COMMERCIAL LAW (LL202)

Course duration: 54 hours lecture and class time (Over three weeks)

LSE Teaching Department: Department of Law

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Pre-requisites: Introduction to legal methods or equivalent

Course Aims:

The course provides an introduction to English/common law commercial law as a whole and focuses on some important aspects. It commences with the basic common law principles governing commercial contracts, including the topic of pre-contractual duties and remedies for breach of contract. The course then considers particular types of transactions in their commercial context including sales, credit and security, syndicated loans, derivatives, multi-party projects, and banking transactions. Aspects of commercial litigation including arbitration will also be considered. These examples are chosen to illustrate the commercial and practical problems arising in different market sectors. A consideration of these paradigms enables an exploration of a wide range of basic principles of law involving contract law, tort law, restitution, and commercial law. The objectives of the course are that students will become familiar with these basic principles of law, so that they can apply them to a wide range of commercial transactions, in the light of the policy objectives which legal regulation pursues, and with an understanding of the context of commercial transactions in which the law operates.

Texts

Reference Texts:

- M. Chen-Wishart, Contract Law, 4th edn (2012) (Abbreviation Chen-Wishart)
- R. Goode, Commercial Law, 4th edition, London, Penguin (2010) (Abbreviation: Goode)
- H. Beale, W. Bishop, M. Furmston, , Contract: Cases and Materials, 5th edn (Oxford, OUP, 2007) (Abbreviation BBF)

Syllabus outline:

Topic 1: Introduction and Freedom of Contract

Topic 2: Terms and their Interpretation

Topic 3: Pre-contractual Duties

Topic 4: Long-term Contracts

Topic 5: Remedies for Breach of Contract

Topic 6: Exclusion Clauses and Agreed Remedies

Topic 7: International Commercial Contracts and Arbitration Sales Law

Topic 8: Multi-party Projects: Privity of Contract and Rights of Third Parties

Topic 9: Sales Law

Topic 10: Credit and Security

Topic 11: Financial law (1) Introduction and Derivatives

Topic 12: Financial law (2) Loans and Bonds

Detailed Syllabus:

Topic 1: Introduction and Freedom of Contract

1. **Freedom of Contract**

What policies and principles should predominate in the approach of the law towards commercial contracts? Should contracts between businessmen be regarded as a field for freedom of contract, so that, subject only to fraud and duress, they should be permitted to make legally enforceable contracts with any content that they choose? Do arguments based upon efficiency support such freedom of contract? Are there any valid policy reasons to limit freedom of contract? Should the law be concerned about fairness? Should the law be concerned about externalities? Is any interference with freedom of contract in commercial contracts an example of unjustified paternalism?

a) **Fairness – The Beguiling Heresy**

Consider Union Eagle Ltd v Golden Achievement Ltd [1997] 2 All ER 215, PC (BBF 590). In this case, the appellant entered a written contract to purchase a flat in Hong Kong for $HK4.2 million, paying a 10% deposit. The contract provided that completion (ie payment of the balance of the price) was to take place before 5.00pm on 30/9/91, that 'time was of the essence in every respect', and that if the purchaser failed to comply with any of the terms of the contract, the deposit was forfeited 'as and for liquidated damages (and not a penalty).' A messenger carrying the payment arrived 10 minutes late at the vendor's solicitor's office, the payment was refused, and the seller purported to rescind the contract and keep the deposit. The purchaser sought specific performance, but was unsuccessful and appealed to the Privy Council. Consider the following questions:

Should the Privy Council have forced the transfer of property (an order of specific performance) or rejected the claim on the ground that the appellant had failed to produce the money on time? Should the claimant be

permitted to rely on an excuse that the messenger was late without fault because the lifts were broken in the building where the defendant's office was located? What policy considerations should influence the court?

Speaking on behalf of the Privy Council, Lord Hoffmann concluded that the claimant was seeking to rely on the 'beguiling heresy' that the courts enjoy an unlimited and unfettered discretion to intervene to give relief from forfeiture of rights where it is unconscionable for the respondent to insist on its contractual entitlements. Lord Hoffmann observed:

> 'It is worth pausing to notice why it continues to beguile and why it is a heresy. It has the obvious merit of allowing the court to impose what it considers to be a fair solution in the individual case. The principle that equity will restrain the enforcement of legal rights when it would be unconscionable to insist upon them has an attractive breadth. But the reasons why the courts have rejected such generalisations are founded not merely upon authority (see Lord Radcliffe in Campbell Discount Co. Ltd v. Bridge [1962] AC 600, 626) but also upon practical considerations of business. These are, in summary, that in many forms of transaction it is of great importance that if something happens for which the contract has made express provision, the parties should know with certainty that the terms of the contract will be enforced. The existence of an undefined discretion to refuse to enforce the contract on the ground that this would be "unconscion¬able" is sufficient to create uncertainty. Even if it is most unlikely that a discretion to grant relief will be exercised, its mere existence enables litigation to be employed as a negotiating tactic. The realities of commercial life are that this may cause injustice which cannot be fully compensated by the ultimate decision in the case.'

In short, Lord Hoffmann argues that any power of the courts to intervene on grounds of fairness threatens to undermine commercial life and therefore such powers should be rejected or at least confined to narrow, certain exceptions.

If the appellant had merely asked for all (or some) of his deposit back, should he have got it? If the contract had stated that in the event of any dispute between the parties, the dispute should be determined by Professor Hugh Collins, in the light of business practice and fairness, but in his absolute discretion, and he had awarded specific performance to the appellant, (mostly because he had never received a Golden Achievement award from the defendant but also because he felt sorry for the appellant who had missed the deadline through no fault of his own), should a court enforce that order?

b) Externalities

The parties to a commercial contract are likely to be concerned about their own interests, but not those of third parties. The question arises when the law ought to control the content of contracts to prevent harm to third parties.

Consider Mayhew v King [2010] EWHC 1121 (Ch). This is an application of the 'anti-deprivation' principle which says, in summary, there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors. This rule protects creditors in the event of insolvency by preventing the debtor from transferring assets out of the reach of creditors.

What other kinds of externalities (interests of 3rd parties), if any, should be grounds for invalidating commercial contracts?

E.g. Competition law/anti-trust law (to protect consumers and other competitors).

2. Formation of Contracts

For a binding contract to be formed in English common law, the parties must reach 'agreement' and the agreement must be supported by 'consideration'.

a) Agreement

Chen-Wishart, Chapter 2.

(1) Offer and Acceptance

As in most legal systems, the test of whether and when the parties have reached an agreement is usually determined through an analysis of offer and acceptance. In Gibson, the court insists on strict fidelity to the rules of offer and acceptance with the effect that even though the parties were in agreement on the principal terms (price and subject matter), there was no binding contract. Gibson v Manchester City Council [1978] 1 WLR. 520, [1978] 2 All ER 583, CA; reversed, [1979] 1 WLR.294, [1979] 1 All ER 972, HL; BBF: 195. In the Court of Appeal, Lord Denning said that 'one ought to look at the correspondence as a whole and at the conduct of the parties and see therefrom whether the parties have come to an agreement on everything that was material'. Lord Diplock, in the HL, insisted on a 'conventional' approach of seeking in the written documents an 'offer' and an 'acceptance' on the same terms. Which approach best corresponds to the reasonable expectations of businesses?

Although the common law does not permit acceptance by silence, it does permit acceptance by the conduct of performing the contract. Brogden v. Metropolitan Railway Co (1877) 2 App Cas 666, HL; BBF: 208

(2) Battle of Forms

Businesses usually prefer to enter contracts on their standard terms of business. The parties may believe or at least hope that they have reached an express agreement, but in fact the inconsistency of the standard forms of business combined with the insistence of both parties to have their own standard form govern the transaction raises a doubt whether agreement on (significant) details was ever reached.

A court in the UK can decide (a) that no contract was agreed; or (b) the terms of one party's standard form governed the contract; or (c) that a contract was agreed but not on either party's standard form terms.

Butler Machine Tool Co Ltd v Ex-Cell-O Corpn (England) Ltd [1979] 1 All ER 965, CA (BBF 225)

Is there a last shot rule? If so, is it justified? Can the court apply such a rule without ignoring some of the evidence that the parties had not yet reached agreement?

Are there any other possible options to resolve the issue?

UNIDROIT General Principles for International Commercial Contracts, Art.2.22 (BBF 229)

> 'Where both parties use standard terms and reach agreement except on those terms, a contract is concluded on the basis of the agreed terms and of any standard terms which are common in substance unless one party clearly indicates in advance, or later and without undue delay informs the other party, that it does not intend to be bound by such a contract'.

Would this rule resolve the problem in Butler Machine Tool?

The empirical evidence is that battle of forms problems are frequent, that businesses know that there is a problem of inconsistency, yet proceed with transactions nevertheless. Often they are concerned to reach agreement on the 'real deal', but not necessarily on the 'paperwork'. How might a business view an insistence by the other party on sorting out the paperwork before any contract can be concluded?

(3) Never Reaching an Agreement

In some cases, it is clear that the parties never reached an agreement and never supposed that they had done so, yet despite the absence of an express contract, performance on the contract may have started, or even have been completed. What are the rights of the parties with respect to work performed and goods delivered in anticipation of a contract? In the absence of a contract, what is the legal basis for a claim? 5

British Steel Corp v Cleveland Bridge and Engineering Co Ltd [1984] 1 All ER 604 (BBF 39)

What kind of remedy does this leave the seller to recover payment for the work and goods? Breach of contract, tort, restitution? Which solution would the buyer prefer, and which the seller? Why are contracts performed before a contractual agreement has been completed?

(4) The Significance of the Formal Agreement

In some cases, the parties are agreed on pretty much everything, but they have not completed the final step, such as an exchange of signed written contracts, as required under the terms of their agreement, yet performance of the contract has commenced and perhaps even been completed. Does the failure to complete the final step mean that there is no contract?

**RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH and Co KG [2010] UKSC 14, [2010] 1 WLR 753*

(b) The Common Law Doctrine of Consideration

Chen-Wishart, Chapter 3

(1) Concept of consideration:

The idea of an exchange. The exclusion of donative promises.

Two concepts of consideration?
- Mutual requests
- Benefit and Burden

Requests and Conditional Promises: *Shadwell v. Shadwell (1860) 9 CBNS 159, 142 ER 62; BBF: 124*
Unilateral Contracts: promise in return for requested action that is performed

Implied requests

Adequacy of consideration

Pre-existing Duty: Different types of duties:
general legal duties: eg promise not to hit someone
contractual duties owed to third parties: eg promise to perform a term of employment
modification of contracts: Williams v Roffey Bros & Nicholls (Contractors) Ltd [1991] 1 QB 1, [1990] 1 All ER 512, CA; BBF 111 Should consideration be a requirement for modifications?

Is the doctrine of consideration a covert mechanism for testing the fairness of transactions?
Does the test of consideration conform to a test of efficiency (wealth-maximisation)?

(2) Intention to Create Legal Relations

The need for a qualification to the doctrine of consideration due to over-inclusiveness.
The origins of the doctrine of intention to create legal relations

(3) Equitable Estoppel

Is there a second substantive test of legal enforceability to deal with a problem of under-inclusiveness in the doctrine of consideration? The reliance model suggests that unrequested detrimental reliance upon a promise or undertaking should be protected by an equitable remedy where the reliance was reasonable and where it would be unconscionable to default on the promise or undertaking.
Proprietary estoppel: Crabb v. Arun District Council [1975] 3 All ER 865, CA; BBF: 155
Is this contract? A promise is enforced, but the remedy is equitable (order to grant right of way), and no compensatory damages awarded (yet).

Questions for Class Discussion:

1. What does 'freedom of contract' mean? How does it opearate in practice?

2. Assess the justice of the decision in Union Eagle Ltd v Golden Achievement Ltd.

3. What are the reasons often given for distinguishing between the law governing commercial contracts (between 2 businesses) and the law governing other sorts of contracts such as consumer contracts? Are there good reasons for favouring freedom of contract in commercial contracts?

4. What factors should a judge take into account in deciding whether parties who have
5. commenced work prior to the completion of a formal contract should be given
6. contractual or restitutionary remedies?

7. Does English law need a doctrine of consideration as a test for the enforceability of contracts, or could it be safely abolished? What purposes does it serve?

Topic 2: Express Terms, Implied Terms, and Interpretation

When asked to advise on a dispute regarding a commercial contract, the first, and quite possibly the last, thing an English lawyers will do is ask to read the express terms of the written agreement and then apply them to the dispute at hand. This practice rests on the assumptions that (a) the court will almost invariably enforce the express terms of the contract because of their fidelity to the principle of freedom of contract, (b) that such terms are readily discoverable, (c) that a court will not add additional obligations (implied terms), and (d) that the meaning of the express terms is readily apparent. The following materials investigate the plausibility of the assumptions in (b),(c), and (d).

Chen Wishart, Chapter 10

1. Discovering the Express Terms

(a) Objective Test of Express Terms

'If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms. (Blackburn J. Smith v Hughes (1871) LR 6 QB 597, BBF 303).

Rectification of inaccuracy in written agreement: *Rose v. Pim [1953] 2 All ER 739, [1953] 2 All ER 739, CA BBF: 307*

(b) Standard Form Contracts and Incorporation

Signature binding: *L'Estrange v F Graucob Ltd. [1934] 2 KB 394 (BBF 345)*

Requirement to take reasonable steps to give notice of terms, and the more unusual and onerous the terms, the more steps that are required:

Interfoto Picture Library Ltd. v Stilletto Visual Programmes Ltd [1988] 1 All ER 348, CA (BBF 336). Dillon LJ 'if one condition in a set of printed conditions is particularly onerous or unusual, the party seeking to enforce it must show that that particular condition was fairly brought to the attention of the other party.' Bingham LJ 'the plaintiffs did not do what was necessary to draw this unreasonable and extortionate clause fairly to their attention.'

AEG (UK) Ltd v LogicResource Ltd [1996] CLC 265, CA (BBF 339). Contract for sale of cathode ray tubes on seller's standard terms, but detailed terms not given to buyer but only available on request. Clause 7.1 gave a warranty against defects caused by faulty materials and bad workmanship, but in 7.7 otherwise excluded implied terms under SGA, and in 7.5. required the purchaser to return goods at its own expense. CA found clause 7 contrary to UCTA. Majority also found clause 7 not included as unusual or onerous; but Hobhouse LJ dissented, saying this term was of the kind one expects to find in commercial contracts. Would it make a difference if the contract had been signed by the buyer? 8

(b) Forgetting the Form

What happens if the seller forgets to use the written form (containing the normal disclaimers)? Does that mean that the form is not incorporated into the contract? Not always:

i. course of dealing: Henry Kendall & Sons v William Lillico & Sons Ltd (The Hardwicke Game Farm Case) [1969] 2 AC 31 (BBF 339);

ii. standard terms of trade: British Crane Hire Corporation Ltd v Ipswich Plant Hire Ltd [1974] 1 All ER 1059, CA (BBF 340).

Would such arguments be accepted in contracts where the buyer is a consumer?

2. Implied Terms

(a) Sources of Implied Terms in the judge-made Common Law

There are several sources:

i. unexpressed intention (officious bystander/business efficacy tests of intention);
ii. importation of general legal obligations (eg duty to be careful in contracts for services (ie the duty of care/negligence liability of Donoghue v Stevenson));
iii. model or standard types of contracts, with standard incidents.

Liverpool City Council v Irwin [1977] AC 329, HL (BBF 415) (implied term that landlord owed a duty to take reasonable care to keep in reasonable repair and useability the common parts of the premises)
Mahmud and Malik v BCCI [1998] AC 20 (BBF 455)

(b) Sources of Implied Terms in Statute: e.g. Sale of Goods Act 1979, s 14

(c) General principle that implied terms cannot override express terms:

Johnstone v Bloomsbury Health Authority [1991] 2 All ER 293, CA (BBF 443)
Paragon Finance plc v Nash [2001] EWCA Civ; [2002] 1 WLR 685, CA

But by statute this may occur (ie compulsory terms) eg term of satisfactory quality in sales of goods to consumers cannot be excluded.

(d) Justification

What is the justification for implied terms (ie law's insertion of additional obligations)? Save on transaction costs? Fairness? Risk allocation? Efficiency?

