BUSINESS LAW IN THE GLOBAL MARKETPLACE

The effects on international business

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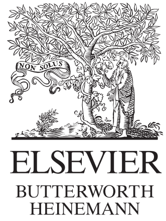
Peter Nayler



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CHAPTER 1

The legal framework for international business

Introduction

'If the law supposes that, the law is an ass' Mr Bumble once famously remarked in Charles Dickens's *Oliver Twist.* Many people will, no doubt, agree with this sentiment, particularly if they have been on the receiving end of the law and its application. While the vast majority of us realise that law 'exists', the same proportion is unlikely to regard it as having an immediate impact on how we conduct our daily lives. True, some people go through their entire mortal existence without being caught up in anything remotely resembling a legal problem, but whether this is down to good fortune or a deft arrangement of their private and/or business affairs is a different matter. Whether one relishes the thought or not, there is no escaping the fact that law is part of the environment in which we live. It is not something existing merely in abstraction but is

all around us. It can and does affect many aspects of our lives. Assuming the guise of an ostrich and burying one's head in the sand may be a tempting option, but the fact remains that the law can bite and presenting it with an easy and ill-prepared target can cause more than a few ruffled feathers.

If we are prepared to recognise that, potentially, the law affects us all in the things we do, how does this manifest itself? Most people appreciate that it is illegal to kill a fellow human being or to point a gun at someone in the street and relieve this person of his or her wallet, but these are examples of criminal law which form but one small part of the law as a whole. While few would fail to agree that such anti-social behaviour as just described should be prohibited and that it should be down to the law to do this, there are very many other situations where a failure to satisfy the requirements of the law can have serious consequences, even if the threat of imprisonment is not one of them. For example, is it widely appreciated that, under English law, a person who witnesses a will cannot take a benefit under it? So if an uncle draws up a 'do-it-yourself' will and bequeaths a substantial legacy to his favourite niece, would he realise that if he requested her to witness his signature, he would simultaneously be depriving her of his benevolence? Likewise, would the average man in the street appreciate that he owes certain duties to persons who may trespass on his land? He might find it strange to be ordered to pay compensation to a teenager who falls down a disused well while stealing apples from his orchard. If a village resident sends a text message to her neighbour making disparaging remarks about the chairman of the Parish Council, would she readily appreciate that this bastion of local democracy may have an action for libel against her? It is unlikely that any of the actors in the scenarios just described would consider themselves to have done anything 'wrong', but nevertheless their actions or, in the case of the disused well, inaction, would be judged according to the requirements stipulated by law and non-compliance with these could have the consequences described.

If the law can impact on our everyday private lives, the same is true for any business activity we may pursue. Those

who are engaged in business may be slightly more streetwise when it comes to the 'legal stuff' than their less commercially oriented brethren but, even so, ignorance or misunderstanding of the law and its effects is hardly a rare phenomenon and attitudes ranging from complacency to outright hostility can often be detected wafting through the corridors of business. 'Law is for lawyers. If there is a problem, let them sort it out; after all it's what they're paid for.' Such a view amongst business practitioners is not particularly uncommon and reflects an innate suspicion that the law and lawyers conspire together to obstruct entrepreneurial flair and endeavour, and that whoever may be the loser in a legal spat, it certainly won't be the lawyers. Such is the antipathy to those versed in the law that, often, professional legal advice is only sought when a problem, which perhaps initially was avoidable, has escalated to a point where extrication at the lowest possible cost is the only option.

On the other hand, however, there are those engaged in business who recognise that law is part of the environment in which they must operate. This fraternity appreciates that, like it or not, the law does regulate, or at least affects, many aspects of business activity. They consider that, in strategic planning, it is far better to identify relevant legal issues as early as possible in the process. Taking these into account at this stage and making necessary adjustments should facilitate, not hinder, the attainments of commercial objectives. Alternatively, initially adopting a 'head in the sand' approach, which fails to identify legal pitfalls, can later present problems that are either insurmountable or, at the very least, expensive to address.

Nor should the law's relationship with business always be looked at from a negative perspective, i.e. 'it's always there to work against us'. There are many situations where an adept use of the law can protect vital business interests; for example, an appropriately drafted contract can be employed as a vehicle for minimising, transferring or, in some circumstances, entirely excluding a variety of commercial risks; or, alternatively, the effective management and assertion of intellectual property rights can be crucial factors when seeking to maintain the integrity of a brand name; and so on.

Although business can be and very often is conducted in a purely national context, there are ever increasing possibilities for such activity to develop an international dimension. This may follow a decision of a domestic producer actively to establish a presence in a foreign market by co-operating with a local 'partner' in one way or another, or going it alone and establishing a branch office or legal entity in the chosen location. However, business activity can take on an international character without such formalised arrangements being involved. A home producer who supplies a single order originating from another country is engaged in an international business transaction. A sole trader who sets up his or her own website offering goods or services is conducting international business with anyone who responds from outside the country in which that trader is located.

International business of even the simplest variety can present problems that are not present in a purely domestic transaction. As in most cases, if the problems can be spotted in advance, the chances are they can be headed off or at least minimised. Slamming shut the stable door when the horse is but a speck on the horizon will provide scant comfort if appropriate safeguards could have prevented the animal's escape in the first place.

However, whether the context is domestic or international, it would be neither realistic nor sensible to expect business practitioners to acquire specialist knowledge approximating that of the professional lawyer. The expertise of the professional is built upon more than simply knowledge of the law but includes skills of analysis and argument developed through long experience of the law in practice. The aim of this book, therefore, is not to supplant the need for appropriate professional advice but to provide the business practitioner with an introduction to the legal framework in which business and, particularly, international business operates. By acquiring an understanding of how the law can impact upon commercial activity, the modern manager should be better equipped to identify potential legal problems while they are still in early gestation. A timely realisation of what might lie ahead may offer the opportunity of taking appropriate action to prevent

the escalation of what may be a controllable situation. By adopting a proactive approach rather than merely reacting to events, a business can better protect its essential interests which, in the heat of today's trading environment, may constitute a vital competitive advantage.

So what is 'law'?

The comments made above stress the idea that the law affects us all in the way we conduct both our private and business lives. But before this can be explored in greater depth, a basic question needs answering: what exactly is meant by the term 'law'? The question is simple to state but not so the answer. In truth, the term 'law' is extremely difficult to define. If asked the question, the average respondent might very well attempt to describe the law as, say, a 'collection of rules' or 'something which you must obey'. While not being 'wrong', such an attempt would not address the essential issue, namely defining the term by reference to its intrinsic character. While it is true to say that law has a regulatory function, the same is also true of many other types of rule and/or custom that seek to control behaviour in any given society or community but which, nevertheless, do not have the character of 'law' as the word is commonly understood. For example, the rules provided by religious or moral teaching may have a strong impact on the way in which people behave, as may the cultural norms observed by a particular community. The rules of etiquette or simply good manners also play a part, but none of the controlling influences just mentioned purely in themselves constitute 'law'. So, however much we may condemn the loutish teenager who refuses to give his bus seat up to an elderly fellow passenger, he is unlikely to have to defend his conduct before a magistrate.

Many great philosophical works have grappled with the inherent problem of distinguishing law from other forms of rule producing normative behaviour, but it is beyond the scope of this book to probe deeper into this, albeit interesting, argument. For present purposes, the definition of law

provided by the Oxford English Dictionary will suffice; here law is defined as:

> a rule enacted or customary in a community and recognised as demanding or prohibiting certain actions and enforced by the imposition of penalties.

The essential characteristics of a rule of law would appear to be that it:

1. has what may be described as the 'official stamp' of state authority, i.e. it has been created by an institution of state having legislative competence or is, otherwise, a rule recognised as having legal force by the courts responsible for the administration of the law within that state;
2. applies equally to and is binding on all members of society. In other words, no one is above the law;
3. results in certain consequences if it is contravened. Such consequences may include, say, a fine or imprisonment if a rule of criminal law is infringed but can also involve less obvious but nevertheless serious consequences. For example, a failure to comply with the law governing the transfer of property may result in the purchaser of a house later discovering that he or she does not in fact have legal title to it.

Chalk and cheese

It should not require the international experience of Marco Polo for someone to realise that the law of, say, Sweden is probably different from that operating in Japan, but such a realisation is not an attribute characterising mankind as a whole. Not infrequently does a person brought up in the legal tradition of his homeland express incredulity at the suggestion that the law in other countries may be different. Such differences can and do exist and for the conduct of international business the implications can be profound. If two companies based in the same country are involved in a dispute, say, over a contract, the law governing the dispute, complex or otherwise, can at least be

identified at the outset. Introduce an international dimension, however, and problems can arise that are unlikely to be encountered in a purely domestic contract. In later chapters, some of these problems will be examined, but for present purposes consider the following scenario: company A offers to provide services for company B at a certain price. Before B responds, A, realising that the quoted price is too low, retracts the original offer and substitutes a new one incorporating a higher price. Can A do this? Leaving aside ethical considerations, A's ability to retract its offer will depend on whether the applicable legal rule permits this. If A and B are located in the same country and the services are to be provided locally, the rights or wrongs of A's action will be decided by the law of the particular country involved. However, suppose that A is located in country X and B in country Y and, furthermore, the services being offered by A are to be provided in country Z. Suppose, also, that the law of X permits A to retract its offer as does the law of Y, but only in certain circumstances. The law of Z, however, contains a rule that an offer, once made, cannot be retracted. The answer to the original question has now become somewhat less certain.

The fact is, however, that although references are frequently made to the 'global marketplace', there is no such thing as a 'global' legal system containing laws of universal application; instead, one finds a mosaic of different systems existing in the world today, each having its own particular characteristics. It should hardly be surprising, therefore, to find disparity in the laws of countries that have had fundamentally different historical, cultural and political development. To compare the law of China with that of New Zealand may, indeed, be like comparing chalk and cheese.

Family ties

At the time of writing, there exist approximately 190 independent states in the world. Does this mean, therefore, that there also exist an equivalent number of different legal systems, all containing widely differing laws? To a certain extent this view is correct, since every sovereign state has the right to enact law and provide for its operation in the territory

concerned. However, a study of the main characteristics of the many apparently differing legal systems in the world would reveal similarities which are shared by more than one. For example, if the laws of, say, countries A and B were examined, the conclusion might be drawn that, in many ways, they are basically very similar. Equally, a comparison of the laws of countries X and Y might reveal a common 'flavour' shared by both. However, if one proceeded to contrast the laws of A and B with those of X and Y, fundamental differences might emerge. If this exercise were pursued on a global scale, it might be concluded that the world's legal systems can, in fact, be reduced to a number of 'families' with the members of each, either by parentage or adoption, sharing a common heritage. Such a conclusion would essentially be correct.

Civil law and common law

Among the major legal families existing today are the *civil law* and *common law* systems. Civil law comprises those systems either based on or influenced to a greater or lesser extent by Roman law. These include the laws of most European continental countries – for example, France, Germany, Spain, Portugal, Italy, Greece, etc. Almost the entirety of South and Central America has either inherited or adopted the civil law, with French law having had a major influence. Again, if one looks towards Africa and considers countries such as Morocco, Algeria, Cameroon, Rwanda, and Madagascar, it can be seen that, due to their historical links with mainland Europe, they belong firmly to the civil law camp.

Common law, on the other hand, is based on English law or, more accurately, the law of England and Wales. Scotland has a separate legal system which, in the main, is based on civil law. Prior to Scotland's union with England in 1707, the country had had close historical links with continental Europe, in particular France. This exposure to European culture had a major influence on the development of Scottish law. Although there are areas of law which apply both to Scotland and England, the innate character of Scottish law stems from the foundation of Roman law upon which it was built.

The historical expansion of British interests throughout the world during the eighteenth and nineteenth centuries also led to the growth in the number of territories where the common law held sway. Although the British Empire disappeared long ago, the legacy lives on in the legal systems of many countries across the globe. Thus, within the common law family one would place the law of Australia, New Zealand, the USA, Canada, Kenya, Zambia, Nigeria, the Indian subcontinent, Singapore, Malaysia, etc. Although countries following the common law tradition have often developed the law to reflect differences in culture and political and social organisation, it still remains true that these systems owe many of their fundamental attributes to the law of England and Wales.

As a final point, it should be noted that some countries have a foot in both camps, operating within their borders elements of both civil and common law. Such countries are referred to as *mixed jurisdictions*. Two examples can be found in the laws of the USA and Canada. In the former, law-making powers exist at both federal and state levels. While federal law applies throughout the country, each of the fifty states which make up the Union enacts law for local application. While most state law is based on common law due to the historical British influence, Louisiana, being a former French colony, has bucked the trend and retained its allegiance to civil law. The French connection also holds sway north of the border in Canada, notably in Quebec which, in contrast to the common law tradition embraced by the other provinces, resolutely adheres to its civil law foundations. As explained above, Scottish law displays many civil law characteristics and to a certain extent, therefore, it could be said that the UK constitutes a mixed jurisdiction.

Distinguishing features of civil law and common law

The civil law and common law systems are fundamentally different as regards concepts, vocabulary and legal method. Thus, for example, a French lawyer may have great difficulty in understanding the way in which an English lawyer approaches the solution of a legal problem and, of course, the

reverse is probably true. However, lawyers from two different countries but whose laws are within the same family will have much less difficulty in terms of communication and comprehension. So, although the laws of France and Germany differ in various respects, these differences are far outweighed by the similarity existing in fundamental concepts and approach. The same could be said of the law of England and Wales and that of Australia. In other words, within the same family there is a common legal language readily understood by those trained accordingly, but which creates the potential for confusion in the minds of those who are not.

If a lawyer practising in a civil law country wants to know the legal rule applicable to a particular situation, the chances are that the answer will lie between the covers of one of the substantial volumes lining the office bookshelves. The reason for this is that civil law is a system giving pre-eminence to written law. In those countries embracing the civil law tradition, great tracts of the law are contained in codes, each containing a myriad of legal rules but structured in a way that is both logical and comprehensive. The cornerstone of the civil law edifice is the civil code. The civil code is a compendium of legal rules governing the relationship between private individuals. Typically, a civil code will be divided up into sections, each dealing with a different issue. Consider the French civil code (*Code civil*) by way of example. This code is divided into three Books, which in turn are divided into chapters. Book One deals with matters such as marriage, divorce, the status of minors, guardianship, domicile, etc. Book Two deals with the various kinds of property while Book Three covers a variety of matters, including succession, contracts both general and particular, delict (civil wrongs), matrimonial property, etc.

The French civil code has been used as a model in many other countries worldwide. However, some countries, while still adhering to the civil law faith, have developed a style and approach of their own. A good example is the German civil code (the *Bürgerliches Gesetzbuch* or 'BGB'). Again, this code is divided into a number of Books, each dealing with a particular matter. However, the structure of the BGB is very different from that of the *Code civil*, as is the style in which it is written. The *Code civil* is often held up as jewel in the crown of legal

draftsmanship, embodying a clarity of exposition and eloquence of language which renders the law, theoretically at least, comprehensible to the man or woman in the street. The BGB, on the other hand, embraces a regime of almost mathematical abstraction in its endeavour to accommodate the infinite manifestations of human interaction within a rationale structure of legal rules. To the outsider, the result is as impenetrable as a hill fog.

While the civil code is at the heart of systems based on the civil law tradition, it is not the only code. Sitting alongside the civil code one will typically find other codes dealing with specific issues – for example, the commercial code, which lays down special rules for those conducting business (merchants); the criminal code; the code of criminal procedure; the code of civil procedure; and so on.

While civil law systems are essentially based on written law, English common law, on the other hand, is sometimes said to be 'unwritten'. This does not mean to say that it exists only in the form of oral incantations, but reflects the idea that the law derives from sources other than written codes. Traditionally, common law evolved from the principles developed by judges when deciding cases before them. Over time, the concept of judicial precedent, as it is now known, became firmly established as one of the defining characteristics of the common law. Under this system a judge hearing a case will generally be bound by the legal principles underlying a previous decision of a higher court involving broadly similar facts. In the case of the common law, therefore, the courts have played a central role in developing the law. Although the bulk of 'new' law created today results from legislation enacted by the legislature and, in this sense, can be said to be 'written', it still remains true that the vast body of legal principle which forms the bedrock of common law has been the result of judicial creativity over hundreds of years. The consequence of all this, when compared with the sometimes abstract conceptualisation of civil law, is to give the common law a pragmatic flavour. Whereas the architect of a code must attempt to visualise problems which might lie ahead and provide legal rules to accommodate them, traditionally the common law judge hearing a case was faced with a problem which had already arisen

and which required a resolution. Any principle of law that he formulated when applied to the facts had to produce a sensible and practical result.

While it is true to say that written codes do not characterise English law and other systems following the common law tradition, this is not to say that codification never plays a part. Indeed, certain areas of English law, effectively, have been codified. However, where this has happened, it represents an essentially different exercise from that found in civil law systems. Whereas the architect of a civil law code is very often designing a framework of rules virtually from scratch, the codification of English law, where this has occurred, has usually involved the draftsman collating into a structured and accessible single source the law relating to a particular subject which had previously been contained in a vast array of judicial precedents and/or statutory provisions. Although the procedure may very well include the modernisation of some of the legal principles involved, essentially it is not a process of invention. Two examples from English law are the Sale of Goods Act 1979 and the Partnership Act 1890. The former provides a comprehensive set of rules governing contracts for the sale of goods, whereas the latter effectively codifies the previous law relating to business partnerships. Similarly, in the USA, the Uniform Commercial Code consists of a uniform system of rules regulating many forms of commercial activity, such as the sale and leasing of goods, negotiable instruments, bank deposits and collections, letters of credit, bills of lading, etc. The UCC, as it is known, has been incorporated into the law of all states except Louisiana which, nevertheless, has adopted most of it. In Canada, on the other hand, the entirety of criminal law has been incorporated into a single Criminal Code.

Other legal families

Apart from the civil law and the common law, there exist other legal traditions in the world although, as will be explained, common law and/or civil law influence may very well also be present in the countries in which they are found.

Socialist law

Before the momentous events of the early 1990s, when the Berlin Wall literally came crashing down, bringing in its wake the collapse of the Soviet Union and the communist regimes of Eastern Europe, legal academics were accustomed to talk of the Socialist legal family. While not being an issue solely of historical interest, the demise of communism in the places just mentioned has certainly operated to decimate the number of family members.

Quintessentially, socialist legal systems are based on the philosophy and ideology propounded by the Marxist–Leninist school of thought. According to this, the basis of any social order is its economic foundation and in particular the relationship existing between the various forces and factors of production – for example, manpower, raw materials, and machinery. Everything else, whether it be spiritual, moral or philosophical thought or the more concrete manifestations of the state and its institutions, including the law, are subservient to this and are to be regarded merely as tools to be applied in pursuance of the economic order that socialism embodies.

Within the socialist society, private property in the form of capital is extinguished and is replaced by the common ownership of the means of production. According to the Marxist–Leninist philosophy, in its advance towards the utopian ideal of communism, society is in a continual state of transition in which capitalism will ultimately be replaced by a communist social order. In the classless society which will then exist, law will wither away because, as all men and women will treat each other as equals, it will simply be unnecessary.

Although, according to the dictates of Marxism–Leninism, the realisation of the communist social order is inevitable, the interim journey requires leadership of single-minded and unquestioning commitment. In the socialist tradition, the Communist Party is the sole repository of such qualities and, accordingly, is charged with the responsibility of ensuring that the road ahead is kept clear of diversions and/or obstructions which may delay arrival at the ultimate destination.

When the Soviet Union disintegrated, Russia and eleven of the former soviet republics joined together to form the Russian Federation. Since then the legal vestiges of the communist era are progressively disappearing as the Federation countries revert to their original civil law traditions.

Of the communist states still remaining, China is perhaps the most notable example. However, even in China the rigidities of the state-controlled economy are progressively being relaxed in favour of a more market-led system. Significant areas of the law are being reformed in order to encourage enterprise and foreign investment. In this process, China is borrowing heavily from other legal systems and in particular from those belonging to the civil law family. China acceded to the World Trade Organisation on 11 December 2001 and it will be interesting to see how far the 'westernisation' of her legal system will be allowed to develop.

Religious law

In addition to the 'secular' systems of law described above, there exist systems based on religious doctrine, a prominent example being Islamic law.

The Shariah or Islamic law is a complex set of rules as revealed by Allah (God) to his prophet, Muhammad, which govern every aspect of human life and by which every faithful Muslim must abide. The highest source of Islamic law is the Koran, which is comprised of a compilation of the utterances of Muhammad accepted by Muslims to be based on divine revelation. For hundreds of years following the death of Muhammad in 632, the principles laid down in the Koran as interpreted and developed by legal scholars provided the governing law throughout the Muslim world. From the nineteenth century, however, various factors including the increasing influence of the European powers on traditional Muslim countries resulted, in many cases, in Islamic law having to adapt to or coexist with western systems. The reality of the modern world has necessitated many Muslim countries developing legal systems which may, to a greater or lesser extent, be based on or incorporate aspects of Islamic law but which, nevertheless, reflect today's social, political and commercial environment.

Making order out of chaos – the classification of law

Bearing in mind that in any given context tens or even hundreds of legal rules may be applicable, how can the hapless individual, when faced with something having the apparent structure and coherence of a can of worms, be expected to make sense of it all? Law is often regarded as opaque, a regulatory fog that only lawyers can penetrate. In part this may be true. Some rules of law are, technically, extremely complex and are more readily understood by the experienced professional than the man or woman in the street. For example, however adept he or she may be at solving the *Times* crossword, it is unlikely that the average citizen would make immediate sense of the legal framework governing financial derivatives.

Awesome as it may at first appear, it is possible to organise the seemingly limitless number of disparate legal rules into something resembling a structure or *legal system*. Within such a system different laws are compartmentalised according to their subject matter – for example, criminal law, property law, and family law. Within a legal system there will also be found rules governing the creation and operation of courts and tribunals to oversee the administration of the law as a whole, including those relating to criminal and civil procedure, the appointment of judges, the role and training of lawyers, etc.

Any system of law has to provide solutions to the problems created by human activity and the type of problem that can arise is not, as a rule, unique to any one country. Whether one is referring to Spain, Denmark, Peru or Israel, neighbours can fall out over where the boundary lies between their respective properties, business partners may disagree over how the business should be conducted, a buyer of goods may wish to reject them on the grounds that they are not of the correct quality, a consumer might be injured as a result of using a defective product, and so on. In all these cases the law contains rules for determining the rights and/or obligations of the parties involved. The main problem facing anyone attempting to solve a legal problem is knowing precisely where to look in order to find the detailed rules relevant to the situation under consideration.

The law of any country can be subdivided or classified into a number of different branches, some of which are explained below. If a lawyer is asked by a client to give advice on a particular issue, a vital first task will be to ascertain the essential facts of the matter. These will form the basis of his search for the appropriate rules of law. The process which will lead him in the right direction is known as 'classification', whereby the facts of a particular issue are 'pigeon-holed' or classified under the relevant part of the law. The difficulty is that civil law and common law systems do not always share the same method of classification. It is possible, however, to adopt a broad approach to the exercise which, although not reflecting the scientific rigour of the legal comparatist, provides a general overview of the law's principal divisions.

Figure 1.1 illustrates some but not all of the main branches of both civil and common law. Although, at first sight, it might seem to have the complexity of an atomic structure, the explanation which follows will hopefully diffuse any such impression and show that the underlying logic is reasonably uncomplicated.

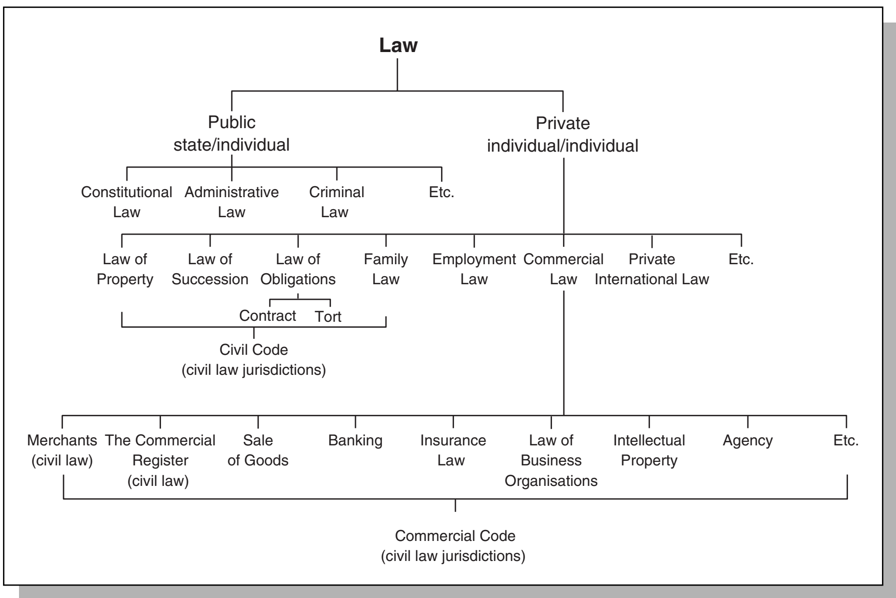


Figure 1.1
The main branches of civil and common law.

The first major division is between *public law* and *private law*. Public law consists of those rules which regulate the relationship between the state and the individual. Within this branch of the law further subdivisions can be found – for example, constitutional law, administrative law and criminal law.

Constitutional law is concerned with defining the powers of and the relationship between the principal institutions of state. For example, in the UK constitutional law deals with such issues as the role and powers of the Monarch, the function of the House of Commons and the House of Lords (the British Parliament) and the relationship between them, the role of the executive in the form of the Prime Minister and the government, the structure of local government and the powers given to it, the status and powers of the armed forces and the police, and the role of the courts and judiciary. This part of the law is also concerned with the relationship between the state, its institutions and the individual citizen and, in particular, the civil liberties of the latter.

Unlike most other countries, the constitution of the UK is not 'written', i.e. there is no single document which can be said to contain the constitution. Instead, it stems from a number of different sources – for example, constitutional conventions (custom), legislation and judicial precedent. It should also be noted that, again unlike many other countries, the courts of the UK have no power to declare an Act of Parliament 'unconstitutional'.

Administrative law is that branch of the law which deals with the operation of government as it affects the individual citizen. The increasingly active role of the government through its many departments and agencies in the control and regulation of daily life often gives rise to disputes. As a result, this has led in most countries to a rapid growth in administrative law to deal with the complaints of the individual against the decisions of administrative bodies. Again, by way of example, in the UK such issues as social security benefits (unemployment pay, housing benefit, etc.), state pensions and the National Health Service would all come within the scope of administrative law.

Criminal law deals with conduct on the part of the individual which the state regards as harmful to society generally and for

the control of which the state assumes responsibility. Most people, when asked 'what is a crime?', will give examples – murder, theft, robbery, etc. – rather than attempt a definition. This is understandable because the term 'crime' is not easy to define. The definition does not lie in the nature of the act itself, for a particular act can constitute a crime as well as a civil wrong under private law. The following example may help to illustrate the point. Suppose that X and Y are neighbours and that X, much to the annoyance of Y, regularly takes a short cut through Y's garden to reach the bus stop. If, in desperation, Y complains to the police, it is unlikely that they would be interested. However irritating X's actions may be to Y, they are unlikely to threaten the well-being of society generally and therefore will not be the concern of the criminal law. Y's remedy will lie in private law and under this he may be able to get an order from a civil court prohibiting X from repeating the conduct complained of and, in some circumstances, compensation. However, if on one occasion, Y remonstrates with X and during the argument X hits Y with a baseball bat, Y's complaint to the police may produce dividends because such conduct, while affecting Y individually, also has wider implications for the general public good and the maintenance of social order. X's conduct will, in addition to infringing Y's private rights, also constitute a crime. In this case, the state might decide to prosecute X in a court having criminal jurisdiction with a view to exacting a penalty from X which will punish him and constitute a warning to others who may be similarly inclined.

Private law consists of those rules of law that govern the relationship between private individuals. An 'individual' in this sense will also include private organisations such as limited liability companies. Private law can be subdivided into several major categories, some of which will now be briefly considered.

Property law lays down the rules regulating the rights a person may enjoy in or over the various forms of property. In civil law jurisdictions, property is usually further divided into *immovable* and *movable* property, the distinction roughly equating with the *real* and *personal* property categorisation of English law. Immovable or real property comprises land and things affixed to it, such as buildings, whereas movable or personal property

basically refers to everything else. An exception to the last point, however, exists under English law because, for mainly historical and technical reasons, leases of land are regarded as personal property. The law also recognises the concept of intangible property, with intellectual property such as patents, trademarks, copyright, etc. being a notable example.

The *law of succession* is concerned with the devolution of property on death. As it is not possible to journey into the hereafter accompanied by one's worldly goods, there has to be a system of rules determining who is entitled to what from the deceased's estate. Some systems of law, such as English, allow a person significant freedom to direct who should benefit from his or her estate by means of a will or testament. Other systems, for example French law, impose limits on such freedom, thereby guaranteeing the rights of inheritance of the deceased's heirs to at least part of the estate irrespective of his or her specific directions.

The *law of obligations* deals with certain forms of legal obligation which can exist between individuals, two prominent examples being those arising under the law of contract and the law of tort, or delict as it is sometimes known.

A *contract* is an agreement made between two or more persons giving rise to obligations which are recognised or enforced by law. For example, if X offers to sell 100 tons of potatoes to Y for £5000 and Y accepts promising to pay the price, a contract is created imposing obligations on both of them. If either X or Y fails to honour his obligation, the other will be able to apply to the court for an appropriate remedy. The distinguishing feature of the contractual obligation is that the parties themselves create it through their agreement. If, in the example above, X and Y had not concluded the agreement they did, X would be under no obligation to deliver the potatoes to Y nor Y to pay the £5000 to X.

Important though the concept of the contract is, it would be entirely wrong to assume that a person can only owe a legal obligation to another if a contract exists between them. Thus, if X, while driving his car in a careless fashion, knocks Y off his bicycle injuring him, the fact that there was no contract between them would have no bearing on Y's right to pursue a claim for compensation against X. The law of *tort* (delict)

imposes on each and every individual certain obligations, breach of which will produce legal consequences. Although the term 'tort' basically means a civil wrong for which the law provides a remedy, common law jurisdictions differentiate between the various categories of wrong by giving them separate names. Thus, in the illustration just given, Y could bring a claim in *negligence* against X for his failure to exercise reasonable care. Other examples are *nuisance* (unlawful interference with a person's use of his or her property, health or comfort and convenience), *trespass* (wrongful interference with the person, goods or land of another) and *defamation* (publishing false statements which damage a person's reputation). While not naming individually the various types of wrong, civil law jurisdictions would, nevertheless, recognise the essential issue involved in the torts just mentioned and provide a remedy accordingly. For instance, paragraph 823 of the German civil code (BGB) forms the basis for many claims in tort by providing that a person is obliged to pay compensation for either negligently or intentionally violating the protected right of another, the protected rights including life, body, health, freedom and ownership of property. In French law, the basic principle which governs the entire law of tort is contained in Article 1382 of the *Code civil*, which states that 'any act committed by a person which causes damage to another obliges that person by whose fault it occurred to make reparation'.

Both the law of contract and the law of tort have a direct bearing on business activity. The contract is the foundation stone of many types of business relationship and for this reason alone it is advisable for any business practitioner to have an understanding of the fundamental principles of this area of the law. In various contexts the law of tort can operate to provide a basis for business liability. For example, one option for a person injured through using a defective product is to bring an action in negligence against the manufacturer. Principles relating to both the laws of contract and tort will be further considered in later chapters.

Family law, as the name suggests, is concerned with matters relating to family life. Thus, the law relating to marriage and divorce, custody of children, financial support, matrimonial property, etc. would be included under this heading.

The branches of private law just considered are, of course, recognised by both common law and civil law systems, and in the case of the latter, the detailed rules are very often found in the civil code. In the common law, however, the equivalent rules are more likely to be found in a disparate collection of precedents and/or statutory provisions rather than within the framework of a code.

Employment law is that part of the law which relates to the employment of labour and matters associated with it. In most developed industrial societies this is an area of the law which is constantly growing as it seeks to balance the legitimate commercial interests of the employer with the rights and entitlements of the employee. Within the scope of employment law are found rules relating to the formation, content and termination of the employment contract, unlawful discrimination, maternity rights, health and safety, trade unions and their activities, and so on.

The term *commercial law* can have a different connotation depending on whether it is being viewed from a common law or civil law perspective. In the case of English law, for example, the term has no precise meaning, often being merely descriptive of those areas of law relating to the supply of goods and services. Indeed, if one examined the contents page of several textbooks bearing the title ‘Commercial Law’, there would be no guarantee that exactly the same subjects would be included. Typically, however, matters such as contracts of sale, agency, negotiable instruments, and contracts of carriage would come under the heading of commercial law. Again, as in many areas of English law, the specific rules relating to the above subjects arise not from a single source but from a variety of sources, including precedent and statute.

