Reddy Charlton SOLICITORS

Think Ahead ACCA

UNDERSTANDING COMMON CONTRACTRUAL CLAUSES

There are many clauses and terms that are common to most commercial contracts. Because such clauses appear in most contracts there can be a misconception that such clauses are standard and therefore benign, not requiring careful and specific review in each instance. It is, accordingly, easy to forget that such provisions were included to deal with a particular risk and that variations in the language of a ‘standard’ provision can have significant consequences. While it might be standard to deal with the subject matter of such clause, it is dangerous to assume there is standard language.

Parties to a contract will spend significant time reviewing, amending and negotiating the terms of the commercial and financial elements of their deal in a contract and not so much time considering the ‘standard’ or ‘boilerplate’ provisions. However, a substantial amount of contract litigation revolves around the interpretation of language and it is often the interpretation of these standard types of clause on which a dispute is won or lost; therefore, it is important to be precise in the language used and to ensure that you understand the impact and effect of the standard clauses.

Below we consider the following contractual clauses and concepts which are commonly misunderstood or overlooked.

1. Memorandums of Understanding
2. Good Faith
3. Endeavours
4. Time of the essence
5. Warranty or indemnity
6. Joint & Several liability
7. Variation clauses
8. Entire Agreement

1. **MEMORANDUM OF UNDERSTANDING**

Heads of Terms, Memorandum of Understanding, Letter of Intent or Term Sheet ('Heads') are some of the variety of the names used to describe the document commonly used in commercial transactions to summarise the proposed commercial terms on which full legal contracts will be based. Heads have many names and no set format but whatever label you put on it, the drafting should be carefully considered.

Heads are useful for a number of reasons;

1.1. Drafting Heads helps to focus early negotiations and put a structure on the deal. This assists with highlighting issues at an early stage.

1.2. The execution of Heads by the parties is usually a good indication of the bone fides of the parties to complete the transaction.

1.3. Heads can be useful to set out the deal and get buy in from third parties such as banks or board of directors.

1.4. They can create a timetable to progress the transaction and allocate responsibility for relevant pre-contract tasks.

However, useful as they are, if not drafted properly there is a danger of unwittingly creating contractual relations.

It is usually the intention that Heads are not legally binding. This is because they only set out the headline commercial points and the details will not have been fleshed out.

It is a common misconception that by calling a document Heads of Terms, Memorandum of Understanding or one of the other commonly used labels this it s isufficient to avoid creating a legally binding contract. This is not the case.

The fact that the document may refer to an intention to enter into more formal contracts at a later date will not necessarily be sufficient demonstrate the parties do not intend to create legal relations until that time.

Furthermore, it has been held by the courts that notwithstanding that a Heads was marked 'subject to contract', if all essential elements are agreed, a contract can be created. This is particularly so where the parties proceed to give effect to the terms of the Heads notwithstanding that the formal contract is not finalised.

While the commercial terms should not be binding, it may be prudent to provide for some binding obligations such as confidentiality, exclusivity, costs and governing law.

Accordingly, you should be careful to explicitly provide that the document (or at least the

relevant terms) is not intended to be legally binding. Otherwise you may find yourself inadvertently bound to an unwanted contract that is difficult and/or costly to resile from.

2. GOOD FAITH

Contract commonly provide for the parties to act in good faith in relation to an element of a contract such a negotiation of a price review or resolution of disagreements or indeed in respect of the implementation of a contract generally. However, generally little thought is given to what this means in practice.

2.1. Express Duty of Good Faith

There are no restrictions on parties including express obligations of good faith in a contract.

The Judge in the case of CPC Group Limited –v- Qatari Diar Real Estate Investment Company[1] summarised the obligations imposed by such a duty as the requirement to

"*adhere to the spirit of the contract, to observe reasonable commercial standards of fair dealing, to be faithful to the agreed common purpose and to act consistently with justified expectations of* [*the other party*]".

While most people would expect their counterpart to act fairly and honestly in their dealings, it is not always clear how far such obligation goes. There have been a many cases in the UK on the subject but most are decided on their facts or the specific interpretation of the good faith clause; e.g. is the duty expressed to apply generally or specifically in relation to particular provisions and in the context what is appropriate. Case law has determined that behaviour such as the giving of false information knowing it will be relied upon or failure to disclose material facts for example may fall foul of the duty. However, a general duty of good faith will not be construed to hinder the commercial interests of either party or dilute express provision s of a contract such as an express entitlement to terminate in a contract.