3. Interpretation

Chen-Wishart, Chapter 10

It is said that 99% of litigated cases concerning commercial contracts turn on questions of interpretation, construction, or meaning of contracts. Why do written contracts cause such a problem? Is the problem that the parties do not always say what they mean or do not always mean what they say? Or is the problem that lawyers write the contracts and don't know what the parties mean? Or is the problem really one derived from the indeterminacy of language in general? Or is the problem caused by the courts because they lack a consistent approach to interpretation of the express terms of contracts? Or is the problem that the courts try to secure a fair result regardless of what the contract says? Collins, 228-231

Thake v Maurice [1986] QB 644, [1986] 1 All ER 497, CA (BBF 330)

*Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 All ER 98 (Lord Hoffmann) (BBF 399)
Schuler AG v Wickman Machine Tools [1974] AC 235, HL (BBF 409, 599)
*Bank of Credit and Commerce International v Ali [2001] UKHL 8, [2002] 1 AC 251, HL (BBF 848)

There seem to be three possible basic approaches to the interpretation of written contracts:

1. A search for the actual intentions of the parties to the contract;
2. An application of the literal meaning of the words contained in the document;
3. An enquiry into what a reasonable person or reasonable promisee would have understood to have been the meaning of the words.

The choice between these different approaches is usually guided by appeals to a variety of policy considerations, including:

- certainty;
- fairness;
- theories of the basis of contracts eg 'will theory', 'reliance theory';
- promoting the utility of using written documents for business planning;
- costs of litigation.

The approach in (1) ('subjective intention') seems to be condemned on various grounds:

- actual intention is often hard for a court to establish;
- the approach may merely reveal that the parties had different intentions;
- the approach does not pay sufficient attention to the actual documents, because it seems to open up the possibility of arguments that whatever the parties may have agreed in writing their actual intentions were completely different so the court can (and should) ignore the written contract.

The approach in (2) ('literalism' or 'formalism') is also condemned on various grounds:

- the meaning of words is not fixed, but must be understood in the context in which it is used;
- literal meanings may lead to absurd results or at least commercially improbable results in some circumstances;
- it ignores the actual intentions of the parties'

The approach in (3) ('objective promisee') is also condemned on various grounds:

- the courts may end up enforcing a contract that neither party actually wanted or intended
- it may sometimes allow the courts to ignore the literal meaning of the words completely

See Sir Christopher Staughton, 'How Do the Courts Interpret Commercial Contracts?' (1999) Cambridge Law Journal 303-313?

'Canons of interpretation' are rules, guides that the courts use when interpreting contracts:

1. The document must be construed as a whole: do not look at clauses in isolation, but interpret them in light of the whole document.

2. In construing a contract, all parts of it should be given effect where possible, and no part should be treated as inoperative.

3. Where a contract contains special provisions as well as general ones, specific provisions will be given greater weight.

4. Where a contract is a standard form contract to which the parties have added special conditions, then (unless the contract provides otherwise), greater weight will be given to the special provisions.

5. The reasonableness of the result of any particular construction is a relevant consideration when choosing between rival constructions.

6. Where there is a doubt about the meaning of a contract, the words will be construed contra proferentem.

See Lord Hoffmann in Investors Compensation Scheme ltd v West Bromwich Building Society [1998] 1 All ER 98, HL (BBF 399): 11

1. Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.

2. The background or 'matrix of fact' includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.

3. However, previous negotiations of the parties and their declarations of subjective intent are excluded for practical policy.

4. The meaning which a document would convey to a reasonable man is not the same thing as the literal meaning of its words as ascertained in dictionaries.

5. A judge may occasionally conclude that the parties have made a linguistic mistake if the ordinary meaning of the words leads to a conclusion that flouts business common sense or suggests an intention of the parties that they plainly could not have had.

Lord Hoffmann's restatement has been much cited and on some level is regarded as authoritative. One important aspect of his approach is that he discards any precedents on the interpretation of particular terms in contracts and any general principles for interpretation other than those cited above. Lord Hoffmann asks: 'If

interpretation is the quest to discover what a reasonable man would have understood specific parties to have meant by the use of specific language in a specific situation at a specific time and place, how can that be affected by authority?' It is not clear that other judges accept this implication of his position: eg BCCI v Ali.

Everyone seems to agree that 'certainty' is very important? Why? What does certainty mean in this context? Is it the most important consideration? If not, what is? And which approach achieves the greatest certainty?

It also seems to be agreed that the prior negotiations between the parties should not be relevant to the question of the meaning of the contract: Chartbrook Ltd v Persimmon Homes Ltd [2009] UKHL 38. Does that make sense? Do Staughton LJ and Lord Hoffman give a good explanation of this exclusion? Everyone agrees that 'rectification' is a limited exception to this rule. Also Lord Hoffmann would admit evidence of the background facts including the use of 'private language' and the commercial purpose of the transaction, which may indirectly involve reference to the negotiations, if not the precise negotiating positions.

It also seems to be agreed that subsequent conduct by the parties in the performance of the contract should be irrelevant to the question of the meaning of the contract (see Schuler v Wykman Tools). Does that make sense? Goode comments: 'Very often the record of negotiations culminating in the contract is the best guide to the intention of the parties, as is their behaviour subsequently'. He suggests that these legal restrictions are 'widely ignored in practice' (though no evidence is cited).

Questions for Class Discussion

1. What is the difference between express and implied terms?

2. On what basis are terms implied into contracts? Are all implied terms implied for the same reasons?

3. 'While academic commentators have welcomed Lord Hoffmann's liberal approach to interpreting contracts, practitioners are dismayed by it'.

4. Discuss.

5. Should judges be able to take into account the parties' pre-contractual negotiations when interpreting contracts?

Topic 3: Pre-contractual duties and the duty of good faith

Pre-contractual duties and the duty of good faith

1. Introduction

Traditionally, the general principle of English law is that parties owe each other no duties during the process of negotiation but with some exceptions (e.g. misrepresentation, fraud).

The rationale of this general principle is that (a) parties are free during negotiations to find the best deal the market has to offer, and (b) imposing obligations on parties before they voluntarily assume them is an interference with liberty and freedom of contract.

However this general principle is viewed today with some scepticism for reasons which will be discussed. Accordingly, it has been suggested in recent years that English law (a) should have or (b) does have a different underlying principle. The most common formulation of that principle is the duty to bargain in good faith, a duty recognised in some other legal systems in Europe (e.g. Germany's principle of 'culpa in contrahendo'). There are other possible formulations e.g. the duty to bargain with care.

Would the recognition of a different underlying principle make any difference in practice?
Would the adoption of such a general principle be too vague to be workable?

This topic requires that you know (a) the scope of the 'exceptions' to the traditional principle of no obligations (b) have a view on whether the 'exceptions' already comprise a different principle (c) if so, what that principle is, and (d) what difference in practical results the (open) adoption of a different principle would make in English law.

Reading (focus on starred items):

- *Walford v. Miles [1992] 2 A.C. 128; BBF 271
- *Esso Petroleum Co Ltd v. Mardon [1976] 2 All ER 5; BBF 328
- East v. Maurer [1991] 2 All ER 733, CA; BBF 372
- Misrepresentation Act 1967, s2(1); BBF 372, 377
- *Petromec Inc v Petroleo Brasiliero SA Petrobas [2005] EWCA Civ 891, paras 120-121
  Multiplex Constructions UK Ltd v Cleveland Bridge Ltd [2006] EWHC 1341 (TCC) (part of the extensive litigation over the Wembley Stadium: see para 15: Part 2 for background facts. Reading should then focus on para 633 onwards: Part 14/Issue 9).
  JSD Corp PTE v Al Waha Capital PJSC [2009] EWHC 3376 (Ch)
  *Rt. Hon Lord Steyn, 'Contract law: Fulfilling the Reasonable Expectations of Honest Men' (1997) 113 LQR 433
  M. Bridge, 'Doubting Good Faith' (2005) 11 New Zealand Business Law Quarterly 426
  R. Brownsword, Contract Law: Themes for the Twenty-First Century, Chapter 5; BBF extracts pp 283-287
  N. Cohen, 'Pre-Contractual Duties: Two Freedoms and the Contract to Negotiate' in J. Beatson and D. Friedmann (ed.) Good Faith and Fault in Contract Law (1995, Oxford: OUP), chapter 2
  Goode, pp 95-6

2. The general principle

The general principle in English law is that there is no obligation during the process of negotiation owed by parties to each other. Traditionally the English courts are reluctant to recognise a duty to negotiate in good faith. Walford v. Miles. 14

Considering the decision in more detail:

a) Did the purchaser receive damages despite the finding that the lock-out agreement was unenforceable? What effects would upholding the lock-out agreement have had in practice? Why was the lock-out agreement held to be binding in JSD Corp PTE v Al Waha Capital PJSC [2009] EWHC 3376 (Ch)?
b) Compare the status of agreements to use 'best endeavours' (i) in the performance of a contract, and (ii) in the negotiation of a contract? Little v Courage Ltd (1995) 70 P. & C.R. 469; Multiplex Constructions UK Ltd v Cleveland Bridge Ltd [2006] EWHC 1341 (TCC) (part of extensive litigation over the Wembley Stadium).
c) What if there is an express agreement to negotiate in good faith? Petromec Inc v Petroleo Brasiliero SA Petrobas [2005] EWCA Civ 891.

3. What might the 'exceptions' to the general principle about parties' negotiations be?

(a) Misrepresentation and misleading statements
    (i) Equitable remedy of rescission.

(ii) Damages:

- fraud/deceit in tort. *East v. Maurer [1991] 2 All ER 733, CA; BBF 372

- negligent misstatement in tort under Hedley Byrne. *Esso Petroleum Co Ltd v. Mardon [1976] 2 All ER 5; BBF 328, Box v. Midland Bank plc [1979] 2 Lloyd's Law Reports 391, South Australian Asset Management Corp. v. York Montague Ltd [1997] AC 191, [1996] 3 All ER 365, BBF 384. (Note the SAAMCO case and others e.g. Nykredit Mortgage Bank plc v. Edward Erdman Group Ltd [1997] 1 WLR 1627 arose from the property boom and crash of the early 1990s and there may be similar issues in the cases which emerge from the credit crunch and its fallout.)

- Misrepresentation Act 1967, s2(1); BBF 372, 377. There are advantages for claimants in proceeding under the Act.

- Breach of collateral contract (collateral warranty). Esso Petroleum Co Ltd v. Mardon.

- (not available for innocent misrep).

(b) Failure to disclose information

i. Terms: Interfoto v. Stiletto [1998] 1 All ER 348 and see week 1's lecture.
ii. Facts: Contracts of utmost good faith/ uberimmae fidei e.g. insurance. In practice this means that insurance contracts may be vulnerable to challenge by insurers. Carter v Boehm (1766) 3 Burr. 1905

(c) Abuse of positions of trust

Duty of good faith owed to principal by agent/fiduciary. Goode p 177 onwards.
An example of a fiduciary relationship is business partners' relationships to one another (e.g. in law firms). It has recently been argued, unsuccessfully, that a commercial banking relationship between an investment adviser and an allegedly "unsophisticated investor" client gave rise to fiduciary duties: JPMorgan Chase v. Springwell [2008] EWHC 1186 (Comm). (Fiduciary relations discussed at para. 572 onwards). (Appeal since dismissed by Court of Appeal).

(d) Misuse of confidential information

i. Implied contract to use information only for authorised purposes.
ii. Tort of disclosure or misuse of 'confidential' information.

(e) Misleading implied promises

i. Collateral Contracts.
Walford v. Miles; Blackpool and Fylde Aero Club Ltd v. Blackpool Borough Council [1990] 1 WLR 1195, [1990] 3 All ER 25, CA; BBF 244
ii. Estoppel and restitution
Walton Stores (Interstate) Ltd v. Maher (1988) 164 CLR 387, High Ct. of Australia; BBF 158
Crabb v. Arun DC[1975] 3 All ER 865, CA; BBF 155
Hoffman v. Red Owl Stores Inc 26 Wis 2d 683, 133 NW 2d 267 (1965); BBF 281

Drennan v Star Paving Co 51 Cal 2d 409, 333 P 2d 757 (1958); BBF 249
British Steel Corp v. Cleveland Bridge & Engineering Co Ltd [1984] 1 All ER 504; BBF 39
Regalian Properties plc v. London Docklands Development Corp [1995] 1 WLR 212; BBF 281

Do these 'exceptions' constitute a different principle?
If so, what is that principle?

4. Traditionally the English courts are reluctant to recognise a duty to negotiate in good faith. Why?

a. The courts are wary of over-broad principles not susceptible to clear and concise application. Moreover, there is no consensus on what its content would be or how to strike a balance between the interests of parties in commercial negotiations.

b. The parties are free during negotiations to find the best deal the market has to offer- i.e. this is part of the operation of the free market: "the legitimate pursuit of self-interest" (Goode, p106)

c. Imposing obligations on parties before they voluntarily assume them is an interference with liberty and freedom of contract.

d. Would the remedies in respect of this duty be impossible to assess? What, if any, analogies may be drawn with other types of claims which are allowed e.g. for loss of a chance? Would this additional means of redress add anything to the existing remedies available?

5. Contrast the position in English law with other legal systems.

A number of other legal systems have a requirement of good faith in negotiations, including:

(a) Principles of European Contract Law

Article 2.301- Negotiations Contrary to Good Faith
(1) A party is free to negotiate and is not liable for failure to reach an agreement.
(2) However, a party who has negotiated or broken off contrary to good faith is liable for the losses caused to the other party.
(3) It is contrary to good faith, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.

(b) UNIDROIT (2010)

Article 2.1.15: Negotiations in bad faith
(1) A party is free to negotiate and is not liable for failure to reach an agreement.
(2) However, a party who negotiates or breaks off negotiations in bad faith is liable for the losses caused to the other party.
(3) It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.

(c) Civil law jurisdictions, e.g. Germany and other common law jurisdictions e.g. US, Teachers Insurance and Annuity Association of America v Tribune Company [1987] 670 F.Supp 491.

Are the situations covered by this requirement of good faith in these legal systems resolved in a different way in this jurisdiction?

6. What difference in practical results would the (open) adoption of a different principle make in English law?

Would the recognition of a different underlying principle make any difference in practice?
Would the adoption of such a general principle be too vague to be enforced?
How would it affect adversarial types of commercial relationship?

What other principles have been suggested in respect of this jurisdiction?

7. Conclusion

JPMorgan Chase v. Springwell [2008] EWHC 1186 (Comm) and Springwell Navigation Corp v JPMorgan Chase and ors [2010] EWCA (Civ) 1221; Bankers Trust International PLC v PT Dharmala Sakti Sejahtera [1995] HC, QBD Comm Ct.

In both cases investors sought to avoid liability and/or seek damages in relation to investments which (in the first case) suffered heavy losses due to the Russian financial crisis in 1998 and (in the second) had exposed the investor by way of a swap to $65million losses because of a rise in interest rates. The cases are useful to consider at the conclusion of this topic for two reasons. First, they show how claimants in this jurisdiction deploy a wide range of the 'exceptions' discussed above in order to attempt to make their case. For example, at first instance, Springwell argued "breach of contract, negligence, breach of fiduciary duty, negligent mis-statement and/or misrepresentation under s.2 of the Misrepresentation Act 1967.." Secondly, these two cases offer interesting examples of the courts' approach to sophisticated investors in this position; in neither case was the investor successful in its claims.

Questions for discussion in class:

Please prepare answers to the following questions, which your class tutors may use as the basis for discussion in the class.

1. Does the law impose duties on the parties at the pre-contractual stage?

2. What justifications can be advanced for the approach taken by English law? Are they convincing?

3. Do you think that English law manages to achieve a fair balance between the interests of the parties?

4. X plc is a large UK-based manufacturing company. In each of the following scenarios, advise X as to its obligations (if any) to its prospective counterparty.

(a) X is in negotiations with B, an insurance company. X's management is concerned because its in-house weather forecasting unit has predicted a wet summer, which is likely to hit sales of one of its core products, plastic garden sunloungers. X is seeking insurance to cover this eventuality.

(b) X is in negotiations with C, a large investment bank. X intends to protect its position as regards the possible wet summer by entering a contract with C, where in return for a premium, C will pay X if certain weather events occur.

3. The concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making representations.
Lord Ackner in Walford v Miles [1992] 2 A.C. 128, 138.

Why have the courts found that imposing a duty of good faith in this context would be "repugnant"? Do you think that the general principle in Walford v Miles is due for reconsideration?

Topic 4 Long-term Contracts: formation and variation

Most commercial contracts occur within a long-term business relationship. In some instances, the contracts may be discrete transactions, but form part of a continuing series of similar transactions. In other instances, the parties enter into a long-term contract that tries to govern the performance of the business relation over a lengthy period of time.