In civil law jurisdictions, on the other hand, the term ‘commercial law’ refers to that separate and distinct branch of the law containing special rules applying to merchants and their commercial activities. Very often this body of rules is contained in a commercial code such as the French *Code de Commerce* or the German *Handelsgesetzbuch* (HGB). The content of commercial law will necessarily depend on the particular jurisdiction under consideration, but by way of illustration a brief foray into the HGB might be helpful.

The HGB consists of five books. Among the matters dealt with in Book One is the concept and status of the merchant (Kaufmann). Although certain aspects of a merchant's activities will come within the remit of the civil code (BGB), he or she will also be subject to the special regime contained in the HGB. At the outset, therefore, it is essential to know who has the status of a merchant. Paragraph 1 defines a merchant as a person who carries on a commercial enterprise. A 'person' can be an individual, a commercial partnership or a company. Paragraph 2 contains a list of nine activities which constitute a commercial enterprise. These are: buying and selling goods and securities, including the manufacture of goods; processing goods received from third parties (for example, carrying on the business of a dry-cleaner); insurance; banking; the carriage of goods or persons by sea, inland waterway or land; forwarding and warehousing; commercial agency and brokerage; bookselling and publishing; printing. Any person conducting any of the above activities is, by operation of law, deemed to be a merchant.

Book One also contains the rules governing the commercial register. This register is administered by the district court (*Amtsgericht*) and consists of a publicly accessible record of information relating to a merchant's business. Every merchant must register the name of the firm (*Firma*) and the location of the business, including branches. If the merchant has given any person powers to represent and act on behalf of the business, relevant details must be registered. The most extensive form of representation is the *Prokura*. According to paragraph 49 'a Prokura empowers the procurator (the representative) to undertake . . . all manner of transactions appertaining to the management of a commercial business'.

Book Two deals with certain forms of business organisation. While limited liability companies are essentially regulated by a separate statutory regime, the rules relating to various forms of commercial partnership are contained in the HGB – for example, the general partnership (*Handelsgesellschaft*, OHG), the limited partnership (*Kommanditgesellschaft*, KG) and the silent partnership (*stille Gesellschaft*).

Book Three contains detailed provisions governing the maintenance and registration of business records and accounts.

Book Four contains the general provisions which apply to commercial transactions between merchants. Commercial transactions are all those entered into by the merchant during the course of his or her business. The obligations imposed on merchants differ from those which apply in the case of ordinary non-commercial transactions.

Book Five deals with the law relating to maritime and admiralty matters.

Various aspects of commercial law will be considered in the chapters which follow, but at this stage a final point should be noted. It was stated above that as far as English law is concerned, the term *commercial law* does not have a precise meaning. However, this is not necessarily the case in other jurisdictions following the common law tradition. It will be recalled that all states in the USA, with the exception of Louisiana, have adopted the Uniform Commercial Code (UCC). Thus, a reference to the commercial law of, say, Carolina would likely be taken to be a reference to the UCC.

Private international law is that branch of the law which comes into play when a legal issue has an international dimension. Consider, for example, a contract concluded between parties located in different countries. If a dispute arises between them that is likely to involve court action, a number of problems can arise which would not be present in a purely domestic context. For instance, before the courts of which country (claimant's or defendant's) should the case be brought? What system of law should govern the contract? If the claimant succeeds in winning an award of damages, will this be recognised and enforced by the courts of the country where the defendant and his assets are located? A similar type of problem can arise in other contexts – for example, over the right of succession to a deceased's estate. Although the deceased might have been resident all his life in one country, he may have owned land in another. A major question may arise as to whether the succession rights to this property are governed by the law of the country where the deceased spent his life or the law of the place where the land is situated.

In the examples cited above, a judge will refer to the rules of private international law in an attempt to resolve the questions posed. It should be remembered, however, that these rules

form part of the domestic legal system concerned, so a French judge will refer to the French rules of private international law, a Brazilian judge to the Brazilian rules, a Japanese judge to the Japanese rules and so on, and, as is very often the case, these rules may differ significantly. Some of the practical issues flowing out of this problem will be considered in later chapters.

It should be remembered that the categories of law which have just been discussed do not represent the sum total of law existing in any given system. They are merely examples of some, but not all, of the law's main branches. In addition, it should not be assumed that all legal systems adopt precisely the same method of classification. The intention has been to give the reader an appreciation of the general types of law which will be found in the legal system of most countries.

The sources of law

Familiarity with the main branches of the law may assist in the preliminary analysis of a legal problem, but if a more thorough evaluation is to be undertaken, precise and detailed rules will have to be identified by tracing them to their source. For example, if the seller of goods fails to deliver what has been ordered, the buyer might recognise that his entitlement, if any, to a remedy will be found in the law of contract. However, in order to pursue his complaint against the seller, the buyer will have to locate the precise rules relevant to his cause. If the dispute were taking place in England, the buyer would be well advised to refer to the Sale of Goods Act 1979.

The principal sources of law will now be considered.

Legislation

The term '*legislation*' refers to that body of law formally enacted by the institution of state which, under the constitution, has law-making responsibility. In the UK, the Parliament at Westminster enacts legislation in the form of *Statutes* (Acts of Parliament). Since 1998, significant legislative powers have been devolved to the Scottish Parliament, covering many areas which formerly would have been the responsibility of the Westminster

Parliament. In the late 1990s, the National Assembly for Wales was also established. Although this body's law-making powers are less extensive than those of the Scottish Parliament, it has responsibility for developing and implementing policies reflecting the particular needs of the people of Wales.

Statutes passed by the Westminster Parliament are referred to as *primary legislation.*

A significant amount of the law regulating business is found in this form. For example:

- The Companies Act 1985 is a major piece of legislation providing the legal framework within which limited liability companies must operate.
- The Supply of Goods and Services Act 1982 imposes strict duties on businesses supplying goods and/or services.
- The Competition Act 1998 outlaws a wide variety of anti-competitive behaviour, and provides for the imposition of severe penalties on businesses which engage in such conduct.

There are, however, many occasions where parliament delegates its general law-making powers to other persons or bodies. Such a delegation may occur when, say, the issue being addressed is far too complex and detailed to be dealt with effectively in primary legislation. Instead, Parliament may enact a statute (the *enabling Act*) so as to provide the broad framework, the details being filled in by the appropriate Minister of State by means of *delegated legislation.* For example, much of the detailed law on social security is found in regulations drawn up by or under the authority of the Secretary of State for Social Security. These regulations, when made in the approved manner, have the same legal force and effect as the Act of Parliament under which they were enacted.

Delegated legislation can take various forms. Most of the powers conferred on Ministers of State by modern statutes are exercisable by ministerial or departmental regulation as in the example just given. Collectively these regulations are known as *statutory instruments.* Delegated legislation can also take the form of *by-laws.* By-laws are the means whereby a local authority, for instance, can make legally binding rules for local application.

In other countries, both primary and delegated legislation will form a major source of law. As has already been explained, large areas of law in civil law countries have been formally enacted into codes. This being so, there will, however, be many occasions when a code needs amending or even replacing and in any civil law country there will be a wide variety of matters covered by legislation other than that exemplified by the various codes. In France, for example, Parliament enacts general law through *lois ordinaires* (statutes). There also exists the possibility for the executive arm of government to create law through *ordonnances* (ordinances). As *ordonnances* are only granted by authorisation of Parliament, they represent a form of delegated legislation. Delegated legislation also exists in the form of *reglements* (regulations), which are passed to facilitate the implementation of the *lois*. *Reglements* issued by the President of the Republic or the Prime Minister are known as *décrets* (decrees), while those issued by individual ministers or by such administrative authorities as the *préfet* (prefect) or *maire* (mayor) are referred to as *arrêtes* (rulings).

The situation in Germany is somewhat different. As it is a federal state, legislative responsibility lies with both the federal parliament (the *Bundestag*) and the parliaments of the sixteen regional states (the *Lander*). Under the constitution (*Grundgesetz*) the *Lander* have the right to enact legislation for the region except in those areas reserved for the federal parliament by the constitution. Although the *Lander*, through their representatives, participate in various ways in the federal legislative process, their exclusive law-making competence is, in reality, limited, being restricted mainly to local government, police, educational and cultural matters.

At both federal and regional levels, primary legislation manifests itself in the form of *Gesetze* (statutes). Included among such legislation are the several general codes – for example, the *Bürgesliches Gesetzbuch* (civil code), the *Handelsgesetzbuch* (the commercial code) and the *Strafgesetzbuch* (the criminal code). As in other systems, power to legislate in Germany is also delegated to individuals and other bodies and institutions. For example, delegated legislation issued by individual government ministries or the *Lander* is termed

Verordnungen or *Rechtsverordnungen* (regulations) while that emanating from, say, local authorities is referred to as *Satzung* (by-laws).

Case law (judicial precedent)

In addition to legislation, law can derive from judgments given by courts when deciding cases brought before them. As a source of law, this is known as *precedent*. As has already been explained, a defining characteristic of common law systems is the role that the courts have played in creating law in this way. This is not to say that in civil law jurisdictions the courts do not fulfil an important function, but any role they perform in establishing legal principles for application in future cases differs, in theory at least, from that of their common law counterparts.

The common law doctrine of judicial precedent basically embodies the principle that, in deciding a case, a judge will be bound by the previous decision of a higher court. This idea needs further explanation.

Firstly, it must be clear what is meant by the 'decision' or, to be more accurate, the 'precedent' established in the earlier case. The precedent is not the decision itself reached by the court but the *rule of law* contained within that decision. This element is known as the *ratio decidendi* and must be distinguished from the *obiter dicta* (things 'said by the way'). At the end of a case, a judge, before handing down a ruling in favour of one or other of the parties, will give his or her reasons for the decision. Collectively these comprise the *judgment*. In contrast to the brevity which typically characterises court judgments in civil law jurisdictions, the judgment of common law judges can be extremely lengthy and detailed. Most of the judgments given by the higher courts will be published in one or more of the series of law reports available, thus giving lawyers, academics and other interested parties the opportunity of subjecting every phrase and sentence to detailed scrutiny.

An essential task in identifying the precedent established by a previous case is to isolate the *ratio* from those parts of the judgment which are merely *obiter*. If one analyses the structure

of a typical judgment, the following basic elements will be found:

1 A summary of the facts which the judge regards as material to the case. For example, the fact that a motorist who causes an accident was, at the time, driving without lights at 80 mph in foggy conditions might all be material facts upon which to base an allegation of negligence, but the fact that he was at the time sporting a beard and moustache would not.
2 A statement of the principles of law relevant to the legal issues disclosed by the facts.
3 A decision based on the application of (2) to (1).

As far as the parties to the action are concerned, the most important part of the judgment is (3) because, subject to the possibility of an appeal, that decides the issue between them. However, as far as future cases are concerned, (1), (2) and (3) are all important because, together, they comprise the *ratio*. The *ratio* of a case can be summarised as those statements of law cited by the judge which, when applied to the legal issue posed by the facts found to be material, lead to the decision in the case.

It is important to emphasise that it is the statements of law applied to the *actual facts* of the case before the court that form the *ratio*. The theoretical reason for this, which, however, does not reflect the reality of the situation, is that judges must concern themselves with finding the law and applying it to the case before them, not making law which is the prerogative of the Legislature. In the course of a judgment, the judge might digress and state, for example: 'If the facts had been . . . I would have decided . . . '. The judge's words cannot be regarded as *ratio* because they do not relate to the actual facts of the case; they are statements which are 'said by the way' or *obiter*. It should not be assumed, however, that *obiter dicta* are devoid of value in future cases for, as will be explained below, in some circumstances they might have significant persuasive authority, even though they do not constitute binding precedent.

Whether a statement is *ratio* or *obiter* is not decided by the judge in the instant case because, in the course of the judgment, he or she will make no distinction between the two.

It will fall to the court in a future case to determine the *ratio* of the earlier one. Thus, depending on the level of abstraction adopted by the court in the later case, the *ratio* as found in the earlier decision can be broad or narrow. By way of illustration, take the example quoted above. Supposing the motorist, X, while driving his car at 80 mph without lights in foggy conditions collides with a car been driven by Y, injuring him. Following the accident Y sues X for compensation and the judge finds X liable. In extracting the *ratio* of this case, a later judge can restrict its significance by defining a narrow *ratio* or, on the other hand, establish a wider principle of law through a broader definition. To achieve the former, the judge may decide that most of the facts are material – for example, 'a person who drives a car without lights at 80 mph in foggy conditions is liable to compensate any person to whom he causes injury'. A wider *ratio* would eliminate some of the facts as material – for instance, 'a person who drives a motor vehicle negligently is liable to compensate any person injured'. This definition would extend the principle to the negligent driving of motor vehicles generally, but a further option for the judge would be to define a *ratio* establishing a general principle of liability for negligent conduct, such as 'a person who by his negligent act injures another is liable to compensate that person for the injuries sustained'. A *ratio* so defined would, in fact, represent the essential principle underlying the law of negligence.

The above explanation stresses the fact that the precedent established by an earlier case lies in the *ratio* of the decision. But when does such a precedent become binding on a court hearing a case raising a similar issue in the future? The answer basically depends on which court decided the earlier case. The courts of most jurisdictions are structured within a hierarchy. For example, in England and Wales, except for questions relating to European law (see below), the *Judicial Committee of the House of Lords* is the final court of appeal. Below this is the *Court of Appeal*, followed by the *High Court* and other courts of equivalent status. There are additional courts below the level of the High Court, but for the purposes of binding precedent, they can be ignored.

All lower courts must apply a precedent set by the House of Lords. The House of Lords can, and occasionally does, depart

from its own previous decisions, but due to the uncertainty and inconvenience which may result from overturning hitherto apparently settled law, it uses this power sparingly. Precedents established by the Court of Appeal bind the High Court and courts coming below it. The Court of Appeal is also bound by its own previous decisions, although there are a number of exceptions to this rule. Decisions of the High Court bind all courts below but do not bind the High Court itself. It should be stated, however, that a court does not always slavishly follow precedent and that there are a number of devices at its disposal should it wish to avoid following an otherwise binding precedent. For example, a court, while acknowledging the precedent, may nevertheless 'distinguish' the present case on its facts. As was explained above, an integral part of the precedent are the facts to which the stated principle of law was applied. This, therefore, provides the judge in the later case with an opportunity to find essential differences in the facts of the case before him as compared with those in the earlier one. Some precedents are distinguished so often that effectively they are shunted off into a siding and rarely followed subsequently.

The above discussion concerned precedents which are *binding* on a court when reaching its decision. Not all precedents are of this nature. A precedent can be merely 'persuasive', which means a court has an option whether to follow it or not. This may occur, for example, when a case raises a legal problem which is not covered by an established binding precedent. The judge hearing the case may look to other sources having persuasive authority, some of which may be more persuasive than others. *Obiter dicta* from courts at all levels can be influential, particularly those originating from the House of Lords or Court of Appeal. The decisions of lower courts might have persuasive authority so far as higher courts are concerned. For example, the Court of Appeal may decide to follow an earlier decision of the High Court where there is no precedent set by either the Court of Appeal or the House of Lords. Where no 'home grown' precedent exists, an English court might look to decisions arrived at by courts in other common law jurisdictions or even decisions of courts administering civil law.

The concept of judicial precedent as described above broadly applies in other countries following the common law tradition,

although its precise operation will differ according to the court structure and other governing factors applicable in the jurisdiction concerned. The same cannot be said as regards civil law countries. In France, for example, there is no fundamental axiom of French law that a judicial determination, even by the highest court in the land, the *Cour de cassation*, has binding effect in any other case. The function of the courts is not to make law but to interpret the law and apply it to individual cases. Indeed, Article 5 of the *Code civil* states that 'the courts shall be prohibited from issuing rules which take the form of general and binding decisions on those cases which are submitted to them'. Although this may represent the theoretical position, practical reality is somewhat different. It would be a mistake to suppose that the decisions of French courts (*jurisprudence*) have no authority beyond the individual case in hand. They are widely cited by lawyers and by textbook writers. Indeed, it would be difficult to express an opinion as to the meaning of a provision of, say, a code without knowing how it had been interpreted by the courts. Many of the decisions of the higher courts appear in law reports, much like in England. These are accepted as having persuasive weight, which only increases as the courts progressively settle down to a uniform and consistent attitude on any particular point. The result is that an undeviating line of reasoning – for example, of the *Cour de cassation* – has an authority, judged from a practical point of view, barely distinguishable from a decision of the House of Lords.

Again, in Germany, precedent (*Prajudizien*), in theory at least, is not regarded as a source of law. As in the case of France, however, the formal decisions of the higher courts and in particular those of last resort – for example, the *Bundesgerichtshof* – have great persuasive authority and are never lightly disregarded. In some areas, the courts have been so active in interpreting legislative provisions or 'gap-filling', where necessary, that labelling their function in this respect as either interpretative or creative becomes somewhat semantic. For example, in competition law, paragraph 1 of the Unfair Competition Act 1909 (*Gesetz gegen unlauteren Wettbewerb*, UWG) provides that 'A person who in the course of business and for the purpose of competition conducts himself in a manner which offends against good morals may be enjoined and held liable in damages'. To say that this

provision is a little generalised would be something of an understatement but, nevertheless, it represents a major plank in German competition law. Over the years the courts have given it detailed consideration and, as a result of the numerous decisions as to its true interpretation, it is possible to specify with reasonable precision the type of conduct which will fall foul of the prohibition.

Academic writing

In many civil law jurisdictions, academics have had a significant influence on the interpretation and development of the law. While not representing a formal source of law in the same sense as legislation, for example, the opinions of leading academics and commentators are, nevertheless, given substantial weight by the legal profession and judiciary alike. Both in France and Germany, the works of highly reputable university professors have great persuasive authority and are regularly quoted by lawyers when presenting cases and, indeed, referred to by judges in court decisions. In England, on the other hand, it is comparatively rare for a lawyer to cite the opinions of even leading academics when presenting a case before a court. At one time, an author would have had to be dead before any credence was given to his work! Over the years, judicial attitudes have gradually changed to the point now where the views of modern-day eminent academics are given due consideration when the court thinks it appropriate.

European community law

The European Union (EU) is a supranational organisation presently consisting of twenty-five Member States. In the coming years this number is set to increase. At the time of writing, a proposed European constitution is provoking a heated debate within and between Member States. Before it comes into force, the treaty embodying the constitution must be ratified by the parliament of each Member State. In addition, a number of countries are submitting the treaty to a referendum, through which the electorate can voice its opinion. The treaty's proponents argue that it merely operates to create a

more streamlined decision-making process which, in the light of the EU's recent enlargement from fifteen to twenty-five Member States, is vital if it is to work efficiently. Those taking a more 'eurosceptic' line insist that the constitution, if implemented, would represent yet a further step in the relentless march towards the creation of a European 'super state'. Who is right, only time will tell.

Whatever the future may hold for the development of the EU, it has not as yet achieved statehood in its own right. This said, however, there is no escaping the fact that, in the context of the present world order, the EU represents a powerful source of political and economic influence. As a source of law its importance cannot be overestimated, as an increasing number of matters, traditionally the preserve of national legislatures, are now being dealt with by the law-making institutions of the EU.

It should not be assumed that EU law applies only to businesses located within the EU itself. Even though operating from a non-Member State, a company will be subject to the EU's regulatory regime in respect of business activity conducted within its borders. The American giant, Microsoft, has discovered this the hard way. In 2004, after a five-year investigation, the competition authorities of the EU came to the conclusion that Microsoft was abusing its market power within the EU to the detriment of its competitors and consumers alike. The company was fined €497 million! Four years earlier, the Japanese electronics company, Nintendo, had felt the full wrath of the EU competition regime when it was found guilty, along with its seven European distributors, of running a cartel. The corporate wallets of the various participants were somewhat lightened as a result.

It is not only in the field of competition law that business can be affected by EU rules. As will be explained in later chapters, employing labour, appointing agents, the exercise of intellectual property rights and liability for defective products are examples of other areas where the impact of EU law can be felt.

EU law takes various forms. Primary sources include the various Constitutional treaties which bind the Member States together. Prominent among these is the Treaty of Rome 1957, which established the original European Economic Community (EEC) and out of which the EU developed. Within its

structure the Treaty of Rome establishes the '*four freedoms*' (the right to free movement of goods, persons, services and capital), which together form the foundation stones of the single European market.

Apart from the Constitutional treaties, an ever-increasing volume of law originates from secondary sources such as *regulations* and *directives*. A regulation is of general application and binding on all Member States in its entirety. Unlike a directive, it is self-executing in the sense that it becomes law without the necessity of national implementing legislation. A directive, on the other hand, is binding on each Member State as to the result to be achieved. Provided that the aims and objectives of a directive are implemented locally, the precise method of achieving this is left to the state concerned. Whereas regulations are used primarily to achieve uniform legal rules throughout the EU, directives, in practice, are used mainly to effect approximation or harmonisation of the national laws of Member States.

EU law, of whatever form, takes precedence over national law. Where there is a conflict between the domestic law of a Member State and EU law, the latter prevails and the courts of that state must give effect to it in preference to national law. The European Court of Justice (ECJ) in Luxembourg is responsible for ensuring that EU law is correctly interpreted and applied. Its decisions are binding throughout the EU and must be followed by the national courts of Member States.

In some contexts, EU law has *direct effect*. This means that it creates rights that can be enforced by individual citizens of Member States. This entitlement also extends to companies and their businesses. So, for example, should a competitor of Microsoft wish to seek compensation for loss suffered as a result of Microsoft's anti-competitive behaviour, it would be able to invoke EU competition rules as a basis for its claim.

Court systems

In every jurisdiction, courts of one form or another will play a major role in the administration of the law. In any system, courts will exist at different levels, some dealing with cases when they are originally presented (*courts of first instance*) and others hearing

appeals from the decisions of those courts (*appellate courts*). A court may have jurisdiction over a wide variety of legal issues or, alternatively, be restricted to certain specialist matters. To illustrate the above points, a general overview of the court systems of England and Wales, France and Germany follows.

England and Wales

The House of Lords

At the apex of the court system is the House of Lords. This court exercises both civil and criminal jurisdiction and, except for matters relating to European law, is the final court of appeal not only for England and Wales, but in some instances Scotland and Northern Ireland as well.

Exercising its civil jurisdiction, the House of Lords hears appeals from the Court of Appeal (Civil Division), the Court of Session in Scotland and the Supreme Court of Northern Ireland. Appeals to the House of Lords are only allowed when a point of law of general public importance is involved. Leave to appeal must be granted either by the lower court against whose decision an appeal is being made or by the Appeal Committee of the House of Lords itself.

In criminal matters, the House of Lords hears appeals from the Court of Appeal (Criminal Division) and, in some instances, the High Court. While the House of Lords hears criminal appeals from the Court of Appeal in Northern Ireland, the Scottish Court of Criminal Appeal is the final court of appeal for Scotland.

The Court of Appeal

The Court of Appeal is divided into Civil and Criminal Divisions. The Court of Appeal (Civil Division) hears appeals on matters of both law and fact from the High Court and the County Court (local court). The court can uphold or reverse the decision of a lower court or substitute a new judgment. Occasionally it may order a new trial.

The Court of Appeal (Criminal Division) hears appeals from the Crown Court against conviction and/or sentence and may dismiss or allow the appeal or order a new trial.

The High Court of Justice

The High Court acts both as a trial court, i.e. hearing cases for the first time, and an appeal court. It sits in London and in twenty-seven regional centres. For essentially administrative reasons, it is divided into three divisions: the Queen's Bench Division (QBD), the Family Division and the Chancery Division. All three divisions can sit as a trial court where one judge sitting alone, having determined both the law and facts of a case, will pronounce a verdict. In addition, each division can sit as an appeal court hearing appeals from certain lower courts. When exercising its appellate jurisdiction, the court normally consists of three judges.

QBD is the largest division. Its workload mainly consists of matters relating to contract and tort, commercial law and admiralty. The court also hears appeals on points of law from the Magistrates' Court and Crown Court through a process known as 'case stated'. This involves an appeal from the lower court on the grounds that the decision of the lower court was wrong in law. The court concerned must state a case for the opinion of the QBD. Such a ruling will then determine the success or otherwise of the appeal.

The Family Division has jurisdiction over matters relating to divorce, nullity, children, financial support and matrimonial property. As an appeal court, it hears appeals from the Magistrates' Court and County Court in matrimonial and family matters.

The Chancery Division has jurisdiction over matters relating to land, mortgages, trusts, revenue, companies and partnerships, administration of estates, insolvency and intellectual property. The court also hears appeals from the County Court in such matters as insolvency and land registration.

The Crown Court

The Crown Court sits both as a trial court and an appeal court in criminal matters. As a trial court it deals with the more serious criminal offences. Cases are heard by a single judge sitting with a jury. As an appeal court, the Crown Court hears appeals against conviction and/or sentence from the Magistrates' Court.

County Court

The County Court exercises exclusively civil jurisdiction. It is essentially a local court, there being over 200 throughout England and Wales. Although it deals with broadly the same subject matter as the High Court, cases coming before the County Court tend to be less complex and involve smaller sums of money than those dealt with by the High Court.

Magistrates' Court

There are over 1000 Magistrates' Courts throughout England and Wales. Most magistrates are appointed from members of the general public and are termed 'lay' magistrates. Normally magistrates sit in benches of three and will be assisted by a legally qualified clerk to advise them as necessary on legal matters.

A Magistrates' Court exercises both criminal and civil jurisdiction. In the context of the former, it tries cases involving less serious offences. However, even the more serious criminal cases are begun in the Magistrates' Court before being transferred to the Crown Court for trial.

The civil jurisdiction of the Magistrates' Court covers such matters as recovery of certain civil debts – for example, income tax and national insurance contributions, and the granting and revocation of liquor licences. It also exercises jurisdiction in a variety of family-related proceedings such as those involving domestic violence and/or occupation of the matrimonial home.

France

Since the Revolution, a strict demarcation line has been drawn between the institutions of state responsible for the administration of the country and the judiciary. It was long ago decided that legal issues involving the former should not fall within the jurisdiction of the ordinary courts but should instead be decided by a system of administrative courts. This separation of powers is still firmly in place today, with the result that France has two systems of courts: the courts of the *ordre judiciaire* (the ordinary courts), which deal with civil

disputes between private individuals and also criminal matters; and the *ordre administratif* (the administrative courts), which have exclusive jurisdiction in all public law matters. What follows is an overview of the ordinary court system.

Tribunal d'instance

The *Tribunal d'instance*, of which there are 450 throughout France, has jurisdiction over all litigation involving civil claims not exceeding approximately £3000 and not within the competence of courts of special jurisdiction (see below). A decision of a *Tribunal d'instance* involving a sum less than £1300 is final and cannot be appealed. The only exception to this is the right to appeal direct to the *Cour de cassation* on a point of law. Where the amount in dispute exceeds £1300, appeal lies to the *Cour d'appel*. Unlike other courts, whose decisions are collegiate, a *Tribunal d'instance* is presided over by a single judge.

Tribunal de grande instance

The *Tribunal de grande instance*, of which there are 175 throughout France, has jurisdiction over all matters exceeding the jurisdictional threshold of the *Tribunal d'instance* and which have not been specifically allocated to another court. The *Tribunal de grande instance* has two divisions: the *chambre civil* and the *chambre correctional*. The former has general jurisdiction over any private law matter except those specifically allocated to special courts – for example, commercial and employment-related disputes. However, it enjoys exclusive jurisdiction over a variety of issues, such as marriage, divorce and separation, patents, land, and road accidents. Cases are heard by three judges who deliver a collective judgment. Unlike the decisions of English courts, there are no dissenting judgments.

When exercising its criminal jurisdiction, the *Tribunal de grande instance* deals with major offences (*délits*). The court normally consists of three judges.

Appeals in both civil and criminal matters lie to the *Cour d'appel*.

Courts of special jurisdiction

Tribunal de commerce (commercial court)

There are approximately 200 commercial courts throughout France. They exercise jurisdiction over commercial disputes and bankruptcies involving merchants and commercial entities. They are staffed by lay judges who must be over thirty years of age and have been engaged in business for at least five years. Judges are elected for terms of two years by and from among businessmen and women whose names appear on the local commercial register. Disputes involving less than £1300 are final; otherwise appeal lies to the *Cour d'appel*.

Conseil de prud'hommes (labour court)

Individual disputes arising between employer and employee are brought before one of the 300 labour courts. As with the commercial court, the labour court is staffed by lay judges elected from the ranks of local employers and employees. A court consists of four judges, with employers and employees being represented equally.

Tribunal des affaires de sécurité sociale (social security court)

This court deals with disputes arising out of the social security system. It consists of a judge of the local *Tribunal de grande instance* and one employer and one employee representative.

Cour d'appel

There are thirty *Cours d'appel* situated throughout the country, each hearing appeals for the courts of first instance described above. An appeal involves a complete re-hearing of the case and the court can substitute its view of either facts or law for that of the lower court.

To accommodate the wide variety and often specialised subject matter of appeals, each *Cour d'appel* is divided into a number of divisions or '*chambres*'. In addition to those *chambres* dealing with general civil and criminal appeals, there are specialist *chambres* responsible for hearing appeals from labour courts and social security courts.

Cour de cassation

The *Cour de cassation* is the highest court in France for non-administrative appeals. Situated in Paris, the court, strictly speaking, is not a court of appeal. Its principal function is to ensure that the law is interpreted uniformly throughout the country and to this end restricts itself to reviewing findings of law, not fact. It can only quash a decision of a lower court of which it disapproves. Unlike a *Cour d'appel*, it cannot substitute its own decision. The only recourse to the *Cour de cassation* is on the basis that the judgment of the court below reveals a '*violation de la loi*', i.e. an incorrect foundation of law. Where the *Cour de cassation* finds this to have happened, the case is remitted for further consideration not to the original court but to another court of equal jurisdiction. This court is not bound by the view of the *Cour de cassation* and if it takes the same view of the law as the original court, the matter is referred to the '*Assemblée plénière*' of the *Cour de cassation*, where all five chambers of the court are represented. If the issues are the same as in the original hearing, the *Assemblée* can enter a final judgment, otherwise the case is remitted to a third court of equal jurisdiction to the original court. This court is bound to apply the law as stated by the *Cour de cassation*.

Finally, it should be noted that, unlike decisions of the House of Lords, judgments of the *Cour de cassation* are not binding on courts hearing similar cases in the future. However, a court which fails to apply the law as declared by the *Cour de cassation* runs the risk of having its decision appealed and successive judgments of the *Cour de cassation* affirming a particular point of view will be strong persuasive evidence of the law and its correct interpretation.

Germany

As compared with the English court system and even that of France, the system found in Germany places great emphasis on courts of special jurisdiction. Thus, alongside the ordinary courts (*Ordentliche Gerichte*) there exist a variety of specialist

courts, each having its own separate appeal structure, culminating in a court of last resort. These courts are: revenue or finance courts (*Finanzgerichte*); administrative courts (*Verwaltungsgerichte*); labour courts (*Arbeitsgerichte*); and social security courts (*Sozialgerichte*).

The ordinary courts handle the bulk of the legal work in Germany and comprise the largest hierarchy. A brief overview of the courts found in this system follows.

Amtsgericht (local court)

There are 718 local courts throughout Germany. They have jurisdiction in civil disputes where the amount involved does not exceed approximately £3000. However, regardless of the sum in question, the local court will also deal with landlord and tenant disputes and various family matters. Providing the amount involved is more than £500, appeal lies to the district court (*Landgericht*). The local court also has jurisdiction to handle cases involving minor criminal offences.

Landgericht (district court)

The district court has jurisdiction in all civil litigation involving amounts over £3000 and also deals with the more serious criminal offences. As stated above, the district court hears appeals in civil and criminal matters from the local court.

Cases are heard before a court consisting of three judges. However, if the litigation is between merchants, the court sits as a commercial court in which the presiding judge is the only legally qualified member, the other two judges being experienced businessmen or women.

Oberlandesgericht (appeal court)

The court of appeal is mainly concerned with hearing civil and criminal appeals from the district court. Except in the limited circumstances where leave is granted for a further appeal to the *Bundesgerichtshof* (see below), the decision of the court of appeal is final.

The court of appeal also acts as a court of first instance for the hearing of the most serious criminal offences, such as treason.

The courts just described are the courts of the *Lander*. Above these in the hierarchy are the federal courts. These comprise the various federal courts of appeal for courts exercising ordinary and special jurisdiction and the federal constitutional court.

The *Bundesgerichtshof* (BGH; federal court of appeal)

The BGH is the final court of appeal from courts exercising ordinary jurisdiction. Sitting at Karlsruhe, it hears appeals from the court of appeal but only if that court has given its consent. Such consent will normally be forthcoming only in those cases involving a novel and important point of law or where the decision of the lower court has deviated from a previous ruling of the BGH. Appeals in civil cases normally concern disputes where the sum involved exceeds £20 000.

Specialist federal courts of appeal

As mentioned above, alongside the ordinary courts, there exist a number of specialist courts, each with their own appeal structure, at the apex of which is a federal court of appeal. At the same level as the BGH, therefore, are also to be found the *Bundesarbeitsgericht* (federal labour court), the *Bundesverwaltungsgericht* (federal administrative court), the *Bundessozialgericht* (federal social court) and the *Bundesfinanzhof* (federal tax court).