Therefore, to assess the extent of the duty imposed by the inclusion of an express duty to act in good faith the context of the agreement and its subject matter will need to be considered to ascertain what objectively are the intentions of the parties in this regard.

2.2. Implied Duty of Good Faith

In general law does not impose a general principle of good faith. There are a number

[1] [2010] EWCH 1535 (Ch)

of reasons for this; contracts require certainty, but the concept of good faith is nebulous and subjective and therefore prone to uncertainty. Furthermore the parties to a contract should be free to negotiate commercial terms and it is not the place of the court to imply a duty between two commercial parties negotiating at arm's length.

However, in a departure from this position a recent Irish High Court case, John Flynn and Benray Limited v Breccia and Michael Mcateer[2], the Court of Appeal did imply a duty of good faith and fair dealing in relation to the terms of a shareholders agreement.

The parties were shareholders in Blackrock Hospital Limited the company that owns Blackrock Hospital. The plaintiff took a loan from Anglo to purchase its shares in the hospital. The Defendant acquired this loan from NAMA and sought to enforce it and appoint a receiver.

The plaintiff challenged the enforcement of the loan on the basis of a breach of an implied duty of good faith in the shareholders agreement. The judge held in favour of the plaintiff. In doing so looked at the relationship created by the shareholders agreement requiring the parties to communicate effectively and cooperate. In addition, he looked at the ongoing relationship created by the shareholders agreement and the fact that the relationship and the nature of the arrangements were not merely commercial. Accordingly, it was held that the implied term meant that the Defendant was not entitled to demand or recover monies other than in accordance with the Shareholders Agreement and therefore the implied term of the shareholders agreement trumped the contractual rights under the loan documents.

The courts had previously been reluctant to imply obligations of good faith and while this case was very much determined on its facts, the court has now determined that it may be appropriate to imply the obligation in certain circumstances particularly where the contract in question is a relates to a long term relationship between the parties and/or where the relationship is not purely business.

It also demonstrates that there is no automatic duty of good faith and therefore if it is expected or required it should be expressly included in the contract.

3. ENDEAVOURS

Where an obligation in a contract is not absolute or the required result not certain to be possible, then commercial contracts will usually provide that one party must try or endeavour to obtain the desired outcome. This obligation to endeavour is usually

[2] [2015] IEHC 547

qualified by the term ‘best’, ‘reasonable’ or ‘all reasonable’ endeavours or other variations.

There has been much debate and case law over the years to ascertain the extent of the effort required to discharge the obligation in each case.

3.1. **Best Endeavours**

This should be agreed with caution as it imposes quite an onerous obligation. It traditionally meant that the party would do everything within their power to achieve the desired result. Arguments as to reasonableness have been accepted to qualify this over the years but it nevertheless required that a party will do all that a reasonable person who wishes to achieve the required result would do. It imposes an obligation to take positive and active steps to achieve the result. This may include incurring financial or other costs associated with achieving the required goal even though this may be to its own commercial detriment.

3.2. **Reasonable Endeavours**

It is clear simply from the meaning of the words that the obligation imposed by ‘reasonable’ endeavours is less than imposed by ‘best’ endeavours. It requires the party to give an honest attempt to achieve the goal. While there is still an obligation to take positive action, this would not require the party to go as far as incur a financial or other disadvantage or pursue a course of action that was unlikely to be successful.

Therefore, if agreeing to impose the lesser obligation of reasonable endeavours one might consider setting out the criteria required to demonstrate satisfaction of the obligation. It should be noted that it has been held by the courts that where such criteria are set down, unless specified otherwise, they are absolute and any cost in complying with those criteria will be for the party on whom the obligation rests. However, without specifying any criteria it may be difficult to enforce a reasonable endeavours clause.

Where there is more than one possible course of action, reasonable endeavours will only require that one such course of action is attempted. While positive action is required by reasonable endeavours such action is minimal and as long as some positive action can be shown the obligation is likely to be satisfied.

3.3. **All Reasonable Endeavours**

This lies somewhere in between ‘best’ and ‘reasonable’. In such case the effort required will be more than the minimal effort required by reasonable endeavours but less than the affirmative actions required by best endeavours. For example, where

there is more than one possible course of action more than one such course may need to be attempted but not all. However, where the line will be draw will likely depend on the relevant circumstances.