Formation

Beale, Bishop and Furmston, chs. 9-10, pp. 259-308.
Chen Wishart, pp. 77-102, 244-63

1. **Commonly used terms in commercial contracts**

   The Chikuma [1981] 1 WLR 314 HL

2. **Factors leading to uncertainty**

   (a) Agreements to negotiate

   Walford v. Miles [1992] AC 128
   Petromec Inc v. Petroleo Brasileiro SA Petrobras [2005] EWCA Civ 891.

   (b) Letters of Intent

   British Steel Corporation v Cleveland Bridge Engineering Co [1984] 1 All ER 504.
   G Percy Trentham Ltd v. Archital Luxfer Ltd [1993] 1 Lloyds Rep 25.
   RTS Flexible Systems Ltd v. Molkerei Alois Muller GMBH & Co KG [2009] EWCA Civ 26, [2010] 1 WLR 753.
   Benourad v Compass Group plc [2010] EWHC 18

3. **Price Variation**

   May and Butcher v. R [1934] 2 KB 17
   Hillas & Co Ltd v Arcos Ltd (1932) 147 LT 503

4. **Mistakes**

   (a) Mistakes in recording the transaction and Rectification

   (b) Mistakes as to the subject matter of the contract

   (i) Cross-purpose mistakes

Raffles v Wichelhaus (1860) 2 H & C 906

(ii) Unilateral Mistake as to Subject matter

Smith v Hughes (1871) LR 6 QB597

(iii) Common Mistakes as to Subject Matter

Contractual provision

McRae v Commonwealth Disposals Commission (1951) 84 CLR 377

Res extincta

Couturier v. Hastie (1856) 5 HLC 673.
Sale of Goods Act of 1979 s 6

Res sua

Cooper v. Phibbs (1867) LR 2 HL 149.

Mistake of 'quality'

Bell v. Lever Brothers [1932] AC 161.
Leaf v. International Galleries [1950] 1 All ER 693.

Mistake in Equity

Solle v Butcher [1950] 1 KB 671.
Associated Japanese Bank (International) Ltd v Credit du Nord [1988] 3 All ER 902.

Common Mistake Rethought

Great Peace Shipping v Tsavliris [2002] EWCA Civ 1407

Contractual variation and frustration

Beale, Bishop and Furmston, pp. 97-174, 459-98.
Chen-Wishart, chapters 3, 7.

(a) Variation of an existing contract

(i) The problem of consideration for the variation

Foakes v. Beer (1884) 9 App Cas 605
Williams v. Roffey Bros [1990] 1 All ER 512, [1991] 1 QB 1
Re Selectmove Ltd [1995] 1 WLR 474, [1995] 2 All ER 531,
Attrill & Others v. Dresdner Kleinwort Limited [2012] EWHC 1189 QB

(ii) Variation and Economic Duress

Pao On v Lao Yiu Long [1979] 3 All ER 65
Universe Tankships of Monrovia v International Transport Workers' Federation: 'The Progress Bulk Carriers Limited v Tube City IMS LLC [2012] EWHC 273 (Comm)

(iii) Effect of Economic Duress

North Ocean Shipping v. Hyundai : The Atlantic Baron [1979] QB 705.
Adam Opel GmbH v. Mitras Automotive (UK) Ltd [2007] EWHC 3481 (QB).

(b) Waiver and Estoppel

(i) Waiver 'in the sense of forbearance'

Hickman v. Haynes (1875) LR 10 CP 598
Hartley v. Hymans [1920] 3 KB 475
Charles Rickards Ltd v Oppenhaim [1950] 1 KB 616.

(ii) Promissory Estoppel

Central London Property Trust v High Trees House [1947] KB 130.
D & C Builders v. Rees [1966] 2 QB 617. 2
Combe v. Combe [1951] 2 KB 215.

(d) Frustration

(i)The doctrine

Paradine v Jane (1647) Aleyn 26
Taylor v Caldwell (1863) 3 B & S 826
Davis Contractors Ltd v Fareham Urban District Council [1956] A.C. 696

(ii) Frustrating events

- Thing ceases to exist: Taylor v Caldwell (1863) 3 B & S 826
- Personal service: Robinson v Davison (1871) LR 6 Ex 269
- Non occurrence of event: Krell v Henry [1903] 2 KB 740

- Supervening illegality: Denny, Mott v James Fraser [1944] AC 265
- Intervening event: Fibrosa Spolka v Fairbairn [1943] AC 32, B.P. Exploration (Libya) Ltd v Hunt [1983] 2 A.C. 352
- Failed adventure: Jackson v Union Marine Insurance (1874) LR 10 CP 125, The Nema [1982] A.C. 724

(iii) Non-Frustrating events

- Failure of supply: Blackburn Bobbin Co Ltd v T.W. Allen Ltd [1918] 2 K.B. 467
- Increased cost: The Eugenia [1964] 2 Q.B. 226
- Foreseeable events: The Eugenia [1964] 2 Q.B. 226
- Fault: Maritime National Fish Ltd v Ocean Trawlers Ltd [1935] A.C. 524, The Super Servant Two [1990] 1 Lloyd's Rep 1

(iv) Remedies

- Appleby v Myers (1867) LR 2 CP 651
- Law Reform (Frustrated Contracts) Act 1943
- BP (Exploration) Libya v Hunt [1982] 2 W.L.R. 253 (HL)
- Gamerco S.A. v I.C.M./Fair Warning (Agency) Ltd [1995] 1 WLR 1226;

Long-Term Contracts – Class material

1. What factors lead to uncertainty in the negotiation of commercial contracts? How can parties minimise the dangers of uncertainty?
2. 'The decision in The Great Peace has finally put the law of common mistake on a rational basis.'

   Discuss.

3. Gemma's Gems is a company which makes high quality designer jewellery for the rich and famous. The company specialises in diamond necklaces. They contact the offices of Ciara's Carats, who are diamond merchants in London, to buy diamonds. Gemma orders £1m worth of 'Matamela' diamonds. These are unique diamonds, for they come only from one diamond mine in southern Africa. Gemma intends to make a unique 'Matamela' necklace, for which a buyer has offered her £10m. Unknown to both parties, there are no more diamonds to be found in the Matamela mine: the last of these diamonds was extracted from the mine in 2010. Gemma also agrees to buy the entire shipment of diamonds aboard the Windhoek, bound for Southampton. In fact, there are two ships called the Windhoek carrying diamonds, both of which are sailing for Southampton.

   Advise Gemma. Does Foakes v Beer have any continuing practical relevance?

4. Does Foakes v Beer have any continuing practical relevance?

5. On 1 January, Myrtle Shipping agrees with Adam's Apples to ship for it 10,000 tons of apples on their ship the Myrtle I from Southampton to Mumbai at £2 per ton freight. On 10 January, while the ship is waiting to load, a revolution takes place in Egypt and the Suez canal is blocked. The voyage will have to be round the Cape of Good Hope and will take three times as long. During this time, the apples may deteriorate and be suitable only as cattle feed. On 12 January, Myrtle repudiates the agreement, and hires the ship out to another client. On 14 January, the canal reopens.

   Advise Adam's Apples.

6. The Green Broad Beanz are a popular rock group, made up of 12 musicians. They are on a long tour of Europe to promote their latest record. They contract with Osborne Macaroon, a famous promoter, to promote their London concert. Osborne guarantees that he will pay the group £10 million, or 85% of the profits of the tickets, whichever is greater. He pays them an advance of £2 million. When performing in Paris, the drummer commits acts of indecency on stage. Potential concert goers are offended by such acts, and ticket sales are extremely poor. The lead singer is also infuriated by this. On the night before the concert, he loses his temper and screams so loudly at the drummer that he loses his voice. The concert is cancelled. Osborne has to refund all the tickets he has sold. The Green Broad Beanz claim they have incurred great expenses in preparing for the concert. They do however have insurance to cover the loss arising from the cancellation of any concerts.

   Advise Osborne

Topic 5 Remedies for Breach of Contract

Chen-Wishart, Chapters 12, 13, 14.

I. The Aims of Remedies for Breach of Contract

Pacta sunt servanda ?

- encourage keeping promises / deter breach

- ensure that breach does not amount to 'loss'
- encourage settlement of disputes

II. Actions for Debt

(1) Claim for money owed - action for the agreed price:

Sales of Goods Act 1979 s 49(1) – Where, under a contract of sale, the property in the goods has passed to the buyer and he wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may maintain an action against him for the price of the goods.

(2) Simplified procedure, leading to a court order for the debtor's assets to be seized and sold up to the value of the debt.

(3) Debt must be 'due' – not if:

- already been paid
- the time for payment not reached

UTCCR – SI 1999/2083, Schedule 2
1. [Terms which may be regarded as unfair are those] which have the object or effect of- … (o) obliging the consumer to fulfil all his obligations where the seller or supplier does not perform his.

- performance not substantially fulfilled (eg SGA s 14(2))

When a contract provides for a specific sum to be paid on completion of specified work, the Courts lean against a construction of the contract which would deprive the contractor of any payment at all simply because there are some defects or omissions. The promise to complete the work is therefore construed as a term of the contract, but not as a condition. … It is, of course, always open to the parties by express words to make entire performance a condition precedent…
Hoenig v Isaacs [1952] 2 All ER 176, CA per Denning LJ

'The present rule is that so long as there is a substantial performance the contractor is entitled o the stipulated price, subject only to a cross-action or counterclaim [or set-off] for the omissions or defects in execution... The converse, however, is equally correct – if there is not a substantial performance, the contractor cannot recover. ... This rule does not work hardly upon a contractor if only he is prepared to remedy the defects before seeking to resort to litigation to recover the lump sum.'
Bolton v Mahadeva [1972] 1 WLR 1009 per Sachs LJ

III. Termination for Breach of Contract

1. Not a 'judicial' remedy… but eventually subject to judicial control ('was repudiation wrongful?')

2. Rule: Termination is available if

'the occurrence of the event deprive[s] the party who has further undertakings still to perform of substantially the whole benefit which it was the intention of the parties as expressed in the contract that he should obtain as the consideration for performing those undertakings'.
Hong Kong Fir Shipping Co Ltd v Kawasaki [1962] 2 QB 26 per Diplock LJ

Situations:

- Repudiation: the other party treats the party as not existent or announces its total default ('anticipatory breach')
- Express termination clauses: the parties defined what king of breach allows termination
- Breach of condition (↔ warranty): the contract (implicitly) characterizes an obligation as such that its breach would deprive the injured party of what is substantiall deprived of what is entitled to.
  → problems of interpretation
  (e.g. Schuler v Wickman [1973] 2 All ER 39, HL)

(3) Exception: loss of right to terminate

- 'Affirmation of contract'
- 'Waiver of breach'

IV. Agreed Remedies (to be considered in more detail in another lecture)

(1) Freedom of Contract – some typical provisions about remedies for breach of contract

- Terms that fix the amount of compensation: 'liquidated damages'
- Terms that provide for the forfeiture of a property right (charges) or a sum of money (deposits): 'security rights'
- Terms that limit the amount of compensation payable: limitation of damages clauses;
- Terms that provide for a wealthy third party to pay outstanding debts: guarantees and indemnities.
- Terms that limit the available avenues for redress: arbitration clauses.

(2) Control of Agreed Remedies

- UCTA 1977 and especially UTCCR 1999: 'reasonableness' / 'fairness'

Sched 1 (d) "[Terms which may be regarded as unfair are those:] permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract;"

- Judicial control: prohibition of overcompensation through contractual 'penalties'

'The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damages.'
Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79, HL

(3) Deposits

Law of Property Act 1925 s. 49(2): Where the court refuses to grant specific performance of the contract, or in any action for the return of a deposit, the court may, if it thinks fit, order the repayment of any deposit.

'The special treatment afforded to such a deposit [of 10%] derives from the ancient custom of providing an earnest for the performance of a contract in the form of giving either some physical token of earnest (such as a ring) or earnest money. The history of the law of deposits can be traced to the Roman law of arra, and possibly further back still… In the event of completion of the contract the deposit is applicable towards payment of the purchase price; in the event of the purchaser's failure to complete in accordance with the terms of the contract, the deposit is forfeit, equity having no power to relieve against such forfeiture. However, the special treatment afforded to deposits is plainly capable of being abused if the parties to a contract, by attaching the label "deposit" to any penalty, could escape the general rule which renders penalties unenforceable.'
Workers Trust and Merchant Bank Ltd v. Dojap Investments Ltd
[1993] AC 573, 578-9 (PC)

(4) Repossession of Goods in Hire-Purchase

but Consumer Credit Act 1974 ss. 90, 91, 129.
[If the debtor has paid one third or more of the price, the creditor cannot recover possession of the goods except by court order, and if the creditor does take the goods, the hire purchase agreement is automatically terminated and the debtor is entitled to recover all his money back. A court can give extra time to pay 'if it appears to the court just to do so'.]

V. Compensatory Damages

(1) If there is no agreed remedy and the claim is not a simple one for a money debt, the primary remedy offered by the courts is compensatory damages for 'loss'.

(2) The notion of 'loss' can be described in various ways:

(a) Reliance interest: putting the injured party back in the position as if there never had been a contract;

(b) Expectation interest: the position the injured party would have been in, if the contract had been properly performed, in so far as money can achieve that, including loss of profits

(3) Two crucial qualifications:

(a) Personal satisfaction/non-pecuniary losses/performance interest:
- Jarvis v. Swans Tours [1973] 1 All ER 71, CA
- Farley v Skinner [2001] UKHL 49 HL

'If the cause is no more than disappointment that the contractual obligation has been broken, damages are not recoverable even if the disappointment has led to a complete mental breakdown. But, if the cause of the inconvenience or discomfort is a sensory (sight, touch, hearing, smell, etc) experience, damages can, subject to the remoteness rules, be recovered.'

(b) Remoteness of loss: Loss of profits incurred as a consequence of breach of contract sometimes not recoverable under the doctrine of 'remoteness of loss'

'The damages recoverable for a breach of contract are such as may fairly and reasonably be considered as arising naturally, ie, according to the usual course of things, from the breach of the contract itself, or such as may be reasonably supposed to have been in the contemplation of both parties at the time they made the contract as the probable result of the breach of it.'
Hadley v Baxendale (1854) 9 Exch 341

SGA ss.50/51: The measure of damages is the estimated loss directly and naturally resulting, in the ordinary course of events, from the buyer's/seller's breach of contract.

But:
'Such a risk would be completely unquantifiable, because although the parties would regard it as likely that the owners would at some time during the currency of the charter enter into a forward fixture, they would have no idea when that would be done or what its length or other terms would be.'
Transfield Shipping v Mercator Shipping (The Achilleas) [2008] UKHL 48 per Lord Hoffmann

Contrast:
'The orthodox approach remains the general [Hadley v Baxendale] test of remoteness applicable in the great majority of cases. However, there may be "unusual" cases, such as itself, in which the context, surrounding circumstances or general understanding in the relevant market make it necessary specifically to consider whether there has been an assumption of responsibility. This is most likely to be in those relatively rare cases where the application of the general test leads or may lead to an unquantifiable, unpredictable, uncontrollable or disproportionate liability or where there is clear evidence that such a liability would be contrary to market understanding and expectations.'
Sylvia Shipping v Progress Bulk Carriers [2010] EWHC 542 (Comm) per Hablen J.

VI. Specific Performance and Injunctions

(1) Specific performance is an order to perform the contract, and an injunction is an order to refrain from breaching the contract. Failure to obey the order is a contempt of court, resulting in fines and possibly imprisonment.

RSC Order 45
Rule 5(1) – Enforcement of judgment to do or abstain from doing any act
Where –

(a) a person required by a judgment or order to do an act within a time specified in the judgment or order refuses or neglects to do it …; or

(b) a person disobeys a judgment or order requiring him to abstain from doing an act,
then, subject to the provisions of these rules, the judgment or order may be enforced by one or more of the following means, that is to say –

(i) with the permission of the court, a writ of sequestration against the property of that person;
(ii) where that person is a body corporate, with the permission of the court, a writ of sequestration against the property of any director or other officer of the body;
(iii) subject to the provisions of the Debtors Act 1869 and 1882, an order of committal against that person or, where that person is a body corporate, against any such officer.