The *Bundesverfassungsgericht (BverfG; the federal constitutional court)*

The German constitution (*Grundgesetz*) provides for an independent court to hear cases of a constitutional nature. Thus, the BverfG decides disputes between the Federation and the *Lander* or between different *Lander*. It also resolves questions concerning the relationship between the federal parliament (*Bundestag*), the *Landers*' representative body (*Bundesrat*), the federal government, the federal President and certain other institutions having a constitutional role.

International co-operation and the harmonisation of business law

Mention has already been made of the fact that laws can and do differ between countries. In the next chapter and those following it, specific examples will be given of the significant divergences that can exist. Suffice it to say at this point that, for the practitioner conducting business on an international scale, such variations can present certain risks. These can arise not only from exposure to differing levels of potential liability, but also from the threat to business interests resulting from the varying degrees of protection afforded by different jurisdictions. This said, however, it must be recognised that, in many areas, co-operative effort both by governments and non-governmental bodies has resulted in a harmonised approach to many issues faced by international business. A number of such initiatives will be examined in their appropriate context in later chapters but, by way of example, mention can be made of the following organisations which, to the present day, have played a major role in smoothing the path along which international business is conducted and, no doubt, will continue to do so in the future.

The International Institute for the Unification of Private Law (UNIDROIT)

UNIDROIT is an international intergovernmental organisation based in Rome. Originally set up as an auxiliary organ of the League of Nations, it is now governed by the terms of the UNIDROIT Statute, a multilateral agreement signed in 1940. UNIDROIT was established to study the needs and methods for modernising, harmonising and co-ordinating between states' private law and particularly commercial law. Its membership currently consists of fifty-nine states.

The instruments employed by UNIDROIT to achieve its mission of harmonisation are several. At its most formal, proposals for change might be the subject of an international *Convention*. Such an instrument is intended to supersede the domestic law of those states which adopt the Convention and

take the necessary legal steps to incorporate it into domestic law of the country concerned. Two such examples are the 1988 Conventions on International Factoring and International Financing. Conventions traditionally tend to be given low priority by national governments when compared with other more pressing business. This, coupled with the fact that a considerable time usually elapses before they come into force, has prompted the frequent use of alternative forms of UNIDROIT instrument. Examples include *model laws* and *general principles*. The former, as the name suggests, represent a model set of laws on a particular subject which states can take into consideration when drafting national legislation on the topic concerned, the model Franchise Disclosure Law (2002) being an example. General principles, on the other hand, are addressed directly to judges, arbitrators and contracting parties who are left free to decide for themselves whether to use them or not. Prominent among these are the *Principles of International Commercial Contracts*, which represent a codified statement of the law governing such contracts.

The United Nations Commission on International Trade Law (UNCITRAL)

UNCITRAL was established by the General Assembly of the United Nations in 1966, its mandate being to further the progressive harmonisation and unification of the law of international trade. It has, to date, a considerable number of documents to its credit, including Conventions and model laws spanning a wide range of issues affecting international business. UNCITRAL has been active in areas as varied as the international sale of goods, the international transport of goods, commercial arbitration, electronic commerce, negotiable instruments, project finance, insolvency, counter trade, letters of credit and construction contracts.

The International Chamber of Commerce (ICC)

The ICC is a non-governmental organisation based in Paris but having representative offices in many countries throughout the world. It was founded in 1919 with the aim of serving

world business through the promotion of trade and investment and the opening up of markets for goods and services. It plays a vital role in setting standards for the conduct of business that have global recognition. Although not compelled to do so, parties to international business transactions frequently incorporate one or other of the ICC's standard sets of business terms into their contracts. For example, most banks in the world operate on the ICC's Uniform Customs and Practice for Documentary Credits when financing exports through letters of credit (see Chapter 7). ICC Incoterms provide a standard definition of trade terms such as f.a.s., f.o.b., c.i.f., etc., upon which countless export contracts are concluded every day (again, see Chapter 7). The ICC produces a wide variety of model contracts upon which parties can base their relationship. Among the model forms available are those relating to international sales, commercial agency, distributorships and franchising. The ICC also facilitates the solution of business disputes through its arbitration and conciliation services, with the ICC International Court of Arbitration having a worldwide reputation in this field (see Chapter 8).

The World Trade Organisation (WTO)

Having its headquarters in Geneva, Switzerland, the WTO seeks to provide a means for addressing the problems associated with international trade. Above all, it provides a forum in which governments can discuss and, through negotiation, reach consensus on how to tackle the difficulties that often hinder the free flow of trade between countries. It also provides an institutional framework within which countries can seek to settle differences that can arise from the pursuit of conflicting national interests.

The WTO was born on 1 January 1995, the offspring of the General Agreement on Tariffs and Trade (GATT) which, since 1948, had provided the rule book for the conduct of international trade. At the heart of the WTO are the various agreements signed by the majority of the world's trading nations. Frequently embodying social and/or environmental objectives, they lay down the limits within which each signatory government must conduct its trade policies. Although the agreements

have been concluded between states and essentially operate at that level, a principal aim is to assist the ground players who produce and trade in goods and services in the conduct of their business.

The WTO agreements cover a wide variety of issues ranging from agriculture, textiles and clothing, and banking, to telecommunications, industrial standards and product safety, intellectual property and much more. However, a number of basic tenets underlie each of the agreements no matter what their individual content. For example, trade without discrimination is a fundamental axiom of the entire system. Each country should abide by the Most-Favoured-Nation (MFN) principle. Thus, as a general rule, it is not permissible for a country to discriminate between its trading partners by, for example, lowering customs duties for one but not others. Nor should it discriminate between its own and foreign products, services or nationals. Therefore, once foreign goods have entered a particular market, they should be treated no differently from those produced locally. Such equality of treatment should also apply to foreign and domestic services and intellectual property rights such as patents, copyright and trademarks.

The promotion of freer trade based on fair competition also forms a thread running through the WTO agreements. The lowering of trade barriers, such as tariffs, quota restrictions and import bans, is generally seen as a way of nurturing greater trade between countries and therefore frequently appear on the negotiating agenda. While increased trade should be encouraged, this should be done on a basis of open, fair and undistorted competition. Preventing or hindering imports through protective measures or gaining an unfair advantage in an export market through, say, 'dumping' represents the kind of activity that could offend against this principle.

The WTO recognises that the implementation of the agreements might cause difficulties for less developed countries and particularly for the poorest. Accordingly, a flexible approach has been adopted and in many cases a period of transition has been allowed to enable the countries concerned to adjust to the implications of having their markets opened up to foreign competition, which the WTO's trade liberalisation programmes require.

Summary

The following issues were dealt with in this chapter:

1. The importance of being able to identify potential legal problems sooner rather than later.
2. The distinguishing characteristics of common law and civil law legal systems.
3. The classification of law into its various branches and how this relates to the solution of legal problems.
4. The role of legislation and case law as sources of law.
5. The relevance and potential impact of EU law on international business.
6. The court structures existing in England and Wales, France and Germany.
7. International organisations involved in the attempt to harmonise law as it affects the conduct of international business.

CHAPTER 2

The formation of business contracts

So what is a contract?

As previously mentioned, the law imposes on us all a variety of obligations and a failure to abide by these can produce consequences which may be expensive. Such obligations can derive from the general law – for instance, a duty not to harm one's fellow citizen through negligent conduct. However, obligations can also be created by agreement. If two or more persons enter into a contract in which they agree to honour certain promises, the law recognises the binding nature of these promises and should either of the parties fail to carry out their undertaking, the other can seek the assistance of the court. This is not just the position under English law; all systems recognising the concept of contractual obligations will take a similar stance.

The contract is an extremely useful device. It allows us through agreement to establish a framework of rules tailor-made to cater for a particular set of circumstances and, subject to certain restrictions imposed by the law, some of which will be examined later, we are free to regulate our relationship in any way we see fit. The essential value of such an arrangement is the certainty it provides. In other words, each party is entitled to rely on performance by the other of the promises made with the assurance that the law will hold to account a party in default. The security so generated has made the contract the cornerstone of business relationships. Whether one is considering a manufacturer channelling its products to the end-user through a distributor, a construction company erecting a dam for a foreign government, a venture capitalist investing in a start-up company or a firm of management consultants providing advice to a client, the bond between the parties is the contract they have made. Very often, however, myth obscures reality. If the average person were asked to describe a contract, references to bulky written documents or 'something you sign containing a lot of small print' would not be uncommon responses. However, contracts are not always bulky nor are they always in written form. True, a major construction contract will involve enough paper to threaten a rain forest, but purchasing a cup of coffee from a vending machine will not. In both cases, however, there exists a contract; the distinction between them relates essentially to the subject matter and the scale and complexity involved.

The comments above stress the idea that a contract results from a voluntary agreement entered into by the parties. However, while it may be true to say that all contracts are agreements, the converse is not true. Not all agreements are contracts. Nearly everyone during the course of a week will make a variety of agreements, some of which will be binding as contracts and others not. For example, the average person may expect to have to pay for groceries purchased at the local supermarket, but is unlikely to feel legally obligated to a friend who, having been invited to dinner, is then disappointed when unforeseen circumstances force the soirée's cancellation. In any jurisdiction there has to be a distinction

between agreements recognised by the law as legally binding and those which are not. Under most systems of law, in order to have the status of a contract, an agreement must display certain characteristics. Basically, these are:

- compliance with any required form;
- an offer which has been accepted;
- capacity of the parties;
- in common law jurisdictions, the presence of 'consideration';
- contractual intention;
- absence of any potential invalidating factors, such as mistake, illegality, duress, and so on.

Each of the above will now be considered.

Compliance with any required formality

Contrary to the popular belief that a contract's validity depends on it being in writing, in most jurisdictions an oral contract can be perfectly valid. The problem with a purely oral contract, however, relates to proof. If one of the parties to such a contract alleges that the other has failed to honour its terms, the court will be unable to assist unless satisfactory proof can be produced showing precisely what was agreed. A case came before the English High Court in 2002 involving Jordan Grand Prix, the company which runs the Jordan Ford Formula One team, and Vodafone, the mobile phone operator. The question for the court to decide was whether a sponsorship contract had been concluded between the two companies under which Vodafone would sponsor Jordan's Formula One team to the tune of £100 000 000. Jordan's chairman argued that the contract had been concluded when Vodafone's global branding director telephoned him from the back of a taxi uttering the words 'You've got the deal!' Jordan could not prove that Vodafone's director spoke the alleged words and so lost the case. Common sense, therefore, would dictate that, where the contract is complicated and/or involves significant sums of money, written evidence in the form of signed documentation is essential.

Despite the general principle that a contract can take any form, in some circumstances the law insists on the presence of writing. This requirement may be either formal or evidential. Where the requirement is formal the absence of the writing will make the contract void – that is, of no effect. In civil law jurisdictions the most formal writing that can be required is the *notarial act*. Here a document is drawn up by and signed before an official known as a *notary*. Contracts involving the sale or mortgaging of land very often are required under civil law to follow this form and, depending on the particular jurisdiction, such a requirement may also extend to other types of contract. For example, under German law, a notary must authenticate the documentation setting up a company and the sale of shares in a company must be executed in a similar fashion.

There is no direct equivalent to the notarial act under English law. The closest analogy is the requirement for some contracts to be 'under seal'. In such cases the contract must be contained in a formal document (a *deed*) that is signed by the parties in the presence of witnesses. Such is the requirement, for example, for the transfer of ownership of land and the granting of a lease of land of more than three years' duration.

There are, however, situations where writing is still a formal requirement but the solemnity of the notarial act or deed is not required. For instance, under English law a contract under which one person agrees to sell land to another must be in writing, as must certain financial instruments, such as bills of exchange and promissory notes.

In other cases the requirement of writing may be only evidential in the sense that if the transaction has to be proved, the party seeking to do so must produce written evidence. For example, the French civil code stipulates that if the sum involved is over €762 a signed written document must be produced. This requirement is not generally applicable where the contract is governed by commercial law (see the section 'Making order out of chaos – the classification of law' in Chapter 1) nor in those situations where the courts have recognised that it may be impossible to obtain written evidence. Such might be the case where a contract is concluded in circumstances where written contracts are not customary – for example, in the context of a particular trade or market. Under English law the

requirement of writing where the value exceeded a certain sum was abolished many years ago. The only contract which today must be evidenced by writing is the contract of guarantee where a person promises to answer for the debt of another.

Offer and acceptance

As has already been emphasised, a contract is based on an agreement between the parties. This is simple to state but there could be situations where it is not obvious whether agreement has occurred. In fact, this might be the very dispute between the parties, with one saying that agreement has been reached and the other denying this is the case. It is no use asking the parties themselves whether they have agreed on something because, depending on who is asked, a different answer would be forthcoming. Any system of law must include a mechanism for determining the presence of agreement. Common law and civil law both invoke the concepts of offer and acceptance. Here, if one party (the 'offeror') makes an offer to do (or not to do) something which is accepted by the other (the 'offeree'), that concludes the agreement. Again, this may seem an idea of childlike simplicity but applying it in practice is not always so straightforward. Where large amounts of money are at stake, disputes can arise at every turn and the approach to dealing with these is not necessarily the same in every legal system.

The offer

The first problem is to ascertain whether an 'offer' has been made by one or other of the parties. This is because only an offer in the strict sense of the word can mature into a contract by acceptance. Suppose that the IT manager of company A has been having discussions with the sales director of company B, a firm of computer specialists. Suppose, also, that the sales director subsequently writes to the manager saying 'Regarding the system configuration we discussed recently, we could do it for £120 000. Let me know what you think.' If the IT manager responds to this letter by 'accepting', would company A be able

to bring an action for breach of contract if company B refused to install the system at the stated price, arguing that their last communication was merely a 'ballpark' figure and not a final commitment? An offer in the view of most jurisdictions must represent an intention by one of the parties to be legally bound to certain stated conditions in the event of acceptance by the other and must be distinguished from preliminary negotiations or an 'invitation to treat'. The crucial factor is the intention behind the words or conduct under scrutiny. While the expression 'intention' normally conveys a subjective meaning in the sense of referring to what is going on in a person's mind at any given time, from a legal point of view it is far safer to assume that intention will be judged objectively. In this case, the test is what a reasonable person, looking at all the surrounding circumstances including the words and gestures used, would assume to be the intention of the party concerned. In other words, you are likely to be judged by how others see you.

Although the question of whether an offer has been made is essentially a question of fact, depending on the circumstances of each particular case, recurrent situations do occur where the law's approach is fairly predictable, as shown in the following examples:

Advertisements

If an advert is placed in a newspaper offering for sale a suite of furniture for £1000, is the advertiser bound to sell it to the first person who responds to the advert willing to pay the asking price? The answer to this question depends on the legal significance of the advert. If it could be regarded as an offer, the person responding would be seen to be accepting, thereby concluding the contract. English law is clear on this point; the mere placing of an advert is regarded as an invitation to treat and not an offer. The rationale for this view is the issue of intention, or lack of it, to be precise. The courts have traditionally been reluctant to attribute to the advertiser an intention legally to be bound to *anyone* who happens to respond with the right price, the preferred opinion being that it should be the advertiser who has the last say. In one case,[1] a wild bird enthusiast placed an advert in a magazine catering

for those similarly inclined. The advert read 'Bramblefinch cocks and hens 25 shillings (£1.25) each'. The reaction to the advert was not entirely what the advertiser had expected because he was successfully prosecuted in the magistrates' court for 'offering for sale' this particular variety of feathered fauna contrary to the Protection of Birds Act 1954. He decided to appeal, arguing that the advert was not an offer in the legal sense of the word but an invitation to treat and that any 'offer' would come from a person responding. The appeal court agreed, taking the view that the advert could have produced an unlimited number of responses while the number of birds available for sale was fixed. Common sense suggested that the advertiser's intention was to generate interest in the birds in the hope that someone would offer to buy at the price stated. A similar reasoning applies to circulars, catalogues and other promotional material that a business may distribute in the course of its trade. It should be noted, however, that while German law shares a similar view to that of English law, French law does not. This is illustrated in a case that came before the *Cour de cassation*.[2] A Monsieur Braquet placed an advert in a local newspaper advertising a plot of land for sale for 250 000ff (€38 112). The advert was seen by Monsieur Maltzkorn, who accepted the 'offer' he said it contained. M. Braquet argued that he was not bound because the advertisement was not an offer but an invitation to treat. The court originally hearing the matter agreed with him, but on appeal this finding was overturned. In the opinion of the *Cour de cassation* the lower court had made an error of law. In fact, M. Braquet's advert constituted an offer to the public which would bind the offeror to the first person who accepted.

Despite the reluctance of English law generally to regard adverts as offers, there *are* situations which can prove exceptions to the rule. If, from the facts of a particular case, it can be seen that the advertiser did demonstrate a serious intention legally to be bound to potential respondents, then the advert will be regarded as an offer. An outbreak of 'flu in the late nineteenth century provides a classic illustration of this.[3] An enterprise by the name of the Carbolic Smoke Ball Company produced and marketed a medical product known as the 'Carbolic Smoke Ball', the use of which would apparently protect

against 'flu and a host of other ailments. In fact, such was the confidence of the company in the preventative qualities of the smoke ball that it put out an advert promising to pay £100 to any person catching 'flu who had used the smoke ball in the manner prescribed. The advert also stated that £1000 had been deposited with the Alliance bank, Regent St., 'showing our sincerity in this matter'. A certain Mrs Carlill, clearly impressed with the claims made for the smoke ball, bought one and used it as directed. Her faith, however, was cruelly betrayed because, as misfortune would have it, she caught 'flu. She sought solace by claiming from the producers the £100 promised in the advert. When they refused to pay up, she sued them only to be met by a barrage of defences. The one relevant in the present context related to the status of the advert. The company argued that it did not constitute an offer but was merely advertising 'hype' and not intended to be taken seriously. The court disagreed, stating that the advert amounted to an offer which Mrs Carlill had accepted. The fact that the company had deposited £1000 with their bank would be interpreted by any reasonable person such as Mrs Carlill as evidence of the company's serious intention. Having similarly dismissed all the company's other defences, the court awarded Mrs Carlill her £100.

The implications of the case just described should be obvious to anyone contemplating launching a business 'promotion' of the sort whereby so many purchases of a particular product will entitle the purchaser to free T-shirt, beach ball, pint of beer or whatever. As will become a recurrent theme in the chapters ahead, if risks can be identified in advance, they can be more effectively dealt with. Given that adverts of the type just mentioned will almost certainly be viewed as offers maturing into contracts with anyone satisfying the conditions, the terms of the promotion should seek to control the potential liability of the advertiser. Putting a time limit on the promotion, or restricting it to 'while stocks last' or 'strictly on a first come, first served basis' would seem a sensible start. Failing to wrap a promotion up in a controlling blanket of terms and conditions can prove expensive. A well-known producer[4] of consumer electrical products has found this to its cost. Trying to kick-start a sluggish market in the UK in the early 1990s,

it offered a free transatlantic air ticket to any consumer purchasing products manufactured by it over a certain value. The stampeding hordes which invaded high street retailers showed that the promotion had achieved its aim in revitalising consumer interest in the type of product concerned, but the financial fallout was horrendous. Had the implications of the promotion been carefully thought through initially by the company, appropriate controls and safeguards could have been built in which would have harnessed the potential cost of honouring its commitments. In the event, it cost the company £48 000 000!

Goods on display in a shop

If an item is displayed in a shop window, can the customer demand to be sold it at the advertised price? Again, the question comes down to whether the shopkeeper can be regarded as making an offer by placing the goods in the window with a price tag attached. By doing so, was he effectively saying 'I am prepared to sell to absolutely anyone who is willing to pay the price?' English law does not attribute this intention to the shopkeeper. A distinguished academic[5] has observed that a shop 'is a place for bargaining not compulsory sales', meaning that a shopkeeper should not be compelled to sell to anyone who enters the shop but should have the final say in who are his customers.[6]

The same view is taken as regards goods on display inside the shop. One case[7] coming before the English courts considered the significance of the high street chemist, Boots, adopting a self-service system in one of its stores. A customer was provided with a basket on entering the shop. Items selected by the customer had to be placed in the basket and presented at the cash desk for payment. A registered pharmacist was located near the cash desk who was authorised, if necessary, to prevent a customer removing any drug from the shop. Boots were accused of contravening the Pharmacy and Poisons Act 1933, which made it unlawful to sell certain drugs unless the sale took place under the supervision of a registered pharmacist. The critical issue in the case was to determine when a sale took place. The Society maintained that the display of goods

in the shop amounted to an offer which the customer accepted when the customer placed the item in the basket. However, the Court of Appeal rejected this argument. In its view, the fact that a shop adopted a self-service system made no difference; it was the customer who made the offer to buy and there was no sale until this offer was accepted. In Boots's case, the acceptance would be made by the cashier at the cash desk. As a registered pharmacist was located there who had authority to intervene if necessary, the sale, in effect, took place under the supervision of the pharmacist and therefore the provisions of the Act had not been contravened.

While German law basically follows the approach of English law as regards goods displayed in a shop, French law takes a different stance. An exploding bottle of lemonade gave the Paris Court of Appeal[8] an opportunity to state its views. A customer was injured when the bottle exploded at the cash desk, but before it had been checked out. The customer sued the shop for compensation. In the court's opinion a sale in a self-service shop 'is complete when the customer, having chosen from the shelf an article offered for sale at a posted price which he accepts, places it in the basket which is provided and which he is bound to use until the goods are checked out at the cash desk'. Accordingly, by selling a product which was unsafe, the supermarket was in breach of contract and would have to compensate the customer for the injuries suffered. As a final point it should be noted that, had the incident occurred in England or Germany, the customer would have had no remedy in contract. In order to bring a compensation claim other avenues would have to have been explored, such as an action in tort.

The examples considered above illustrate particular situations in which the courts have laid down general principles. In other situations, the individual facts of the case will demonstrate whether or not there is an intention on the part of one of the parties to make an offer. It should also be noted that the word 'offer' (or 'acceptance' for that matter) need not necessarily be used. The words (if any) uttered by one party may be indicative of that party's intention but are not necessarily decisive. The context in which the words are employed, together with all the surrounding circumstances, should be

taken into account. It should also be borne in mind that an offer and acceptance can be made by conduct and without any words being spoken. Thus, if a customer selects a newspaper from the display stand in a newsagent's shop and then offers the money to the assistant behind the counter who places it in the till, there has been an offer and acceptance even though not a word has been exchanged; the customer made an offer which was accepted by the shop assistant.

Termination of the offer

Although it might be stating the obvious, an offer must exist before it can be accepted. Although one party may have originally made an offer, it may have ceased to exist by the time the other party decides to accept. In what circumstances, therefore, does an offer come to an end? Two situations where this can happen are if the offer lapses or is revoked. As will be seen, the approach can differ according to the legal system under consideration.

Lapse

An offer once made does not remain in existence for the rest of eternity. Most systems of law recognise that an unaccepted offer will eventually lapse through the passage of time. The question, of course, is at what point in time does this happen? Under English, French and German law an offer lapses after a *reasonable* time. What is reasonable will depend on all the circumstances of the case including, for example, the subject matter of the offer. It should hardly require an overly developed sense of perception for someone to appreciate that an offer, say, to sell a recently landed shoal of haddock might lapse in a shorter time than an offer to sell the trawler which caught it. Where the subject matter of the offer could be susceptible to sudden price changes, the party making the offer is entitled to a speedy response. This was the argument presented by Mr Montefiore when sued in the English courts in the mid-nineteenth century by a company whose shares he had subscribed for but later refused to take up.[9] Thinking that the Ramsgate Hotel looked a good investment prospect,

Montefiore wrote to the company on 8 June 1864 offering to buy shares. Five months later the company allotted him shares, but as they did not now seem to be such an attractive proposition he refused to take and pay for them. He argued that by the time the company had eventually come round to accepting his offer, it had lapsed and, accordingly, he was not obligated to take the shares. The court agreed with him.

If a deadline for acceptance is set, the offer will lapse on the expiration of that deadline. Thus, if a seller offers goods to a potential purchaser with the proviso that he must accept within a given time, the seller is not bound if the purchaser accepts outside that time limit. Of course, the seller might be willing to ignore the lateness and go through with the transaction, but the important point to bear in mind is that he does not have to. Where there is no deadline, any unresolved argument as to what is a reasonable time would ultimately have to be decided by the court. Anticipating what a court might decide is not an exercise of scientific exactitude. The party making the offer is, to a large extent, in the driving seat and should take any opportunity which presents itself to control his potential liability. Inserting a deadline for acceptance will at least fix the period during which the offering party is exposed to the liability which would result from an acceptance. To submit this issue to judicial capriciousness would not appear to be the height of prudence!

Revocation

If a person makes an offer, can they later revoke it? After all, what appears to be a good idea at the time might does not necessarily continue to be so. Not all legal systems afford the offering party the luxury of being able to change their mind. German law recognises the binding nature of an offer in the sense that once it has been received by the other party, it cannot be revoked and any attempt to do so will have no effect. A revocation that arrives before or simultaneously with the offer will, however, be effective. The offeror, moreover, can avoid the binding effect of an offer by expressly providing for this – for example, by using such words as ‘offer subject to change’ (*Angebot freibleibend*) or ‘revocable offer’ (*Angebot widerruflich*).

French law, on the other hand, accepts that while the offeror is entitled, in principle, to revoke an offer before it is accepted, he must not do so until a reasonable time has passed. As always, what is reasonable will depend on the circumstances of the case. Suffice it to say that if the offeror revokes his offer before this period has elapsed, he will potentially be liable to compensate the other party for financial loss incurred as a result. Where a deadline is contained in the offer, German and French law, and, for that matter, most other civil law systems, stipulate that the offer cannot be revoked before the deadline. Attempting to do so will, again, present the offeror with potential financial consequences.

When it comes to the binding nature of an offer, German law is at that end of the scale representing the strictest position, while France comes somewhere in the middle. The relaxed attitude taken by English law in this matter, however, places it firmly at the opposite end. Under English law an offer is freely revocable before acceptance and, subject to one exception, it makes no difference whether there is a deadline or not. The reason for this stems from a concept peculiar to English law and those systems based on it. English law requires a promise to be supported by *consideration* before it is enforceable. Consideration is a complex idea and will be more fully explained in the 'Consideration' section below. For present purposes, however, it can be described as the exchange element in a contract. Basically, a promise will only be enforceable if something is given or promised in return. For example, an offer to sell a car for £5000 will become binding once the offeree accepts, thereby promising to pay the price. Until this occurs, there is no consideration to support the offeror's promise to sell and therefore he would be under no obligation to keep the offer open for any given time. Even if the offeror indicated that he would keep the offer open for a stipulated period, this again would not be binding on the offeror because, in the normal course of events, there would be no consideration provided by the offeree to support this promise. However, as mentioned above, there is one situation where a promise to keep an offer open for a stated period will be binding and that is where an option contract has been created. By way of illustration, suppose a farmer approaches a property

developer and offers to sell him a field for £100 000, stating also that, for a payment of £2000, he will keep the offer open for twelve months. If the developer thought that land prices could rise sharply over the coming months, he might think the farmer's proposal was attractive. By accepting the twelve-month option and promising to pay the £2000 requested, the developer will have provided consideration and if, within the twelve-month period, the farmer should revoke his offer to sell the field, he would be in breach of the option contract and liable to the developer accordingly.

Critics of the English rule on the revocability of offers view it as potentially unfair on an offeree who, having 'accepted' the offer, might thereafter act on the assumption that a contract had been concluded only to discover that the offer had been revoked in the meantime. Such criticism is, in part, met by the requirement that, if the offeror wishes to revoke his offer, he must communicate this fact to the offeree before acceptance. Such a requirement would have greater merit if it necessitated the offeror either to communicate personally with the offeree or at least ensure that the offeree was aware of the fact that the offer had been revoked. It appears, however, that neither of these are demanded by the law and that it may be sufficient if the offeree learns of the revocation through an independent source. This was the outcome that befell the claimant in a case brought before the court in 1876.[10] Mr Dickinson had received a letter from Mr Dodds offering to sell him a house. The letter stated that the offer would be kept open until 9.00 a.m. on the following Friday. On Thursday afternoon Dickinson was informed by a Mr Berry that Dodds had been negotiating the sale of the property with a person called Allan. Dickinson accepted the original offer in a letter which was delivered to Dodds at 7.00 a.m. on Friday. However, it transpired that Dodds had signed a contract to sell the house to Allan on the Thursday. When Dickinson sued Dodds for breach of contract the court stated that since there was no consideration for the promise to keep the offer open, Dodds could revoke it at any time. Furthermore, when Berry informed Dickinson of the negotiations with Allan, this indicated that Dodds no longer intended to sell the house to Dickinson and therefore amounted to a communication of the

revocation to him, hence there was no contract. This decision has been criticised for producing uncertainty. What amounts to a *reliable* source of information? Is the offeree bound by gossip? It appears to be a question of fact in each case; namely, was the information such that a reasonable person would have been persuaded of its accuracy?

It should not be assumed that the English rule on revocability of offers applies in exactly the same way in other common law jurisdictions. For example, while American law generally accepts the principle that, options aside, an offer can be revoked before acceptance, the UCC[11] provides an exception in the case of 'firm' offers. The rule, which only applies to written offers by 'merchants' to buy or sell goods, provides that if an offer states that it is to be binding or 'firm', it may not be revoked during any period specified or, if none, for a reasonable period not exceeding three months. In addition to the UCC exception, American courts are also reluctant to allow an offeror to withdraw an offer where the offeree relies to a substantial degree on its continuing existence. Such was the view expressed in a case[12] where a subcontractor had quoted a price to the main contractor who was bidding in connection with a building project. The latter had relied on the subcontactor's quote when preparing its own bid on the main contract and, accordingly, it could not be withdrawn.

The acceptance

An offer matures into a contract when it is accepted. Generally, there must be some external evidence of the offeree's intention to accept; as a general rule mere silence will not suffice. Take the following example: X writes to Y offering to buy Y's Ferrari sports cars for £500, adding that 'if I do not hear from you by 6.00 p.m. this Friday, I will assume you have accepted my offer'. If the deadline passes without Y making contact, X might start celebrating on the assumption that the car in question is now his. Such celebrations, however, would be premature because it is highly unlikely that any system of law would regard a contract of sale to have been concluded between X and Y. The reasons for this are not difficult to see. To begin with, Y's silence is equivocal; he might not have received X's

letter or, even if he had, he might have regarded it as a joke and ignored it. Either way, his silence does not evidence an intention to accept. Moreover, if it were otherwise, the law would effectively require Y to take steps to prevent a contract being concluded even though he might not have invited it in the first place. A law such as this would only encourage unscrupulous marketing strategies such as inertia selling, whereby a sales operator, having farmed addresses from a telephone directory or something similar, dispatches goods to unsuspecting consumers stating that they will be liable for the price unless the goods in question are returned.[13]

Although most systems of law accept the general principle that silence does not constitute acceptance, there are exceptions. In German law, for example, there are situations where a party can be legally bound as a result of failing to respond to a communication from the other. This is particularly so in the case of commercial letters of confirmation. When a business contract is concluded orally, one party will often subsequently send to the other a written confirmation of what has been agreed. If the contents of the letter differ from the oral agreement but are nevertheless accepted without objection, the agreement will be treated as modified or amplified in accordance with the letter of confirmation. In this instance, the recipient is deemed through silence to be accepting variations to an already concluded agreement. In some circumstances, however, his silence might operate to conclude a contract, although no such binding agreement had taken place during the negotiations. A case[14] coming before the *Bundesgerichtshof* in 1953 illustrates the point. In this case the agent of a metal-processing firm had been negotiating with a scrap metal dealer over the purchase of a large quantity of scrap metal. The negotiations had proceeded on the basis of a list which stated the amounts and prices of the items for sale together with the date and method of delivery. Shortly after the negotiations, the metal-processing firm wrote to the scrap metal dealer confirming it had purchased the quantities offered at the prices stated on the list. The scrap metal dealer did not respond. When sued for failing to deliver, he argued that no contract had been concluded. The court disagreed, holding that the scrap dealer's silence

amounted to an acceptance of the letter of confirmation and a contract was concluded as a result.

The lesson to be learnt, therefore, is that in the type of situation described above, the recipient of a letter of confirmation must object promptly, otherwise he risks being legally bound to its content. One crumb of comfort, however, is that the additions or modifications contained in the letter of confirmation must be consistent with the general tenor of the negotiations. This requirement, together with the courts' refusal to reward any conduct smacking of dishonesty, will thus deprive the trickier operator of the opportunity of slipping something 'new' into a confirmation letter in the hope that it will find its way into an eventual contract.

Even though the offeree evidences an intention to accept the offer, the acceptance must be absolute and unqualified. A response by the offeree which seeks to introduce variations does not amount to an acceptance but instead constitutes a *counter offer*. The effect of the counter offer is to destroy the original offer, which cannot then be accepted. For a contract to result, the counter offer will have to be accepted by the original offeror.

