case of *Hartley,* a similar thing happened as in *Stilk,* i.e. crew members of a ship were promised higher salaries to return the ship home after the desertion of some of the sailors. However, in this case 17 out of 36 sailors deserted, so there was an obvious increase in the amount of work and safety hazards accruing to the remaining crew members, so they were entitled to the promised wage-raises.

[15] McKendrick 1997:81
[16] ibid. p.83

The fact with *Williams* is that it is a fairly fresh decision that is pointing to a recent rethinking on the sides of the courts. Thus, this case by no means guarantees that the breaking of the orthodox rule is an established fact. Moreover, it was not merely a case of breaking the orthodox rule, but rather of introducing a further factor into the analysis of the problem: *practical benefit.* What were the practical benefits in Williams' case?
1. The contract would not be broken
2. The defendants were spared the trouble of finding an alternative contractor
3. The defendants were spared the trouble of breaking further contracts with other parties
4. The defendants could impose further conditions on the plaintiffs as to the method of work and payment.

The first three benefits are indeed highly dubious, since they really only amount to the performance of existing duties. The fourth benefit could be seen as a practical benefit, and it is probably this factor that led the House of Lords to argue in favour of the plaintiff.

Where does Fashion Ltd stand in relation to *Stilk, Hartley* and *Williams*? First of all *Williams:* what practical benefit, comparable to 4 above, will Retail Ltd get in us performing the contract? It seems very little, and unless there is evidence of new terms imposed by Retail through this new deal, there is little hope in comparing our situation with that of *Williams.* In addition, the decision was not exactly a popular one among the courts, so Fashion Ltd might well find themselves having to go right up to the House of Lords in order to have a chance of winning the case on the terms of *Williams.*

Secondly, *Hartley.* Fashion Ltd will indeed need to work twice as much in order to get the same amount of work done as promised in the contract. But there is reason enough to say that mutineering sailors cannot be compared to unreliable suppliers: one can more easily provide for the latter situation occurring, for example through *insurance,* than for the former.

Where can one get hold of competent sailors if one is stranded in the middle of the Pacific Ocean?[17]

Thirdly, *Stilk*. The way things look, the courts may well use *Stilk* to argue against Fashion Ltd, especially since this is the orthodox interpretation and since the two alternative interpretations, as I have shown above, do not hold for our case.

Thus, to sum up, I would recommend the management of Fashion Ltd not to try and recover the additional sum promised by Retail Ltd, since the cost of litigation don't seem to justify the risk of fighting against one of the most established rules of the common law: consideration must not relate to the performance of an existing duty.

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[17] not exactly as glamourous in *Hartley*.