(2) - Equitable orders are awarded only exceptionally where:

(a) common law remedies (ie damages) would be 'inadequate' to meet the 'justice' of the case;
(b) they are 'practicable' and not force personal service; and
(c) it would not be unfair or oppressive to enforce the contract at the date of judgment (Patel v. Ali [1984] Ch 283)

(3) Orders for specific performance are very rarely granted in practice for breach of contracts (other than for the transfer of interests in land)

'No authority has been quoted to show that an injunction will be granted enjoining a person to carry on a business, nor can I think that one ever would be, certainly where the business is a losing concern.'
A-G v Colchester Corporation [1955] 2 QB 207, 217 per Lord Goddard CJ

'The purpose of the law of contract is not to punish wrongdoing but to satisfy the expectations of the party entitled to performance…. The exercise of the discretion as to whether or not to grant specific performance starts from the fact that the covenant has been broken. Both landlord and tenant in this case are large sophisticated commercial organisations and I have no doubt that both were perfectly aware that the remedy for breach of the covenant was likely to be limited to an award of damages. The interests of both were purely financial: there was no element of personal breach of faith… No doubt there was an effect on the businesses of other traders in the Centre, but Argyll had made no promises to them and it is not suggested that CIS warranted to other tenants that Argyll would remain. Their departure, with or without the consent of CIS, was a commercial risk which the tenants were able to deploy in negotiations for the next rent review.' 28
Co-operative Insurance Society Limited v. Argyll Stores [1998] AC 1 per Lord Hoffmann

Exceptional case:
Sky Petroleum v. V.I.P. Petroleum [1974] 1 All ER 954: Party suffering from breach would have to go out of business if no specific performance were granted.

(4) Usual justification for absence of specific performance as normal remedy is efficient breach: if a party to a contract can by breaking the contract and paying full compensation still be better off, then breach maximises wealth.

UNIDROIT Principles (2010)

Article 7.2.2 (Performance of non-monetary obligation)

Where a party who owes an obligation other than one to pay money does not perform, the other party may require performance, unless

a. performance is impossible in law or in fact;
b. performance or, where relevant, enforcement is unreasonably burdensome or expensive;
c. the party entitled to performance may reasonably obtain performance from another source;
d. performance is of an exclusively personal character; or
e. the party entitled to performance does not require performance within a reasonable time after it has, or ought to have, become aware of the non-performance.

contrast:

Article 6.2.1 (Contract to be observed)
Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship.

Questions for Classes on Topic 3 – Remedies for Breach

1. What are the primary and secondary remedies for breach of contract in English common law and in equity? Why are English courts so reluctant to grant specific performance? Is the principle of pacta sunt servanda nothing but an illusion in English law?

2. Tom and Jerry enter into a contract under which Tom promises to convey part of a tract of land to Jerry and Jerry promises to pay £ 100,000 and to build a 'first class theatre' on it. The underlying understanding of the parties, based on a report of an independent expert, was that the building of the theatre would enhance the value of A's remaining land at least by 150%, maybe up to 250%. A conveys the land to B, who pays the price but eventually refuses to build the theatre. What remedies are available to A?

3. Isn't the right to right to refuse payment of money owed under the contract the same as the right to terminate the contract?

4. Explain why Hadley v Baxendale is so important for the English law of damages? Doesn't it undermine the principle of full compensation?

5. In order to have the right to terminate the contract, the party suffering from a breach must be able to show that it was essentially deprived of what it was entitled to expect under the contract. In order to obtain specific performance, the party suffering from a breach must be able to show that the common law remedies would be inadequate to meet the equity of the case. Is there a common logic in the sense of 'if money can fix it, money it is'?

Topic 6: Exclusion Clauses and Agreed Remedies

Introduction

General Question. To what extent are the parties to a commercial contract free to select their remedies for breach of contract? The short answer is that the parties generally have freedom of contract. As ever, we concentrate on the scope of the exceptions.

Policy issues. On the one hand, freedom of contract has the advantage that the parties can plan carefully in advance the consequences of any breach, take those potential costs into account when pricing the deal, and bargain to protect any particular interests that they might have in relation to the transaction. On the other hand, a remedy provided in a contract might prove to be either oppressive in the sense that it effectively compels one party to perform a contract unwillingly or unfair in the sense that the remedy provides protection that far exceeds any losses to the injured party.

Scope of Question. There are a host of ways in which the parties can provide for remedies for breach of contract, e.g.:

Security rights to ensure payment (considered elsewhere in this course)
Termination clauses
Exclusion of liability clauses
Limitation of damages clauses
Indemnity clauses
Guarantees.

We consider here some of these types of terms in contracts, with a special focus on those where it is possible to challenge the validity or effectiveness of the clause.

Chen-Wishart Chapters 12 and 14.

1. **Liquidated damages clauses: an agreement that in the event of breach of contract a fixed sum (or a sum calculable by reference to fixed criteria) will be payable**

These terms serve useful purposes: reduce uncertainties about the appropriate level of compensation, offer the quick procedure of claims for an agreed sum, determine the scale of the risk in advance, enable insurance arrangements or other kinds of guarantees/indemnities to be comprehensive, avoid difficulties in proving speculative losses, and reduce delays in payment, and encourage settlements.

But the courts have required liquidated damages clauses to specify a level of compensation which is genuine pre-estimate of the loss, and if it is more, it will be dubbed a 'penalty' and be unenforceable (though ordinary damages for breach of contract may still be claimed).

Unclear distinction between price terms and liquidated damages clauses: eg Interfoto v Stiletto, but to be a penalty clause the payment must be triggered by breach of contract.

A fixed amount of damages may still be enforceable even if with hindsight it exceeds actual loss, provided that at the time of formation of contract the fixed amount was the expected likely loss or at least an average of expected likely losses: Dunlop v New Garage.

Many writers trained in economic analysis have questioned whether the courts should invalidate penalty clauses. One argument (eg Rea) is that the price paid reflects the advantage obtained from a penalty clause, so that by disallowing a penalty clause, the court upsets the balance of fairness in the contract.

*Dunlop Tyre v. New Garage [1915] AC 79 BBF 689
Lombard North Central plc v. Butterworth [1987] QB 527, CA BBF 605
Rea, 'Efficiency Implication of Penalties and Liquidated Damages' (1984) 13 Journal of Legal Studies 147; BBF 696
Beale and Dugdale, 'Contracts between Businessmen' (1975) 2 British Journal of Law & Society 45; BBF 223
H. Collins, 'Fairness in Agreed Remedies', in C. Willett, Aspects of Fairness in Contract (London, Blackstone, 1996), ch.5
Compare the position in a civil law jurisdiction: O. Lando & H. Beale, Principles of European Contract Law (London, 2000), 453

2. **Termination clauses**

The general principles governing the right to terminate a contract for breach of contract are considered in: Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaishs Ltd [1962] 2 QB 26, CA (BBF 498); Cehave NV v Bremer Handelsgesellschaft mbH (The Hansa Nord) [1975] 3 All ER 739 (BBF 501). Under these principles, the courts

are reluctant to permit termination for breaches that have no or few adverse effects on the injured party, but nevertheless they recognise that by convention and agreement even apparently trivial breaches can justify termination of a contract. In other words, whether or not a particular breach should entitle one party to terminate the contract depends ultimately on how the court interprets the contract and the significance it attaches to breach of particular terms.

The language of condition and warranty is often used by the parties to signal that breach of a particular term (a condition) will entitle the other party to terminate the contract. But this legal convention is not always accepted by the courts: Schuler (L) AG v. Wickman Machine Tool Sales Ltd [1973] 2 All ER 39, HL (BBF 527). The phrase that 'time is of the essence' is treated as a special signal that lateness gives the right to terminate. In general in commercial contracts, where the contract specifies a particular time for performance, a court will almost certainly treat this as a condition.

But the parties can express the right to terminate in straightforward terms eg breach of clause X will entitle the other party to terminate the contract, and provided that the term is clear, it will be enforced by the courts. If there has been no breach of the relevant term yet a party purports to terminate the contract for this reason, a court will regard this termination as a repudiatory breach of contract itself. See Woodar Investment Development Ltd v Wimpey Construction (UK) Ltd [1980] 1 All ER 571, HL (BBF 585)

3. Deposits: a fixed sum of money, payable in advance, which is forfeited by breach of contract by the depositor

An earnest of future performance in the form of a sum of money which will be forfeited on breach is a deposit. 32
Deposits are excluded from the rule against penalties and are in general enforceable: Union Eagle v Golden Achievements.

However, deposits can be challenged for being excessive. The test seems to be whether the deposit is reasonable, which in turn depends upon the customs of the trade: Workers Trust v Dojap. An unreasonable deposit has to be returned in full, though (presumably) ordinary damages for breach of contract may still be claimed.

4. Exclusion Clauses

*Unfair Contract Terms Act 1997; BBF 1004-13
*George Mitchell (Chesterhall) Ltd. v. Finney Lock Seeds Ltd. [1983] 2 AC 803, [1983] 2 All ER 737, HL; BBF 1014

UCTA: Confined to exclusion clauses: s.13; not unfair terms generally. But extended concept of exclusion: s.3: applies to express terms that apparently entitle one party to render performance substantially different from that which was reasonably expected, or no performance at all with respect to part or all of the his obligations. Question in Paragon Finance was: is power to vary interest rate at bank's discretion within s.3? No –because the term does not affect the bank's performance obligations, only those of the borrowers.
Includes contracts between businesses, but special rules for contracts where one party 'deals as a consumer'.

Declares some exclusion clauses invalid, (eg. 2.(1) negligence liability for personal injury) but for others grants a judicial discretion to determine whether a term is `fair and reasonable'.
S.11(1) `the term shall have been a fair and reasonable one to be included having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.'

Questions for Class Discussion

1. Is there a coherent set of principles behind the way in which the courts approach agreed remedies?

2. Is the approach of the courts towards penalty clauses justifiable? Should penalty clauses be enforced under English law? What do you think of the solution proposed in article 7.4.13 of the UNIDROIT Principles (http://www.unidroit.org/english/principles/contracts/principles2010/integralversionprinciples2010-e.pdf)?Is the equitable control over 'penalty clauses' justifiable and consistent with other aspects of judicial control over remedies agreed in the express terms of the contract?

3. Why is Schuler a controversial decision?

4. Peter a government minister, wants a large dome shaped building completed by 31st January at 12 noon for a great public event on New Years Eve 1999/2000. Peter insists in the specification for tenders that the works be completed on time and that there should be a 25% reduction of the price if the dome is not completed on time. Bob the builder bids successfully for the job (£100 m). The building is completed one day late, and as a consequence Peter suffers a nose dive in popularity ratings, threatening his chances of being re-elected and leading to his sacking by the Prime Minister. Peter and the government refuse to pay Bob more than £75m.

   Advise Bob on his claim for £25 m.

Topic 7: International Commercial Contracts and Arbitration

A. Alternative Dispute Resolution in Commercial Law

I. Origins of ADR

- Self-government of medieval fairs and boroughs
  - rules based on trade usages (law merchant, lex mercatoria) applied by peers (merchant courts)

Lex Mercatoria from The Little Red Book of Bristol (circa 1280 AD) 34

'In all market courts all judgments ought to be rendered by the merchants of that same Court and not by the mayor or steward of the market… When a judgment is rendered in a market forum according to the law merchant, execution is immediately demanded. This execution belongs first and principally to the lord of the market or to the lord's lieutenant in the market.'

- in 17th century absorbed into common law (Holt CJ, Lord Mansfield)
- Privileges of foreign traders: right to use arbitration tribunals (Carta mercatoria 1303, Treaty of Utrecht with Hanseatic League 1474)
- Still today: peer dispute settlement mechanisms of trade associations for their members
  → amiable composition:
  - no rigidity of procedural rules
  - no application of the law but decisions ex aequo et bono
  - (cf. s 46(1)(b) Arbitration Act 1996)
  - Examples:
    - Grain & Feed Trade Association (GAFTA) London
    - Financial Industry Regulatory Authority (FINRA) New York

II. Internal governance mechanisms

- Parties can anticipate future disputes in contractual clauses
  - contractual mechanisms: penalties, termination, exclusion, relief from forfeiture, deposits / performance bonds, etc.

- architects certificates
- dispute management mechanisms: negotiations, mediation, conciliation, adjudication, arbitration
  = possibility to tailor mechanisms for individual contract

LCIA recommended clause for Mediation and Arbitration
'In the event of a dispute arising out of or relating to this contract..., and if the dispute cannot be settled through negotiation, the parties shall first seek settlement of that dispute by mediation in accordance with the [...] Mediation Procedure...
If the dispute is not settled by mediation within [ ] days of the appointment of the mediator, or such further period as the parties shall agree in writing, the dispute shall be referred to and finally resolved by arbitration under the [...] Arbitration Rules...'

→ (partial or temporary) exclusion of interference by courts
= exception to rule of general jurisdiction (ius dicere) of state courts

Conditions for such derogation:

- either prior agreement of parties: (partial / temporary) waiver of right to access to justice (cf. Art 6 EHRC)

s 9 Arbitration Act 1996
(1) A party to an arbitration agreement against whom legal proceedings are brought … in respect of a matter which under the agreement is to be referred to arbitration may… apply to the court in which the proceedings have been brought to stay the proceedings as far as they concern that matter.
(4) On an application under this section the court shall grant a stay unless satisfied that the arbitration agreement is null and void, inoperative or incapable of being performed.

- or statutory ADR: e.g. s 108 Housing Grants, Construction and Regeneration Act 1996:

'(1) A party to a construction contract has the right to refer a dispute arising under the contract for adjudication under a procedure complying with this section...
(3) The contract shall provide that the decision of the adjudicator is binding until the dispute is finally determined by legal proceedings, by arbitration (if the contract provides for arbitration or the parties otherwise agree to arbitration) or by agreement.

III. Arbitration

- The (myth of the) traditional advantages of arbitration
  speediness: dedicated arbitrators, single instance, swift enforcement
- costs: deriving from speediness
- competence: possibility to choose specialists, including non-lawyers (engineers, accountants)
- flexibility (see above II)
- confidentiality: award, existence of and material used in arbitration

- Other reasons for opting for arbitration
  - in England: avoiding barristers
  - in the U.S.: avoiding jury trial

  - Especially at the international level: an efficient regime of enforceability of arbitration agreements and awards in 146 countries

→ UN Convention on Recognition and Enforcement of Foreign Arbitral Awards (NY 1958)
  - enforceability of arbitration agreements; Art II(1) and (3) NYC
  - no double exequatur; cf. Arts III and V(1)(e) NYC
  - presumption of validity upon presentation of agreement and award

→ burden of proof on award debtor for grounds for refusing enforcement
Art V(1) NYC

- lack of valid arbitration agreement or non-respect for its scope; (a)&(c)
- violation of due process or of procedure provided in agreement; (b)&(d)
- award not yet binding on parties or set aside in country of origin; (e)
  - no review of the merits, although public policy exception; Art V(2)(b) NYC
- importance of choice of place of arbitration
  - default regime for many legal questions (cf. s 2 AA 1996)
  - place of setting aside (cf. Art V(1)(e) NYC
- importance of the place of enforcement; Art V(2) NYC
- importance of institutional rules: e.g., compare s 69(1) Arbitration Act 1996 with Art 26(9) LCIA Rules; or s 46(3) AA 1996 with Art 22(3) LCIA (see also below).

B. The Internationalisation of Commercial Law

I. Co-ordinating legal diversity: Conflicts of Laws

1. The impact of the international dimension

Unfair Contract Terms Act 1977
26 International supply contracts
(1) The limits imposed by this Act on the extent to which a person may exclude or restrict liability by reference to a contract term do not apply to liability arising under such a contract as is described in subsection (3) below.
(2) The terms of such a contract are not subject to any requirement of reasonableness under section 3 or 4: and nothing in Part II of this Act shall require the incorporation of the terms of such a contract to be fair and reasonable for them to have effect.
(3) Subject to subsection (4), that description of contract is one whose characteristics are the following—
(a) either it is a contract of sale of goods or it is one under or in pursuance of which the possession or ownership of goods passes; and
(b) it is made by parties whose places of business (or, if they have none, habitual residences) are in the territories of different States (the Channel Islands and the Isle of Man being treated for this purpose as different States from the United Kingdom).
(4) A contract falls within subsection (3) above only if either—

(a) the goods in question are, at the time of the conclusion of the contract, in the course of carriage, or will be carried, from the territory of one State to the territory of another; or
(b) the acts constituting the offer and acceptance have been done in the territories of different States; or
(c) the contract provides for the goods to be delivered to the territory of a State other than that within whose territory those acts were done.

2. Choice of the applicable law

Freedom of choice
Regulation (EC) No 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I)
Article 3 – Freedom of Choice
1. A contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract.