The essential characteristic of a counter offer is that it amounts to a *rejection* of the offer. Not every response from the offeree which is at variance with the offer will amount to this. An offeree, whilst not wishing to reject the offer out of hand, may nevertheless attempt to get an improvement in its terms. His response, therefore, may amount to no more than a request for clarification or further information from the offeror. Such was the view taken by an English court in a case[15] coming before it in 1880. On Saturday, the defendant offered to sell 3800 tons of iron to the claimant at 'forty shillings (£2) net cash per ton, open until Monday'. Early on Monday, the claimant telegrammed the defendant: 'Please wire whether you would accept forty shillings for delivery over two months or, if not, longest limit you would give'. The defendant did not respond. At 1.34 p.m. on the same day, the claimant sent a telegram to the defendant accepting the offer to sell at forty shillings cash. Meanwhile the defendant had sold the iron to someone else and had telegrammed the claimant at 1.25 p.m. to inform him. The telegrams crossed.

The vital question to be determined was whether the defendant's offer was still in existence when the claimant accepted it in the telegram sent at 1.34 p.m. If the claimant's first telegram amounted to a counter offer, the defendant's offer would have been destroyed and could not subsequently be accepted. Alternatively, if the claimant's response was merely an enquiry, then the offer would be still in existence when he accepted by the second telegram. In the court's view the claimant had not made a counter offer but had addressed to the defendant 'a mere enquiry which should have been answered and not treated as a rejection of the offer'.

In responding to an offer, therefore, the offeree should make his or her intentions clear. An attempt to elicit further concessions from the offeror should be presented in a way which does not indicate a rejection of the original offer. In this way, the offeree can still have 'a second bite of the cherry' by being able to accept the first offer if no further movement on the part of the offeror is forthcoming.

The principle that an acceptance must mirror the terms of the offer has a particular resonance in the context of a very common business situation. The parties to a contract will often have their own standard terms of business that, typically, will appear as 'small print' in one or other of the documents exchanged between them. In negotiating a contract, the parties will probably focus on the main issues to be agreed and may not expressly make reference to each other's standard terms. However, if a dispute later arises over the contract, it may very well be at this point that the standard terms become an issue. As the two sets of terms are seeking to protect different interests, it is highly likely that their content will diverge significantly. Each party, no doubt, will be insisting that their standard terms should prevail over those of the other. The scene is set, therefore, for a conflict known as the 'battle of the forms'. A case[16] decided by the English Court of Appeal in 1979 offers some guidance for identifying the party most likely to emerge victorious. A company called Butler Machine Tools sent a quotation for the supply of machine tools to another company, Ex-Cell-O. The quotation stated that it was subject to Butler's terms of business, which were 'to prevail over any conditions in the buyer's order'. Included in the terms of business was a 'price escalation'

clause, which allowed Butler to raise the quoted price if costs increased between the time of manufacture and delivery. Ex-Cell-O placed an order subject to their terms and conditions. These were different from Butler's terms, notably in that there was no price escalation clause. Ex-Cell-O's order also contained a tear-off slip which the seller was invited to sign and return. The slip stated that 'we accept your order on the terms and conditions thereon'. Butler signed and returned the slip with a covering letter confirming that Ex-Cell-O's order had been entered into their books in accordance with their sales quotation. Butler subsequently claimed an additional £2800 under the price escalation clause. In determining whose terms of business should prevail, the court applied a traditional offer and acceptance analysis to the communications which had occurred between the parties. Butler's quotation amounted to an offer. Ex-Cell-O's order was not an acceptance because it made reference to different terms of business. Instead, it amounted to a counter offer which Butler accepted by signing and returning the tear-off slip. The court regarded the accompanying letter as simply confirming the price and did not incorporate Butler's terms of business into the acknowledgement slip. Additionally, the provision in Butler's terms which sought to 'leap-frog' Ex-Cell-O's conditions of purchase failed to achieve this result because, like all the other terms, it was merely part of the offer contained in the quotation. As a result, the contract was concluded on Ex-Cell-O's terms of business and, accordingly, Butler was not entitled to the extra £2800.

The court's approach in the above case suggests that, where documentation is exchanged between the parties containing differing terms of business, the terms which are last presented will, if accepted by the other party, prevail. The clearest evidence of this would be where one of the parties signs an acknowledgement agreeing to the other party's terms. Even if there is no written acceptance, conduct might amount to the same thing; for example, if a seller of goods, having received an order on the buyer's terms, nevertheless supplies the order without raising any objection, this will probably be regarded as acceptance of the buyer's terms.

The approach taken by English law in resolving the battle of the forms is not one necessarily applied in all jurisdictions. In

some systems, the problem is sometimes resolved by using techniques such as ascertaining the parties' 'true intention' or by applying the requirements of 'good faith'. The outcome of adopting either of these approaches will be difficult to predict in any given situation and particularly at the time the contract is being concluded. The result of all this will be to leave the parties uncertain as to whose terms of business form the basis of the contract. The safest way for a company to proceed is to ensure that its terms of business are presented to the other party in a clearly visible and comprehensible format *before* the contract is concluded and that the other party's specific agreement to these can be proved by, for example, a signed acknowledgement. Whether such steps will be practical, or even possible, in every situation is, of course, another question.

As a final point, it should be noted that, despite a party winning the battle of the forms, the law might still intervene to render ineffective some or even all of the standard terms if it considers them to have been used in an unfair or abusive way. This situation will be further explained in the next chapter.

Even if the offeree's acceptance conforms in every respect with the terms of the offer, it will still require communication to the offeror before a contract will come into existence. Two issues arise here. In what way should the offeree communicate his or her acceptance and at what point in time does it take effect? As regards the former, the offeror may use any *reasonable* means to communicate the acceptance so, for example, an offer made orally might be regarded as inviting an oral response and, similarly, where an offer is made through the post, accepting it in the same way might also appear to be reasonable. However, the offeror might specify a particular method of replying and if this is not followed, the question will then arise as to whether there has been a valid acceptance. Often, the offeror will have a particular object in mind and if the method chosen by the offeree achieves that object, the fact that it differs from the precise method indicated by the offeror will not matter. For example, an offer might require a reply 'by return of post'. If this is taken to mean *a written* and *quick* response, an acceptance made by telephone a week later would not suffice but a signed note delivered by hand the

same day probably would. In some situations, however, a stipulated method of replying might be compulsory in the sense that, unless it is followed, no contract will be concluded. So, for example, a seller of goods might state in the offer that should the offeree wish to accept, he or she should sign and return the tear-off slip at the foot of the quotation. As the indicated method is so specific, accepting in any other way would probably be ineffective.

The above issue was concerned with *how* the acceptance is communicated. An equally important question is at what point in time can the acceptance be regarded as having been communicated to the offeror? Under English law, a distinction has to be made between a situation where the parties are in instantaneous communication and where they are not. In the former case, for example, where they are negotiating face to face or over the telephone, communication is not deemed to be effective until it is actually received by the offeror. Thus, if the parties are facing each other across a table and the words of acceptance uttered by one of them are drowned out by the noise of an aircraft flying overhead, there would be no contract. The words would have to be repeated so that the offeror could hear them. The same would be true if the parties were talking on the telephone and the offeror's earpiece went dead before the offeree had replied with an acceptance. In both the examples just given the offeree will be in a position to know that communication of his acceptance has been unsuccessful and so is obliged to repeat his efforts. The same reasoning has been applied to telexes and, although not actually decided, will probably apply to faxes as well. The position with emails remains less clear. If an email communication is regarded as instantaneous or almost instantaneous, then it could be argued that the same rule should apply. However, often an email is not instantaneously transmitted to the addressee when the sender presses the 'Send' button. It might, for example, be temporarily stored on a server and sent at a later time. If this is the case, an analogy could be drawn with an acceptance made by post, for which a different rule applies. It has long been recognised in English law and a number of other common law jurisdictions that, in these circumstances, the acceptance becomes effective on posting and not on receipt. The same is

true even though the letter is lost and never arrives! However, before the rule applies, two preconditions must be met. Firstly, the post must be seen as an appropriate means of communication and, secondly, the letter must have been properly stamped and addressed.

Many explanations have been put forward for what might be referred to as the 'postal rule' but, in essence, it is an arbitrary rule based on convenience rather than sophisticated legal doctrine. When the post is used, the offeree is usually not in a position to know whether his acceptance has been received by the offeror. This is unlike the situation when the communication is instantaneous. Having posted his reply, the offeree might then alter his position to his detriment on the assumption that a contract has been concluded. It is also true to say that the offeror may be prejudiced where, not having received a letter from the offeree, he assumes no acceptance has been made only then to find it has. Of the two parties, one has to suffer the consequences of a late, misdirected or lost postal acceptance. The rule favours the offeree. It could be argued that, by expressly or implicitly approving use of the post, the offeror is agreeing to take the risk of things going wrong. If the offeror is reluctant to accept this risk, he can always require actual receipt before being legally bound. Although it is advisable to state this requirement explicitly, one case[17] demonstrates that, in some circumstances, it can be inferred. An offer to sell a house was made in the form of an option. The option stated that it was 'exercisable by notice in writing' to the intending vendor. A written notice was posted but it never arrived. The court found that, on its true interpretation, the offer indicated that actual communication was required and therefore no contract had been concluded.

In the case of American law, the postal rule is generally applied. This is despite hostile academic opinion and the fact that, in a number of cases, courts have refused to follow it. In the civil law world, there is no universally accepted principle governing postal acceptances. German law, for instance, has no place for the postal rule. It makes no distinction between instantaneous and postal communications. To be effective, an acceptance has to be received. In the business context, this has been interpreted as meaning received within the 'sphere of

influence' of the offeree or, in other words, asking when it would be reasonable to assume that the letter, in the normal course of events, would have been collected from the mailbox. In similar fashion, the Italian civil code[18] provides that a contract comes into being as soon as the offeror knows of the acceptance, such knowledge being presumed as soon as the letter arrives at the offeror's normal address. French law, on the other hand, has no clearly defined principle. The *Cour de cassation* has consistently held that the time of acceptance depends on the facts of the particular case and especially on the intention of the parties. Accordingly, it is possible to find cases where the contract has been concluded on the posting of the acceptance and others where this has occurred only on receipt.

Before leaving the postal rule, a note of caution should be sounded. Even under English law, one of its most ardent supporters, the rule only applies to postal *acceptances*; it is not a rule that applies to postal communications generally. So, for example, if the offeror writes to the offeree revoking the offer, this will only take effect on receipt and not on posting. A case[19] decided in 1880 illustrates the interplay of the different rules applying to posted revocations and acceptances. A company called Van Tien Hoven posted a letter in Cardiff on 1 October addressed to Byrne, a company based in New York, offering to sell some goods. On 8 October, Van Tien Hoven posted a second letter revoking the offer. This letter arrived on 20 October but, in the meantime, on 15 October, Byrne had posted a letter confirming its acceptance of the offer. The court decided that the revocation was not effective until it reached Byrne on 20 October, but by that time the offer had already been accepted.

Capacity of the parties

In order to conclude a binding contract, a person must have the legal capacity to incur contractual obligations. Most systems of law seek to protect the very young and those suffering from mental disorders from the consequences of their improvidence. As a result, it is probable that an individual belonging

to one or other of these groups might lack full capacity to contract. For example, persons who have not reached the age of majority will generally have restricted contractual capacity. Contracts entered into with minors are in the majority of cases, therefore, unenforceable against them. This is not a blanket rule, for in every system there will exist exceptions. For example, under English law, a minor will have to pay for 'necessaries' that have been supplied. Necessaries are 'goods (or services) suitable to the condition in life of the minor and to his actual requirements at the time of sale and delivery'.[20] To qualify as necessaries, the goods or services must have a utility value and not be mere luxuries. In determining this, two factors are relevant. Firstly, the minor's condition in life will be considered. If the individual concerned is wealthy, even expensive goods or services could be necessaries provided that they are useful. Secondly, the minor must not already be adequately supplied with the goods or services in question. So when a Cambridge undergraduate with a penchant for fancy waistcoats bought eleven of these garments from an outfitter, he was not obligated to pay for them because, at the time, he had a wardrobe full of them![21]

Contracts which are advantageous or beneficial to the minor may also be binding. This is the view taken by English and German law, so contracts which enable him or her to earn a living may be enforceable. However, contracts which are manifestly to the *disadvantage* of the minor are, under most systems, likely to be void. Therefore, anyone contemplating entering a contract with a minor should bear in mind the risk of the contract being unenforceable. The involvement of a person having full capacity as a guarantor may offer a degree of protection but, even so, the risks as a whole should be given full consideration.

Consideration

Consideration was briefly mentioned in the 'Offer and acceptance' section above in connection with option contracts. A slightly more extensive foray into the intricacies of this concept follows.

To the civilian lawyer consideration is an enigma, but to his common law counterpart it is a vital contractual ingredient representing the cement which binds the parties to their agreement. In the common law tradition, contract law is not concerned with gifts or merely gratuitous promises. Unless a promise is contained in a document known as a 'deed' (see 'Compliance with any required formality' section above), a formality that does not characterise the vast majority of commercial dealings, it must form part of a bargain if it is to be enforceable. A bargain is a two-way transaction and in order to determine whether such a relationship exists in any given situation, the law looks for the presence of consideration. Consideration has been variously defined. In one case[22] the court was of the opinion that 'a valuable consideration in the sense of the law may consist either in some right, interest, profit or benefit accruing to one party or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other'. This definition emphasises the benefit and/or detrimental aspect of consideration; it must represent either a benefit received by one party or a detriment or loss suffered by the other party. So if X makes a promise to Y, Y will only be able to enforce it if he can show that in responding he either suffered a detriment or, alternatively, that X received a benefit. If X's promise was to pay Y £1000 and was made in return for Y's promise to paint X's house, it will be enforceable. The reason is that Y has suffered a detriment by promising to paint X's house and X has received the corresponding benefit contained in the promise. It should be noted, however, that although one party's detriment may be the other party's benefit, as in the example just given, this need not always be the case. So, for example, if X's promise had been made in return for Y's promise to paint Z's house, it would, nevertheless, be enforceable. While Y has still suffered a detriment in response to X's promise and thereby provides consideration, the beneficiary is now Z and not X.

A distinction has to be made between *executory* consideration and *executed* consideration. Executory consideration involves the exchange of promises. For example, X promises to sell and deliver to Y five tons of wheat at £70 per ton and it is agreed that the wheat will be delivered and paid for two

weeks later. This is a binding contract of sale despite the fact that both promises have yet to be carried out. The reason for this is that the consideration is the promise *itself* not the performance of the act. Thus, if after the exchange of promises X informed Y that he would not deliver the wheat as agreed, he would be in breach of contract, Y's promise to pay having provided the necessary consideration for X's promise to deliver.

Executed consideration, on the other hand, is where one party's promise is made in return for the performance of an act by the other. In this situation, the promise will only be enforceable when the required act has been completed. The classic example of executed consideration is in the case of rewards. For example, if X loses his dog and places an advert in a newspaper offering £100 for its safe return, Y, by finding and returning the dog, will have both accepted the offer and provided the consideration for the promise contained within it. A similar principle would apply in the case of a marketing promotion where, say, a breakfast cereal producer offers a 'free' beach towel to consumers who collect and return ten coupons from promotional packets. The company will only be obligated to those who respond in the prescribed manner.

Apart from the situation just mentioned, most commercial contracts will be founded on executory consideration, the transactional element being represented by the exchange of promises, the subject of which is to be performed at a later date.

Consideration must not be *past*. This means that the respective promises of the parties must be given in response to each other. If someone performs an act or service for another and the recipient makes a promise but *subsequent to* and *independent of* the act or service in question, this promise will be regarded as an expression of gratitude for past favours and not as forming part of a contract. The promise made would be based on *past* consideration. For example, suppose X's fence blows down in a storm while he is away on holiday and his neighbour, Y, expends considerable effort in re-erecting it. If X, on his return, promises to pay Y £50 for his endeavours, would this promise be enforceable? Unfortunately for Y, the answer is no. As Y's actions preceded X's promise and were independent of it, they would amount to past consideration which, in the eyes of the law, is no consideration.

A slightly different situation might occur where one party performs an act or service at the request of the other but with no mention of payment being made. If the party benefiting subsequently makes a promise to pay for the service provided, it may well be that he will have to honour the promise. This was acknowledged as long ago as 1615,[23] when a condemned man by the name of Braithwaite had asked a certain Lampleigh to do all he could to obtain a pardon from the king. Lampleigh eventually achieved this but, in doing so, had expended a great deal of time and money. Braithwaite, no doubt overcome with gratitude, later promised to pay Lampleigh £100 for his services. Braithwaite's emotional state appears to have soon stabilised, however, because he failed to honour his promise. The court decided that as the services had been performed as a result of the previous request by Braithwaite, his promise was enforceable. The previous request and the subsequent promise were to be treated as part of the same transaction.

However, it should be noted that a subsequent promise to pay for services previously requested will only be enforceable if, at the time the original request was made, there was an understanding that the services would be paid for or, in other words, the request was made in a business sense. In this situation, the subsequent promise can be viewed as a confirmation of something which was always implicit. This can be seen from a case[24] involving the management of intellectual property rights which came before a court in 1892. The owners of certain patent rights entered into an arrangement with a person by the name of Casey, under which Casey was to 'push' the invention to which the patent related. Eventually the owners wrote to Casey stating 'in consideration of your services as the practical manager in working our patents we hereby agree to give you a third share of the patents'. The court decided that the promise was enforceable on the grounds that the request for Casey's services had carried with it an implication that those services would be paid for. The subsequent promise evidenced an admission of what a reasonable payment would be.

Consideration must be *real* in the sense of having some economic value, however small. The courts will not enforce vague promises or promises where there is no benefit at all or where no detriment is suffered. In other words, the consideration

must not be *illusory*. An example can be found in a case[25] involving an agreement by a father to let his son off repaying a debt. The son had borrowed money from his father, giving him a promissory note in return. Subsequently the father agreed to release his son from the promissory note in return for him undertaking to 'cease complaining that he was not as well treated as his brother'. When the father died, the executor of his will sued the son on the promissory note. The son pleaded the agreement with his late father. In the court's view the 'consideration' which the son had provided was nothing more than a promise 'not to bore his father'. Accordingly it was illusory and the son was liable on the promissory note.

Although consideration must have some value, the court will not investigate whether the respective promises of the parties are economically equivalent. If this were the case, then anyone who considered himself to have made a bad bargain could ask the court to set the contract aside. It is often said that the court is not there to repair bad bargains. Therefore, provided there is evidence of a serious intention, a contract to sell a Picasso painting for £1 is a perfectly binding contract. However, where the consideration appears to be grossly inadequate, there may, on further investigation, be evidence of fraud or undue influence, but in the absence of such circumstances the contract is good. In the above example, the £1 consideration will be termed 'nominal', being present merely as a technical device to transform an otherwise unenforceable promise into a binding obligation. A lease of land is sometimes given in return for a 'peppercorn' rent. This token consideration, nevertheless, converts the arrangement into a binding contract. Such was the case when the executor of a will tried to evict the deceased's widow from what had formerly been the matrimonial home.[26] During his lifetime, Mr Thomas had expressed the wish that his wife, if she should survive him, should be able to live in the house which was in his sole name. After Mr Thomas's death, his executor agreed to let Mrs Thomas live in the house, firstly because of her husband's wishes and secondly on payment of £1 per year. The court ruled that Mrs Thomas should be allowed to remain in the house, not because of her husband's wishes but because of her promise to pay £1 per year.

Although consideration need not be *adequate* it must be *sufficient*. At first sight this statement appears to be contradictory because in everyday language 'adequacy' and 'sufficiency' mean basically the same thing. However, in the context of consideration, they represent different ideas. While *adequacy* refers to economic value in the sense indicated above, *sufficiency*, on the other hand, is concerned with the question of whether the substance of a promise is *capable* of forming consideration in the eyes of the law. As has already been explained, a party to a contract can show consideration by suffering a detriment in response to the other's promise. If the party concerned is already under a duty to act in a particular way, there would appear to be no detriment incurred merely by promising to do something which this person is already obliged to do. In such a case, the consideration is said to be insufficient. So from where can such pre-existing duties originate? Firstly, the promisor may be under a duty to act in a particular way either because of the office he or she holds or because of the law. An old case illustrating this point is Collins v Godefroy.[27] Collins had been subpoenaed to give evidence in a case in which Godefroy was involved. Godefroy had promised to pay Collins £6 for his attendance at court. It was decided that the promise of payment was not enforceable because, by promising to attend the court hearing, Collins was only doing what he was required to do by law – that is, under the subpoena – and therefore had not provided consideration.

However, where the act performed goes beyond what the law or the particular office strictly requires, it will amount to consideration. A strike at a coal mine in the 1920s provides an example.[28] The managers of the mine requested police protection during the strike. The police authorities considered that a mobile force would be adequate to deal with any disorder which might arise but the company requested that police officers be billeted on the premises. The police agreed to provide such a presence but at a cost of £2200. When the company was sued on its refusal to pay the agreed sum, it pleaded absence of consideration as a defence. The House of Lords considered that, although the police were under a public duty to provide protection, they had a discretion when it came to deciding on the level needed in any particular

situation. Where the police provided greater protection than they considered strictly necessary, consideration would be shown. The police were entitled to recover the £2200 from the company.

A second situation where there may be a question mark over the sufficiency of consideration is where the parties are already in a contractual relationship and one of them makes a further promise in relation to that contract. If the 'consideration' provided by the other party for this additional promise consists merely in performing his part of the original contract, it is difficult to see what detriment he has suffered. The problem is best illustrated by referring to two contrasting cases having a nautical flavour. In one,[29] a sailor by the name of Stilk was under a contract to work a particular voyage. During the voyage two crewmen deserted and the captain of the ship, unable to find replacements, promised to pay the remaining crew extra wages if they completed the voyage. The court decided that the promise was not enforceable as Stilk had provided no consideration. By promising to complete the voyage, he was merely promising something which he was already bound to do. The original contract obligated him to meet normal emergencies during the voyage and desertion by only two members of the crew was one example of this.

Stilk's failure in the above case should be contrasted with the success enjoyed by one of his seafaring brethren in very similar circumstances. In this case,[30] however, the number of desertions was so great as to make the ship unseaworthy. By agreeing to work the ship home in return for extra pay, the claimant had provided consideration. The fact that the desertions had rendered the ship unseaworthy had the effect of releasing the remaining crew from their original contracts. By promising to complete the voyage, the claimant was, in fact, entering into a new contract.

The above two cases involved the 'detriment' aspect of consideration. However, it should be remembered that there are two sides to every coin and that one party's detriment often represents a 'benefit' to the other. Although the performance of a pre-existing contractual duty might not impose an additional burden on the party concerned, it could, because of the particular circumstances of the case, confer a positive benefit on the

other party. At least, this was the view taken by the judge in a more recent case than the two just considered. The defendants in the case[31] were the main contractors engaged to refurbish a block of flats. They employed the claimants as subcontractors to carry out carpentry work for an agreed price of £20 000. Part way through the contract, the claimants got into financial difficulties as a result of having underestimated the amount of work involved and there was a distinct possibility that they would not be able to complete the contract. This possibility greatly concerned the defendants because, if they did not complete the refurbishment on time, they would incur heavy financial penalties under the main contract. Accordingly, the defendants promised the claimants an additional £10 000 if they completed the work according to schedule. The court ruled that they were bound to pay this sum as they had received significant benefits as a result of the claimants' promise. The assurance that the claimants would complete the work meant that the defendants would avoid the penalty in the main contract. Furthermore, by keeping the claimants on board, the defendants would also not be put to the trouble and expense of employing other contractors to complete the carpentry work.

The requirement that a promise must be supported by consideration in order to be enforceable can, in some circumstances, produce unjust results. This is particularly so where a party in reliance on an, albeit gratuitous, promise has altered his position for the worse. In the absence of consideration, he will have no recourse against the promisor. For example, suppose that Y promises to pay the first year tuition fees should X decide to enrol on a university course. If X does so he will obligate himself to the university for payment of the fees, but if he attempts to reclaim reimbursement from Y under his promise he would fail. This is because there would be no consideration to support Y's promise. As previously stated, consideration represents the transactional element in a contract. Each party makes his promise *in response to* and *in order to obtain* the counter-promise of the other. In the above example, Y did not make his promise *in return for* a promise by X to enrol on the course and therefore it was unsupported by consideration.

In order to address the injustice apparent in situations such as the one just described, the American courts have developed a doctrine known as 'promissory estoppel'. According to this, even a gratuitous and informal promise will be enforceable against the promisor if the promisee has changed his position to a material degree in reliance on the promise and such reliance was foreseeable by the promisor. The principle was invoked in a case[32] where an uncle promised to finance his nephew's studies if the latter spent the year in Paris broadening his appreciation of European culture. Although having means of his own, the nephew relied on this promise and went to Paris. On his return, he reclaimed his expenses from his uncle, who refused to pay. Despite the absence of consideration, the court nevertheless held the uncle to his promise.

English law recognises the doctrine of promissory estoppel but in a more restricted form than that existing under American law. While American law will allow a promisee to sue the promisor in order to enforce a gratuitous promise, under English law the doctrine only operates to provide the promisee with a defence if sued by the promisor. An example of where this can happen involves the part payment of debts. Suppose that X owes Y £1000 under the terms of a pre-existing contract. If X falls upon hard times and is unable to pay the amount owing, would a promise by Y to accept £500 in full settlement of the debt be binding on Y? At first sight the answer must be no, because X has failed to provided consideration. Promising to pay only half of what he owes Y can hardly be regarded as a detriment and therefore would not amount to consideration. However, if Y proceeded to sue X for the outstanding £500, the doctrine of promissory estoppel would come to the latter's aid. Having made an unequivocal promise to X, Y would be prevented or 'estopped' from reneging on it. This said, however, the legal authorities are not entirely clear on whether X's original obligation to pay the £500 balance is extinguished or merely suspended. In the latter eventuality, it could be that a sudden improvement in X's fortunes would also operate to revive Y's entitlement to the remainder of the debt.

As stated at the beginning of this section, consideration is a peculiarity of common law systems. It has no direct counterpart in civil law. In German law, for example, a promise made with serious intent is binding without the need for any counter-promise from the recipient. On the other hand, Article 1108 of the French civil code specifies that a contractual obligation is only valid if it has *cause*. The requirement of cause is one of the distinguishing features of the French family of legal systems. Very broadly, cause can be described as the 'end pursued' by a party who enters into an obligation. Thus, where X and Y conclude an agreement under which X is to sell a painting to Y for €10 000, the cause of X's promise will be Y's promise to pay and the cause of Y's promise will be X's promise to hand over the painting. At this point it might be tempting to conclude that cause is basically the same as consideration, for in the above example the cause of each promise is the counter-promise received from the other party. In the context of common law, the consideration for each party's promise would similarly be represented by the promise of the other. However, such a conclusion would not be entirely correct. The concepts of consideration and cause may appear to overlap in bilateral agreements such as in the illustration just given, but in the case of gratuitous promises they will not. For example, if X had promised to transfer the painting to Y by way of gift, there would be no consideration under common law to support this promise. However, X's intention to benefit Y in this manner would be the end he was pursuing and therefore would be the cause of his promise. Although French law would only enforce X's promise if it were the subject of a notarial act (see 'Compliance with any required formality' section above), the distinction between cause and consideration remains valid.

Contractual intention

Before the parties will be legally bound by the arrangements they have made, it will have to be shown that they intended this consequence. All systems recognise the distinction between purely social or informal agreements and those of a more

serious nature. While in the former case it is unlikely that the parties will be regarded as having the intention to be legally bound, in other situations a presumption to this effect may arise. This may be especially so in the context of business relationships. However, even here, there may well be situations where the parties' actual intention is not immediately obvious. For example, during negotiations, particularly those involving a complex transaction, the parties might reach a number of staging posts. The problem may arise whether, at any of these points in time, they have become legally bound to each other. For instance, they may exchange 'letters of intent'. Such a document may contain an agreement in principle together with a list of outstanding issues to be addressed. If, on its true interpretation, it is merely a statement of intent, it is unlikely to be legally binding. On the other hand, an agreement may be concluded 'subject to contract'. Here the parties are indicating that, while they have reached agreement in principle, they do not intend to be bound until their agreement is contained in a formal written contract. In other situations, the parties, having agreed on all major points, may leave over for future agreement certain other matters. Such an arrangement is sometimes referred to as *heads of agreement*. Whether they will be legally bound at this stage will depend on their intention as ascertained from the facts of the particular case, but what may be relevant are matters such as the importance of the outstanding issues and whether the parties have provided a mechanism for settling disputes if they cannot agree. The approach taken by the English Court of Appeal in one case provides a useful illustration.[33] The claimant, who was owner of a petrol filling station, sold some adjoining land to the defendants on condition that they entered into a contract to buy all petrol for their coach business exclusively from him. A contract was duly signed under which the defendants agreed to buy petrol from the claimant 'at a price agreed by the parties from time to time'. It was further agreed that any dispute arising under the agreement should be submitted 'to arbitration in the usual way'. The defendants broke the agreement and when sued argued that it was incomplete and therefore unenforceable. The court didn't share this view and decided that, in default of agreement, the defendants must pay a reasonable price. Several factors led the court to this decision, including the fact that both

parties believed the agreement to be binding, it had been acted upon for a number of years and the arbitration clause provided a means for settling disputes over the price of petrol without the need for further agreement between the parties.

In the situations described above, the parties have, as a result of their negotiations, reached an agreement which may or may not be legally binding depending on the circumstances. But what if one of the parties breaks off negotiations before an agreement of any sort is reached? Is there any comeback for the other party, who might have relied on the negotiations producing a successful outcome? As a general rule the parties are entitled to act in their own interests and this may, of course, involve one or other of them walking away from the negotiations. In English law there is no general duty to negotiate in good faith and therefore a party breaking off negotiations will not, in the normal course of events, incur liability to the other. However, the situation can be different in other systems. The American courts have applied the doctrine of promissory estoppel (discussed above) in the context of contractual negotiations. If one party raises in the other a reasonable expectation that a deal will ultimately be struck, then if this fails to happen the disappointed party may recover expenditure incurred in reliance on this expectation and in some circumstances may even be entitled to damages for the loss of the bargain. In civil law jurisdictions, there often exists a duty to conduct one's business activities according to the requirements of 'good faith', which may very well include the process of negotiation. Such is the position in French and German law. Under French law, where one of the parties breaks off negotiations with the intention of harming the other, or simply does so in bad faith, they may have to compensate the other party for loss resulting. Similarly, if it can be proved that a party entered into negotiations without a serious intention to conclude a contract, they may incur liability to the other. The French approach is broadly replicated under German law. So, for example, if one party has deliberately or negligently led the other to believe that a contract will be concluded, they will have to compensate their opposite number for any expenditure incurred as a result of this.

Absence of any factors which might undermine the contract's validity

Although an agreement might possess all the characteristics of a contract, there might be factors present which make it less than fully valid. The consequence of this might be to render the contract void or voidable. In the former case the contract is a complete nullity, whereas in the latter case the contract, although initially valid, can be avoided or, to use a technical expression, *rescinded* at the option of the party adversely affected.

Mistake and misrepresentation

Every system of law has to deal with the situation where one or possibly both of the parties concludes a contract under a mistaken belief. Where both parties are mistaken, this can prevent them reaching a consensus in the first place. For instance, if X offers to sell fifty tonnes of peas to Y and Y accepts, thinking the offer was for beans, the parties are at cross purposes and no contract would result. On the other hand, only one of the parties may be mistaken; for example, believing the facts to be 'A', X might enter a contract with Y, when in reality the facts are 'B'. On discovering the true situation, X might wish to escape the contract. One question to ask is whether X's mistaken belief was induced by something said or done by Y. For example, if Y persuades X to buy an antique table by knowingly misstating its age and with the intention that X should rely on this statement, X, on discovering the truth, would be able to rescind the contract and claim damages for deceit. Such a remedy would be recognised in most jurisdictions.

Although a party is generally not obliged to volunteer information, there are circumstances where a duty of disclosure exists and, by remaining silent, that party will be regarded as misrepresenting the truth. Under French law, the duty of disclosure is quite extensive. For example, in one case[34] the seller of a house omitted to inform the buyer of a plan to build a piggery nearby. He was liable to the purchaser for failing to disclose this

fact. Liability was established in another case[35] where a vendor sold land to a purchaser which he knew was going to be used for building a hotel on. He did not reveal to the purchaser that the only source of water was from a spring on land which still belonged to the vendor and which, in any event, would be totally insufficient for the purchaser's needs. German and English law tends to be more restrictive but even so there are instances when a party is under a duty of disclosure. For example, under German law such a duty exists in the case of sales of used cars. English law imposes extensive duties of disclosure in the case of insurance contracts. In such a contract there is an obligation on the assured to disclose to the insurer all material facts. Material facts are those which would influence a prudent insurer in deciding whether to accept the risk and, if so, the amount of the premium to be charged. Failure to disclose such facts will entitle the insurance company to avoid payment on the policy. English law also provides a remedy where a half-truth is offered. This occurs where a party makes a statement correct on the face of it but by virtue of what is not disclosed conveys a false meaning; for example, when selling a car, saying that it has had only one previous owner might be factually correct, but failing to state that this was a driving school might operate to convey a false impression.