While it is always preferable to have absolute obligations in a contract it is not always possible or appropriate. In such circumstances the extent of the effort required by the party in question should be considered and, if possible, specifying the criteria required to discharge the obligation is useful. However, where that is not possible, whether you end up at best or reasonable endeavours will likely come down to the strength of the negotiating position of the relevant parties and the importance of the clause in question to the overall contract.

4. TIME IS OF THE ESSENCE

To say something is 'of the essence' in normal language suggests that it is of vital importance. This is also the case in contractual terms but the consequences of missing a deadline were the contract states that 'time is of the essence' can have significant consequences.

4.1. If time is of the essence in relation to exercising a right, then that right will be lost if not exercised within the prescribed time.

4.2. If time is of the essence in relation to the performance of a contractual duty, then that duty is a condition. Therefore, failure to perform the duty within that time period is a repudiatory breach. That is to say, it will give rise to a right of termination by the other side at common law, in addition to other remedies that may be available.

5. WARRANTY OR INDEMNITY – WHAT'S THE DIFFERENCE?

5.1. What is a warranty?

A warranty is a contractual statement. A claim for a breach of warranty gives rise to a contractual claim for damages. The entitlement to damages is such as to put the innocent party in the position it would have been in had it not been for the breach of warranty. A breach of warranty may result in a liability but unless that liability in turn reduces the value of the assets purchased, no damages would be payable. If the value of the asset is reduced as a result of the breach of warranty, then the damages recoverable would be the amount of that loss irrespective of whether this is more or less than the liability incurred.

Accordingly, if you purchased a company for €10, your maximum loss would be €10 notwithstanding that the breach of warranty may have resulted in the company incurring liabilities far in excess of that. A warranty therefore acts as retrospective

price adjustment and the onus is on the buyer to demonstrate breach and quantify the loss arising from that breach.

5.2. **What is an Indemnity**?

An indemnity is a promise to reimburse the indemnified party in relation to a particular type of liability should it arise. It is a contractual promise to make good the loss on a euro for euro basis, rather than an entitlement to sue for damages. Its purpose is to move the risk for a particular matter back to the indemnifier. Indemnities are generally used where there is a specific concern regarding a likely liability or where a claim on foot of a warranty may not be possible or sufficient to adequately compensate euro for euro for the potential liability.

A warranty claim may not be possible or fully compensate the buyer but an indemnity against such liability offers guaranteed compensation to the buyer in that eventuality.

5.3. **Important differences between the two**

5.3.1. A breach or warranty may give rise to a cost or a liability being incurred but that liability may not result in a corresponding diminution in the value of the assets acquired. The entitlement to damages only extends to the amount of the loss of value in the assets and not the actual liability incurred. An indemnity claim on the other hand would entitle the innocent party to be reimbursed for the full cost of liability incurred as a result of the breach of indemnity irrespective of whether it resulted in a loss of value in the assets acquired.

5.3.2. There is a common law obligation to mitigate one’s loss in respect of a breach of warranty but no such corresponding duty for a breach of indemnity

6. JOINT AND SEVERAL OR JOINT OR SEVERAL

Where more than one person takes on an obligation together, their liability may be joint and several, joint or several. When entering into a contract each person must be conscious of what is expected of them under the contract and the implications that may follow should they fail to comply with their obligations.

6.1. **Joint and Several Liability**

This arise where each party is jointly liable but also severally promises that the obligation will be fulfilled by one of them.

A and B jointly and severally agree to pay €100 to C
C is owed €100 and may claim it from either A or B. There are three promises. A and

B jointly promise to pay €100. A promises that €100 will be paid by A or B and B promises that €100 will be paid by wither A or B.

6.2. **Joint Liability**

This is when two or more parties jointly promise to carry out the same obligation for another person. Therefore, there is only one obligation which both parties are fully liable to discharge. Once the obligation is discharged, whether it was discharged solely by one of the parties, the obligation automatically falls away from the other parties who are jointly liable.

A and B jointly agree to pay €100 to C
C is entitled to €100 and may claim the money from either A or B. If one pays the money the obligation of the other is discharged.

6.3. **Several Liability**

This arises when two or more persons make separate promises to another person. The difference with several liability clauses is that each person is liable only for their own specified obligations set out in the contract. If a party is unable to perform their own obligations completely, the other party cannot be compelled to complete those obligations and consequently the responsibility does not pass.