Limits of choice of law
Regulation (EC) No. 593/2008 ('Rome I')
Article 9 – Overriding mandatory provisions
1. Overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation.
2. Nothing in this Regulation shall restrict the application of the overriding mandatory provisions of the law of the forum.
3. Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful. In considering whether to give effect to those provisions, regard shall be had to their nature and purpose and to the consequences of their application or non-application.
Article 21 – Public policy of the forum
The application of a provision of the law of any country specified by this Regulation may be refused only if such application is manifestly incompatible with the public policy (ordre public) of the forum.

2. Choice of non-state law

State Courts
Regulation (EC) No. 593/2008 ('Rome I')
Article 3 – Freedom of choice
1. A contract shall be governed by the law chosen by the parties...
2. The parties may also choose as the applicable law the principles and rules of the substantive law of contract recognised internationally or in the Community.
However, questions relating to matters governed by such principles or rules which are not expressly settled by them shall be governed by the general principles underlying them or, failing such principles, in accordance with the law applicable in the absence of a choice under this Regulation. [original proposal, COM(2005) 650 final]

Arbitral Tribunals
Arbitration Act 1996
46 Rules applicable to substance of dispute
(1) The arbitral tribunal shall decide the dispute—
(a) in accordance with the law chosen by the parties as applicable to the substance of the dispute, or
(b) if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal.
(2) For this purpose the choice of the laws of a country shall be understood to refer to the substantive laws of that country and not its conflict of laws rules.
(3) If or to the extent that there is no such choice or agreement, the tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.

LCIA Arbitration Rules (1998)
Article 22 – Additional Powers of the Arbitral Tribunal
(3) The Arbitral Tribunal shall decide the parties' dispute in accordance with the law(s) or rules of law chosen by the parties as applicable to the merits of their dispute. If and to the extent that the Arbitral Tribunal determines that the parties have made no such choice, the Arbitral Tribunal shall apply the law(s) or rules of law which it considers appropriate.
(4) The Arbitral Tribunal shall only apply to the merits of the dispute principles deriving from "ex aequo et bono", "amiable composition" or "honourable engagement" where the parties have so agreed expressly in writing.

II. Overcoming legal diversity: Harmonisation and Uniformisation of Commercial Laws

1. Uniform Global Commercial Contract Law?

- International Treaties: e.g.
- Conventions on the Uniform Law of International Sales of Goods and Uniform Law on the Formation of Contracts for the International Sales of Goods (1964)
→ Uniform Laws of Sales Act 1967 (c.45)
- UN Convention on the International Sale of Goods (Vienna 1980) [not ratified by UK]
- Model Laws: e.g.
- UNCITRAL Model Law on Cross-Border Insolvency (1997) [not adopted by UK]
- UNIDROIT Model Franchise Disclosure Law (2002) [not adopted by UK]
- Model Contract Clauses: e.g.
- Uniform Customs and Practices for Documentary Credits, UCP 600
- INCOTERMS
- General Principles of Contract Law (non-state law): e.g. UNIDROIT Principles (2004)

2. Harmonisation of Commercial Contracts Laws in the EC

- Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents
- Directive 2000/35/EC of the European Parliament and the Council of 29 June 2000 on combating late payments in commercial transactions

- Towards a European Civil Code?
- Principles of European Contract Law
- Draft Common Frame of Reference:
  http://video.google.com/videoplay?docid=852539341160949048

Questions for Class on Topic 4 – ADR and Internationalisation

1. Why can parties conclude contracts? Why can they choose the law applicable to their contract? Why can they have their disputes decided by 'private judges'? Can they actually make their own law? Discuss the meaning of party autonomy in the light of global transactions and in historic perspective.

2. What are the differences between the various alternative dispute resolution mechanisms that are at the parties' disposal?

3. When reaching the end of long negotiations of a complex joint venture contract for the operation of an airport in Kuala Lumpur, your client, a multinational infrastructure and logistics company, ask for your advice regarding the choice of law and the choice of a dispute resolution mechanism. What would your preliminary advice be for considering the different options?

4. What does the English Arbitration Act 1996 (AA) mean in section 46 by 'such other considerations as are agreed by [the parties]'? How is section 46 (especially paragraph 3) AA different from the equivalent provision in the LCIA Rules? How can they fit together?

5. Do you think Europe needs a common civil code? What is happening in the meanwhile?
6. (If you have time, have a look at: http://www.youtube.com/watch?v=D0EEnUSyyd4)

Topic 8 Multi-Party Projects: privity of contract and the rights of third parties

Beale, Bishop and Furmston, ch 46.
Chen Wishart, ch. 4.

1. The general rules

1.1. C may not enforce a contract made between A and B which was intended to confer a benefit upon C.

- Dunlop Pneumatic Tyre Co v Selfridge [1915] AC 847
- Tweddle v Atkinson (1861) 1 B & S 393
- Scruttons v Midland Silicones Ltd [1962] AC 446

1.2. A contract between A and B cannot impose obligations on C, or restrict C's legal rights.

- Haseldine v Daw [1941] 2 K.B. 343

2. Devices to avoid the privity rules

2.1 'Collateral' agreements

- Shanklin Pier Ltd v Detel Products Ltd [1951] 2 KB 854

2.2 Agency

- The Eurymedon, New Zealand Shipping v Satterthwaite [1975] A.C. 154

2.3 Bailment and sub-bailment

- Morris v Martin [1966] 1 Q.B. 716
- The Pioneer Container [1994] 2 A.C. 324

2.4 Trust

- Lloyd's v Harper (1880) 16 Ch D 290
- Re Schebsman [1944] Ch 43

2.5 Liability in Tort

- Grant v Australian Knitting Mills [1936] A.C. 85
- Consumer Protection Act 1987, Part I
- Norwich CC v Harvey [1989] 1 W.L.R. 828
- White v Jones [1995] 2 AC 207

3. Enforcement by the promisee

3.1 Enforcement of a positive promise

- Beswick v Beswick [1966] AC 58

3.2 Enforcement of a negative promise

- Gore v Van der Lann [1967] 2 Q.B. 31

3.3 Seeking damages

- Woodar v Wimpey Construction [1980] 1 W.L.R. 227
- Jackson v Horizon Holidays [1975] 1 W.L.R. 1486
- Linden Gardens Trust v Lenesta Sludge [1993] 3 All E.R. 417; pp. 432-437; and 421- 422
- Panatown Ltd v Alfred McAlpine Construction Ltd [2000] 4 All ER 97
- Rolls-Royce Power Engineering Plc v Ricardo Consulting Engineers Ltd [2003] EWHC 2871 (TCC), [2004] 2 All ER (Comm) 129

4. Statutory avoidance

4.1 Particular examples

- Road Traffic Act 1988, s. 148(7)
- Third Parties (Rights Against Insurers) Act 1930
- Consumer Credit Act 1974, s. 56, s. 75
- Resale Prices Act 1976, s. 26

4.2 The Contracts (Rights of Third Parties) Act 1999

Background:

Law Commission (1991) Consultation Paper No. 121 Privity of Contract: Contracts for the Benefit of Third Parties

Law Commission (1996), Law Com No 242, Privity of Contract: Contracts for the Benefit of Third Parties

4.2.1 The third party's right to enforce the contract

's 1 (1) Subject to the provisions of this Act, a person who is not a party to a contract (a "third party") may in his own right enforce a term of the contract if—(a) the contract expressly provides that he may, or (b) subject to subsection (2), the term purports to confer a benefit on him.'

's 1 (2) 'Subsection (1)(b) does not apply if on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party.'

Nisshin Shipping Co Ltd v Cleaves & Co Ltd [2003] EWHC 2602, [2004] 1 Lloyds Rep 38
Laemthong International Lines Company Ltd. v. Artis and Others, (The Laemthong Glory) (No. 2) [2005] EWCA Civ 519
Prudential Assurance Co Ltd v Ayres [2007] EWHC 775

s 1 (3) 'The third party must be expressly identified in the contract by name, as a member of a class or as answering a particular description but need not be in existence when the contract is entered into.'

Avraamides v Colwill [2006] EWCA Civ 1533

Further Reading:

- Burrows, 'The Contracts (Rights of Third Parties) Act and its Implications for Commercial Contracts' [2000] LMCLQ 540
- MacMillan, 'A Birthday Present for Lord Denning: The contracts (Rights of Third Parties) Act 1999' (2000) 63 MLR 721
- Stevens, 'The Contracts (Rights of Third Parties) Act 1999' (2004) 120 LQR 292
- Adams and Brownsword, 'Privity of Contract—That Pestilential Nuisance' (1993) 56 MLR 722
- Coote, 'The Performance Interest, Panatown, and the Problem of Loss' (2001) 117 LQR 81
- Kincaid, 'Privity Reform in England' (2000) 116 LQR 43
- Phang, 'Sub-bailments and Consent—The Pioneer Container' (1995) 58 MLR 422
- Smith, 'Contracts for the Benefits of Third Parties: in Defence of the Third Party Rule' (1997) 17 OJLS 643.

Topics for Class Discussion On Multi party Projects and Networks

1. In what ways can the benefits which parties intend to confer on third parties by their contract be recovered by them?

2. Bordeaux Bottlers export fine wines from France to the United Kingdom. They always contract with Vasily's Vessels to carry a cargo of their finest wines on board their ship, the Vasily 1. The ask Vasily's Vessels to transport two crates of expensive wine, one white and one red. Their contract of carriage includes the following term:

   the carriers and any servants, agents and stevedores whom the carriers may from time to time employ shall be exempt from all liability, for any loss of damage, whether caused by negligence or otherwise, to any goods carried on the SS Vasily 1. Such exemption extends to the loading and unloading of any goods so carried.

   Vasily's Vessels also tell Bordeaux Bottlers that the goods will be unloaded by their subsidiary company, Steven's Stevedores, and housed at their premises pending collection. The contract between

Vasily's Vessels and Steven's Stevedores exempts the latter's servants or agents from all liability for damage to any goods unloaded.

When the ship reaches the port, one of the stevedore's crane operators carelessly drops one of the containers he is unloading onto the whole consignment of red wine, which is all destroyed. Later, while lifting the white wine, he allows it to fall into the water.

Bordeaux Bottlers now want to sue Steven's Stevedores.

Advise Bordeaux Bottlers.

3. What has been the effect of the Contract (Rights of Third Parties) Act 1999?

Topic 9 Sales Law

This part of the course studies problems arising in sales of goods between businesses. The central problems arise from the buyer being dissatisfied with the product in some respect, usually concerning its quality, and from the seller being concerned to receive payment.

1. Buyers' Remedies

(a) Sale by Description.

In many sales of goods by reference to written documents, the seller provides a description of the goods. This express term is legally binding like any other express term of the contract. But the Sale of Goods Act 1979 s. 13 makes special provision about such terms.
*SGA s. 13 (1) Where there is a contract for the sale of goods by description, there is an implied term that the goods will correspond with the description.
(1A) As regards England and Wales and Northern Ireland, the term implied by subsection (1) above is a condition.
A sale of goods by description (under s.13) occurs where in the terms of the contract descriptive words are used for the purpose of identifying or defining the goods and these terms are relied upon by the buyer. The effect of the application of s.13 is that breach of a descriptive term of the contract always triggers the buyer's right to reject the goods (no matter how minor the breach) – though that effect has now been modified by a new statutory provision SGA s.15A: BBF 594.

*Arcos Ltd v EA Ronaasen & Son [1933] AC 470; BBF: 428.
*Harlingdon & Leinster Enterprises Ltd v Christopher Hull Fine Art Ltd [1990] 1 All ER 737; BBF: 429.
Further reading: Goode: pp. 290-298.

(b) Implied Terms of Quality

(i) Common Law Principles

M.G. Bridge, 'The Evolution of Modern Sales Law' [1991] Lloyds Maritime and Comparative LQ 52; 44
Peden, 'Policy Concerns Behind Implication of Terms in Law' (2001) 117 LQR 459.

(ii) Statutory Implied Terms

*Sale of Goods Act 1979, s.14 (as amended). BBF 427
s.14(2) 'satisfactory quality' and
s. 14(3) 'fitness for buyer's purpose'.
Sale of Goods Act 1979 s.14

(1) Except as provided by this section and section 15 below and subject to any other enactment, there is no implied term about the quality or fitness for any particular purpose of goods supplied under a contract of sale.

(2) Where the seller sells goods in the course of a business, there is an implied term that the goods supplied under the contract are of satisfactory quality.

(2A) For the purposes of this Act, goods are of satisfactory quality if they meet the standard that a reasonable person would regard as satisfactory, taking account of any description of the goods, the price (if relevant) and all the other relevant circumstances.

(2B) For the purposes of this Act, the quality of the goods includes their state and condition and the following (among others) are in appropriate cases aspects of the quality of the goods –

(a) fitness for all purposes for which goods of the kind in question are commonly supplied,
(b) appearance and finish,
(c) freedom from minor defects,
(d) safety, and
(e) durability.

2(C) The term implied by subsection (2) above does not extend to any matter making the quality of goods unsatisfactory-
(a) which is specifically drawn to the buyer's attention before the contract is made,
(b) where the buyer examines the goods before the contract is made, which that examination ought to reveal, or
(c) in the case of a contract for sale by sample, which would have been apparent on a reasonable examination of the sample.

(3) Where …the buyer, expressly or by implication, makes known…to the seller…any particular purpose for which the goods are being bought, there is an implied condition that the goods supplied under the contract are reasonably fit for that purpose…except where the circumstances show that the buyer does not rely, or that it is unreasonable for him to rely, on the skill or judgment of the seller.
(6)…the terms implied by subsections (2) and (3) are conditions.

*Slater v. Finning [1996] 3 All ER 398 [1997] AC 473, HL.
Goode, pp. 298- 323.

2. Exclusion Clauses

The SGA 1979 provides that in principle the parties can agree to exclude the statutory implied terms, and the general principle of freedom of contract permits exclusion or limitation of liabilities arising under other express terms. But these principles are all now subject to Unfair Contract Terms Act 1977, ss. 6, 11, 12, Sched 2; BBF: 982, 983, 997, which in effect requires in a commercial contract the exclusion clause to be 'fair and reasonable'. E.g. George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd [1983] 2 AC 803, [1983] 2 All ER 737, HL: BBF: 1000

4. Remedies for Breach of Quality Standards.

If the seller is in breach of the contract of sale by having supplied sub-standard goods, what remedies are available to the buyer? Should the buyer be always entitled to 'reject' the goods, or is that unfair to the seller in some (most?) instances? Should the parties to the contract be entitled to determine the nature of the buyer's remedy for breach by the express terms of the contract? If the buyer claims damages instead, how should the damages be calculated? In a commercial context, should the damages always include 'loss of profits', or should some losses of this kind be regarded as too remote? What is the purpose of the doctrine of 'remoteness in the law of damages'? Do the legal sanctions for breach of contract in this context provide adequate incentives for the seller to conform to the expected quality standard?

(a) General Common Law of Breach Permitting Termination

Chen-Wishart, Chapter 12
*Hong Kong Fir Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd [1962] 2 QB 26, [1962] 1 All ER 474, CA; BBF 563.
*Bunge Corp v Tradax Export SA [1981] 2 All ER 513, HL. BBF: 571
Schuler AG v Wickman Machine Tools [1974] AC 235, [1973] 2 All ER 39, HL. BBF: 409, 595.

Under the general law of contract, a party may only terminate a contract for a serious breach of contract, sometimes called a fundamental breach or a repudiatory breach.
The general test for whether or not a breach is serious looks at the effects of the breach on the injured party. The question is 'does the occurrence of the event deprive the party who has further undertakings still to perform of substantially the whole benefit which was the intention of the parties as expressed in the contract that he should obtain as the consideration for performing those undertakings?' (Lord Diplock: Hong Kong Fir v KKK).
In their contract, however, the parties may specify that breach of a particular term should entitle the other party to terminate the contract.

Certain phrases have conventionally been regarded as indicating that breach of a term amounts to a fundamental breach eg 'time of the essence'; 'condition'. time clauses for delivery of goods in Bunge v. Tradax, even though the breach may cause no loss whatsoever.
Should the courts always respect such terms? In Schuler v Wykman Tools the court treats breach of a term labelled as a 'condition' as not giving a right to terminate. Does this destroy the one possible beneficial use of the distinction between conditions and warranties (ie the saving of transaction costs)?

(b) Rejection, and Conditions and Warranties under the Sale of Goods Act.

A buyer who terminates a contract for the seller's breach is usually described as having 'rejected' the goods. The right to reject the goods arises normally either for breach of s.13 implied term (lack of conformity with express terms of description) or s.14 implied terms. These implied terms are described as 'conditions' and under the statutory scheme, breach of condition gives rise to the right to rejection.