Where the mistake has not been induced by the actions or words of the other party, civil law and common law take different approaches. Under the former, there are many situations where mistake may invalidate the contract, whereas, say, in English law, mistake does not have such an effect as a general rule. If the mistaken party wishes to avoid the contract, he will normally have to establish that the other party was guilty of a misrepresentation. A misrepresentation occurs where a party is induced to enter a contract having relied on statements made by the other that turn out to be false. So, for example, if X is persuaded to buy a second-hand car from Y having been told by Y that the car is five years old, has only done 25 000 miles and has been regularly serviced, X might feel somewhat annoyed subsequently to learn that it is ten years old, has done 100 000 miles and been serviced only occasionally. In such circumstances it would not be unreasonable for X to claim his money back, arguing that if he had known the true

facts he would have never entered the contract. In order to claim rescission, X would not necessarily have to establish that the statements of Y were made fraudulently. The remedy would still be available if Y had merely been negligent in making them or, indeed, had himself believed in their accuracy.

In civil law jurisdictions, mistake over an essential quality of the thing contracted for can entitle the mistaken party to avoid the contract. As an illustration, suppose that X and Y are negotiating over the sale of a painting by X to Y and believed by both to be a Picasso. If it subsequently turns out to be a copy, under French and German law Y would probably be entitled to rescind. In the case of English law, on the other hand, the contract would be held good because a mistake relating solely to the quality of the subject matter of the contract would not invalidate it. The only situation where Y would be entitled to rescind would be if his belief in the painting being a Picasso had been induced by a misrepresentation on the part of X.

A mistake as to the identity of the other contracting party, as a general rule, does not invalidate the contract since, in the majority of cases, identity is irrelevant. The principal concern of the mistaken party is likely to be securing performance by the other party no matter who he or she, in fact, turns out to be. So, if X enters a contract with Y in the mistaken belief that Y is Z, the contract will be good. However, if it could be shown that X intended to contract with Z and only with Z, there would be no consensus and therefore no contract. An English case[36] provides an illustration of this. A rogue named Blenkarn ordered goods from Lindsay & Co., giving his address as 37 Wood Street, Cheapside, London. He signed the letter in such a way that it appeared to come from Messrs Blenkiron, a respectable firm carrying on business from 123 Wood Street, Cheapside. The name of Blenkiron was known to Lindsay, but they were not aware of the trading address. Lindsay sent the goods to Blenkarn at 37 Wood Street. Blenkarn subsequently sold the goods to Cundy, an innocent purchaser, who was then sued by Lindsay for the return of the goods. Lindsay argued that the contract with Blenkarn was void for mistake and consequently the ownership of the goods had not passed to him. As a result, he could not pass ownership to Cundy. The court decided that Lindsay intended to deal only with Messrs Blenkiron. As the

contract with Blenkarn had been made under a mistake, it was void. Unfortunately for Cundy he had to return the goods.

A slightly different situation occurs where the mistake relates not to the physical identity of the other party but, say, to some characteristic or attribute of the person concerned. Civil law will allow rescission of the contract where the mistake relates to some essential quality or characteristic of the other party – for example, creditworthiness, age or criminal record. In other words, the mistaken party must show that he would not have entered the contract had he known the true nature of the person with whom he was dealing. Under English law, mistake as to the attributes or qualities of the other party will not invalidate the contract unless the mistake has resulted from a misrepresentation by that party.

Duress

As a contract should represent a voluntary meeting of minds, the law will come to the aid of a party who has entered into one only as a result of unlawful threats or duress. Duress consists of compulsion, threats or violence to force a person to act against his will. The threat must be unlawful; therefore, violence would clearly amount to duress. Equally coming within its scope, however, are less obvious forms of coercion. For example, if X threatens to tell Y's wife of her husband's adultery unless Y settles a debt owing. Despite the fact that Y might be guilty of infidelity and his wife might have a legitimate interest in knowing of this, the threat would be unlawful as it has nothing to do with the issue between X and Y. On the other hand, a threat by X to sue Y for the debt unless he pays would be lawful pressure.

In many jurisdictions, the law recognises that an inequality in bargaining strength existing between the parties, while not amounting to coercion *per se,* can nevertheless allow the stronger party to exert unfair pressure on the weaker one and to the latter's disadvantage. This is particularly so where consumer transactions are involved. In this context, the law often intervenes to protect the consumer from the potential exploitation that can result from this situation. However, where the relationship between the parties is purely commercial, the law's intervention is less likely on the grounds that, in

the normal run of business activity, the interplay of economic forces can often advantage one party to the detriment of the other. This said, however, there are circumstances where, even in business relationships, the law will seek to control transactions where one party has been disadvantaged not as a result of normal market forces but by the use of unlawful pressure exerted by the other. English law, for example, has extended the concept of duress to cover cases of economic duress. The court regarded this as present in a case[37] in which X had agreed to build a stand for Y, who was making a presentation at an exhibition. X's employees demanded extra pay from X and threatened to strike if they did not receive it. X told Y that work on the stand would not proceed unless the extra sums were paid by Y as an increase in the contract price. In order to get the stand completed, Y paid the amount demanded and afterwards claimed its return. The court held that Y had only agreed to an increase in the contract price as a result of economic duress and therefore he was entitled to reclaim the sum involved. While not invoking the concept of economic duress as such, courts in other jurisdictions have relied on a variety of devices – for example, the requirements of 'good faith' and the notion of the 'unconscionable' bargain – in order to control the unfair use of bargaining strength. These and other ideas will be explored further in the next chapter in the context of standard terms of business.

Illegality

In virtually all jurisdictions, a contract made for an illegal purpose will be void. An obvious example would be a contract which involved the commission of a criminal offence, such as providing for the distribution of profits from an illegal drug- or people-trafficking operation or one whose object is to defraud the tax authorities. An English case[38] illustrating the latter involved a contract of employment made between the claimant and the defendant. Under the agreement, the claimant was to be paid a weekly wage of £13 for his services plus £6 expenses. Both parties were aware that the claimant's expenses would never amount to that sum. Income tax was deducted from the £13 wages but not from the £6, which was paid as a reimbursement of expenses.

Having been dismissed from his job, the claimant sued the defendant for arrears of pay. As the payment arrangements were intended to conceal the true state of affairs from the Inland Revenue, the court held the contract to be illegal and void. Accordingly, the claimant failed in his action.

A contract does not always have to possess a criminal element in order to suffer the consequences of illegality. In most jurisdictions, a contract which offends against public policy or, to use the French expression, *ordre public*, will also be regarded as illegal. Such contracts often involve conduct branded as immoral – for instance, a contract of prostitution or one tending towards corruption in public life. In an English case,[39] a wealthy donor made a substantial contribution to the funds of a charitable institution having been promised a knighthood in return. When the honour failed to materialise, he sued the charity only to be rebuffed by the court, which regarded the transaction as against public policy and, accordingly, void.

A contract can also be viewed as against public policy although not involving immoral conduct as such. A classic example would be where two businesses conclude a contract, the object of which is to reduce or eliminate competition between them. For example, X and Y might agree not to sell their respective products below a certain price or they may agree to share markets. Whatever benefits such arrangements might bring to the parties, the law of most countries will regard their anti-competitive nature as against the public interest and therefore void. In addition to the 'sanction' of nullity, it is likely that the parties could also face other penalties in the form of fines and, in some cases, imprisonment for the individuals concerned. In Chapter 6, further consideration will be given to the law's role in controlling anti-competitive behaviour in the marketplace.

Summary

The following issues were dealt with in this chapter:

1 Formalities relating to contract formation such as the requirement of writing and notarisation.
2 The concepts of offer and acceptance.

3 Principles relating to the common law doctrine of consideration.
4 Contractual intention.
5 Capacity.
6 The effect of mistake, duress and illegality on the validity of a contract.

Notes

1 *Partridge* v *Crittenden* [1968] 1 WLR 1204.
2 Cass civ 28.11.1968.
3 *Carlill* v *Carbolic Smoke Ball Co* [1893] 1 QB 256.
4 Hoover.
5 Winfield, 55 LQR 518.
6 It should be noted that, although the shopkeeper is contractually entitled to refuse to sell, liability could arise from other directions; for example, advertising a product at a price at which you are not prepared to sell may constitute a criminal offence under the Trade Descriptions Act (1968).
7 *Pharmaceutical Society of Great Britain* v *Boots Cash Chemist (Southern) Ltd* [1953] 2 QB 401.
8 Paris 14.12.1961.
9 *Ramsgate Victoria Hotel Co* v *Montefiore* [1866] LR 1 Exch 109.
10 *Dickinson* v *Dodds* [1876] 2 ChD 463.
11 S.2.05.
12 *Drennan* v *Star Paving Co* [1958] 51 Cal 2d 409; 333 P 2d 757.
13 Despite the absence of any contractual obligation to pay the price, many systems of law include specific legislation to protect consumers in these circumstances; see, for example, the Unsolicited Goods and Services Act 1971 (UK).
14 BGHZ 11, 1.
15 *Stevenson* v *McLean* [1880] 5 QBD 346.
16 *Butler Machine Tool Co Ltd* v *Ex-Cell-O Corporation (England)* [1979] 1 All ER 965, CA.
17 *Holwell Securities Ltd* v *Hughes* [1974] 1 All ER 161, CA.
18 Articles 1326 and 1335, *Codice civile*.
19 *Byrne & Co* v *Van Tien Hoven & Co* [1880] 5 CPD 344.
20 Sale of Goods Act 1979, s.3(3).
21 *Nash* v *Inman* [1908] 2 KB 1, CA.
22 *Currie* v *Misa* [1875] LR 10 Ex 153.
23 *Lampleigh* v *Braithwaite* [1615] Hob 105.
24 Casey's Patents, *Stewart* v *Casey* [1892] 1 Ch 104.
25 *White* v *Bluett* [1853] 23 LJ Ex 36.
26 *Thomas* v *Thomas* [1842] 2 QB 851.

27 Collins v Godefroy [1831] 1 B & AD 950.
28 *Glasbrook Bros Ltd* v *Glamorgan County Council* [1925] AC 270.
29 *Stilk* v *Myrick* [1809] 2 Camp. 317.
30 *Hartley* v *Ponsonby* [1857] 7 E & B 872.
31 *Williams* v *Roffey Bros & Nichols (Contractors) Ltd* [1990] 2 WLR 1153.
32 *Devecmon* v *Shaw* [1888] 69 Md 199, 14A 464.
33 *Foley* v *Classique Coaches Ltd* [1934] 2 KB 1.
34 Cass civ 2.10.1974, D 1974 IR 252.
35 Cass civ 7.5.1974, Gaz Pal 1974 2.184.
36 *Cundy* v *Lindsay* [1878] 3 App Cas 459.
37 *B & S Contracts and Design* v *Victor Green Publications* [1984] IGR 419.
38 *Napier* v *National Business Agency Ltd* [1951] 2 All ER 264.
39 *Parkinson* v *College of Ambulance Ltd* [1925] 2 KB 1, KBD.

CHAPTER 3

The structure and content of business contracts

The express and implied terms of a contract

Although the parties might have concluded a contract, disputes may arise over its execution. Unless it is known precisely what each party agreed to do, it will not be possible to judge whether or not there has been a shortfall in performance. Thus, in any given situation it will be necessary to define the obligations created by the contract or, in other words, its *terms*.

Both civil law and common law recognise that the parties are basically free to decide the nature and extent of their contractual obligations. As will be explained later, there are situations where the law will intervene to prevent exploitation or unfairness but, beyond this, the parties are free to tailor the contract to meet their own particular requirements.

The first question to ask is 'What did the parties actually write or say to each other before they made the contract and

which was intended to form part of it?' or, to put it another way, 'What are the *express* terms of the contract?' In many cases, these might be very detailed, particularly if the subject matter is complex or, depending on the circumstances, they could be very simple – for example, where a customer goes into a bar and orders a beer. Whatever the nature of the contract, the parties are unlikely to have provided for *every* eventuality in their agreement and a problem might arise between them which is not expressly covered by the contract's terms. For example, suppose that X, a supplier of fine wines, offers to sell to Y for €1500 the last twenty-five bottles of Beaujolais 1999 remaining in his cellar and Y accepts. Although X and Y have made a contract in which the subject matter and price are defined, other issues could arise between them for which they have not provided. For instance, is it X's responsibility to arrange delivery of the wine to Y and incur the associated costs, or is it up to Y to collect the wine? Whoever's responsibility it is, when is delivery to take place? When must Y pay for the wine? If the wine is accidentally destroyed before Y obtains possession, must Y still pay for it? And so on. 'Gaps' such as these will have to be filled and it will be down to the law to do this. The law provides 'default' rules that will operate in the absence of express provisions agreed by the parties. It would be a mistake, therefore, to assume that the sum total of the contractual 'package' consists merely of what the parties have specifically agreed between themselves. There may be many situations where their relationship is regulated by rules of whose existence they were unaware and, as might be expected, these rules can differ from country to country. Before examining this idea further, a little more must be said about express terms.

The express terms of a contract can take a variety of forms. To take a number of examples:

1 The parties might have had their agreement reduced to writing and embodied in a document tailored to the particular transaction. Although disputes may have to be resolved over the interpretation of the wording, as a general rule it will be the provisions of the document alone which will determine the nature and extent of the obligations between them.

2 Within the context of a particular industry or trade, a model form of contract might be available and the parties might choose to use this as a basis for their relationship. For instance, the Federation Internationale des Ingenieurs-Conseil (FIDC), located in Switzerland, has produced three model forms of contract which are widely used in the construction industry. These are the FIDC Conditions of Contract for Civil Engineering Works, the FIDC Conditions of Contract for Electrical and Mechanical Works, and the FIDC Conditions of Contract for Fixed Price Turnkey Contracts.

3 The contract might be based on one party's standard terms of business. Mention has already been made of these in Chapter 2 in relation to the 'battle of the forms'. Standard terms have the general advantage that they provide a common framework which can be applied to numerous contracts of a particular type without the necessity of having to draw up individual terms for each transaction. However, for the company whose terms govern the contract, there are significant advantages. They are unlikely to have been negotiated and therefore will be weighted in favour of the party seeking to impose them. In this way, standard terms can be used as a device for transferring onto the other party certain risks in a way that is sometimes unfair. This is particularly so where the potential liability of the party whose terms apply is either limited or excluded altogether. For this reason, standard terms are often regulated by law, especially in the case of consumer contracts. The use of standard terms will be further considered later in this chapter.

4 In their agreement the parties might have referred to another document or notice containing additional terms and conditions. For instance, a passenger making a bus or train journey usually receives a ticket. An examination of the ticket will often reveal writing which will refer to detailed terms and conditions of transport which can be inspected at some other place,

> such as in the bus/train timetable or at the company's headquarters. Provided that appropriate steps have been taken to alert the passenger to the existence of these conditions, they will be regarded as having been incorporated into the contract *by reference*.

In the context of international trade, export transactions usually include specific trade terms not normally used in connection with purely domestic contracts. As will be explained in Chapter 7, these terms will serve to allocate between the parties certain responsibilities. Among the most commonly employed are f.a.s., f.o.b. and c.i.f., and while terms such as these are universally used in international trade, their interpretation can vary from country to country. In order to avoid the uncertainty which this can produce, the parties might decide to adopt a standard definition of the particular term employed. One of the most widely used set of standard definitions is contained in 'Incoterms' published by the International Chamber of Commerce (ICC) in Paris. By concluding a contract, say, 'c.i.f. Rotterdam (Incoterms 2000)', the parties would be incorporating into the contract the obligations attaching to a c.i.f. contract as defined by the 2000 edition of Incoterms.

Although the terms of a particular contract might have been ascertained, they might not be viewed in the same way in every jurisdiction. In many parts of the common law world, for example, contractual terms are classified as either *conditions* or *warranties* according to their status, with the former being regarded as more important than the latter. A condition is a fundamental obligation that goes to the root of the contract. A warranty, on the other hand, is a lesser obligation that is subsidiary to the contract's main purpose. The distinction between a condition and warranty is important as regards the remedies available if they are broken. Breach of a condition is so serious that the innocent party has the choice of either refusing to perform any obligations which are still outstanding and, further, claiming damages for any financial loss incurred *or* electing to continue with the contract but seeking damages as compensation for the loss resulting from the other's breach. Breach of a warranty, however, does not allow the innocent

party to refuse further performance, the remedy being restricted to a claim for damages. The distinction between a condition and warranty is not always easy to draw. The world of opera provides two illustrations of this. In one case[1] coming before the English courts in 1876, a diva by the name of Madame Poussard had entered into a contract to play a part in an opera, the first performance of which was due to take place on 28 November 1874. Before this date, Madame Poussard was taken ill and was unable to perform. The defendants were forced to find a substitute but in doing so had to offer this person the part for the entire run of performances. Madame Poussard eventually presented herself on 4 December but, for the reason just mentioned, the defendants informed her that her services were no longer required. No doubt smarting with indignation, she sued them for breach of contract. Unfortunately, her professional pride suffered yet another blow when the court decided that her failure to appear on the first night was a breach of a condition and, accordingly, the defendants were entitled to regard the contract as over. Madame Poussard's fate should be contrasted with that of one of her fellow artistes in another case[2] brought the same year. Here, the defendant, who was director of the Royal Italian Opera at Covent Garden, engaged the tenor, Bettini, 'to fill the role of primo tenor assoluto in theatres, halls and drawing rooms . . . in Great Britain and Ireland' during the period 30 March to 13 July 1875. The contract also stipulated that Bettini should be in London at least six days before 30 March in order to attend rehearsals. Bettini fell ill and did not arrive for rehearsals until 28 March. At this point, the defendant refused to accept his services, arguing that his late appearance discharged the contract. Unlike Madame Poussard, Bettini was successful in his claim for damages. In the court's opinion, the rehearsal clause was subsidiary to the main purpose of the contract and was therefore only a warranty and not a condition. As a result the defendant was not entitled to refuse Bettini's services and, accordingly, was liable to him in damages.

Although a condition is a major term of the contract, it is not inevitable that breach of such a term will cause substantial damage to the innocent party. The actual damage might, in

fact, be minimal. Nevertheless, the innocent party is still entitled to refuse to carry out any outstanding obligations on his part. If he has not begun to perform at all, this means, in effect, that he can walk away from the contract completely. This can allow an unscrupulous party to escape what may have become an unprofitable contract by relying on the other party's breach, even though little or no damage has been caused as a result. In a number of common law jurisdictions, the courts have acknowledged the potential injustice of allowing one party to extricate himself from a contract merely because the other has breached what was, technically, a condition and, as a result, are prepared to recognise a third species of contractual term, the *innominate* or *intermediate* term. Here, the law is more concerned with how serious the actual consequences of the breach are rather than with the relative status of the particular term involved. The English Court of Appeal adopted this approach in a case[3] concerning the charter of a ship and, in particular, the owner's obligation to provide a seaworthy ship. 'Seaworthiness' has a technical meaning and, to use the words of one of the judges,[4] consists of an obligation which 'can be broken by the presence of trivial defects easily and rapidly remediable as well as by defects which must inevitably result in the total loss of the vessel'. The claimants had chartered a ship to the defendants for a period of twenty-four months. Due to a variety of reasons, including the incompetence of the engine room staff and the ship's antiquated machinery, twenty-four weeks were lost. The defendants' patience finally ran out and they refused to continue with the contract. The claimants admitted that the ship was unseaworthy and that, accordingly, they had breached the contract. However, they argued that their breach did not entitle the defendants to abandon the contract only to claim damages. In reaching its decision the court did not attempt to classify the claimants' obligation as either a condition or warranty but instead evaluated the significance of the breach by looking at the events which had occurred as a result. The critical factor was to ask whether, as a consequence of the claimants' breach, the defendants had been deprived of *substantially the whole benefit it was intended that they should receive under the contract.* Only where this happens is the innocent party entitled to

regard the contract as discharged. In the instant case, the court did not view the claimants' breach as so serious to permit the defendants to abandon the contract. As a result, they were liable in damages to the claimants.

Although contractual terms can be classified in the ways described above, it is not always certain whether in any given case a court will 'slot' a particular term into the condition/ warranty category or regard it as innominate and then focus on the seriousness of the breach. If, in the contract itself, the parties make it clear what consequences shall follow in the event of a breach – for example, a right by the non-breaching party to refuse further performance – uncertainty is reduced although not entirely eliminated. For example, if the right of termination is to apply even for a trivial breach, the party seeking to rely on this entitlement must convince the court that, on its true interpretation, the term applies to such a breach. In one case,[5] a four-year maintenance contract contained an express provision allowing one party to terminate in the event of the other's breach of '*any* of its obligations under the contract'. However, despite the clause's emphatic language, the court refused to give it a literal interpretation. On the other hand, the wording of the contract might incorporate such terms as 'condition' and/or 'warranty'. Whether the court will attribute the technical meaning to these expressions is another matter. Schuler AG, a German company, found itself having to defend its use of words in front of an English court in a dispute with Wickman Machine Tool Sales Ltd, its UK distributor.[6] Schuler manufactured heavy presses for use in the motor industry and had agreed to give Wickman sole selling rights for these products within the UK for four and a half years. Clause 7(b) of the contract obliged Wickman Ltd to send its representative to visit six named UK motor manufacturers at least once every two weeks to solicit orders. The term was expressly stated to be a condition, an expression not used in any of the other twenty clauses of the agreement. Wickman failed to make a number of visits and Schuler terminated the contract. Although the clause was described as a condition, the crucial question was whether the use of that word carried with it the legal and technical meaning or merely its everyday meaning. It is highly probable that Schuler, or more likely

their lawyers, incorporated the word intending its technical sense, but the House of Lords refused to see it that way. The clause required Wickman to make over 100 visits to motor manufacturers over the contract period. If it amounted to a condition, a single missed visit would have entitled Schuler to terminate the contract. The court could not accept that that was the parties' true intention. Accordingly, the term was a warranty and not a condition. Schuler was liable to Wickman for wrongful termination.

In some circumstances a term can be given its legal status either by statute or precedent. An example of the former exists under the Sale of Goods Act 1979, which imposes on the seller of goods a number of obligations relating to their description, quality and fitness for purpose. These obligations are expressly stated to be conditions of the contract. In particular contexts, the courts might have decided on a term's status. A contract for the hire of a ship (charter party) often contains a statement indicating the date it will be available for loading. The courts have traditionally classified 'expected readiness' clauses such as these as conditions.

In the event that a term cannot be categorised unequivocally as a condition or warranty either by reference to the provisions of the contract itself or as a result of a statutory or judicial classification, it is likely to be regarded as innominate and the focus of attention will be shifted to the consequences of the breach. The crucial question then to ask is whether, as a result of the breach, the innocent party has been deprived of substantially everything contracted for. If this is found to be so, that party is entitled to regard the contract as over, otherwise the remedy is in damages alone.

Although not recognising the distinction between conditions and warranties, civil law nevertheless has to grapple with the problems posed by one party's failure to perform in accordance with the terms of the contract. The right of the innocent party to terminate the contract is generally recognised, but the precise circumstances in which this right can be invoked and the procedure for doing so vary from country to country. More will be said about this in Chapter 4, which examines in greater detail the remedies for breach of contract but, for present purposes, suffice it to say that the right of

termination will, to a large extent, depend on the seriousness of the breach in terms of the resulting consequences for the innocent party.

As was stated earlier, the express terms of the contract are those which the parties have either in words or documents specifically agreed should be part of it. Where they have left gaps in their agreement, the law will often provide default rules which will apply in the absence of a contrary intention. While the approach of civil law and common law to this 'gap-filling' exercise differs in material respects, the results can often be similar.

Civil law tends to classify contracts by name – for example, sale, hire, agency, brokerage, and so forth – and lays down in the relevant code the obligations relating to such contracts. When the contract negotiated by the parties does not correspond with a recognised named contract, the courts will resort to a variety of interpretation devices – for example, by drawing an analogy between the contract in question and the one in the code it most closely resembles. The existence of these 'nominate' contracts goes some way to explaining the different drafting styles found in civil law and common law jurisdictions. A contract drawn up by an English or American lawyer, for example, is often a long and detailed document which attempts to provide for every contingency. On the other hand, a contract prepared against the background of civil law can be relatively short and simple. While the most important matters might be expressly provided for, the parties may decide to leave the details to be determined in accordance with the provisions of the governing code.

In common law jurisdictions, the court will resort to the notion of the 'implied' term to determine aspects of the agreement not explicitly covered by the parties themselves. In the case of English law, for instance, implied terms can take various forms, such as:

- *Terms implied from previous dealings between the parties.* If the parties have an established relationship, it may be possible to address any omissions in a current transaction by asking whether the matter has arisen before and, if so, what provision they made. In these

circumstances, it is likely that the same approach will be adopted for the latest contract.

- *Terms implied by custom.* Where the contract has been negotiated against the backdrop of a particular trade or market, it is very probable that, within such a context, custom and practice will have built up and been accepted over many years. The assumption will be that the parties intend such custom and practice to apply to their dealings and so, in the absence of any contrary intention, it will be implied into their contract.
- *Terms implied by statute.* In the case of certain types of contract, terms are implied by Act of Parliament. A classic example of where this happens is in relation to contracts for the sale of goods. Such contracts are governed by the Sale of Goods Act 1979, which is, in effect, a code establishing a framework of rules regulating the relationship between the seller and buyer of goods. For the most part, the parties are free to dispense with the provisions of the Act and substitute their own, but in the absence of a contrary agreement, the Sale of Goods Act will imply terms into their contract. So, for example, the Act contains rules on the passing of ownership and risk; the seller's obligations as regards the quality of the goods to be supplied; place and time of delivery; the buyer's duty to accept and pay for the goods; and so on. It is worth noting that the 1979 Act updated, with very little amendment, the original legislation enacted in 1893. The fact that the provisions of the 1893 Sale of Goods Act substantially remained intact despite an interval of eighty-six years is testimony to the quality of the draftsmanship employed. It is probably for this reason that the Act was used as a model for sale of goods legislation in a number of other common law jurisdictions, Australia, India and Canada to name just three.
- *Terms implied by the court.* In certain categories of contract, the courts have been prepared to imply terms. A good example is the contract of employment.

> Whatever the employer and employee may have expressly agreed, there may well be other obligations imposed on them by virtue of the terms implied by law; for instance, the employee will have to show 'good faith and fidelity' towards the employer, and demonstrate reasonable skill and care in the performance of his or her duties. The employer, on the other hand, is under an obligation to take reasonable care to protect the health and safety of his employees. This duty extends to taking due care in respect of the premises where the work is to be undertaken, the way it should be performed, and the plant and machinery to be used.

By now it should be appreciated that the relationship existing between the parties can be affected by contractual provisions not necessarily agreed expressly between themselves. As mentioned above, a good example of where this can happen is a contract for the sale of goods. Although the law relating to such contracts can be complex, an overview of some of the problems that may arise between the parties will serve as an illustration of how their respective positions can be affected by the application of the rules laid down by law. It will be seen that, despite some differences, common law and civil law share a similar view in many respects.

Certain aspects relating to a contract for the sale of goods

The principal obligation of the seller in a contract of sale is to deliver the goods and transfer ownership in them to the buyer. The buyer is under a corresponding duty to accept the goods and pay for them.

Ownership

A contract of sale involves the transfer of ownership from seller to buyer. The time when ownership passes is important for a number of reasons. For example, in many jurisdictions, the risk

of the goods being accidentally lost, damaged or destroyed will normally pass from seller to buyer at the same time as the ownership passes. Thus, the buyer may still have to pay for the goods even though they have become commercially useless. From the buyer's point of view, therefore, it is vital for him to know when the goods are at his risk because this will have a direct bearing on the insurance cover required. After all, you only insure against the risks you have, not the ones you don't.

Another classic scenario involving the passing of ownership is where the seller allows the buyer a period of credit but, nevertheless, delivers the goods to him in the meantime. If the buyer becomes insolvent before the credit period has expired, the seller is in a quandary. As an unpaid seller he will have to line up with all the other unsecured creditors of the buyer and the chances of him recovering the amount owing are slim to say the least. However, if the contract goods are still identifiable, the seller may be content to forgo the debt and instead send a truck round to the buyer's premises in order to repossess them. Whether he is entitled to do so will depend on whether the ownership has passed to the buyer. If it has, the goods will form part of the insolvent buyer's assets and as such will be used for the benefit of creditors generally.

In order to identify the time of passing of ownership, the nature of the goods in question will have to be determined. To use a distinction adopted in common law but one which has its equivalent in civil law, goods can be *specific* or *unascertained*. Specific goods are those which are identified and agreed upon when the contract is made. So, for example, a contract to buy a second-hand car would be for specific goods, as would a contract for a watch selected by a customer from a display tray. In both cases, the precise 'physical' object which is the subject of the sale is known when the contract is made. In the case of unascertained goods, the identity of the goods only becomes known *after* the contract is made. A contract for the sale of a new car of the same specification as seen in the showroom would be for unascertained goods because, until the seller had acquired the required model from, say, the manufacturer or importer, the physical identity of the contract goods would be unknown. The same would be the case if, in the second example above, the customer had

purchased a watch from a catalogue. A contract for purely generic goods (for example, 1000 tons of soya beans) would be for unascertained goods, as would a contract for goods from part of a larger bulk (for instance, 5000 litres of olive oil from a tank holding 100 000 litres).

Under English and French law, unless the parties have shown a contrary intention, the ownership in specific goods passes at the time the contract is made. So even if the goods have not been physically delivered to the buyer, the ownership will have transferred and, with it, the risk. The consequence of this, which may come as a surprise to the buyer, is that he will still have to pay the price even though the goods have been lost or damaged or have otherwise deteriorated, provided this has not occurred through the seller's fault.

In the case of unascertained goods, the ownership can pass once the contract goods become identifiable. English law requires the goods to be 'appropriated unconditionally' to the particular contract, which appears to mean more than just earmarked for the buyer's order. The test would seem to be whether the seller has taken steps to commit the goods irrevocably to the contract with the buyer. In the example quoted above, it might be thought that ownership of the 5000 litres of oil would pass when this quantity has been siphoned off from the bulk holding tank, drummed up and labelled with the buyer's name. However, it may be that this chain of events lacks the degree of irrevocability required by 'unconditional appropriation' since the seller, theoretically at least, could divert the oil to a third-party contract and yet still fulfil the contract with the buyer by siphoning off another 5000 litres. While loading the drums onto a lorry for delivery to the buyer could be the extra step needed to transfer ownership, actual delivery would be decisive.

While English and French law generally agree on the time of passing of ownership, German law, on the other hand, takes a different approach. Although the contract of sale creates an *obligation* for the seller to transfer ownership to the buyer, the contract does not operate to effect the transfer. Unless otherwise agreed, ownership, whether in specific or unascertained goods, will only pass when the contract is performed – that is, on delivery. The passing of risk, however, is not dependent on

the transfer of ownership and will normally occur when the goods are delivered even if, for reasons explained later, the passing of ownership has been postponed to a future time.

Description

Where goods are sold by reference to a description, they must correspond with that description. So a '100 per cent woollen' coat must be just that, as must the vintage and origin of a bottle of wine sold as 'Château Lafite 1962'. In English law, for example, the rule is, again, found in the Sale of Goods Act. In order to be a sale by description the buyer must be shown to rely on the description. This obviously occurs where the buyer has not seen the goods – for example, if they have been ordered from a catalogue. However, a sale can be by description in circumstances where the buyer has seen the goods. It can be so even if they are selected by the buyer from the seller's stock. This would be the case in a supermarket sale, where nearly all goods are described on their packaging or on signs or notices placed by the shelves. Nor will a sale cease to be one by description merely because the buyer examines the goods before purchasing them. A case[7] involving a used car of dubious pedigree illustrates this. The defendant advertised a car for sale as being a 1961 Triumph Herald 1200. The claimant visited the defendant and during an inspection of the car noticed a metal disc on the rear of the vehicle which bore the figure 1200. The claimant bought the car only to discover that all was not as it appeared to be. The rear half of the car was, indeed, a 1961 Triumph Herald 1200 but, unfortunately, the front half was not. It originated from an earlier model. The welding holding the two halves together was defective and, as a result, the car was unroadworthy. The court decided that as the claimant had relied on the advertisement and the metal disc, the sale was one by description and, despite the fact he had examined the car, he was still entitled to damages.

Quality and fitness for purpose

The seller undertakes certain obligations with regard to the quality of the goods. In the case of English law, the Sale of

Goods Act implies into the contract a term requiring the goods to be of *satisfactory quality*, meaning that they must 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 other relevant circumstances. The description may be a crucial indicator of whether the goods are of satisfactory quality. If an item is described as 'shop-soiled' or as a 'second', the purchaser cannot complain on finding a slight blemish which would not be acceptable in the absence of such a description. Similarly, the purchaser of an older second-hand car cannot expect the same quality as if it were new. At one time such a vehicle was of satisfactory quality if it was safe and roadworthy. This is no longer the true test. Even with a used car, the required quality will vary according to the circumstances. In one case[8] a second-hand Mercedes was sold for £5000 with 37 000 miles on the clock. It broke down after a further 500 miles because of burnt-out valves and badly worn valve seats. The repairs cost £635. Although expert evidence suggested that such faults would not normally occur after only 38 000 miles, the court nevertheless decided that the car was of satisfactory quality. In its view, mileage such as this would inevitably cause some wear and tear and the cost of repairs was not particularly great in comparison to the price paid by the buyer. The price, in appropriate circumstances, may also be relevant. An item sold at an unusually low price may be expected to be of an inferior quality to one sold under the same description but at the normal price. Of course, the price is not always a factor. Articles sold at a discount in an 'end of season' sale or at 'knock-down prices' in a liquidation sale would be expected to be of the same quality as those sold under a similar description but without a price reduction.