A and B severally agree to pay €100 to C
C is entitled to €200, €100 from each of A and B. There are two separate contracts. One between A and C for €100 and one between B and C for €100. A has no responsibility for sums due by B and vice versa and payment by one of the money owed will not discharge the other. If C is only owed €100 and the obligation is several then it should be expressed a several obligation to pay €50.

6.4. **Proportional liability**

Joint and several is generally the default where there is more than one obligor as this gives the maximum protection to the other party. However, the difficulty is that under joint and several liability, parties can be unfairly burdened for example where a minority shareholder is required to take on the full burden of warranties despite only receiving a minority shares of the proceeds. To deal with this parties often seek to express the obligations as joint or several without understanding what that means and therefore may not in fact decrease the liability of the parties.

In such a case where the parties will not share equally in the proceeds or where it is unreasonable for each party to take on the full obligation, then if it can be negotiated,

you may seek to cap the liability of each party to their pro rata entitlement to the benefit.

7. VARIATION CLAUSES

The general position is that irrespective of what the contract says, if the parties are in agreement, then they can do something different and effectively vary the contract. However, beware, that contracts commonly provide variation clauses that provide that the contract may not be varied unless all parties agree in writing. This may seem sensible and indeed in relation to certain contract essential. However, consider contracts where it may not be appropriate to get all parties to sign a variation each time there is a change for example a partnership or shareholders agreement where things change with time and circumstances and by the course of dealing the parties may change how they do things.

If the contract requires that changes need the express written agreement of the parties, then changes will not be valid without it and it would be open to a party to seek to enforce the original contract terms.

In a recent decision before the Supreme Court in the UK[3], it was held that 'no oral modification' clauses are valid and enforceable. This has been viewed as a departure from the prior position which allowed contracting parties to effectively agree to not be bound by a written variation clause.

When seeking to implement a change to the contract or vary it in any way, parties to that specific contract should ensure that they have adhered to the variation requirements. If a party fails to do so, they will risk being in a position where they are unable to enforce such variations.

However, beware, as if it is likely in practice that it is appropriate that changes be agreed orally and in the course of dealing, then such a clause is not appropriate.

8. ENTIRE AGREEMENT CLAUSE

Despite being the subject of much litigation and contractual disputes the common entire agreement clause is often overlooked and misunderstood.

8.1. What is it?

The purpose of an entire agreement clause is to try and confine the deal being done to what is expressly set out in the written contract between the parties. In addition, such clauses commonly include express language excluding claims for

[3] MWB Business Exchange Centres LTD v Rock Advertising LTD [2016] EWCA

misrepresentation.

8.2. **Entire Agreement statement**

In the normal course all the terms of a contract are as set out in written agreement. In order to avoid any claim to the contrary, such as a claim that matters discussed in negotiations or included in the heads of terms but not ultimately included in the contract form additional terms or collateral side agreements, the contract will expressly state that all the intended terms are included in the relevant documents.

8.3. **Exclusions**

A basic entire agreement statement will not prevent the following:

8.3.1. A claim that one party was induced to enter into the contract on the basis of misrepresentations of the other.

8.3.2. A claim for rectification of an error in the contract if it does not reflect the deal actually done.

8.3.3. A claim based on representations or agreements made after the contract is concluded.

8.3.4. Terms being implied to give the contract business efficacy or external evidence being introduced for the purpose of interpreting the contract.

8.4. **Exclusion of liability for Misrepresentation**

It has been widely held that a bare entire agreement statement will not prevent liability for misrepresentation. Therefore, it is extremely common for entire agreement clauses to expressly exclude liability for misrepresentation. This can be achieved by

8.4.1. including a statement to the effect that neither party has relied on any pre-contractual representations thus precluding a claim for misrepresentation by way of estoppel and/or

8.4.2. including an express limitation on the ability to make a claim or avail of otherwise available remedies in respect of pre-contractual representations.

It is also common for the clause to include a restriction from making a claim for misrepresentation in respect of the contents of the agreement by confining the parties' remedies to breach of contract.

Such clauses are useful but should be carefully considered. As with all contractual clauses, it should set out precisely what it is intended to include or exclude.

Furthermore, caution should be exercised to ensure that the terms of the limitations are reasonable, particularly if dealing with a consumer or where the parties do not have equal bargaining power.

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