This statutory scheme sometimes creates the problem that the buyer rejects for breach of condition when the effects of breach are not especially significant. Compare:
Arcos Ltd v EA Ronaasen & Son [1933] AC 470; BBF: 428.
*Cehave NV v Bremer Handelsgesellschaft mbH, The Hansa Nord [1975] 3 All ER 739, CA BBF: 566
* SGA 1979 s.15A: BBF 594. This provision states that a breach of condition under ss.13 and 14 will not be regarded as giving the right to reject the goods if 'the breach is so slight that it would be unreasonable' for the buyer to reject.

But the buyer does not have to reject the good for breach of condition. Under the Sale of Goods Act 1979 s. 11(2); BBF 560, the buyer may 'elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.'

The buyer loses the right to reject the goods (but retains any right to compensation) by 'acceptance' of the goods. What amounts to acceptance? Sale of Goods Act ss. 34, 35, 35A; BBF: 614

There are two main remedies envisaged by the Act for the buyer:

(1) reject the goods (in effect termination for serious breach), or

(2) accept the goods though claim damages for the poor quality/non-conformity.
(It is also sometimes possible to obtain specific performance of specific, ascertained, and 'unique' goods).
Under the Act the remedy of rejection is available if (and only if)

(1) the breach of contract is a breach of 'condition' (not a breach of 'warranty'); and
(2) the goods have not been 'accepted'.
(the buyer can always treat a breach of 'condition' as a breach of warranty by accepting the goods and claiming compensatory damages instead SGA s.11).

The Sale of Goods Act specifies that the implied terms of conformity (s13), satisfactory quality and fitness for notified purpose are 'conditions' (s.14(6)).
The courts traditionally interpreted the express terms of contracts of sale also within this framework, so that some express terms are regarded as 'conditions', others as (mere) 'warranties'. This dual system of classification of terms seems to break down in the cases. Why does it break down? Why is it necessary to create 'intermediate terms', where the effect of breach determines whether or not there is a right to reject?
In the Hansa Nord the court plainly wants to deny a right of rejection (thus it has to find no breach of warranty of merchantable/satisfactory condition), yet wants to award damages for breach of quality. How is this result achieved? 47
Is the purpose of the distinction between conditions and warranties to determine when it is reasonable to confine the buyer to a remedy in damages for breach of the quality standard in the contract? By what criteria should we determine the reasonableness of the limitation on the remedy available to the buyer. Should this depend on what the parties say in the contract? Should this depend upon the effects of the breach on the buyer? What effect does the following reform have?

SGA s.15A (1) Where in the case of a contract of sale-
(a) the buyer would, apart from this subsection, have the right to reject goods by reason of a breach on the part of the seller of a term implied by section 13, 14 or 15 above, but
(b) the breach is so slight that it would be unreasonable for him to reject them,
then, if the buyer does not deal as consumer, the breach is not to be treated as a breach of condition but may be treated as a breach of warranty.

(a) Rejection and Acceptance

Rejection is special terminology in the sale of goods for termination of a contract by the buyer for breach of contract. It is potentially a powerful, self-help remedy; the buyer does not have to return the goods (s.36).

SGA s.35 (1) The buyer is deemed to have accepted the goods subject to subsection (2) below -

(a) when he intimates to the seller that he has accepted them, or
(b) when the goods have been delivered to him and he does any act in relation to them which is inconsistent with the ownership of the seller.
(2)Where the goods are delivered to the buyer, and he has not previously examined them, he is not deemed to have accepted them under subsection (1) above until he has had a reasonable opportunity of examining them for the purpose-
(a) of ascertaining whether they are in conformity with the contract…

The right to reject the goods is typically lost by (a) doing something inconsistent with the ownership of the seller (eg eating them, using them, selling them), or (b) lapse of reasonable time. Asking for 'repair of goods' or reselling the goods, however, are not necessarily regarded as 'acceptance' (s.35(6)). It is possible to accept the part of the goods which reach the quality standard and reject the remainder, but all the satisfactory goods are then deemed to have been accepted (s. 35A).

SGA s.30(1) Where the seller delivers to the buyer a quantity of goods less than he contract to sell, the buyer may reject them, but if the buyer accepts the goods so delivered he must pay for them at the contract rate.
(2A) A buyer who does not deal as consumer may not - (a) where the seller delivers a quantity of goods less than he contracted to sell, reject the goods under subsection (1) above …if the shortfall …is so slight that it would be unreasonable for him to do so.

(c) Damages

The buyer can claim damages for breach of the express or implied terms of the contract (in addition to any rejection of the goods in some cases). What is the measure of compensation?

Sale of Goods Act 1979 s. 53.
*Slater v Hoyle & Smith Ltd [1920] 2 KB 11, CA. BBF 654
*Bence Graphics International Ltd v Fassson UK Ltd [1997] 1 All ER 979, CA, BBF 657.: restriction on recovery for difference in value if no actual loss due to successful resales.
Lazenby Garages Ltd v Wright: lost throughput leading to lost profits.

What is the purpose/policy behind such restrictions on recovery? Are the restrictions about (a) fairness between the parties? (b) protection of the practice of making contracts from deterrent levels of damages? (c) incentives to disclose information? (d) incentives to take out insurance (e) who should have taken out insurance (because this party could have done it at the least cost) (f) risk allocation?

Does the law provide sufficient incentives to perform contracts and conform to quality standards in sales? Is the law in fact aimed at encouraging efficient breach of quality standards?

2. Seller's remedies

(a) Action for Price

SGA 1979 s. 49 BBF: 725.

(b) Action for Damages
Lazenby Garages Ltd v Wright [1976] 2 All ER 770, CA; BBF: 661

(c) Retention of Title
Under this quasi-security scheme, the seller parts with possession, but continues to assert legal title of the goods until paid in full under express terms of the contract. The retention of legal title is not a registrable charge, though it is likely to be regarded as such if it purports to retain or obtain a proprietary interest in either (a) products made from the seller's goods; or (b) the financial proceeds of sub-sales by the buyers to third parties.
SGA s.19(1) Where there is a contract for the sale of specific goods…the seller may, by the terms of the contract…, reserve the right of disposal of the goods until certain conditions are fulfilled; and in such a case…the property I the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.
For further discussion, see credit and security below.

Questions for Class Discussion

1. Does the requirement that goods be of satisfactory quality mean that they must be free from defect?

2. Are goods unsatisfactory if they are below average in quality?

3. How effective, in your opinion, is section 15A of the Sale of Goods Act 1979 in controlling excessive use of the right to terminate a contract?

4. Do you agree with the result in Bence Graphics? Can you think of a principled way of reaching the opposite result?

5. Heuristic Devices plc is a manufacturer of widgets. Advise it in respect of its liability under the following two contracts:

(i) Heuristic agrees to sell 20,000 widgets to Jetson plc, delivery as required by Jetson but no later than three months after the contract date, which is July 1. On August 15, on a rising market, Heuristic advises Jetson by letter that it has no intention of performing the contract. Jetson takes no action in response to this letter but, on 2 October, it issues proceedings against Heuristic claiming damages.

(ii) Heuristic supplies 10,000 widgets to Turbo plc on March 1. The widgets are all defective and Heuristic is in breach of its obligations under s 14(2) and s 14(3) of the Sale of Goods Act. Turbo uses the widgets in its manufacturing process to make atomic smashers. Some of these atomic smashers are bought by Rutherford plc, which suffers extensive losses of profit when they break down in service. This breakdown is due to the defective widget components in the atomic smashers. Rutherford complains about the atomic smashers to Turbo on May 1 and is threatening legal proceedings.

Topic 10: Credit and Security

It is a truth universally acknowledged that creditors who can take security for payment will do so. Security can be resorted to when a debtor defaults, so that the creditor need not line up with unsecured creditors for a small dividend when the debtor goes into (individual) bankruptcy or (corporate) winding-up proceedings. Moreover, security can be enforced before formal insolvency proceedings run their course or even commence.

Security can take broadly two forms. One is personal security, often a personal guarantee. Directors of a company frequently give personal guarantees to a lending bank along with the security over its assets given by the company itself. The other form of security is proprietary security. Our concern in these two seminars lies with this latter form of security.

Proprietary security may be granted consensually or it may arise by operation of law (as in the case of equitable and common law liens). These two seminars deal with consensual security.

Consensual security in English law takes one of three forms: the pledge, the charge and the mortgage. The distinction between charges and mortgages is largely eliminated in practice. Both are used to take non-possessory security, so that the debtor may continue dealing with its assets in the normal course of business. Pledge, which we need to note only in passing, is a form of possessory security and thus more suited to non-productive assets, like shares and bullion. (A general reference below to security interest includes these three forms of security.)

Although it is not recognised in formal legal terms as security in England, the reservation of title by an unpaid seller serves the same purpose in practical or economic terms. It commonly arises where a seller of goods reserves the so-called right of disposal under section 19 of the Sale of Goods Act 1979 until the buyer pays for

the goods. Informal trade credit is frequently extended by sellers to buyers on a 30-60 day credit cycle. The reservation of title clause in a contract of sale gives the seller some protection if the buyer defaults or goes into insolvency proceedings. (Reservation of title is also seen in asset financing, where a financial institution reserves title to equipment and capital goods under conditional sale, hire purchase or similar transactions, pending payment by instalments over a protracted period.)

Consensual, proprietary security and reservation of title are the subjects of these two seminars.

The central themes of these seminars are the following:

- (a) the avoidance of lending risk;
- (b) contractual certainty and autonomy;
- (c) the tension between individual contractual rights and collective rights;
- (d) the existence or not of a fair balance among creditors.

GENERAL REFERENCE

R M Goode, Legal Problems of Credit and Security (3rd ed 2003)
RM Goode, Commercial Law (3rd ed 2004), chs 22-23, 25
H Beale, M Bridge, L Gullifer and E Lomnicka, The Law of Personal Property Security (2007) (particularly chapter 1)

For a global survey of English security law for a continental readership, see M Bridge, "The English Law of Security" [2002] European Review of Private Law 483.
See also E Ferran, Company Law and Corporate Finance (Clarendon 1999), 488-512, 529-39

1. Security, title reservation and insolvency

The key point about security and reservation of title upon insolvency is that they remove assets from the debtor that would otherwise be distributed amongst all its creditors on a rateable, or pari passu, basis. Only property belonging to the bankrupt vests in the trustee-in-bankruptcy. A company liquidator (who will not normally need a vesting order) has powers to deal with the company's property. A seller reserving title to goods, and a creditor taking a security interest in the debtor's goods, therefore stand outside the formal insolvency processes administered by the trustee and the liquidator. This is subject, however, to encroachments made on the rights of secured creditors (and to a lesser extent those reserving title) in insolvency legislation (see below).

Insolvency Act 1986, ss 107, 145(1), 283(1)(a), Sch 4 para (6).
Oditah, "Assets and the Treatment of Claims in Insolvency" (1992) 108 LQR 459

2. Freedom of contract between debtor and secured creditor

It is a particularly marked feature of the law governing the creation of security in England that debtor and creditor are free to arrive at their security bargain without considering the effect of this bargain on third parties. A creditor, in fact, can sweep up in its security all of the debtor's assets, thus leaving nothing (apart from statutory intervention: see below) for distribution to unsecured creditors in bankruptcy or corporate liquidation. Public policy is conventionally regarded as having no part to play in English law in regulating the bargain struck between secured creditor and debtor.

Nevertheless, at various intervals in the law, although parties in their contract may strive for a certain effect, their bargain may be recharacterised against their wishes. One such case concerns attempts to avoid the creation of security in the formal legal sense (the reasons for this will appear below). Another concerns the difference between fixed and floating charges (again, dealt with below). English courts sometimes say they look beyond the form of an agreement to its substance, but what do they mean by this? Is this public policy under another name?

Re Curtain Dream Plc [1990] BCLC 925
Welsh Development Agency v Exfinco [1992] BCLC 148

Did the draftsman of the documents in Re Curtain Dream commit a few slips of the pen which, if avoided, would have led to a different result?

What was the draftsman trying to achieve in Welsh Development. Do you agree with the result?

3. Reservation of title

Under this head we shall examine the use of title reservation devices to protect the supplier of goods from the risk of non-payment by the buyer. The device employed by sellers in this area is the Romalpa clause, which builds upon the provisions of the Sale of Goods Act 1979. There is little that is controversial about the reservation of title in the original goods: what has generated the real difficulties has been the attempts by sellers, under extended reservation of title clauses, to "reserve" title to the money proceeds of the goods supplied and to the goods manufactured from the goods supplied as well as their money proceeds. After some initial success, the attempt to characterise these extended title clauses as reservation clauses has foundered: they are now consistently regarded by the courts as giving rise to registrable charges. It is quite an impracticable proposition for the great majority of trade suppliers to comply with charge registration requirements in the Companies Act 2006 (ss 860 et seq) so as to perfect their security against other creditors of the buyer.

Title retention, though not formally recognised by the law as security in the proper sense of the word, in fact functions as a security and, in those cases where it works, can be more effective than a security interest. First of all, if a buyer (or a hirer under a hire purchase transaction or a lessee under a financial lease) receives goods the property in which has been retained by the unpaid seller, then the seller's interest will always override any security claimed by a chargee (or mortgagee) who has had dealings with the buyer in the latter's capacity as chargor. The chargee is able to take security only over assets that the buyer has to charge, which excludes goods the property in which has been retained by the seller. It does not matter that the mortgage might have been given before the contract of sale was concluded. Secondly, title retention is cheap and easy to

accomplish. It requires no formality and the seller need not comply with registration requirements laid down in the Companies Act 2006 (ss 860 et seq) (the Bills of Sale Act 1878 (Amendment) Act 1882 for individuals).

Clough Mill Ltd v Martin [1985] 1 WLR 111
Armour v Thyssen Edelstahlwerke AG [1991] 2 AC 339
Tatung (UK) Ltd v Galex Telesure Ltd [1989] BCC 325
Re Peachdart Ltd [1984] Ch 131
Sale of Goods Act 1979, ss 17, 18 Rule 5, 19

Do you agree with Robert Goff LJ in Clough Mill that a properly drafted clause will allow a seller to "reserve" title to new goods manufactured with those supplied by the seller? How might it be done? Do you also agree with him that a seller exercising its rights should, one way or another, have to account for any surplus (over and above the price owed by the buyer) realised after the goods have been repossessed and sold?

Apart from any extended reservation of title clause, do you think that sellers should have the right to trace into the proceeds (new goods or money) deriving from the goods they supplied?

4. Types of consensual security

We shall deal with mortgages and charges. Unlike land, it is still possible to grant a mortgage over personalty, so that title passes to the mortgagee subject to a cesser on redemption (that is, an automatic reversion to the mortgagor) when the mortgage debt is repaid. The practical difference between a mortgage and a charge is that, at law, a broader range of remedies is available for mortgages than for charges. Drafting practice, however, has eliminated this distinction, as chargees have successfully bargained for the further remedies of mortgagees. Even judges in the House of Lords (Lord Hoffmann, for example) speak of mortgage and charge as though they were the same thing and legislation also follows the same trend (Law of Property Act 1926, s 205(1)(xvi) (mortgage includes a charge); Companies Act 2006, s 861(5) (charge includes a mortgage)).

Whereas a mortgage (of personalty) involves a defeasible transfer of ownership to the mortgagee, a charge does not involve a transfer. Instead, it is an encumbrance affecting the property charged until the charged debt has been repaid. A mortgage can be either a legal or an equitable mortgage, but a charge exists only in equity. (Although the common recognised co-ownership, it did not recognise undifferentiated rights in a bulk.)

The existence of a charge depends upon an intention to create a charge. When is that intention present?

Swiss Bank Corpn v Lloyds Bank Ltd [1982] AC 584 (read the judgment of Buckley LJ in the Court of Appeal)
Re Cosslett Contractors Ltd [1998] Ch 495

5. Fixed and floating charges

The modern bank debenture (loan instrument) typically recites a series of fixed charges over identified types of property, before concluding with a floating charge that sweeps up all remaining property. Very broadly, a fixed charge requires the specific consent of the chargee if the chargor is to dispose of the charged property. A

floating charge involves the grant of an authority by the chargee to the chargor to deal with, and even dispose of, the charged property in the ordinary course of business.

The distinction between a fixed and a floating charge has been a battleground in recent years. At stake, is the position of the chargee bank upon the chargor company's liquidation. If a charge is a floating charge, the chargee has been to a degree expropriated by legislation in favour of certain creditors (preferential creditors) and unsecured creditors (to a limited financial extent). The battle has centred on debts owed to the chargor company by its trading partners, which (like stock-in-trade and work in progress) are part of a company's circulating as opposed to fixed capital. For a time, banks were able to take a fixed charge over the chargor's debts but recent decisions of the Privy Council and House of Lords mean that such attempts to take a fixed charge will be recharacterised as a floating charge.