In addition to being of satisfactory quality, the goods must also be reasonably fit for any purpose expressly or implicitly made known to the seller by the buyer. If the buyer intends using the goods for their normal purpose, this does not have to be expressly stated. However, where the intended use does not come within the range of purposes to which goods of that kind are normally put, the seller must be made aware of this fact. This can be seen in a case[9] where the claimant broke out

into a painful rash after wearing a tweed coat made to order for her by the defendant. Apparently, she had an unusually sensitive skin but had not informed the defendant of this fact. It transpired that her dermatitis was due to an allergic reaction to the material used in the coat. The defendant established that a person of normal skin sensitivity would have been able to wear the coat without suffering such a reaction. Further, he argued that, as he was unaware of the claimant's particular circumstances, he could not be held liable if the goods supplied were not fit for her precise requirements. The court agreed with him and the claimant lost her case.

The requirements of satisfactory quality and fitness for purpose apply only where the seller is selling the goods in the course of a business. Accordingly, in private sales no such obligations on the part of the seller will arise. Therefore, unless the seller has misrepresented the quality to the buyer or it can be shown that the expected quality was *expressly agreed* between the parties, the buyer will have no complaint if the goods are unfit for the purpose for which they were bought.

Not only must the actual contract goods meet the quality standard, but so must any other items supplied along with them. This would apply to, say, containers and packaging and any foreign matter mixed in with the goods. A delivery of coal dramatically illustrates the last point.[10] The claimant ordered a ton of coal from the defendants. Unbeknown to her, a shovelful she placed on her fire contained an unexploded detonator! The result was predictable enough and although the claimant escaped injury, her house did not. No doubt to her astonishment the County Court judge decided that as the coal itself was of satisfactory quality, a requirement that did not extend to the detonator, there was no breach of contract. Common sense, however, reasserted itself in the Court of Appeal. In its view, coal is not bought by the lump but by the bag and as such must be fit for burning. Coal which contains an unexploded detonator clearly is not.

As a final point, it should be noted that the Sale of Goods Act 1979 gives many of the seller's obligations the status of

conditions. This applies to the requirements relating to satisfactory quality and fitness for purpose as well as description, which was explained above. It will be recalled that breach of a condition entitles the innocent party to terminate the contract. In the context of a contract for the sale of goods, this means that the buyer is able to reject the goods and reclaim the price. However, he will lose this right if he fails to reject them after having had a reasonable time to examine them for conformity with the contract. In such circumstances, he will be deemed to have accepted the goods and any remedy he may have will be restricted to damages.

The approach of German and French law to the question of quality is broadly similar to that of English law. If a defect in the goods renders them unfit for the purpose intended by the parties, then under both systems the buyer has a choice of either rejecting them and reclaiming the purchase price or affirming the contract but seeking a reduction in the price. In both cases the buyer must act promptly once he discovers the defect.

Delivery

Under English law, a date specified in the contract for delivery of the goods is normally regarded 'as of the essence' – that is, of vital importance. If the seller does not comply with this date, the buyer would be entitled to withdraw from the contract and refuse to accept late delivery. If no date is specified, the seller is under an obligation to deliver within a reasonable time.

In the case of both German and French law, late delivery entitles the buyer to withdraw from the contract and, depending on the circumstances, claim damages. However, before these remedies are available under German law, the buyer must serve on the seller notice, setting a time by which delivery must be made. If this is not complied with, the buyer can withdraw.

As for the place of delivery, English, French and German law provides that, in the absence of contrary agreement, the delivery shall be made at the seller's place of business. Thus, the seller will have discharged his obligations under the

contract by making the goods available for collection by the buyer who, in turn, will be responsible for all the associated costs.

'What if?' and standard terms of business

An essential purpose of the express and implied terms of a contract is to encapsulate the obligations each party owes to the other. However, it is not the only purpose; it also provides a mechanism for allocating certain risks between the parties. If we had the ability to foresee the future, we could plan out actions in order to avoid pitfalls which may be lying in wait. Unfortunately, life is not like that. We are at the mercy of events, many of which are beyond our control. Although it is not possible to predict with certainty what the future holds, in many situations it is possible to anticipate what *could* happen. Therefore, by taking appropriate steps, one should be able to avoid the adverse consequences which may result if the foreboding proves correct. A party who is about to commit him- or herself to a contract and the obligations that come with it would be well advised to ponder the 'what if?' question before taking the final step. By asking this question, scenarios can often be identified having the potential for causing major problems for the party concerned should they materialise. By way of example, suppose that an entrepreneurial young woman called Sally Greenfingers has just started a garden design and landscaping business. Her first client is Lord Toff, who has asked her to design and construct an ornamental garden at Posh Towers, Lord Toff's stately home. The design that Sally prepares incorporates a small ornamental lake stocked with Koi carp, decorative lawns, an arboretum and pathways constructed out of Cornish slate. Sally quotes a fixed price to include all labour, materials, fish for the lake and trees for the arboretum. Lord Toff is impressed by both the design and the price and, accordingly, gives Sally the go-ahead to start work. As Posh Towers is opened to the public, Lord Toff wants the project completed for the beginning of the coming season, when visitors wishing to enter the garden will be charged extra. Sally starts work but disaster strikes at every

turn. While excavating the site for the lake, heavy clay is encountered. In order to keep to the time schedule, Sally has to hire an additional digger with driver at considerable extra cost. The slate for the pathways arrives three weeks after the date promised by the suppliers. The decorative lawns have to be relaid when it is realised that the original turf was not of the correct quality. As a result of these delays, the garden is not completed by the contract date. Lord Toff is refusing to pay Sally the final instalment due under the contract and, further, is claiming £5000 for business lost due to the late opening of the garden. This, together with the extra costs associated with the lake, is bad enough but matters only get worse. Half the Koi carp die within a few weeks from fin rot and it transpires that a tree planted in the arboretum was infested with a voracious type of beetle, which has now transported itself to Lord Toff's orangery, causing untold damage.

At the time Sally entered the luckless contract with Lord Toff, she probably never imagined that fate could be so cruel. But had she done so and asked herself a number of questions, she might be in a better position than that in which she is presently mired. For example, 'What if I incur extra costs which have not been factored into the price quoted for the job? What if suppliers either fail to deliver materials on time or deliver the wrong materials and this puts back completion of the whole project? What if the client seeks to hold me responsible for any financial loss resulting from this? What if items supplied by me turn out to have some hidden defect which makes them useless or, worse, produces serious knock-on effects?' If Sally had pondered these questions and visualised the risks to herself suggested by the answers, when negotiating the project with Lord Toff, she could have pressed for appropriate provisions to be included in the contract. For instance, a clause allowing her to increase the quoted price if additional and unforeseen costs were incurred, a completion date stated as a target but one not to be regarded 'as of the essence' of the contract, an exclusion of liability for defects in any materials or other items supplied under the contract and, in particular, an exclusion of liability for any consequential loss or damage suffered by the client as a result. Whether Sally would have been able to persuade Lord Toff to agree to these

terms is another matter. The strength or weakness of her bargaining position would be the crucial factor. If there were no other landscape gardeners available at the time and for some reason it was imperative for Lord Toff to have the extra facility available for visitors to Posh Towers by the beginning of the season and at the lowest possible cost, he might have been willing to agree to Sally's terms. On the other hand, the scales might not have been weighted entirely in her favour. If she were in competition with several other landscapers bidding for Lord Toff's business, if there was little possibility of other work coming along at the time and she was desperate for the contract in order to get her business off the ground, she would be in no position to dictate terms to Lord Toff. In fact, it would be the other way round. Lord Toff could insist on an assured completion date, maybe with heavy financial penalties if this were not met. And far from agreeing to exclude Sally's liability for defective materials and consequential loss, he might have resolutely demanded quality guarantees for all aspects of the contract's performance, with extensive indemnity provisions applying if these were not honoured.

The lessons from this experience could dictate the way Sally approaches future contracts. Having seen what can go wrong, she might decide to draw up terms upon which she is prepared to do business no matter who the client or what the project. These terms will be standard for all contracts entered into by her and not the result of individual negotiation. As a consequence, the risks associated with events going awry will be transferred from Sally to the client. As most of her clients are unlikely to read, let alone contest, her terms of business, the problems she encountered with Lord Toff are unlikely to reoccur. At least that is the idea but, as will be explained, for the game plan to work, a number of legal obstacles will have to be overcome and failure to do so will result in the risks of which she hoped to rid herself once more being deposited on Sally's doorstep.

Standard terms are a fact of commercial life. Most businesses operate on them. In addition to controlling and transferring risk, standard terms might also serve to displace the terms or rules which otherwise would be imposed by the law. Where each party has its own standard terms, the contract will be

governed by those of the party which wins the 'battle of the forms' referred to in Chapter 2. Whether the terms of the supplier or buyer apply, suffice it to say that they will differ in important respects. The point can be illustrated by considering a number of issues which are typically dealt with in standard terms relating to contracts for the sale of goods.

Price

A seller who has agreed to supply goods at a certain price might face having his profit margin reduced or eliminated as a result of his own supplier revising their prices.

Often a seller will include in his terms of business a price escalation clause, enabling him to increase prices in line with increased costs. The purchaser, on the other hand, might specify in their terms of business that the price shall remain fixed. By way of example, consider the following clauses, one taken from a seller's standard terms and the other from the purchaser's:

- *Conditions of sale*: 'The company reserves the right to vary the price if the cost of labour, materials or other services varies from that at the contract date and in any event orders will be invoiced at the price ruling at the date of dispatch.'
- *Conditions of purchase*: 'The quantities, price or specification of the goods shall not be altered by the seller without the written consent of the buyer.'

Passing of ownership

If the buyer becomes insolvent before they have paid the seller, the seller will have to present its claim like any other unsecured creditor. After payment of the secured and preferential creditors, it is unlikely that there will be sufficient funds to pay the unsecured creditors. Accordingly, the seller might seek to recover the goods, but this will only be possible if he has retained ownership in them. A very common provision in standard terms of sale is a 'retention of title' clause. Under this, the seller attempts to retain ownership until he has been

paid. Such clauses can be effective especially where the contract goods are still identifiable. The position becomes more problematic when the goods have been mixed with other goods or have lost their identity in some other way. Some clauses even attempt to extend rights of ownership to other goods – for example, those into which the contract goods have either been incorporated or, during whose production, consumed. Such extended clauses have met with varying degrees of success. However, it is unlikely that a manufacturer of animal foodstuff would, by dint of clever draftsmanship, be entitled to claim the cow which had consumed the fodder supplied under the contract. The following is an example of a simple retention of title clause. It should be noted that the seller, while retaining ownership in the goods, has nevertheless transferred the risk to the buyer on delivery. Had this provision not been included, the risk would have still remained with the seller:

> Where goods are sold to the purchaser, the ownership of such goods shall not pass upon delivery but shall remain vested in the vendor until such times as payment in full thereof is made by the purchaser . . . Notwithstanding the reservation of ownership in such goods by the vendor, the risk relating to such goods shall pass to the purchaser on delivery . . .

Conditions of purchase may, however, counter the retention of title by the seller by stating, for example:

> The property in the goods shall pass to the buyer on delivery without prejudice to any right of rejection which may accrue to the buyer.

Delivery times

If the seller agrees to deliver by a certain date, failure to comply with this might entitle the buyer to cancel the contract. Accordingly, conditions of sale frequently introduce flexibility into delivery dates, for instance by providing that:

> The seller will endeavour to complete the order on the date agreed but any times quoted for delivery of goods are to be treated as estimates only and shall not be binding.

The buyer's terms, however, might stipulate:

> The seller shall comply in all respects with the buyer's programme for delivery of goods and/or commencement, execution and completion of work.

Although standard terms have their legitimate uses, sometimes they can be employed in a way the law regards as unfair. While they enable the conduct of business to be rationalised by making it unnecessary to negotiate the provisions of each transaction separately and may be fuller, clearer and more suitable than the terms which would otherwise be implied by law, companies also use them in similar vein to Sally Greenfingers in order to shift on to the other party as many as possible of the risks associated with the transaction. In addition to the above examples, typical clauses may also exclude the firm's liability for non-performance or defective performance; conversely, they may prevent the other party from setting off debts due to them, withdrawing from the transaction or cancelling the contract, or they may impose financial penalties in the event of delay on the part of the other party. Whatever the content of the standard terms, they are heavily weighted in favour of the company imposing them. While the customer has the theoretical option of going elsewhere, in reality this may be futile because it is likely that other companies will operate under standard terms which are little if any better. The customer might try to haggle over the terms with a view to substituting some that are less disadvantageous to it, but if the other party is a large and economically powerful organisation, they may simply refuse to negotiate over their terms and present the other with the option of 'take it or leave it'.

Given the potential unfairness of standard terms, in many jurisdictions their use and effectiveness are controlled by law. While in many cases the controlling mechanisms are principally designed to protect the private consumer, there are situations where the law will intervene in business-to-business transactions. Basically, in order to be effective, standard terms must be incorporated into the contract, be free of ambiguities or uncertainty as to their meaning or scope and comply with any relevant legislative provisions.

If the standard terms are not incorporated into the contract, they cannot be relied upon. Therefore, the party imposing the terms must take all reasonable steps to bring them to the other's attention before the contract is made. Accordingly, where the terms are not readily visible or appear in print so small as almost to be illegible, they may well not be incorporated. Whatever steps are taken to bring the terms to the other party's attention, these must occur before the contract is made. If they are only presented after the conclusion of the contract they will clearly not form part of it and, as a result, will be ineffective. In an English case,[11] the claimant was a guest at a hotel owned by the defendants. During her stay, a fur coat was stolen from her room. A thief had managed to obtain the keys to the claimant's room from behind the reception desk, which was unsupervised at the time. There was a notice in the room which stated that the defendants were not responsible for articles lost or stolen. The court decided that this notice was not incorporated into the contract which was concluded at the reception desk.

In many civil law countries, there is an overriding requirement that business is conducted according to the principles of good faith and fair dealing. This notion has sometimes been used to strike down unfair terms. An illustration of this can be seen in a decision of the German Supreme Court in 1956.[12] The claimant bought a suite of new bedroom furniture at a shop owned by the defendant. Soon afterwards, the drawers stuck, the veneer peeled off and other defects appeared. Although the defendant made an attempt to repair the furniture, this was unsuccessful. The general conditions of business excluded all rights arising out of the contract of sale, except the right to have the goods repaired. The court decided that the standard terms deviated too far from those implied by law and that as the claimant's only contractual entitlement was to have the goods repaired, a right which had turned out to be useless, he must be allowed to enforce his rights under the contract arising under the general law. The relevant right here was to have the price reduced or, on returning the goods, have the purchase price refunded. The exclusion of these rights was held to be invalid.

Another device which courts have often used to control the effectiveness of unfair terms is restrictive interpretation. Generally, any uncertainty or ambiguity as to the meaning or extent of the term in question will be construed in the way which is least favourable to the party relying on it. This is known as the *contra proferentem* rule. An example of this can be seen in a case coming before the English courts in 1954.[13] A five-seater car was carrying six passengers when it was involved in an accident. The owner's insurance policy excluded liability if the car was carrying any 'excess load'. The insurance company denied liability, arguing that carrying six people in a five-seater car was excessive loading. The court held that the term 'load' should be interpreted to refer to 'goods' only. Since the excess was in the number of people being carried, the contractual provision was invalid.

In many countries, specific legislation has been introduced to restrict the operation of unfair terms. In Germany, the General Conditions of Business Act came into force on 1 April 1977. It is designed to protect the weaker party where standard terms of business are involved. It does not apply to individually negotiated contracts but only to 'contract terms which have been drafted beforehand for use in a number of transactions and which one party puts to the other when the contract is being formed'. Apart from consolidating in statutory form the principles developed by the courts, the Act also seeks to regulate other aspects of standard terms of business. In its opening paragraphs it lays down a number of general principles. For example, standard contract conditions will be deemed to be incorporated into the contract only if, at the time of its conclusion, the party relying on them (a) expressly refers the other party to them or, if this is impossible in practice, refers to them by means of a clearly visible notice at the place at which the contract is concluded, and (b) allows the other party a reasonable opportunity to inspect them. Finally, the party submitting to the terms must agree to accept them. 'Surprise clauses' are deemed not to be incorporated. These are terms which, bearing in mind the general nature of the contract, are so unusual that the other party would not expect them to be included. The Act invalidates a large number of standard terms which deviate too far from the terms implied by the civil and

commercial codes. For example, such is the case with a term which excludes the right of the innocent party to rescind the contract or claim damages in the event of non-performance by the other. A provision excluding the liability of the seller of new goods for defects in them would be similarly invalidated, as would a clause excluding or limiting liability or damage resulting from a grossly negligent breach of contract by the party whose terms are at issue. Where clauses such as these are deprived of effect, the terms implied by law will apply.

In France, the courts have invoked the *contra proferentem* rule to invalidate unfair terms and have been known to refuse to enforce standard terms so drafted as to be either incomprehensible or illegible. Furthermore, any attempt by one party to exclude liability arising from intentional fault or gross negligence will not be permitted. Although there is no legislation regulating standard terms of business *per se*, statutory control is exercised over unfair terms in consumer contracts; for example, in a contract of sale, any clause excluding or limiting the rights of the consumer to compensation for breach by the other of his obligations is void.

In the UK, the Unfair Terms in Consumer Contracts Regulations 1999 allow the court to invalidate terms in consumer contracts where, contrary to the requirements of good faith, they cause 'a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer'. There is also specific legislation aimed at controlling exemption clauses under which one party might seek to exclude or limit liability which may arise due to his default. The Unfair Contract Terms Act 1977, which applies to both consumer and business-to-business contracts, provides that certain exemption clauses are void while others can be valid if considered reasonable. An example of a void clause would be one seeking to exclude liability for causing death or personal injury through negligence. A clause in a consumer contract exempting a commercial seller of goods from his obligations relating, say, to quality and fitness for purpose would be similarly void.

Under the Unfair Contract Terms Act, some exemption clauses can be valid if they are reasonable. What is reasonable will depend on the precise circumstances of the individual

transaction. However, the Act does provide some guidelines. For example:

1. The relative strength of the bargaining positions of the parties. Thus, if the bargaining positions are unequal, it may be unreasonable for the stronger party to rely on the exemption clause, particularly if there was no obvious alternative source of supply which the weaker party could use.
2. Whether the customer received any inducement to agree to the exemption clause, such as a lower price, or had the opportunity of entering an equivalent contract with another supplier but without having to submit to a similar clause. If, in the latter case, the customer chooses to stay with the first supplier despite the presence of the exemption clause, this may be relevant to whether the clause is reasonable or not.
3. Whether the customer knew, or ought reasonably to have known, of the existence and extent of the term. If the clause had been pointed out to the customer and he was fully aware that it reduced the liability of the supplier, this would be a factor in deciding whether the latter should be allowed to rely on it. The fact that the parties had dealt with each other before would also be relevant, as would the fact that the exemption clause was customary in the particular trade involved.

In a case[14] involving lost wedding photographs, the notion of reasonableness was put to the test. The claimant took a film of a friend's wedding to the defendant's shop for processing. As there were no other photographs of the nuptial event, the claimant wished to combine those he had taken into an album which he intended giving to his friend as a wedding present. Unfortunately, the film was lost. When sued, the defendant relied on an exemption clause which read 'All photographic materials are accepted on the basis that their value does not exceed the cost of the material itself. Responsibility is limited to the replacement cost of the film itself. No liability will be accepted, consequential or otherwise, however caused'. Apparently this kind of exemption clause was standard throughout the trade. The issue turned on whether the clause

was reasonable. The court found that the claimant had no real choice but to submit to the clause as it was so widespread. The defendants could foresee that the subject matter of the film might be irreplaceable, in which case its loss would be a serious blow to the claimant. While a two-tier pricing system giving the customer the option of assuming the risk of loss but at a lower price might have been reasonable, in the present circumstances the exemption clause was compulsory regardless of the value of the film. Accordingly, the clause was unreasonable and the claimant was entitled to damages.

In many countries, the law takes a stricter line with exemption clauses in consumer contracts than it does with those in business-to-business contracts. The reason for this stems from the view that, while consumers need protection, businesses should, in general, be able to look after themselves. In some circumstances, the use of standard terms to shift risks from one party onto the other might be a perfectly legitimate exercise. A good illustration of this is a case[15] which came before the English House of Lords in 1980. Photo Production Ltd, the claimants, owned a factory. They were concerned about the risks posed to the premises at night, particularly by fire and intruders. Accordingly, they employed the defendants, Securicor Ltd, to provide a night patrol service for the factory. The contract was on Securicor's standard terms of business, which expressly stated that under no circumstances would they be responsible for any wrongful act or default committed by a Securicor employee. One night, the patrolman assigned to Photo Production's factory lit a small fire which got out of control and destroyed the factory. Photo Production sued Securicor for damages totalling £648 000. Securicor sought to rely on the exemption clause in the contract and, in what at first sight might appear to be a surprising decision, the court allowed them to do so. As the facts arose before the Unfair Contract Terms Act 1977 came into force, the House of Lords based its decision on the law existing at the time. However, it is clear that had the clause been subject to the 1977 Act, the court would have found it to be reasonable. Although it might seem bizarre to allow Securicor to escape liability resulting from something they were employed to prevent, a closer analysis of House of Lord's reasoning divulges the rationale underlying the decision. An important factor in

determining whether, in any given situation, it is reasonable to transfer a particular risk or risks onto the other party is related to insurance and whether appropriate cover can be obtained. If it can, then which of the parties should be responsible for arranging it? In the present case, the risk which Securicor was attempting to exclude was fire damage. As property owners normally take out an insurance policy which includes fire damage, the court found it reasonable for Securicor to shift this particular risk onto Photo Production. By avoiding having to double insure an already covered risk, Securicor did not have to carry this cost as an overhead and, consequently, were in a position to offer their services at a lower price than otherwise would have been the case. The court regarded this risk allocation as fair and reasonable in the circumstances and would not intervene.

In summary, it will be recalled that contractual terms can arise from a number of sources and take a variety of forms. Where they originate from an individually negotiated contract or a model form adapted to meet the parties' specific requirements, they reflect a true consensus between the parties. The nature and scope of the obligations created will depend on the commercial objectives to be attained and the strength of each party's negotiating position but, nevertheless, the end product is the result of a genuine agreement. The same cannot necessarily be said where a contract is based on the standard terms of one of the parties. Unless there is equality of bargaining strength, they are more likely to reflect the ambitions of the party having greater economic muscle. Where such an imbalance results in a transfer of risk which is unfair, the law will intervene in order to redress the balance and establish a degree of contractual justice for the party who would otherwise be disadvantaged.

Summary

The following issues were dealt with in this chapter:

1 The distinction between the express and implied terms of a contract.
2 The sources of express and implied terms.

3. Aspects relating to contracts for the sale of goods including description, quality, passing of ownership and risk, and time and place of delivery.
4. The role of standard terms of business in allocating risks between the parties.
5. Legal control of standard terms of business and, in particular, exclusion clauses.

Notes

1. *Poussard* v *Spiers & Pond* [1876] 1 QBD 410.
2. *Bettini* v *Gye* [1876] 1 QBD 183.
3. *Hong Kong Fir Shipping Co Ltd* v *Kawasaki Kisen Kaisha Ltd* [1962] 2 QB 26.
4. Diplock, LJ.
5. *Rice* v *Great Yarmouth BC* [2000] *The Times*, 26 July.
6. *Schuler AG* v *Wickman Machine Tool Sales Ltd* [1974] AC 235.
7. *Beale* v *Taylor* [1967] 3 All ER 253.
8. *Business Application Specialists Ltd* v *Nationwide Credit Corp Ltd* [1988] RTR 332.
9. *Griffiths* v *Peter Conway Ltd* [1939] 1 All ER 685.
10. *Wilson* v *Rickett, Cockerell & Co Ltd* [1954] 1 QB 598.
11. *Olley* v *Marlborough Court Ltd* [1949] 1 KB 532.
12. BGHZ 2, 90.
13. *Houghton* v *Trafalgar Insurance Co Ltd* [1954] 1 QB 247.
14. *Woodman* v *Photo Trade Processing* [1981] 131 NLJ 935.
15. *Photo Production Ltd* v *Securicor Transport Ltd* [1980] 1 All ER 556.

CHAPTER 4

Non-performance of contractual obligations

Change of circumstances making performance of the contract impossible

If the parties to a contract perform their respective obligations as they should, all well and good and everyone is happy. However, a situation may arise where one party's performance either fails to materialise at all or, even if it does, falls short of what was required under the contract. In such a case, the aggrieved party may well regard the other to be in breach and seek an appropriate remedy, something to which, in the majority of cases, he would be entitled. However, the defaulting party might seek to disclaim responsibility by arguing that in the time since the making of the contract, circumstances have changed and that his failure to perform should be judged in this light. For example, suppose that X contracts to sell to Y a quantity of grain at a specified price and in the period

following the conclusion of the contract the market price of grain doubles. If X has to buy grain on the open market in order to supply Y's order, it could well be that, far from making a profit on the transaction, he will incur a significant loss. In such circumstances, X might argue that he should be relieved of the obligation to deliver at the original price. Although such an argument might not seem entirely unreasonable, it is unlikely to find favour with the law. This is because of a general rule which states that a party will not be released from their original obligations merely because circumstances have changed, making it more expensive or difficult for them to perform. This said, however, in most jurisdictions there are some, albeit limited, circumstances where the strictness of the rule is mitigated. Should any of these apply, the party in default is excused performance and will not be liable for breach.

The common law is somewhat reluctant to excuse a party due to a change in circumstances. The general view is that the parties are free to stipulate in the contract those events which either bring the contract to an end or entitle one or other of them to an adjustment of its terms. If they fail to take this opportunity, the law will not intervene. Even so, common law does recognise that in some situations it may be unjust to hold the parties to the original bargain. Should such a situation arise the contract will be regarded as *frustrated*. Where this happens the contract comes to an end without any fault being attributed to the party who has failed to perform.

The doctrine of frustration as applied in English law is very strict, being the exception rather than the rule. There are only a limited number of occasions where the doctrine will operate. The following are examples.

In a contract which requires personal performance by one of the parties – for instance, an employment contract – the death or continued illness of that party will frustrate the contract. This can be seen in a case involving a band called the Barron Knights.[1] The claimant was the band's drummer, who had been engaged under a contract for five years. He was required to play on seven nights a week when the band had engagements. This obviously proved too much for him because he fell ill. His doctor told him that he could only play

on four nights a week. On receiving this news the band fired him, arguing that the claimant's illness had brought the contract to an end. The court agreed. While acknowledging that a temporary illness would not have this effect, the court was of the view that, because of his illness, it was impossible for the claimant to continue the contract in a business sense and therefore it must be regarded as frustrated.

A subsequent change in the law, making performance of the contract impossible, is a well-recognised cause of frustration. In one case,[2] the defendant leased land to the claimant. He promised that he would not allow any building to be erected on the adjoining land that he retained. However, a railway company, acting under powers granted to it by a statute passed after the lease had been signed, compulsorily purchased this land and built a station on it. The court excused the defendant from his promise on the grounds that it was impossible for him to honour it due to the railway company's exercise of its statutory powers. It should be noted that the defendant was released from his promise because the events that prevented him complying with it were not foreseeable at the time the contract was made. On the other hand, if the party failing to perform should have foreseen the events in question, he will be taken to have assumed the risk of them occurring and should have protected himself by making appropriate provisions in the contract. If he fails to do this, the doctrine of frustration will not come to his rescue. This can be seen in a case[3] where the claimant was granted a right to display an advertising sign on the defendants' hotel for seven years. Within this period, the local authority, acting under its statutory powers, compulsorily acquired the hotel and demolished it. The court decided that as the defendants should have foreseen the possibility of the hotel being compulsorily purchased, the contract was not frustrated. As the judge put it, 'they could have provided against the risk but they did not'.

A contract will also be frustrated where, through the operation of the law or as a result of a subsequent change in the law, performance of the contract becomes illegal. For example, the Trading with the Enemy Act 1939 prohibits trading with an enemy of the UK in time of war. Any contracts whose performance would violate this prohibition will be frustrated.

A contract between an English company and a Polish company at the time of the Second World War illustrates the point.[4] The contract provided for the manufacture by the English company of certain machinery which was to be shipped to the port of Gdynia in Poland, where the purchasers were based. Before the machinery was delivered, Gdynia was occupied by enemy forces and as a result the contract was frustrated. The rationale underlying the decision was that, although it might have been physically possible to deliver the machinery, there was an overriding public interest at stake which could only be served by ensuring that no assistance was given to the enemy's economy in time of war.

Where the contract is made on an assumption that a particular state of affairs will continue to exist and subsequently this turns out not to be the case, the contract will come to an end through frustration. So a music hall owner was held not liable to a concert organiser who had hired the hall for a number of specified dates only to be deprived of the venue when the hall was accidentally destroyed by fire before the first concert took place.[5]

A contract can be frustrated if a subsequent change in circumstances makes achievement of the commercial objective impossible. It may be that the contract is capable of *literal* performance but, if this happened, the contract would be a different one from the one originally made by the parties. In this instance, the changed circumstances can be said to have frustrated the *common venture*. A good illustration of this involved the planned coronation of King Edward VII in 1903.[6] The claimant owned a room overlooking the proposed route of the coronation procession and had let it to the defendant for the purpose of viewing the festivities. The procession did not take place due to the king falling ill, but the claimant still demanded payment of the rent. The court decided that the cancellation of the procession discharged the parties from their obligations since it was not possible to achieve the real purpose of the contract. Although the contract could still *literally* be performed in the sense that the defendant could have had occupation of the room on the agreed day, this was not the object of the agreement. The contract was for the hire of a vantage point from which to view the procession and not

merely for the hire of a room. Accordingly, the defendant was not liable for the rent.

For the contract to be frustrated in the type of situation just described, the entire commercial objective must be unattainable. If a part of it can be rescued, the contract will stand. This can be seen in another case[7] finding its way into court as a result of King Edward's illness. As part of the coronation celebrations, the British fleet had assembled off Spithead in order to be reviewed by the King. The defendant had agreed to hire the claimant's steamboat for the day of the review in order to take passengers on a trip to witness the review itself and then on an excursion round the fleet to allow closer inspection of the ships. Although the review was cancelled, the fleet remained. The defendant refused to hire the boat as agreed despite the fact that it could still have been used to provide a cruise around the fleet. When sued for the hire fee he argued that the contract had been frustrated. The court was unmoved. The Royal Navy Review was not the sole basis of the contract and it would still have been possible to achieve part of the commercial objective. Accordingly, the defendant was liable for the hire fee.

On the other hand, if the changed circumstances merely make performance of the contract more onerous or more expensive for the party concerned, it will not be frustrated. As one judge[8] has explained, there must also be 'such a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing than that contracted for'. The case giving rise to this somewhat inelegant statement of legal principle involved a construction contract under which the claimants agreed to build seventy-eight houses for the defendants for £94 000 within a period of eight months. However, due to various factors, including lack of adequate supplies of labour and building materials, the construction work took twenty-two months and cost the claimants £115 000. Although there was no provision in the contract which allowed them to recover the total sum from the defendants, they nevertheless pursued this objective via a different route. They argued that the original contract was frustrated and that, as a result, they were entitled to recover a reasonable sum for the work carried out, which in their view amounted to £115 000.

The court held that they were only entitled to the amount stipulated in the contract. The shortages of labour and materials had merely made the contract more difficult and expensive for the claimants. The nature of the obligation had not fundamentally changed, which had always been to build houses, something that the subsequent events had not altered.

A similar view was taken in a number of cases arising out of the closure of the Suez Canal in 1956. In one,[9] a company agreed to sell a quantity of goods for shipment to the purchaser from Port Sudan to Hamburg during the period November/December 1956. The price was to include the cost of the goods, insurance and carriage to Hamburg. Although the contract did not state that shipment would be via the Suez Canal, both parties had assumed that this would be the case. On 12 November 1956 the Suez Canal was closed. Although the goods could have been shipped to Hamburg round the Cape of Good Hope, this route would have been two and a half times longer and, as a result, would have doubled the cost of the carriage. The sellers argued that the closure of the Suez Canal had frustrated the contract. The court disagreed. Although shipment via the alternative route involved a change in the anticipated performance of the contract, it was not such a fundamental change from the original method of performance so as to frustrate the contract.

The reluctance of English law to release a party from what has become an overburdensome contract is not shared in every common law jurisdiction. For example, in some American states, the courts will apply a rule of commercial impracticability to encompass situations where the performance of the contract, although not physically impossible, has become excessively difficult and/or expensive. Thus, the buyer of a gravel pit was excused further performance once he had extracted the gravel above the waterline. Removal of the gravel below this level would have been far more expensive and would have involved different technology.[10]

While not recognising the doctrine of frustration, French law nevertheless acknowledges that a contract can be discharged as a result of supervening impossibility. The concept invoked in such circumstances is that of *force majeure*. This doctrine has found its way into most civil law systems influenced by

French law. *Force majeure* is narrower than the common law doctrine of frustration. It covers only events which make performance of the contract impossible, not those making it more onerous or expensive to perform. Neither does it apply to situations where the foundation of the contract has disappeared, rendering the attainment of the commercial objective impossible. In addition to rendering performance impossible, an event of *force majeure* must also be unforeseeable and insurmountable. The latter requirement imports the idea that the event in question must be unavoidable. If the defaulting party could have taken steps to prevent the event occurring, he will not be excused performance. So where a strike by employees of the defendant prevented him performing the contract with the claimant, his plea of *force majeure* failed because, by agreeing to the employees' demands, the strike could have been avoided.[11]

To reduce uncertainty over the type of occurrence which will excuse performance, the parties often stipulate in their contract the events which do and do not amount to *force majeure* and the precise consequences should any of these arise.

Although *force majeure* is essentially a principle of French law, it is recognised in common law systems. The parties might include in their contract general expressions such as '*force majeure* excepted' or 'subject to *force majeure*'; however, they are more likely to incorporate a *force majeure* clause containing an extensive list of those eventualities, either bringing the contract to and end or permitting an extended time for performance. An example of such a clause reads as follows:

> Strikes, lockouts, labour disturbances, anomalous working conditions, accidents to machinery, delays en route, policies or restrictions of government, including restrictions on export or import licences, war (whether declared or not), riot, civil disturbance, fire, act of God, or any other contingency whatsoever beyond the control of either party, to be sufficient cause for any delay or non-performance traceable to any of these causes.

German law has more in common with the English doctrine of frustration than the principles governing impossibility of performance under French law. However, unlike English courts, courts in Germany will occasionally vary the terms of the original contract or order performance of a new contract

made by the court. Like English law, German law also recognises as excusing performance changed circumstances which remove the commercial foundation of the contract. So, for example, where a concert hall was booked specifically for a recital by a famous opera singer, her illness destroyed the basis of the contract.[12] A similar view was adopted when the lease of a boat-house adjoining a lake was rendered pointless due to sailing on the lake being subsequently banned.[13]

The above therefore makes it clear that it is not always possible to predict with any degree of certainty the precise events excusing a party from performance. In the previous chapter mention was made of the 'what if' scenario. This emphasised the potential advantages to be gained through a willingness to think the worst. Such an approach can produce dividends in the present context. Although it is not possible to predict all the events making performance of a contract impossible or impractical, it is not beyond the wit of man to anticipate the typical kinds of event having this effect. Including in the contract a list of these, together with a stipulation of the ensuing consequences should any of them occur, will produce a higher degree of certainty than would be the case if the effect of supervening events was to be governed by the law of frustration or *force majeure*.

Remedies for breach of contract

Unless excused performance on the grounds of frustration or *force majeure*, a party who fails to perform in accordance with the terms of the contract will be in breach. In such circumstances, the aggrieved party will be entitled to seek one or other of the remedies provided by the law. Although in many situations monetary compensation is the remedy of first resort, it is not the only one, as will be explained below.

Specific performance

Under this remedy, the party in default is ordered to perform the contract. In common law jurisdictions, specific performance is granted purely at the discretion of the court and then

only in exceptional circumstances. It will not, for example, be ordered where the contract is for the performance of personal services, so it would not be available in the case of an employment contract. The general reluctance to award specific performance is based on the view that, in most cases, the aggrieved party can be adequately compensated in money. Therefore, if X has contracted to sell his car to Y, it is highly unlikely that Y could obtain an order requiring X to make actual delivery to him. However, where the article sold is unique, the court might be persuaded that damages are not a sufficient remedy, in which case an order of specific performance is more likely to be granted. Land can be said to be unique and so contracts for the sale of land are frequently enforced by an order of specific performance. While contracts for the sale of goods generally will not attract the remedy, the sale of a family heirloom or valuable painting might.

French law, like common law, will not order specific performance where performance is deemed personal in nature. In this case, the only remedy will be damages. Where the contractual obligation is not personal, the court will often provide a remedy which, while not *forcing* the party in default to perform his contract, will at least *encourage* him to do so. The most common example of this is where the court makes an order requiring the party in default to perform coupled with a fine known as an '*astreinte*' if he does not. An *astreinte* is a civil fine imposed upon the breaching party for each day, week or month that he fails to comply with the court order.

Under German law, specific performance is available in all circumstances where a party fails to perform his contractual obligations. Accordingly, at the request of the innocent party, German courts will order the party in breach to perform. Judgments for specific performance are enforced in different ways depending on the type of obligation involved. For example, in a contract for the sale of goods, the court bailiff, with the assistance of the police if necessary, will dispossess the seller of the item sold and deliver it to the buyer. If the obligation is personal in nature, the order will be enforced judicially by the threat and eventual imposition of fines and/or imprisonment on the party in default. However, there are a number of obligations for which these enforcement procedures will

not be used, such as a contract of employment. Like French and English law, German law restricts the remedy available for breach of such a contract to damages.

Although having the theoretical option of claiming specific performance, the innocent party, in practice, is more likely to attempt to rid himself of the contract and seek an alternative source of supply rather than hold the defaulting party to the original bargain. Any financial loss which results from this course of action will be recoverable in the form of damages.

Rescission

The innocent party may still have outstanding obligations of his own to perform under the contract and wish to be released from these or, to use the technical term, have the contract *rescinded.* Most jurisdictions recognise the right of a party to be free of a contract which the other has failed to honour in material respects. However, the precise circumstances where such a right may exist can differ. As was explained in the previous chapter, English law categorises contractual terms as either conditions, warranties or innominate terms. The aggrieved party is only released from his outstanding obligations where the breach relates to a condition or a term classified as innominate and where the effects are such to deprive him of substantially everything contracted for. In such a case, the innocent party does not have to apply to the court for an order releasing him from the contract; he can simply take the decision himself and, if necessary, plead the other party's breach as a defence should he be sued for wrongful repudiation.

Unlike English law, French law is reluctant to recognise self-help as a remedy. In most situations, a party seeking rescission of the contract because of the other's breach will have to apply to the court for an order releasing him from any obligations of his still outstanding. Whether such an order will be granted is entirely within the discretion of the judge. In some, albeit very limited circumstances, the aggrieved party can act unilaterally to terminate the contract without recourse to the court. This has been held to apply, for example, in circumstances where the breach is so destructive of the trust existing between the

parties as to make the continuation of the contract intolerable. The contract itself might expressly reserve the right of one party to terminate the contract in the event of a breach by the other. However, there are a number of contracts in which such a provision will be ineffective – for instance, certain consumer contracts – and, in any event, the court will adopt a restrictive approach to the interpretation of such clauses. In addition, a party wishing to rely on a contractual right of termination will first have to serve a notice of default on the other, demanding performance unless this requirement is expressly excluded by the contract.

Although German law gives the innocent party the right to terminate without having to obtain a court order, before such a right can be exercised the aggrieved party must serve on the other a notice requiring him to perform in accordance with the contract within a stipulated time. If the party in default fails to comply with this notice, the contract can be terminated. In some circumstances, the serving of a notice is not necessary – for example, in a situation where the defaulting party has indicated that he has no intention of performing or where performance of the contract would be pointless (such as the delivery of Christmas trees after Christmas).

Damages

Damages consist of the payment of money and are intended to compensate the innocent party for the financial loss caused by the other's breach. Only exceptionally will they contain a punitive element and then only in circumstances where the party in default has been guilty of conduct so reprehensible as to deserve censure.

Liquidated damages and penalties

A party who elects to pursue an action for damages through the courts faces the double uncertainty of, firstly, not knowing whether he will win the case and, secondly, even if he does, the amount of damages the court will award.

For this reason, therefore, the parties very often provide in the contract itself for a stipulated sum of money to be paid in

the event of specified breaches. While such clauses have many advantages, including certainty and avoiding the cost and time of court action, they can also be abused. An economically superior party might impose what amounts to a financial 'penalty' on the weaker party. For example, the contract might include a provision requiring the party in default to pay a sum of money in the event of a breach but which, on closer examination, is so excessive or unreasonable, bearing in mind the maximum amount of damage a breach could cause, that the only assumption to be drawn is that it was not intended to be compensatory but a threat to ensure compliance by the weaker party.

In English and American law, a distinction is drawn between *liquidated damages* and *penalties*. The former represent an attempt by the parties to pre-estimate the likely damage which will result from a breach, whereas the latter are imposed '*in terrorem*' and hang like the sword of Damocles over the party required to perform. If a contractual payment is found to be a penalty, it will be declared void and damages will be assessed by the court. Whether a provision is viewed as liquidated damages or a penalty will depend on the circumstances of the case, but a number of factors might be relevant. For example, a stipulated sum which bears no resemblance to the damage that might occur will probably be a penalty. Such would be the case, for instance, if a contract under which a builder was engaged to carry out work worth £100 provided that he should pay £25 000 in the event of a breach. When a single lump sum is payable on the occurrence of one or more of several events, some of which may produce serious damage and others little damage, the presumption will be that the sum is a penalty. This was the view taken by the court in an early twentieth century case involving the Ford motor company.[14] The defendant in the case was a distributor of Ford cars. In the contract with Ford, he agreed not to sell any car or parts below list price nor to sell to other dealers.[15] The contract further provided that the defendant would pay to Ford £250 as 'agreed damages' in the event of each and every breach of the agreement. In the court's opinion the sum was a penalty. Although Ford was likely to suffer damage if its distributor breached the contract, it would not be possible to anticipate

the precise damage in each case. Whereas a provision for a single payment might have been legitimate if it was reasonable in amount, the sum payable in the present case was substantial and therefore should be regarded as a penalty. This finding should be contrasted with that in a similar case[16] where a distributor of Dunlop tyres agreed not to sell to certain named persons and, further, not to sell below Dunlop's list price. The contract provided that £5 'by way of liquidated damages' should be paid for every item sold in breach of the agreement. The court decided that damage to Dunlop from a general breach of contract would be certain but the damage resulting from any single item sold in breach of the agreement would be impossible to predict. The stipulated sum of £5 was a genuine attempt to pre-estimate the loss to Dunlop and therefore was enforceable.

Finally, it should be noted that if the sum stipulated in the contract is in the nature of liquidated damages, the aggrieved party will be entitled to recover only this amount. This is so even if the actual loss suffered is greater than the contractual sum. A manufacturer of silk products found this to its cost.[17] The company had engaged the defendants to erect certain plant at its factory. The work had to be completed by a specified date. In the event that this date was not met, the defendants had agreed to pay the silk company £20 for every week the work remained unfinished. The plant was eventually completed thirty weeks late. The silk company claimed their actual loss, which amounted to £5850. The court decided that damages would be awarded based on £20 per week. In the event, therefore, the claimants recovered only £600.

While not recognising the distinction between liquidated damages and penalties, French law nevertheless permits the parties to stipulate in the contract the payment of a specified sum should one party commit breaches of the agreement. However, where the stated sum is either manifestly *excessive* or *insufficient* the court, at the request of one of the parties, can diminish or increase the contractual payment as appropriate in order to compensate that party for the actual damage suffered.

German law permits agreements both as to liquidated damages and penalties. Whereas the former are intended to reflect the loss which might result from a breach of contract,

the latter is an arbitrary sum payable in certain events and is not related in any way to the financial consequences that may, in fact, result. Even though a penalty may be excessively high, the general rule is that it will nevertheless be enforced. The potential harshness of this rule is mitigated in certain situations. For example, a non-merchant who is liable to pay a penalty that is unreasonably high may apply to the court for a reduction to a reasonable amount. Further, penalties cannot be included in standard consumer contracts although liquidated damages, if reasonable, are permitted.

Unliquidated damages

If the parties have not provided for the payment of liquidated damages in the contract or, if having done so, the provision is nevertheless declared void by reason of being excessive, damages will be assessed by the court. In such a case the award will be for *unliquidated damages*, the aim being to put the innocent party in the same financial position he would have been in if the contract had been performed according to its terms. This said, however, the claimant will not necessarily be compensated for all his losses, despite the fact that they can be attributed to the other party's breach of contract. Were it otherwise, the party in breach would face liability potentially without limit. A taxi driver who, through bad driving, fails to get his passenger to a meeting on time might be surprised to learn that this shortfall in performance has deprived his passenger of the opportunity of securing a contract which would have saved his ailing business. He would, no doubt, be horrified then to discover that he is personally liable for all the financial consequences flowing out of the business's subsequent collapse. In all jurisdictions, there exist mechanisms for limiting damages awarded for a breach of contract. In common law systems, damages cannot be recovered if they are too *remote*.

The test of remoteness was laid down in a famous case[18] brought before an English court in 1854, but one subsequently recognised and applied widely throughout the common law world. The claimant owned a flour mill which suffered a broken drive shaft. He employed the defendant, a transport company,

to take the broken shaft to a factory in order that it could be used as a pattern for a new one. All that the defendant knew was that the article to be carried was a broken drive shaft of a mill and the claimant was the owner of that mill. The defendant delayed delivering the shaft to the factory beyond a reasonable time and was therefore in breach of contract. As a result of this, the mill was idle for a longer period than would otherwise have been the case and so the claimant sued the defendant for damages representing the loss of profits which would have been earned during that time. In determining whether the claimant should succeed, the court formulated a principle for establishing the liability of the defendant for loss caused by his breach of contract; the principle has become known as the 'rule in Hadley v Baxendale'. Basically damage will be too remote unless it arises 'naturally' from the breach in the sense of being the inevitable loss which the defaulting party should have appreciated would result. However, the party in breach will not be liable for 'unusual' loss unless he should have had it in contemplation as likely to arise at the time the contract was concluded. To put it another way, the defendant will only be liable for the damage he should have reasonably foreseen resulting from his breach. In the case itself, the defendant was not liable because, at the time he entered into the contract, he did not appreciate that the mill would remain idle. For all he knew, the miller might have had a spare shaft which, apparently, was the custom at the time. The mill therefore had remained idle due to circumstances of which he was unaware. Accordingly, he would not have had in contemplation the likely loss of profits to the claimant if he breached the contract.

A later case[19] illustrating the rule in Hadley v Baxendale involved a contract for the installation of a boiler for use in the claimants' business. The claimants were launderers and dyers who wished to expand their business. For this purpose they needed a larger boiler. The defendants, an engineering company, agreed to deliver and install such a boiler by 5 June. They knew the nature of the claimants' business and had been made fully aware that the boiler had to be installed as quickly as possible. In fact, the boiler was not up and running until 8th November. The claimants sued for breach of contract, claiming damages representing the loss of profit that an

increase in their business would have generated. They also claimed for the loss of profit on highly remunerative dyeing contracts which, unbeknown to the defendants, they had been negotiating with the government but which were subsequently lost due to the delay in the installation of the boiler. In the event, the claimants were successful in their first claim but not in the second. The court decided that as the defendants knew the claimants required the boiler for immediate use in their business, they should have foreseen that a delay would result in the loss of profits such use would have produced. Accordingly, they were liable to compensate the claimants for this loss. However, as the defendants knew nothing of the high-value contracts being negotiated with the government, they could not have foreseen this loss resulting and were therefore not liable for it.

In much the same way as common law, French law applies a test of reasonable foreseeability as a means of curtailing liability for damages for breach of contract. In assessing the amount of compensation, the court can only take account of such loss as is immediate and a direct consequence of the breach, and then only to the extent to which this could have been in the contemplation of the parties at the time the contract was concluded.

Under German law, however, contractual liability is more extensive than under English or French law. The German civil code provides that a party in default is liable for *all* direct harm resulting from his breach whether or not it could have been foreseen. The somewhat alarming implications of this are in part mitigated by the requirement that the harm must have been *caused* by the breach. While not resorting to a test of foreseeability, German courts will probably strike down the more outlandish claims for damages on the basis that loss of this type is more likely to have arisen independently of the breach and not as a result of it. Whether it be in the context of English, French or German law, therefore, the fate awaiting the unfortunate taxi driver in the example given above might not be so grim as originally suggested.

In all jurisdictions, the innocent party is expected to take reasonable steps to mitigate the damage resulting from the breach. So, for example, if the supplier of goods or services

fails to deliver, the buyer would be expected to make a reasonable effort to find alternative sources of supply, the measure of damage being the difference between the contract price and the price he has to pay for the alternative. If no steps are taken to mitigate the loss, the innocent party's damages will be reduced or, in some cases, extinguished entirely. For example, in an English case,[20] the claimant was employed by a partnership for a term of two years After six months, the partnership was terminated by the retirement of two of the partners. The business was carried on by the remaining two partners, who were willing to continue the claimant's employment on the same terms, but he refused. The court decided that, although the dissolution of the partnership operated as a wrongful dismissal of the claimant and therefore constituted a breach of contract, it would have been reasonable for him to have accepted the offer of continued employment. Accordingly, he was entitled only to nominal or token damages.

Summary

The following issues were dealt with in this chapter:

1. The principles relating to frustration of contract.
2. The distinction between frustration and *force majeure*.
3. The remedies for breach of contract, including specific performance, rescission, and liquidated and unliquidated damages.

Notes

1 *Condor* v *The Barron Knights Ltd* [1966] 1 WLR 87.
2 *Bailey* v *De Crespigny* [1869] LR 4 QB 180.
3 *Walton Harvey Ltd* v *Walker & Homfrays Ltd* [1931] 1 Ch 274.
4 *Fibrosa Spolka Ackcyjna* v *Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32.
5 *Tayler* v *Caldwell* [1863] 3 B & S 826.
6 *Krell* v *Henry* [1903] 2 KB 740.
7 *Herne Bay Steam Boat Co* v *Hutton* [1903] 2 KB 683.
8 Lord Radcliffe, in *Davis Contractors Ltd* v *Fareham UDC* [1956] AC 696.
9 *Tsakiroglou & Co Ltd* v *Noblee Thorl GmbH* [1962] AC 93.

10 *Mineral Park Land Co* v *Howard* [1916] 156 P 458 (Cal).
11 Cass civ 14.4.1972.
12 OLG Bremen, NLJ 1953, 1393.
13 BGH2, 188.
14 *Ford Motor Company Ltd* v *Armstrong* [1915] 31 TLR 267.
15 At the time restrictions of this kind were permissible. Under present-day competition law they would probably be declared void.
16 *Dunlop Pneumatic Tyre Co* v *New Garage & Motor Company Ltd* [1915] AC 79.
17 *Cellulose Acetate Silk Co Ltd* v *Widnes Foundry Ltd* [1933] AC 20.
18 *Hadley* v *Baxendale* [1854] 9 Ex 341.
19 *Victoria Laundry (Windsor) Ltd* v *Newman Industries Ltd* [1949] 2 KB 528.
20 *Brace* v *Calder* [1895] 2 QB 253.

CHAPTER 5

Legal forms of business organisation

Introduction

Regardless of its nature and where it is conducted, a business has to be structured within a defined legal framework. In every jurisdiction, the law provides a number of options from which to choose. The proprietors of the business will select the form best suited to their particular needs. These may relate to issues such as limitation of liability, flexibility of management structures, privacy of financial data, taxation, and sources of finance. As the structures available are creatures of the law, they will be regulated by the detailed rules of the particular country involved. While no two countries' laws will be the same, at a general level it is possible to identify forms of business organisation in most jurisdictions that possess broadly similar characteristics. In this chapter, examples are taken from the UK, the USA, France and Germany. The main issues which will be examined relate to

formation, liability of members of the organisation, management and control, and liability of those entrusted with the management of the business towards investors and outside creditors.

A person wishing to set up a business must select from the options available a legal structure to act as a vehicle for the conduct of the business. In some jurisdictions the menu of choice might be more extensive than in others; however, the laws of most countries recognise forms of business organisation, which can broadly be categorised as follows:

1 the sole proprietorship;
2 partnerships of one form or another;
3 various types of company with limited liability.

As regards the terminology used in connection with the above, it should be noted that in civil law countries the term 'company' tends to be employed for both partnerships and limited companies. In the case of French law, for example, the term '*société*' is used in connection with both the *société en nom collectif* (the general partnership) and the *société a responsibilitée limitée* (the limited liability company). Similarly, the German term '*Gesellschaft*' is used for both an *Aktiengesellschaft* (public limited company) and *Kommanditgesellschaft* (limited partnership). In common law jurisdictions, however, the terminology remains distinct, with the term 'company' usually being reserved for an organisation having a separate legal identity from its members, two examples being the *public limited company* and the *private company*. Civil law also often classifies business organisations as 'civil' or 'commercial', the former being regulated primarily by the provisions of the civil code, while the latter are subject to the stricter regime contained in the commercial code and/or specific legislation. As most business activities will operate through commercial structures of one sort or another, for the purposes of this chapter, business organisations discussed in the context of civil law jurisdictions will be assumed to be commercial.

The sole proprietorship

The sole proprietorship and its equivalent under French law (*enterprise individuelle*) and German law (*einzelunternehmer*) is the simplest form of business organisation. The formalities

governing the establishment of a sole proprietorship are generally less onerous than for other types of organisation. In fact, English law imposes no formalities as such. A person who wishes to conduct his or her business in this way can start trading immediately. One requirement, however, concerns the use of business names. If a person carries on a business under a name which is not his or her own name, the provisions of the Business Names Act 1985 will have to be complied with. So, for example, if Fiona White adopts the name 'The Flower Basket' for her florist business, she will have to ensure that her own name appears on documentation such as her business letters, invoices, orders for goods and services, etc.

In civil law jurisdictions, however, it is likely that certain formalities will have to be satisfied before a sole proprietor can start business. One likely requirement will involve certain basic information relating to the business, including the name under which it is to operate, being recorded on the commercial register. Until this procedure has been complied with and other necessary documentation obtained, full legal status will not be afforded to the sole proprietor and his or her business.

While the relative simplicity of formation makes the sole proprietorship an attractive vehicle for the single individual wishing to carry on a small business, the downside is the unlimited personal liability that comes with it. This is because there is no separation between the identity of the business and that of the proprietor. The proprietor is in effect trading on his or her own account and will, accordingly, be fully liable on contracts and other legal obligations undertaken on behalf of the business.

The general partnership

The general partnership is recognised in both common law and civil law jurisdictions. This form of organisation involves two or more persons jointly pursuing a business purpose and agreeing to share both profits and losses. The partnership has certain advantages over other types of business organisation. For instance, as it is based on a contract, the

partners are generally free to determine for themselves exactly how the business should be run, rather than having to operate within the statutory framework applicable in the case of some other forms of organisation. Additionally, the formalities involved in creating and running a partnership are often less burdensome than those that would apply in the case of, say, a limited liability company. Financial information relating to the business generally remains private and, in many jurisdictions, operating as a partnership may have personal tax advantages for the partners. In the case of English and American law, for example, the profits of the business are taxed only once, whereas in the case of an incorporated company, for instance, they are taxed twice, once at the corporate level and again when distributed to the shareholders as dividends.

The general partnership can have disadvantages too, the principal one being the unlimited liability of the partners for the debts and other legal obligations of the business.

Under English and American law

A general partnership is the relationship which exists between persons carrying on business with a view to profit. Unlike companies, partnerships do not require any special formalities in order to be created. All that is needed is a partnership agreement, which can be expressed or implied. Hence, partnerships can be created orally or, as is usual, by writing or even by conduct. An example of when conduct could demonstrate the existence of a partnership would be where, say, X and Y agree to purchase a quantity of goods from the liquidator of a bankrupt business, sell the goods and divide the profits between themselves. The fact that they both contribute towards the cost of the project, jointly manage the sale and agree to divide the profits would probably indicate a partnership. The fact that it was a business venture limited to one project would be irrelevant.

From a practical point of view, a written partnership agreement is usually advisable. At least this ensures that the partners understand the precise nature of their relationship from the outset. The partners are free to structure the agreement in

any way they wish, but typically an agreement would include the following:

- the partnership name;
- a description of the partnership business;
- the names of the partners;
- the capital to be contributed by each partner;
- a statement as to how the profits are to be divided and losses shared;
- a provision covering the payment of salaries, interest on any loan granted by a partner to the business, drawings, etc.;
- how the business is to be managed;
- a statement of the general power of individual partners and any limitation on their authority to act on behalf of the partnership;
- admission of new partners and the retirement of existing partners;
- the duration of the partnership.

In the absence of express agreement, legislation in the form of the Partnership Act 1890 (UK) and the Uniform Partnership Act (USA) provides default rules which define the essential elements of the relationship between the partners. For example, in the absence of contrary agreement, profits and losses are shared equally between the partners and all partners are entitled to participate in the management of the business on an equal footing.

A partnership under American law is a separate entity from the partners, but not so under English law. Under both systems, however, each partner is fully liable for the partnership debts and other obligations arising through the conduct of the business. Therefore, a creditor whose debt is left unsatisfied even after the realisation of the partnership assets can proceed against the partners personally and, if necessary, make each of them bankrupt.

In the eyes of the law, every partner is the agent of his or her fellow partners. The consequence of this is that a partner acting within the scope of his or her authority can bind the entire partnership. If a partner exceeds the *actual* authority that he or she has been given under the partnership

agreement, the remaining partners will, nevertheless, still be bound if the act in question comes within the partner's *ostensible* authority. Ostensible authority is the kind of authority that a person dealing with the particular business involved would assume a partner to have. For example, suppose that A, B and C are partners in a transport business and the partnership agreement stipulates that any decision to acquire new vehicles for the business requires the unanimous agreement of all three partners. If, despite this restriction, B concludes a contract with X to purchase an additional lorry for the business, A and C will, in addition to B, also be liable on the contract unless it can be shown that X knew or had reason to believe that B was acting without authority. A and C's only recourse would be to pursue B for breaching the partnership agreement. As each partner has the ability to saddle his or her fellow partners with extensive liability, even when acting contrary to the agreement existing between them, it is vital that the partnership relationship is based on trust and confidence. The moral is therefore that you should not enter into a partnership with someone from whom you would not buy a second-hand car!

Under French law – the *société en nom collectif*

As mentioned in the introduction to this chapter, under French law, the term *société* includes both companies and partnerships, and basically the same formation procedure applies to both. For this reason, forming a general partnership (SNC) in France is a more involved and lengthy process than is the case in the UK or USA. Broadly, the following steps will have to be taken:

1. Preparation of the articles of association. The articles may contain any provisions the partners wish but, at the very least, must contain clauses specifying the name, duration, registered office, purpose of the business and the registered capital.
2. Signature of the articles.
3. Payment of a registration fee and stamping of the documents.

4 Publication of a notice in a legal gazette informing the public of the formation of the SNC.
5 Deposit with the clerk of the commercial court office of the articles and other specified documentation.

The SNC, like other *sociétés*, is a separate legal entity from its members. This said, however, all the members are fully liable for the debts of the business. Like its English and American counterparts, the SNC is based on agreement between the members and, accordingly, they have a large measure of freedom in the way they structure their relationship.

Under German law – the *Offene Handelsgesellschaft* (OHG)

The commercial code provides that an OHG is a partnership of two or more persons established under a firm name for the purposes of running a commercial business and in which all partners have unlimited liability. The relationship between the partners is governed by the partnership agreement, a copy of which must be registered in the commercial register. Although an OHG is not a legal entity, it can nevertheless, under its firm name, acquire rights, incur liabilities, sue and be sued.

All partners can take part in management and conclude contracts on behalf of the business. Any limitation on the authority of an individual partner will not affect a third party acting in good faith unless it is recorded in the commercial register.

Partnerships where some or all of the partners' liability is limited

Although the general partnership gives the partners freedom to organise the running of the business in any way they see fit, it comes with the price tag of unlimited liability. This can be a daunting prospect, even in the case of a small business where the partners know and, hopefully, have confidence in each other. However, there are situations where, because of the size of the business and the number of partners involved, such

intimacy is lacking. By way of example, take a large professional firm of, say, lawyers or accountants. It is not unusual for such businesses to have tens if not hundreds of partners. In such an organisation the bond which should underpin the relationship between partners is clearly lacking. It is highly likely that an individual partner will never have met a significant number of his fellow partners, let alone worked alongside them. Nevertheless, the spectre of unlimited liability is ever present. Given that the negligence of one partner – for instance, in giving advice to a client in respect of a major corporate acquisition – could incur liability for the firm on an unimaginable scale, the risk exposure which this presents for individual partners might be unacceptable.

In most countries, an alternative form of partnership is available in which a number or, in some cases, all of the partners can enjoy limited liability. However, whether a structure such as this is an appropriate vehicle for addressing the problem just described will depend on the precise legal attributes given to it in the jurisdiction concerned.

Under English and American law

In both the UK and the USA, a limited partnership (LP) can be formed. However, unlike the general partnership, the LP in both countries requires registering with the appropriate government authority. An LP must have at least one general partner whose liability is unlimited. The liability of the remaining partners can be limited to the amount of their contribution to the partnership assets. The limited partners must take no role in the management of the business, this being left to the general partner(s). If a limited partner does participate in management, he will become fully liable as a general partner.

In the USA, an LP can be used for most types of business, the exceptions being banking, insurance and the majority of professional partnerships, such as lawyers and accountants. In the UK, the LP has never gained popularity and is not a commonly used form of business organisation.

A newer form of partnership recognised in both the USA and UK is the limited liability partnership (LLP). In the UK,

the Limited Liability Partnership Act 2000 was enacted largely as a result of pressure from the large accountancy practices, a number of which had faced substantial damages claims over allegedly negligent advice. Although requiring registration as a separate entity, the LLP is like a general partnership except that an individual partner's liability for another partner's acts is limited to the amount of their contribution. The extent to which a partner's liability is limited differs between UK and USA LLPs. In the case of a UK LLP, each partner acts as the agent of the LLP and not of his co-partners. While an individual partner will still be liable to third parties for the consequences of his or her own negligence, the other partners will not. In the USA, the individual partner is fully liable for the consequences of his own actions, whether this arises from contract or negligence. In most states, the remaining partners will escape liability. However, under the law of a sizeable minority of states, it is only against claims arising through the negligent actions of a fellow partner that others are protected; all partners remain fully liable for claims arising out of contract.

Under French law – the *société en commandite simple* (SCS)

The SCS is used comparatively rarely. Like the English and American model, the general partner(s) has/have unlimited liability while the limited partners enjoy limited liability. The limited partners, however, may not participate in management.

Under German law – the *Kommanditgesellschaft* (KG)

Unlike in the UK, the USA and France, the limited partnership is a popular form of business organisation for small and medium-sized businesses in Germany. There must be at least one general partner and one limited partner. A KG must be registered with the commercial register, the registration application containing the name of the partnership, the details of those who are limited partners and the amount contributed by the partners.

Management is conducted by the general partner. The limited partners are usually excluded from the management of the business and have no power to represent the partnership unless this is agreed and registered in the commercial register. Even where the limited partners do have authority to represent the business, this doesn't remove their limited liability.

A hybrid form of the KG also widely used in Germany is the *GmbH & Co. KG*. In this form of organisation the general partner is a limited liability company (GmbH). Very often the limited partners will also be shareholders in the GmbH. Apart from providing the individual investors with limited liability, a principal reason for establishing a GmbH & Co. KG at one time were the tax advantages that could be gained. These have now largely disappeared but, nevertheless, the GmbH & Co. KG still remains a popular choice.

The company with limited liability

In most jurisdictions, the most widely used form of business organisation is a company with limited liability. As will be explained, there are various types of limited company but they all have two central features in common. Firstly, a company, in the eyes of the law, has a legal personality distinct from that of the human members who control and administer it. The consequence of this is that a company:

1. has rights and obligations under the law;
2. has contractual capacity and can make contracts on its own behalf;
3. can own property in its own right;
4. can sue and be sued in its own name.

The second principal feature of the limited company is the fact that the personal liability of its members is limited to the amount they have invested. So, if the assets of the company are insufficient to meet its liabilities, individual members who have paid for their shares in full will face no further liability.

Under English law

A famous case[1] which was decided by the House of Lords in 1897 graphically illustrated the advantages to be gained through trading as a limited company. A Mr Salomon decided to form a company through which to conduct his leather boot business. He had previously run his business as a sole trader but sought to take advantage of a statute enacted over thirty years previously, which allowed any trader to form a company provided certain stipulated requirements were satisfied. The company which was created was called Salomon & Co. Ltd. Salomon had sold his business to the company for £39 000, payment being made in the form of 20 000 £1 shares and £9000 in cash. The remaining £10 000 took the form of a loan by Salomon to the company but secured on the company's assets. Such an arrangement is called a debenture.

Under the legislation governing the formation of companies at that time, a company had to have seven shareholders. Accordingly, six other people were allocated one share each. Despite the multiplicity of shareholders, it does not take advanced arithmetical skills to be able to see where power and control lay. Of the 20 006 issued shares, Salomon held 20 000. Salomon & Co. Ltd was, in effect, a 'one-man company'.