Evans v Rival Granite Quarries Ltd [1910] 2 KB 979
Agnew v Inland Revenue Commissioner [2001] 2 AC 710
Re Spectrum Plus Ltd [2005] 2 AC 680
Insolvency Act 1986, ss 29(2), 175, 386 and Sch 6 (as amended by the Enterprise Act 2002) and s 176A and Sched B1 para 65 (both as added by the Enterprise Act 2002)
RM Goode, Commercial Law (3rd ed 2004), ch 27
S Worthington, "Floating Charges: The Use and Abuse of Doctrinal Analysis", in J Getzler and J Payne, "Company Charges: Spectrum and Beyond" (Oxford University Press 2006), ch 3

What is "crystallisation" of a floating charge and why if at all is it significant?

6. Publicity (the Companies Act scheme)

The registration of company charges was introduced in England in 1900. A clear motivation behind the duty to register from the outset was the belief that the concealment of secured credit was an evil calculated to mislead those dealing with the company. Registration was designed for the protection of those doing business with the company so that they might see how much of a company's assets would be available for distribution in an insolvent liquidation. Registration would also do much to clarify the rights of secured creditors if the company debtor went into liquidation, and the rights of those purchasing the company's property, since it would avoid the evils of backdated documents and provide the charge with a badge of authenticity. Registration has also proved useful to those interested in the affairs of the company, such as financial analysts, credit reference agencies and potential investors. Credit reference agencies, in particular, may be seen as substitutes for unsecured creditors in the examination of a company charges register.

Companies Act 2006, ss 859A-859R, 860-61, 869-70, 874, 894
National Provincial Bank and Union Bank of England v Charnley [1924] 1 KB 431

Should all company charges be registered? What about reservation of title clauses? How reliable is the information available form Companies House about the state of a company's affairs?

Does the Charnley decision subsidise carelessness?

7. Enforcing the security

A defining feature of the English law of security is the way that it permits secured creditors to enforce their security without going to court and without having to await the outcome of insolvency proceedings. Before changes wrought by the Enterprise Act 2002, this was done by means of the ability, granted by contract, to appoint a so-called administrative receiver. (This right remains for pre-2002 debentures and for designated capital markets and private finance initiative transactions.) The debenture would grant the creditor an irrevocable power of attorney to appoint, in the name of the debtor company, an administrative receiver who was the agent of the company chargor with the primary task of paying down the debenture. (Technically, the company did it to itself.) This same procedure, under another name ("administration" – extended in meaning under the 2002 Act) is still available, though subject to certain checks and balances in the cause of those modern goals, transparency and accountability.

Insolvency Act 1986, s 29(2), Sched B1 (as added by the Enterprise Act 2002) (in outline).

Do you see why banks still need to take floating charges (apart from the recent decisions of the Privy Council and House of Lords on fixed charges over debts)?

Should secured creditors have so much control over the enforcement of their security?

8. The Future

There have been numerous calls over the last 30-40 years for a thorough reform of the English law of security. 55
Most recently, the Law Commission has issued two consultative documents and a report which, for all practical purposes, are defunct. At the heart of this intensive debate has been the question whether English law should adopt the approach of Article 9 of the American Uniform Commercial Code. The main features of Article 9, for present purposes, are the following. (1) It adopts a functional, rather than a technical legal, definition of security. So reservation of title is treated like security, which affects registration and remedies. (2) It bases priority among competing security interests (this is a simplification) on the date of registration ("filing", to use the technical expression). (3) Only barebones details of a security interest are filed ("notice filing"), and there is nothing corresponding to the (English) Registrar's conclusive certificate. There are various reasons for the rejection by the practising profession of these reform proposals, including a sentimental attachment to the floating charge, a belief in the principle that something not broken does not need to be fixed and a genuine concern that reform would have an upsetting effect on the capital markets, where title-based transactions (such as so-called "repos") are in common use. The consultative documents and report are worth consulting to gain a fuller understanding of the existing law. For those who are interested, here are the citations:

Registration of Company Charges: Property other than Land (Consultation Paper No 164, 2002)
Company Security Interests (Consultation Paper No 176, 2004)
Company Security Interests (Report No 296, Cm 6654, 2005)
RM Goode, "The Modernisation of Personal Property Security Law" (1984) 100 LQR 234

Credit and Security – Class material

1. Why and how does English law distinguish between fixed and floating charges?
2. Explain how crystallisation operates.
3. Should title reservation be treated as a security?
4. Is English law too tolerant of artificial transactions in the area of lending? Should it defined security according to the form of a transaction or according to the function it served?
5. Is English law too favourable to secured creditors?
6. Does the registration of company charges serve a useful purpose?

Topic 11 Financial law (1) Introduction and derivatives

1. Introduction

Financial law has been defined as 'the law and regulation of insurance, derivatives, commercial banking, capital markets and investment management sectors' and as a subset of commercial law (Benjamin, 2007: 4). The sources of financial law are market practice, case law and legislation, though not always in that order. For example, there is little public sector regulation of syndicated lending with the result that, in such deals, much turns on the terms of the contracts which lenders and the borrowers negotiate for themselves. By contrast, the capital markets are heavily regulated by European and domestic legislation and individual investors will have little say about the terms and conditions of their securities.

The function of financial law is to translate risks of many kinds (for example, your house burning down) into credit risk, and then to permit the circulation of units of risk among market participants (Benjamin: 3). Valdez has described how in the financial markets 'the money goes round and round, just like a carousel on a fairground' (Valdez, 2007: 3) but as we will see, it is in fact more helpful for lawyers to think about the movement of risk, not money.

The purpose of this lecture is to explore the importance of the contract law element of English financial law. The positions which parties enter into may be economically complex and sometimes bafflingly so, even for experts (certain derivatives which fuelled the ongoing financial crisis have been called 'the banking equivalent of space travel' (Tett, 2009:7)) but all may be understood in legal terms as contracts in one form or another. This perspective affords a number of insights which we shall explore the first part of lecture, drawing on a broad range of examples from across the markets and making reference to developments since the financial crisis broke out in 2007.

The second part of the lecture will look in more depth at one part of financial law, that relating to derivatives. While derivatives have long played an important role in the markets for commodities and agricultural products, for example, certain innovative types of credit derivatives grew at an exponential rate from the mid-1990s and played an important part in the build-up to the financial crisis. Much attention is now being paid at national and international levels to how this market should be reformed. Having outlined by way of background some of the very different types of products involved in this category, we will discuss innovation, legal risk and current proposals for reform in this area, applying some of our previous discussion to this particular, specialised context.

Reading

- J. Benjamin, Financial Law (Oxford: OUP, 2007), chapter 1 and section 4.4
- Lord Turner, The Turner Review (London: FSA, March 2009) pp. 27-28, 81- 83, 108- 110. http://www.fsa.gov.uk/pubs/other/turner_review.pdf
- Hazell v Hammersmith and Fulham LBC [1990] 2 QB 697, 739-741

- Bankers Trust International plc v PT Dharmala Sakti Sejahtera (1995) 4 Bank LR 381(overview of highly complex facts only, but focus on the causes of action including misrepresentation brought by the claimant).
- BNP Paribas v Wockhardt EU Operations (Swiss) AG [2009] EWHC 3116 (Comm) (QBD)
- The International Swaps and Derivatives Association's website, at http://www.isda.org/
- Ed Murray "UK Financial Derivatives and Commodities Markets" in M. Blair and G. Walker (eds) Financial Markets and Exchanges Law, (Oxford: OUP, 2007), chapter 6.

The following are not required for the course but may be of interest:

- S. Valdez, An Introduction to Global Financial Markets (Basingstoke: Palgrave Macmillan, 2007)
- S. Henderson, Derivatives, (London: LexisNexis UK, 2002)
- G. Tett, Fool's Gold (London: Little Brown, 2009)

2. Understanding financial positions as contracts

Legally speaking, the positions which market participants enter into are contracts of one form or another. These contracts may be analysed by thinking about how risk moves between the parties.

For example:

- Under a contract of insurance, the insurer assumes the insured's risk of a particular event happening. Funds move if and when the insured suffers loss. During the life of the contract, the insured has a credit risk as regards the insurance company. Prudential Insurance Co. v IRC [1904] 2 KB 658
- Similarly under an indemnity, the surety assumes a liability to pay if and when the principal debtor defaults. To this extent, the surety assumes the creditor's risk of the debtor defaulting but the creditor has a credit risk as regards the surety. ILG Capital v Van Der Merwe [2008] EWCA Civ 542
- In a syndicated loan, funds move at the outset of the transaction from a syndicate of lenders to a borrower. During the life of the loan, the lenders assume the credit risk of the borrower defaulting, which they may address, for example, through a guarantee or an indemnity. Redwood Master Fund, Ltd and Others v TD Bank Europe Limited and Others [2002] EWHC 2701 (Ch)
- When Eurobonds are issued, funds move from investors (initially the managers) to the issuer. Up to maturity, the bondholders assume the credit risk of the issuer defaulting on the coupon (interest) and/or principal. Elektrim SA v Viviendi Holding Corp; Law Debenture Trust Corp v Vivendi Holdings Corp [2008] EWCA Civ 1178

Across these different areas of financial law, market practice, case law and legislation are all relevant but of differing levels of importance. For example, contrast how public sector regulation protects of the following (if at all):

- An investor buying bonds issued by a UK supermarket company, which are listed on the London Stock Exchange.
- An insurance company writing an insurance policy to protect an ice cream business in the event of a wet summer.
- A bank lending money to a start-up IT company in reliance on an indemnity from one of the wealthy directors.

- A bank lending money as part of a syndicated facility to a railway company which will use it to buy new rolling stock.

How important, in these examples, are the other sources of financial law ?
In each case, which party is likely to have the most bargaining power and which contracts do you think will be most heavily negotiated?

3. Contract law as a tool for innovation in the financial markets

The financial markets based in London have long been a site of innovation, for example the first Eurobond issue was arranged here in July 1963 for an Italian national highways authority. More recently certain innovative practices in the securitisation market have been implicated in the build-up to the financial crisis. Indeed, Lord Turner's 2009 review described part of the cause of the crisis as 'macro trends meet financial innovation' (The Turner Review, Chapter 1).

While some innovation turns on matters such as economics or tax law, other innovative practices may be understood as contract law-based responses to various problems which presented themselves in the financial markets. For example:

Markets facilitated by the standardisation of contracts.
Issue: Privately negotiated contracts, sometimes entered into in high volumes and at speed by traders, which have to address the full range of legal issues as well as the economic terms, expose parties to cost, delay and risk.
Response: Standardisation of contracts driven by trade associations. e.g. ISDA's Master Agreement for the 'over-the-counter' derivatives market and LMA's Facility Agreement for the syndicated loans.

Contractual credit risk mitigation.
Issue: Borrowers under syndicated loan facility agreements have no disclosure obligations (either on signing or during the life of the loan); the usual rule of caveat emptor applies.
Response: Sophisticated contractual drafting, which is now market standard, enables the providers of capital to flush out information on signing and to monitor the borrower closely during the life of the loan. These 'representations', 'repeating representations' and 'covenants' are drafted to impose a significant disclosure burden on the borrower. This gives the lender early warning of any problems which the borrower might be facing so they can take pre-emptive action as provided for in the 'events of default' section of the agreement. 'Cross-default' provisions mean that the lenders can also benefit from the protections enjoyed by other creditors of the borrower under their agreements. This is a particularly useful device if the market has become less 'lender friendly' over time.

Secondary market in loans
Issue: For various reasons, lenders may wish to sell their participation in a loan to a third party, for example if the loan has many years to run and the bank wishes to free up capital for new deals. Legal techniques for the transfer of property such as novation, assignment, sub-participation, risk participation can be onerous for lenders in practice, e.g. in terms of serving notice (s. 136 Law of Property Act 1925) or obtaining consents

(novation). Shopping around for a transferee may also breach a bank's duty of confidentiality to its client. Tournier v National Provincial and Union Bank of England [1924] 1 KB 461

Response: Transfer Certificates were developed in the 1980s and it is now standard to find them schedule to the facility agreement. Taking advantage of the concept of the unilateral offer, they simply require that lenders sign and deliver the certificate to the Agent for the loan participation to be transferred to a new lender. This has facilitated the market in secondary loans, making these positions much more liquid. This also means that new types of participants, such as hedge funds, have become involved in the loan market as transferees.

As to confidentiality, standard drafting in the LMA Agreement gives the borrower's consent to lenders making disclosures to potential transferees, though the borrower may require confidentiality agreements to be signed.

4. Common causes of action in the financial markets.

When borrowers become insolvent or transactions lead to losses not profit, parties may be inclined to sue either their counterparty or a third party. It is common for claimants in this position to launch multiple causes of action, some of which may be based on contract law. For example:

Misrepresentation, breach of contract, breach of collateral contract claims. When parties which suffer heavy losses in the financial markets they sometimes seek remedies on the basis that they were induced into the contracts by false statements or that contractual terms were breached. For example: JPMorgan Chase v. Springwell [2008] EWHC 1186 (Comm) and Springwell Navigation Corp v JPMorgan Chase and ors [2010] EWCA (Civ) 1221; Bankers Trust International PLC v PT Dharmala Sakti Sejahtera [1995] HC, QBD Comm Ct. In both of these cases investors sought to avoid liability and/or seek damages in relation to investments which (in the first case) suffered heavy losses due to the Russian financial crisis in 1998 and (in the second) were extremely complex and had exposed the investor by way of a swap to $65million losses because of a rise in interest rates. Both cases saw several different causes of action pleaded. In the first case, Springwell argued (at first instance) "breach of contract, negligence, breach of fiduciary duty, negligent mis-statement and/or misrepresentation under s.2 of the Misrepresentation Act 1967..". In the second case, the claims included lack of authority, misrepresentation, breach of contract and breach of duty of care. 60

However, these two cases offer interesting examples of the courts' approach to sophisticated investors in this position; in neither case was the investor successful in its claims.

Suing Agents and Arrangers and other third parties: When borrowers become insolvent, lenders may seek redress from other parties such as the bank that has arranged the loan, for example claiming misrepresentation or breach of contract. However, Agents and Arrangers now include extensive disclaimer language in the loan agreement itself and in the preliminary documents, which was found to be effective in IPE Fund SA v Goldman Sachs International [2007] EWCA Civ 811.

Penalty clauses: Penalty clauses are void in English law: Dunlop Pneumatic Tyre Co Ltd. v New Garage and Motor Co. Ltd [1915] A.C. 79. Parties in the financial markets have tried to argue that various terms of their contracts are 'penal' in nature and therefore void. For example, a bank recently claimed that contractual provisions in the ISDA Master Agreement which allow the early termination and 'close out' of transactions were unenforceable for this reason. However, in this case the court found that there was no realistic prospect

of this argument succeeding. BNP Paribas v Wockhardt EU Operations (Swiss) AG [2009] EWHC 3116 (Comm) (QBD)

What appears to be the approach of the English courts when considering these sorts of claims brought by participants in the financial markets?

However, it is also worth noting here the ramifications for the financial markets of decisions such as:

- Hazell v Hammersmith and Fulham LBC [1990] 2 QB 697; and
- Haugesund and another v Depfa ACS Bank [2009] All ER (D) 34.

5. Derivatives

Derivatives have long played a valuable part in the commodities and agricultural markets e.g. the derivatives traded at the Chicago Mercantile Exchange (http://www.cmegroup.com/trading/commodities/). However, from the mid-1990s complex credit derivatives were used to trade risk separately from underlying assets; this market exploded in size and contributed to the build up to the financial crisis as described in the 2009 Turner Review.

Legal definition

A derivatives contract is, very broadly, a bilateral contract

i. under which the rights and obligations of the parties are derived from or defined by reference to, a specified asset type, entity or benchmark [for example oil, agricultural products, shares, bonds, currency, ship charter rates, electricity, weather, bandwidth ...]
ii. the performance of which is agreed to take place on a date significantly later than then date on which the contract is concluded. i.e. settlement date more than 3 business days, possibly decades after the trade date. (Benjamin, paragraph 4.31)

Exchange-based vs. over the counter (OTC) products

'an exchange creates a private and closed contractual world, buttressed by limited access ('members only'), a detailed regulatory framework (to try to ensure an orderly and fair market), standard rules and procedures, standard contracts and standard procedures to resolve disputes' (Murray, p 279).

By contrast, OTC derivatives are entered into off-exchange. They are privately negotiated and can be highly bespoke products, for example used by many large companies to hedge specific risks. Derivatives lawyers will normally be focus on issues arising in relation to the OTC markets. ISDA is the trade association for off-exchange derivatives dealers and other participants in these markets, and it has over 800 members worldwide.

Sources of legal risk in the OTC markets

- Authority: Hazell, Haugesund
- Disputes about the making of contracts: Confirmations and Master Agreements. Traders calls recorded. Powercor Australia Ltd. V Pacific Power [1999] VSC 110.
- Credit default swaps: Serving notices and Credit Events: ISDA Determinations Committee.
- Jurisdiction disputes: Calyon v Wytwornia Sprzetu Komunikacynego PZL Swidnik SA ('PZL') [2009] EWHC 1914 (Comm)

- Global markets: e.g. Metavante case: A NY bankruptcy court's recent ruling on a clause in the ISDA Master Agreement in the context of the Lehman Brothers administration has given rise to much debate, not least because goes against the finding in a similar case in Australia in 2003.
- The impact of precedent on widely used standard terms e.g. see BNP Paribas case above about early termination under the ISDA Master Agreement.

Proposed reforms

OTC derivatives, and in particular a type of credit derivative called credit default swaps, have attracted widespread regulatory attention in the fall out of the financial crisis. This is because of the opacity of this market, its explosive growth and its role in contributing to systemic risk in the run up to the crisis. For example:

The role of CDS in the near-collapse of AIG

Many of AIG Financial Products' bespoke CDSs with European banks included 'credit rating triggers' so that in the 15 days or so that followed its credit ratings downgrade on 15 September 2008, AIG FP had to funded approximately US$32 billion of collateral calls. Its subsequent rescue by the US Treasury was in part motivated by the large net selling position the insurer had in the CDS market, as a counterparty to CDS of over US$400billion. Had AIG had collapsed, this 'highly concentrated' market would have left very many protection buyers without the protection of their CDS contracts, leading to widespread destabilisation across the world markets.

One reform which has been mooted is the product regulation of CDS contracts along the lines of insurance. See The Turner Review, page 108 onwards.

However, while product regulation remains a long way off, the FSA, HM Treasury, the G20, the European Commission and the Obama Administration have all endorsed the idea of extending central counterparty (CCP) clearing to the CDS markets. Much about this proposal remains undecided at the time of writing- e.g. which CDSs will this be required for? What will happen to the highly bespoke products? How will global co-operation be achieved? However what is certain is that more CCP clearing will go on in this market in the future. As contract lawyers, it is interesting to note that many of the central benefits of such arrangements derive from the standardisation and novation of contracts so that the CCP may act as buyer to every seller and seller to every buyer.

Questions for discussion in class:

1. Do you think that the usual rules of contractual construction should be applied by the court to a standardised financial contract which is very widely used around the world?

Consider as part of your answer:

- What if the usual rules of contractual construction were applied in a case between two particular parties, resulting in a precedent which massively disrupted the international markets?
- Does it make sense for the court to try and find the 'intention of the parties' if the parties are using a market standard contract drafted by a trade association?

2. A year ago Barley Ltd and Maple Bank entered into a five year derivatives contract. This was one of Maple's new interest rate swaps.

Under the terms of the swap, Barley has to pay Maple a variable rate of interest on a notional amount (£250 million) each month. This interest payment is calculated by reference to a formula so complex it needs special software installed at Maple's offices to work it out each month (Amount 1). In return, Maple has to pay Barley a fixed rate of interest on the notional amount each month. (Amount 2). In practice, Amounts 1 and 2 are netted so that only one sum is paid each month, depending if amount 1 is bigger than 2, or vice versa.

Barley Co. is a very experienced international investment company which has extensive positions in shares and bonds, but it has not used derivatives before. It intended this deal to be an investment yielding an income over the 5 years, and it explained this to Maple. When it became a client of the bank, Barley signed the usual disclaimers that it recognised that investments can go 'up or down' and that it was not getting investment advice from Maple. Before signing the derivatives deal Barley was given a long handbook about the deal, including details of the formula to produce Amount 1, but Barley's representatives did not understand the first few pages so did not read the rest. At the signing meeting before the paperwork was completed, one of the salespeople at Maple told a director of Barley that this was 'the deal of a lifetime', and that other clients of Maple had signed up to similar derivatives recently.

The deal has been a disaster for Barley so far, and it has had to pay £100 million to Maple Bank. No one at Barley thought that the formula could have such drastic results and they wish to terminate the contract immediately. Moreover, it turns out Barley was the only client of Maple to take this product.

Advise Barley.

Topic 12: Financial law (2): Debt finance

1. **Introduction**

In the previous session we defined financial law and explored how contract law underpinned the positions that market participants enter into. We also discussed unfunded contracts called derivatives. The purpose of this lecture is look in detail at another area of financial law, namely the law relating to debt finance. In particular, we will focus on loans and bonds. Both these types of debt finance represent important examples of how commercial contract law may work in practice.

The first part of the lecture will cover the background to the topic of debt finance, contrasting debt and equity as means of raising finance and, within debt, contrasting loans and bonds. The second part of the lecture looks

at loans, in particular the facility agreement between lender(s) and borrower, in more detail. The final part of the lecture discusses bonds, explains some of the jargon associated with that market and examines the nature of the contracts in place between the different parties involved in a bond issue and in the secondary market.

Reading

(1) Background to debt finance

J. Benjamin, Financial Law (OUP, 2007) chapter 8

(2) Loans:

A. McKnight, The Law of International Finance, (Oxford: Oxford University Press, 2008) , 3.1-3.14 inclusive and chapter 9 (not 9.2.5). [N.B. J. Benjamin, Financial Law (OUP, 2007) section 8.1.2 (bank loans) and R. Cranston, Principles of Banking Law (OUP, 2002) chapter 11 both cover the same issues but in less detail.]

The LMA's Guide to Syndicated Loans, especially section 3 (Parties to a syndicated loan).
http://www.lma.eu.com/uploads/files/Introductory_Guides/Guide_to_Par_Syndicated_Loans.pdf

Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland Plc [2010] EWHC 1392 (Comm) (attempt by a member of syndicate to claim that it had been induced to participate by misrepresentations made by the Arranger bank).

(3) Bonds:

Before the lecture, use the FT to find a recent article about a corporate or a sovereign bond.

A. McKnight, The Law of International Finance, (Oxford: Oxford University Press, 2008), chapter 10, with focus on sections 10.2-10.6 and 10.9.

P. Wood, The Law and Practice of International Finance: University Edition, (London: Sweet & Maxwell, 2008), paras 11.01- 11.32 (comparison of loans and bonds)

Bank of New York Mellon v GV Films Ltd [2009] EWHC 3315. Case about an events of default under bond documentation, which entitled the trustee to accelerate the payment of bonds. The trustee was awarded summary judgment (i.e. judgment without a full trial).

Satinland Finance SARL and ar v BNP Paribas Trust Corp UK Ltd & Irish Nationwide Building Society [2010] EWHC 3062 (Ch). Case brought by holders of subordinated bonds against background of financial problems of the issuer (INBS) and government intervention into its business.

The following are not required for the course but may be of interest:
S. Valdez, An Introduction to Global Financial Markets (Basingstoke: Palgrave Macmillan, 2007)
E. Ferran, Principles of Corporate Finance Law (2008, Oxford OUP)

2. Background to debt finance

The basic purpose of the financial markets is to match borrowers in need of funds with entities and individuals willing to lend them money on the promise of a return of some kind. When creditors lend capital they are assuming a risk that the borrower will not repay them, but in return they receive (usually) some sort of return, e.g. interest or a dividend.

Companies, governments, banks and public sector bodies like the European Financial Stability Fund all rely heavily on debt finance. In 2010 alone, the British Government issued £143,870 million in debt while UK listed companies raised £347,715 million by issuing debt securities on the London Stock Exchange's Main Market.

Gearing (or leverage) is the ratio of debt to equity. A higher level of debt than equity is regarded as desirable for companies in the interests of economic growth. However, sometimes gearing can become dangerously high. For example, before the US hedge fund LTCM crashed 1998 its gearing reached 50:1.

2.1 Contrasting debt and equity

- Examples
- Income
- Capital
- Ownership
- Ranking on a winding-up

However, note the convergence between debt and equity in the form of convertible bonds, bonds with warrants and 'equity' tranches of bond issues.

You are in a position to provide funds to the following. Would you chose debt or equity?

- A new social media website set up by two undergraduates in London.
- A large UK-based supermarket chain
- A French clothing company which is looking to raise sterling in London in order to expand into the UK.

2.2 Contrasting loans and bonds

Loans and bonds are both funded positions and types of debt finance. Some of the contract terms in loans and bonds may look similar, for example both may include a 'negative pledge'. However, legally speaking and otherwise, there are some important distinctions between them:

- Size of the potential investment pool
- Nature of potential investors
- Privacy v publicity
- Documentation
- Listing on a regulated market, e.g. the London Stock Exchange's Main Market.
- Regulatory treatment
- Transferability

3. Loans

Bank lending ranges from overdrafts to very large syndicated loans made as part of leveraged buy-outs. Because there is almost no public sector regulation which will protect a lender extending funds to a borrower, any protections need to be negotiated and included in the contract under which funds are lent. This means that lawyers acting for banks spend a lot of time negotiating, drafting and approving the facility agreement before a deal is signed and the funds drawn down.

3.1 Syndicated bank loans

- Syndicated and bilateral loans. Why might a bank lend as part of a syndicate? What are the advantages for a) the banks and b) the borrower of a syndicated loans? What are the possible downsides?
- Role of the Arranger and the Agent in a syndicated loan. Why should a bank take on these roles?
- In a syndicated loan the lenders have 'several' liability. Where would this leave the borrower if one of the syndicate became insolvent?
- Different types of loans reflect the needs of different borrowers, for example, term loans and revolving credit facilities.

3.2 Facility Agreements

The facility agreement is the contract governing how and when the loan will be drawn down and paid back with interest.

- The role of the Loan Markets Association and how documentation is prepared in practice.
- A facility agreement for a syndicated loan to a commercial borrower can be broken down into those parts (1) governing the relationship between the borrower and lenders and (2) other supporting provisions.
- The borrower/ lenders relationship:
- Operational provisions e.g. how and when money will be lend and repaid. The rate of interest may be fixed or floating and will usually reference the London Interbank Offer Rate (LIBOR) plus a margin of a certain number of 'basis points' (each 0.01%).
- Clauses designed to protect the lenders' margin.
- Credit risk mitigation. This includes conditions precedents, representations, covenants and events of default (see below).
- Supporting provisions
- For example, there will be provisions describing how lenders can transfer their share of the loan to a new lender.
- Why might a lender want to transfer its share of the loan? How as a matter of law might a lender transfer its rights and its responsibilities under a contract to another party? Will the borrower have to be informed?

3.3 Events of default

Events of default are designed to protect the Lenders if something goes wrong, or threatens to go wrong, with the Borrower. On the happening of an event of default, the Lenders immediately have the right to stop lending and demand the drawn down funds back. Absent events of default, the Lenders would have to rely

solely on (1) their rights under contract law, for example suing for breach of contract if the Borrower did not pay interest when due, and (2) their rights under insolvency law as creditors. If this is the default position, why might Lenders seek to improve their position?

Events of default usually include (amongst others):

- non-payment of sums due under the agreement
- breach of a financial covenant
- breach of the facility agreement
- misrepresentation
- cross-default (which is designed to give the Lenders the same rights as other creditors of the Borrower enjoy under their contracts).
- insolvency
- unlawfulness

The consequences of an event of default are very serious for the Borrower. Usually the Lenders can cancel the Borrower's right to any sums not yet drawn down, declare that the loan plus interest is immediately repayable and/ or put the loan on demand. Moreover, an event of default may trigger cross-default clauses in other contracts which could have devastating effects for the Borrower.

How might an event of default be 'softened' during negotiations, i.e. drafted to give the Borrower breathing space to rectify matters before the Lenders take action.

Case study: Liverpool F.C. 67

The extensive contractual rights afforded to Lenders under loan agreements mean that they can play a decisive role in negotiations about the Borrower's financial difficulties, restructuring or change of control.

Consider, for example, the role played by Lenders (including RBS and Wachovia) in the recent litigation about the change of ownership at Liverpool F.C. Before its takeover by New England Sporting Ventures (NESV), the club had over £300m debt. As a result, the Lenders were closely involved in the dispute about the takeover bid for the club in October/ November 2010. This culminated in RBS securing an injunction preventing the then owners Hicks and Gillett making changes to the board of the club with a view to preventing the sale. The sale to NESV finally went through on 15 October 2010.

Despite all the protections built into the typical loan agreement, the Lenders may still end up exposed if the Borrower and/or the Guarantor of the Borrower's liabilities fail. In this case, the Lender may look to sue another party such as the Arranger. There are a range of possible causes of action here, including misrepresentation, breach of contract, breach of a duty of care and even breach of fiduciary duty.

Consider Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland Plc [2010] EWHC 1392 (Comm).

4. Bonds

Bonds are a second type of debt finance and a type of capital market instrument. They are issued by public companies, such as Tesco plc, sovereign entities, municipalities and even by special purpose vehicles (SPVs) as part of complex structured products.

The bond market is huge, dwarfing the equity market. As noted, UK listed companies issued debt worth £347,715 million in 2010 on the Main Market of the London Stock Exchange. In the same year and on the same market, UK listed companies raised £19,306 million by issuing equity.

4.1 What is a bond?

Bonds are debt securities which are issued in return for subscriptions made by investors. After the initial issue, there is usually subsequent (secondary) trading in the bonds.
While the loan agreement will describe the circumstances in which the Lenders will make funds available to the Borrower, in the case of a bond, the debt is 'represented by and encapsulated in the bond instrument itself' (McKnight: 490) which is expressed as being payable to the bearer. This is important in a number of respects. Most importantly, it means that the person holding the bond is entitled to the interest and repayment of capital. This makes transferability much easier than with a loan.

4.2 Jargon

What are the following?

- Eurobond
- Foreign bond
- Medium Term Note Programme
- Commercial Paper

The FT in January 2010 reported that 'Investors snap up 'Yankee' bonds'. The article described how 'Non-US companies and banks have sold a record amount of dollar bonds in January, making it the busiest month to date for the so-called 'Yankee bond' market. The lure of the US capital markets reflects the huge pool of investors looking to buy dollar bonds …'
What kind of bonds are 'Yankee' bonds?

4.3 A bond issue

We will briefly consider the stages of a bond issue, including the following:

- Mandate
- Working towards listing
    - [Why? quoted Eurobond exemption from withholding tax. Broader investment base]
- Signing: Subscription Agreement and Agreement Amongst Managers
- Closing: Listing effective

The bond terms and conditions are found:

- printed on the reverse side of the global bond (and the definitive bonds if they are issued);
- in schedules to the fiscal agency agreement or trust deed
- in the prospectus or listing particulars.

In several respects the bond terms and conditions mirror those in a loan. For example, there will be Events of Default in both. However there will be important differences in the extent and nature of such terms as between bonds and loans.

Do you think such terms will be drafted so as to be more onerous for the recipient of capital in a bond issue or under a loan?

4.4 Litigation

In the wake of the financial crisis, there have been several instances whereby noteholders have gone to court to try to preserve their position as issuers have encountered financial difficulties. However, the court is not always sympathetic to such attempts, especially if they would involve 'side-stepping' clear contractual terms:

> Satinland Finance SARL and ar v BNP Paribas Trust Corp UK Ltd & Irish Nationwide Building Society [2010] EWHC 3062 (Ch). This case was brought by holders of subordinated bonds against the background of the grave financial problems of the issuer (INBS) and government intervention into its business. The bondholders' claims (seeking to have trustee take enforcement action and present a winding up petition as regards the issuer) were dismissed: there was no contractual basis in the bonds' terms which justified the action and there was no basis on which court could exercise its discretion to direct and control trustees.

For an action brought by the trustee (on behalf of the bondholders) against an issuer on the basis of a number of events of default, see :

> Bank of New York Mellon v GV Films Ltd [2009] EWHC 3315. There were several events of default under the bond documentation, which entitled the trustee to accelerate the payment of bonds. The trustee was awarded summary judgment (i.e. judgment without a full trial).

Referencing these cases, what advantages can you see for bondholders in having a trustee represent their interests?

5 A van Duyn and N Bullock and R Milne, 'Investors snap up 'Yankee' bonds' Financial Times (30 January 2011).

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