The company traded on for some time but financial difficulties began to mount. In order to raise more money for the business, Salomon sold his debenture to a person called Broderip for £5000, which he then loaned to the company. Despite the fresh injection of cash, the fortunes of Salomon & Co. Ltd did not improve. The company defaulted on the interest payments due to Broderip who, as result, proceeded to enforce his rights under the debenture. As a secured creditor Broderip had a preferential claim to the assets of the company covered by the security. After repayment of the monies due to Broderip, there was nothing left for the unsecured creditors. So incensed were they that, through the liquidator, they brought an action against Salomon. It was at this time that the relationship between Salomon and his company came under scrutiny. The liquidator's main thrust was to attack both the validity of the sale of the business by Salomon to his company

and the subsequent issue of the debenture to him. The lower courts decided that, because of Salomon's total control of Salomon & Co. Ltd, he and the company should be treated as the same person. In these circumstances, the company had a right of indemnity against Salomon for all its debts. Salomon appealed to the House of Lords. This court rejected the view that he should be identified with the company. Salomon & Co. Ltd had been properly constituted according to the requirements of the Companies Act 1862 and as a result:

1 Salomon and the company, in the eyes of the law, were separate persons. As such there was no reason why they could not contract with each other. Accordingly, the sale of the business by Salomon to the company was perfectly valid, as was the debenture which had been issued to him in respect of the loan.
2 The separate legal identity of Salomon & Co. Ltd meant that the debts of the company were its responsibility and not Salomon's. Accordingly, Salomon was not liable to the unsecured creditors.

The significance of the House of Lords' decision was certainly not lost on the business community and its legal advisers. It was clear that budding entrepreneurs wishing to set up a business could, by trading through a limited company, distance themselves from the risks involved, thereby protecting their personal assets. In the years following the decision in Salomon's case, limited liability companies began springing up in the commercial landscape like mushrooms in an early morning meadow.

The principle that a company must be viewed as a distinct entity from its shareholders is known as the 'veil of incorporation', which operates to shield the shareholders from the legal consequences of the company's actions. There are, however, situations where practical reality might reduce the perceived advantages of this. For example, if a bank is asked to provide a small company with a loan, the directors and shareholders, who are likely to be the same people, will invariably be asked to enter into personal guarantees. If the company defaults on the loan, the bank will be able to proceed against the individuals concerned, despite their identity being distinct from that

of the company. There are also situations where the court is prepared to 'lift the veil' so as to go behind the corporate personality in order to discover who were the individual members responsible for a particular act. For example, the law will not allow a person to evade his or her legal obligations by sheltering behind a company. In one case,[2] a Mr Horne was employed by a company called Gilford Motors. His contract of employment contained a clause prohibiting him from soliciting Gilford Motors' customers after he had ceased to work for the company. Horne left his job and started a business in competition with Gilford Motors. No doubt he thought he was being very clever because the business was operated by a company set up in his wife's name. Through this company he approached directly the customers of his former employer. Gilford Motors successfully applied for a court order against both Horne and the company preventing him from continuing to do this. In the court's opinion, the company was merely a 'sham' to enable Horne to evade his contractual obligations. A similar view was taken in another case[3] where the defendant had contracted to sell a piece of land to the claimant but later changed his mind. In order to avoid having to go through with the sale, he set up a company of which he was the principal shareholder and director and transferred the land to it. The court would have none of it and ordered the defendant and his company to complete the sale to the claimant.

In some situations statute intervenes to lift the veil of incorporation. An example can be found in s.349 of the Companies Act 1985, which provides that a company must clearly display its name on all bills of exchange, promissory notes, cheques and orders for goods or money professing to be signed for and on behalf of a company. If this requirement is not met and the company defaults, the signatory will be personally liable. Even minor irregularities can have this effect. In one case, a company secretary accepted a bill of exchange drawn on his company. When inserting the company's name on the bill, he inadvertently omitted the word 'limited'. Had he done so, he would have saved himself a significant amount of money. In the event, the company defaulted on the bill and the secretary was held personally liable for the amount due. Despite the apparent harshness of the principle, the rationale behind it is

clear. A person is entitled to know what kind of organisation he or she is dealing with. The word 'limited' is meant to act as a warning that if the company defaults, the only recourse will be against the company itself and its assets. If the warning sign is omitted, the assumption might be drawn that an organisation with unlimited liability is involved, such as a partnership. The misled party might not have dealt with the company if the true state of affairs had been known.

Under the provisions of the Insolvency Act 1986, there are situations where personal liability can be imposed on individuals in the event of a company becoming insolvent and having to be wound up. Two examples are *fraudulent trading* (s.213) and *wrongful trading* (s.214).

If the liquidator thinks that the business has been carried on with the intent to defraud the creditors of the company, he can seek a court order against the individuals involved, requiring them to contribute to the company's assets. Although the likely targets for such action will be the directors, where the circumstances permit there is no reason why shareholders and even employees could not be pursued. The problem for the liquidator, however, is proving fraud, which is no easy task. The essential element is dishonesty. If it could be proved that the directors allowed the company to continue incurring debt when they knew full well that the creditors would never be repaid, fraud would be established. However, if the decision to carry on trading was based on an assumption that the company's financial woes were temporary and better times were just round the corner, an allegation of fraud may be more difficult to substantiate. As one judge[4] has said, fraud involves 'real moral blame' and even if a person of minimal commercial competence would have realised that the company was doomed, the decision to soldier on might, in fact, be the result of misplaced optimism or simply ineptitude, neither of which, alone, amounts to dishonesty.

Suing the directors for fraudulent trading has its risks. If the liquidator is unsuccessful, the defendant might very well be entitled to recover his or her legal costs, which could be substantial. As these will have to be paid out of the company's assets, the funds available to the creditors will be reduced further. The prospect of failure may therefore act to deter a

liquidator from launching a case unless success is almost a racing certainty.

If, in any given case, evidence of fraud is thin on the ground, a better option may be for the liquidator to bring an action against the directors for *wrongful trading*. Dishonesty does not have to be established in order for such a claim to be successful. If the liquidator can prove that, at some time before the commencement of the winding up of the company, a director knew or ought to have known that there was no reasonable prospect of avoiding insolvent liquidation, the director concerned can be ordered to make such contribution to the company's assets as the court thinks proper. Whereas a finding of managerial incompetence might negate an allegation of fraud, it will not avail a director accused of wrongful trading. This is because the defendant's actions will be judged against the standard of a reasonably diligent person having the general knowledge, skill and experience that could reasonably be expected of someone carrying out the same functions as the defendant. So despite the fact that a director might have been genuinely unaware of impending financial disaster, he or she will not avoid liability if a reasonably competent person, occupying the same position in the company as the director, would have come to the conclusion that the game was up and that the ship was about to hit the rocks. The one saving grace is that if the defendant can show that he or she took every step that ought to have been taken to minimise the potential loss to the creditors a liquidation would cause, liability will be avoided. This assumes that the director knew that the company was heading towards an insolvent liquidation in the first place and, secondly, that whatever action was, in fact, taken would be judged appropriate according to the standard of the hypothetical reasonably competent person mentioned above. The message for anyone holding the position of a company director should be, therefore, that if the financial storm clouds start gathering serious consideration should be given to how to proceed. From this moment on the risk of personal liability will begin to loom. Seeking appropriate professional advice from the company's accountants, lawyers and bankers would seem to be a must. A director who is concerned about the company's future would be well advised to have those

concerns recorded in the minutes of board meetings together with any action proposed. If it can be shown that there was active engagement of the company's professional advisers and that subsequent decisions were taken on the basis of the advice received, there is a good chance that the director concerned will avoid having to contribute to the company's assets.

English law recognises two types of limited company, namely the public company and the private company. In both cases, the company is formed by registration with the Registrar of Companies. Under English law there is no concept of the notarial deed or pre-company structure that exists in many civil law countries. Basically the founders of the company must send to the registrar certain documents, including the articles and memorandum of association (the company's constitution), a statement of the names of the first directors and that of the company secretary, and a statement of how the capital of the company is constituted. If the appropriate fee is paid and the documents are in order, a certificate of incorporation will be issued which, in effect, is the company's birth certificate.

Unless a company is registered as a public company, it will be classified as a private company. The constitution of the company must state it is a public company and certain minimum capital requirements will have to be satisfied. In the case of a private company, there is no minimum share capital required before a certificate of incorporation will be issued. However, a public company will only be registered as such if the share capital stated in its constitution (the authorised capital) has a nominal (face) value of at least £50 000. Further, the company will not be allowed to start trading until the registrar has granted it a trading certificate and this will not be forthcoming unless the company has actually issued to its members shares having a nominal value of £50 000 and has received at least a quarter of this. If the company starts trading without a trading certificate, the directors will be personally liable for the debts of the company which remain unpaid. A private company, on the other hand, can start trading immediately on registration. A public company must have at least

two members and two directors, whereas a private company need have only one of each, who can be the same person. The name of a public company must end in 'public limited company' or 'plc'. In the case of a private company the name must end with 'limited' or 'Ltd'.

Private companies are generally less strictly regulated than public companies. As a result, for the small or medium-sized business the private company is the obvious choice. By unanimous resolution, the members can elect to opt out of some of the regulations which apply to companies generally – for example, the need to have an annual general meeting, the requirement for the directors to lay accounts before a general meeting, and the annual appointment of auditors. In addition, the financial reporting requirements are less onerous than in a public company. For small and medium-sized private companies, significantly less detail is required when filing accounts with the registrar of companies.

As private companies are often used for family and other businesses where the relationship between the members is akin to a partnership, the constitution of such companies frequently imposes restrictions on the transferability of the shares. Typically these will involve pre-emption clauses, requiring any member who is contemplating transferring his or her shares to an outsider to notify the company of this intention. These shares will then have to be offered to the other members, who will have first refusal. If there are no takers, the shares can be transferred to the third party. However, there may be a provision in the constitution which states that, in the event of the shares not been taken up by existing members, the company itself will acquire them.

A disadvantage of a private company is that its potential sources of finance are more restricted than those of a public company. For example, a private company is prohibited from inviting the public to subscribe for shares or other securities issued by it. Most public companies have started life as private companies and at some stage in their development have converted to a public company in order to gain access to the capital markets and the finance raising opportunities which they provide.

Under French law

It will be recalled that the term *société* applies to both partnerships and companies, and that the formation procedure for both is basically the same, namely:

1. preparation of the articles of association;
2. signature of the articles;
3. payment of the registration fee;
4. publication of the appropriate notices in a legal gazette;
5. deposit with the commercial court of the articles and other specified documents.

The two principal forms of limited liability company that can be formed under French law are the *société à responsibilité limitée* (SARL) and the *société anonyme* (SA), the former having broadly similar characteristics to an English private limited company and the latter to the public limited company. In both a SARL and an SA, the liability of the members is limited to the amount of their investment.

A SARL can be formed to carry on most commercial activities. It must have a minimum capital of at least €7500. The SARL is the only French company which can be formed with one member; the maximum number, however, is limited to fifty. As with an English private limited company, there are often restrictions on the transferability of shares in a SARL.

An SA is more appropriate for the larger enterprise. It must have at least seven members, but no maximum limit is imposed. The minimum initial share capital must be €37 000, of which at least 50 per cent must have been received. If the company intends making a public offering of its shares, the minimum capital is €222 000. There are no restrictions on the transferability of the shares in an SA.

Under German law

The two forms of limited company which can be formed under German law, broadly equating with the English private limited company and public limited company, are the *Gesesellschaft mit beschränkter Haftung* (GmbH) and the *Aktiengesellschaft* (AG).

The GmbH is the most popular form of business organisation for small and medium-sized enterprises. The articles of association must be drawn up in the form of a notarial deed and signed by the members or, if only one, the single member. The articles must contain certain information, including the name, domicile and purpose of the company, capital contributions of the member(s), and details of the directors. The minimum initial capital required for registration is €25 000, of which at least 25 per cent must have been paid. In the case of a single-member company, the member must also provide a security bond for the unpaid balance of the capital. Provided that the documentation is in order, the GmbH will be registered in the commercial register. It is only at this time that it acquires legal personality. Any person acting on behalf of the GmbH before registration will be personally liable for any legal obligations incurred. Any such obligations will be assumed by the GmbH once it is registered.

The regulatory framework governing AGs is far more detailed and complex than that applying to GmbHs and, for this reason, the AG is more appropriate for the larger business. An extremely complicated formation procedure is required, which commences with at least five founders who are to take up shares drawing up the articles of association in notarial form. The information that this document must contain includes the name of the company, the company seat, the purpose of the business and details of the basic capital, which must have a face value of at least €50 000. Once the articles have been executed, the founders will appoint the auditors of the future company for the first tax year. As will be explained later in this chapter, an AG has a two-tier board structure consisting of the supervisory board and the management board. At this stage in the company's formation, the founders will also appoint the initial supervisory board, which in turn will appoint the management board. The founders must then draw up a report covering the entire formation process. In addition, members of both boards of directors must carry out an examination in order to verify that the correct formation procedures have been observed. After this has been completed, an application can be made for the company's registration in the commercial register. A court official

will be appointed to ensure that all legal requirements have been satisfied and, this being the case, the company will then receive its registration. As with a GmbH, it is from this point in time that an AG acquires legal personality and anyone who acts on behalf of the company before this stage is reached will incur personal liability.

Groups of companies

The two characteristics shared by all the forms of limited company just described are separate corporate personality and limited liability for shareholders. The combined effect of these features makes the limited company an attractive proposition for those who wish to carry on a business yet minimise their own personal risk. In fact, it could be argued that encouraging entrepreneurship while limiting the commercial risks of those involved is one, if not *the*, policy behind the principle of incorporation. Earlier in this chapter, reference was made to the English case of Salomon v Salomon & Co. Ltd. It will be recalled that the company was held to be a separate legal entity from Salomon, even though he exercised total control over it. The House of Lords' decision spelt out in graphic form the benefits of incorporation, which were then seized by the business community with both hands. The result was an explosion in the number of limited liability companies being registered to the point where, today, the limited company is by far the most popular form of business organisation in the UK. The basic logic enshrined in Salomon's case also underpins the approach of the courts in many other common law and civil law jurisdictions towards the significance of incorporation, the result being that the limited liability company's popularity is reflected the world over.

As has been emphasised, a company has legal personality and as a consequence of this has the right to conclude contracts and own property in its own name. Accordingly, a company can own shares in another company and, depending on the number of shares held, can control that company. In such a situation, the 'parent company/subsidiary relationship' is said to exist. Although a corporate shareholder, the parent

company is nevertheless entitled to the rights attaching to the shares it owns by virtue of either the company's constitution or the general law. If the average person was asked to explain what Toyota or Honda does, in each case a probable reply would be along the lines of 'it's a company which makes cars' or words to that effect. As a description of the type of business carried on under these names, such a response is, of course, correct. However, it misses an essential point. Neither the Toyota nor Honda businesses are conducted through a single company. In each case, significant aspects of the business, such as research and development, manufacturing, distribution, and property management, are likely to be operated through companies which are separate but controlled by the Toyota or Honda parent. In addition, the international dimension of each business will involve companies incorporated in different countries, but subject to varying degrees of control from the 'home base'.

By forming a number of subsidiary companies, a parent company can organise the operation of its business in a way that reflects its strategic management objectives and, further, minimises the risk to its core assets. Other businesses can be developed or acquired by adding other members to the corporate family. Corporate groups, formed by a number of interrelated companies, are a common feature of the economic environment. While the architects of the original laws allowing for the creation of limited companies may have had the likes of Mr Salomon in mind, they might have been surprised to know that the basic idea they were promoting would be a principal factor underlying the structural sophistication of many present-day business enterprises.

One issue arising out of the parent/subsidiary relationship concerns the rights of creditors who have dealt with a subsidiary company which then becomes insolvent. Not unreasonably, the creditors might look to the parent company or even other subsidiaries within the group for payment of their debts. However, they face a fundamental problem, as Figure 5.1 shows.

The problem faced by the creditors of an insolvent subsidiary is that, in the eyes of the law, the subsidiary is a separate entity from the parent company which controls it. Accordingly, the creditors can look only to the assets of the company they

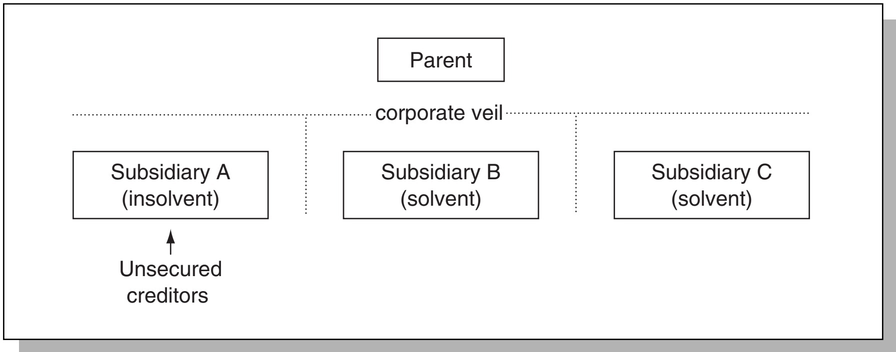


Figure 5.1
The parent/subsidiary relationship.

dealt with, those of the parent company being protected by virtue of its limited liability. A claim against the other subsidiaries would seem even less legally justified because, apart from being members of the same group, there is no direct relationship between the insolvent company and its solvent fellow subsidiaries.

While the corporate group is a phenomenon recognised in all jurisdictions, few legal systems have evolved a regulatory framework specifically targeted at this form of organisational structure. However, long ago, Germany recognised that a parent company may have a higher regard for the interests of the group as a whole than for the separate interests of its individual members. The pursuit of corporate objectives could therefore often seriously disadvantage minority shareholders in a subsidiary company and also its creditors. German law adopts an 'enterprise' approach to corporate groups. While recognising the parent company's right to manage the overall corporate interests of the group, the law also seeks to protect other interests, particularly those of minority shareholders and creditors of its subsidiaries. Although the statutory framework regulating corporate groups applies principally to public companies (AGs), many of the principles embodied in the regulations have been extended by the courts to groups of private companies (GmbHs). The rules, which apply to a variety of corporate structures, are extremely complex but their overall aim is relatively simple – to promote a fair balance between the

interests of the group as a whole and those of its constituent members. For example, if a parent company causes its subsidiary to enter into a transaction disadvantageous to it, the parent must compensate the subsidiary. If this does not happen, the subsidiary can sue its parent for any loss resulting from the transaction. The claim can be brought on behalf of the subsidiary by the shareholders and creditors. Where a parent company has 100 per cent control of its subsidiary by virtue of shares held, the parent company is liable for all the debts of the subsidiary. In such a case, the veil of incorporation is clearly torn apart.

In other jurisdictions, holding a parent liable for the debts of its subsidiary is the exception rather than the rule and the circumstances where it will arise are difficult to predict. In France, for instance, the parent runs the risk of being held liable where the subsidiary is merely a 'façade'; there is a substantial commingling of the assets of the parent and subsidiary or where third parties have been presented with the impression of a single unit.

Despite attempts to introduce an *enterprise* approach to corporate groups into English law,[5] the courts are still firmly wedded to the principle that a parent and its subsidiaries are separate legal entities and that the liabilities of a subsidiary are its alone and not those of the parent. The 'entity' principle, as it is sometimes called, is the general rule in American law also. This said, however, there are instances where the court will be prepared to 'pierce the veil'. The situations where this will operate to impose liability on the parent are not defined, but factors such as the degree of control exercised by the parent over the subsidiary's day-to-day operations and how well the subsidiary is capitalised may well be relevant. The courts seem to take a different stance depending on whether a contractual or tort-based claim is involved. In the case of the latter – for instance, a claim against the parent in respect of injuries caused by a defective product manufactured by a subsidiary – the courts may be more willing to impose liability on the parent. However, in the absence of fraud or deception, it is unlikely that a parent will be responsible for the contractual liabilities of a subsidiary which is adequately capitalised and enjoys a substantial degree of autonomy.

Under Australian law, there are a number of mechanisms which have been developed for piercing the corporate veil. For example, the Corporations Act 2001 provides that a parent company shall be liable for the debts of an insolvent subsidiary where at the time a particular debt was incurred there were reasonable grounds for suspecting the subsidiary's insolvency and the parent or one or more of its directors knew of those grounds or, given the degree of control exercised by the parent, should have known of them.

While acknowledging the general principle of a parent company's limited liability, in many jurisdictions the degree of control exercised by the parent company might be considered a factor in determining whether, in reality, the parent is a director of its subsidiary. As will be explained in the next section, company directors owe various duties to their company and, in certain situations, to its creditors. Breach of these duties can lead to personal liability. Therefore, if a court views a parent company to be a director of its subsidiary because of the control exercised, the parent company could incur liability. This would not result from any general piercing of the corporate veil between the parent and the subsidiary, but from the status of a 'director' which the parent company may have in the circumstances of a particular case.

The management and control of limited companies

The partners of a general partnership or limited liability partnership are free to organise the management of the business in any way they wish. However, where the business is operated through a limited liability company, the management and control function must be accommodated within the framework prescribed by the governing legislation.

Although a limited company has legal personality, as an artificial entity, it must nevertheless operate through human agents. Although the terminology used to describe the persons fulfilling this role may differ from jurisdiction to jurisdiction, essentially they can be collectively referred to as the company's 'directors'. In all jurisdictions, the core role played by directors

in the management of a company is recognised. In their representative capacity, they can bind the company through the actions they take, which in turn has implications for shareholders, employees and creditors alike. They are also custodians of the company's assets, and as such must utilise those assets for proper corporate purposes and not in a way that conflicts with their own personal interests. The law must also ensure that control mechanisms are in place to ensure as far as possible that directors do not abuse their position to the detriment of the company' shareholders and other stakeholders. The legal framework defining the relationship between directors and the company, its shareholders and other potentially affected parties will be dictated by the law governing the company's incorporation. As is to be expected, no two legal systems will approach the issue in exactly the same way.

In most, if not all, civil law and common law jurisdictions, the management and control of limited companies is divided between the board of directors and the shareholders acting in general meeting. Except for matters specifically reserved for the general meeting by the governing legislation, the law leaves the distribution of powers between the directors and the general meeting to the company's constitution. As a rule, the directors are given wide powers to manage the business of the company, and although the shareholders generally have no direct control over how these powers are exercised, they retain ultimate control through their power to appoint and, in particular, dismiss the directors, the latter often being a right which cannot be removed by the company's constitution. However, if an individual director has a service contract with the company, unless the dismissal is for good cause, it will amount to a breach of contract for which the director will be entitled to be compensated. If the contract in question was for a fixed term, an early termination of this could involve the company having to pay substantial damages. Therefore, in some jurisdictions, in order to prevent directors effectively entrenching themselves by means of extended fixed-term contracts, it not unusual to find a limit being placed on the time for which a director can be appointed. In the case of a French public company, for example, a director cannot be appointed by the articles for more than three years or, if

appointed by the members, for more than six. In both cases, however, a director coming to the end of his or her term can be re-elected.

Directors act collectively as a board. However, authority to act on behalf of the company is usually delegated to individual board members. The most extensive executive authority will be delegated to a single director, known variously as the managing director, chief executive officer, president or similar title. In many cases, more restricted authority will be given to other individual members. These directors often have responsibility for specific corporate activities, such as marketing, finance, production, and human resources. In addition to the directors having executive powers, a board may well include other directors. These 'non-executives' will often be appointed because of the special skills, experience or contacts they can bring to the company. They also often carry out a supervisory role, operating as a check on the executive arm of the board.

In some jurisdictions, such as the UK and Australia, the concept of the 'shadow director' is recognised. This is someone who, although not officially appointed as a director, nevertheless acts in that capacity. A person, for whatever reason, may wish to remain in the background but still have a great influence on the decisions the board of appointed directors take. In such circumstances, he or she is likely to be regarded as a shadow director and will be subject to the same duties and obligations as any other director.

In France and Germany, the law recognises two structures for the management and control of limited companies – the unitary board structure and the two-tier system. While the latter is an optional form for French public companies, it is compulsory in Germany for public companies and also for private companies employing more than 500 people.

The unitary model consists of a single board of directors appointed by the shareholders and having overall responsibility for managing the company's business. The two-tier structure consists of a management board, which has broadly the same role and function as a unitary board, and a supervisory board. The latter, while not having management authority, exercises a supervisory and controlling function over the executive board. In the case of a German public company, the supervisory

board is appointed by the shareholders and the employees and, for companies employing more than 500 people, its membership must include employee representatives. The supervisory board appoints and dismisses the management board.

In the UK, the management and control structure is the same for both public and private companies. The structure is that of a unitary board and shareholders acting in general meeting.

Figures 5.2 and 5.3 illustrate the distinction between the unitary and two-tier structures.

If the company's constitution places restrictions on the directors' power to bind the company, as a general rule this will not affect third parties acting in good faith. However, directors who act without authority will be liable to the company for any loss caused as a result.

Directors owe strict duties to their company. They must exercise their powers in good faith and for the benefit of the company as a whole. In some jurisdictions, such as the UK, the 'company' essentially equates with the interests of the shareholders and the directors will be judged according to whether the promotion of these interests is the motivation behind their actions. In other countries, notably Germany, the directors must act not only in the interests of the shareholders, but in those of the employees as well. In carrying out their tasks, directors must not place themselves in a position where their

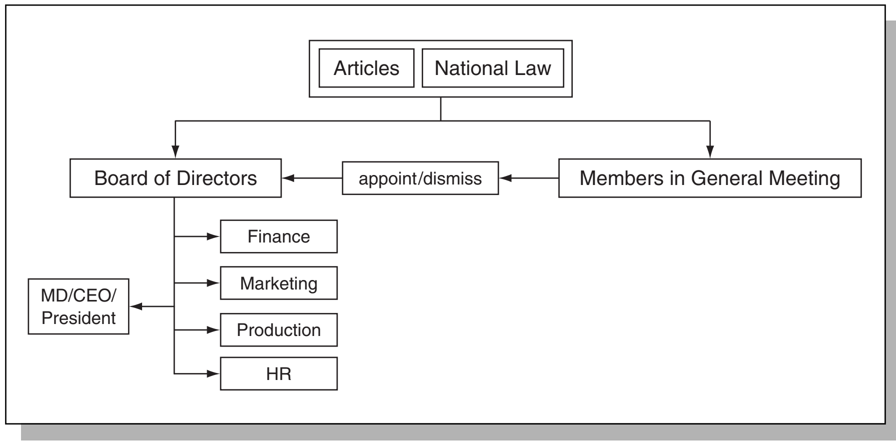


Figure 5.2
Unitary structure.

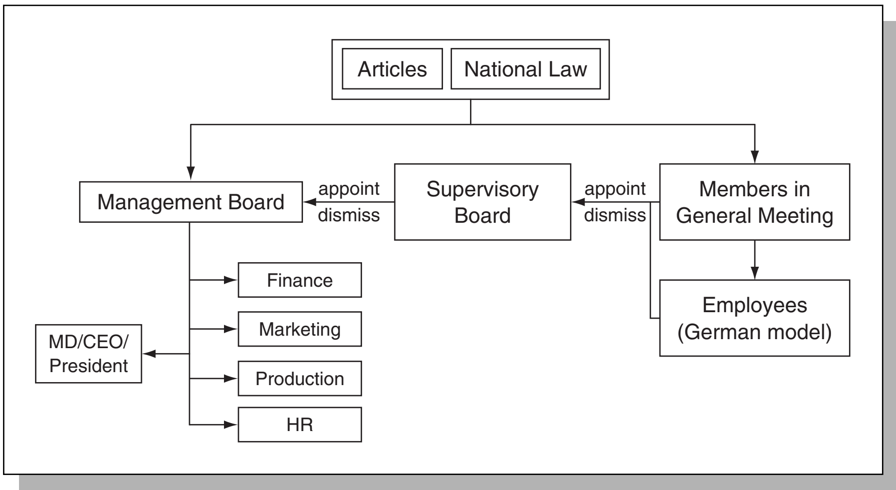


Figure 5.3
Two-tier structure.

own personal interests conflict with those of the company. If they make secret profits or exploit for personal gain commercial opportunities arising because of the position they hold in the company, they will be liable to account for any gain received. This rule can be applied very strictly. For example, in an English case,[6] the defendant was the managing director of a company which had been negotiating a contract to provide services to the gas board. The gas board then told the defendant that his company would not get the contract, but that if he left the company he would personally be contracted to provide the services. The defendant left his company, ostensibly on the grounds of ill-health, and started work for the gas board. Although the defendant's company would not itself have benefited from the contract with the gas board, the defendant had made a secret profit out of an opportunity which had only arisen by virtue of his connection with the company. Accordingly, he was in breach of his duties as a director and was liable to account for the profit he had made.

Directors must show reasonable skill and care in the performance of their duties. If they fail to do so they will have to compensate the company for any loss resulting. In some circumstances, they may be liable to the company's creditors. For example, under German law, a director who is guilty of

gross negligence will be liable to creditors who do not obtain satisfaction from the company. As was explained earlier in this chapter, in the UK a director of an insolvent company found to have traded wrongfully can be ordered to contribute towards the debts of the company.

Directors can also be under wide-ranging statutory duties. Depending on the jurisdiction, these might include, for example, restrictions on companies giving loans to directors, requiring directors to disclose any personal interest in company contracts and where a director contracts directly with the company, the necessity for obtaining prior approval from the shareholders. Directors will also often have to disclose details of any shares that they or members of their immediate family hold in the company and notify the company of any further acquisitions or disposals.

Summary

The following issues have been dealt with in this chapter:

1. The distinguishing features of the principal forms of business organisation.
2. The advantages and disadvantages of trading as a partnership.
3. How the 'corporate veil' protects the shareholders of a limited company.
4. Why the creditors of an insolvent subsidiary company are usually prevented from pursuing the parent company for payment of their debts.
5. The alternative legal structures available for the management and control of limited companies.
6. The circumstances where company directors can incur personal liability.

Notes

1 *Salomon* v *Salomon & Co Ltd* [1897] AC 22.
2 *Gilford Motors Ltd* v *Horne* [1933] Ch 935.
3 *Jones* v *Lipman* [1962] 1 WLR 832.

4 Judge Bromley QC, in Re a Company (No. 001418 of 1988 [1991] BCLC 197).

5 See, for example, *DHN Food Distributors Ltd* v *Tower Hamlets Borough Council* [1976] 3 All ER 462, where a parent and two wholly owned subsidiaries were regarded as a 'single enterprise'. However, the case involved the parent company's claim for compensation when its land was compulsorily purchased by Tower Hamlets BC and did not involve the issue of a parent company's liability towards creditors of the subsidiary. It should be noted that the court's approach in this case has not found favour in later cases.

6 *Industrial Developments Ltd* v *Cooley* [1972] 2 All ER 163.

CHAPTER 6

Legal aspects relating to the international marketing of goods and services

Introduction

As a business grows, those responsible for its management will look for new markets to enter. While opportunities in the home market may well present themselves, casting an eye beyond the horizon might reveal the existence of untapped or underexploited markets just waiting to be plundered. Dipping

a toe into the international marketplace might be a tempting option, but one which should be approached carefully. Lurking below the surface are dangers which could turn the expansion dream into a nightmare. Doing business in an international context raises legal issues which are quite different from those arising from purely domestic activity but which, nevertheless, will have to addressed by any company considering exporting its goods or services abroad. As has been emphasised in preceding chapters, different countries have different laws. This will be of little importance to a company whose business activities are confined to the domestic market, but should those activities be extended beyond the national border, the divergences which exist between legal systems can have a significant impact on the way the business should be conducted and, in consequence, the success or failure of the project involved.

This chapter considers some of the legal aspects of doing business abroad, including ways of establishing a presence in the export market, liability for product defects, rights attaching to intellectual property and the role played by competition law. In the following chapter, the export contract itself will be examined together with the associated financing arrangements.

Establishing a presence in the export market

A company wishing to export its products abroad will normally have to arrange some form of representation in the country concerned. Although directing operations from the home base is a possibility, lack of familiarity with the local market and the business culture operating there could present problems. It is probably wiser to involve someone who has local knowledge and contacts to approach and who also knows how to navigate through any regulatory red tape which may apply.

There are a number of options available to a business wishing to establish a presence in a foreign country, each having

advantages and disadvantages from a legal perspective. Among the range of possibilities are the following:

- appointing an agent to introduce and, depending on the circumstances, conclude contracts on behalf of the exporter;
- appointing a distributor for the territory concerned;
- opening a branch office or forming a subsidiary in the export territory;
- establishing a joint venture with a local partner;
- if the exporter has intellectual property rights, such as a patent or trade mark, licensing a person to exploit these in the export market;
- concluding a franchise agreement with a local company.

The principal features relating to the above arrangements will now be considered.

The appointment of a self-employed agent in the export territory

An agent in the legal sense is a person authorised by another person, the 'principal', to represent and act on behalf of that person and legally bind him or her in relation to third parties. As can be seen from Figure 6.1, the agency relationship involves three parties.

In the commercial world, the term 'agent' is sometimes used to refer to other types of relationship which do not, in fact, give rise to an agency in the sense described above. For example, if an Australian company is an appointed Peugeot 'agent' for Queensland, the Australian company will be a distributor for

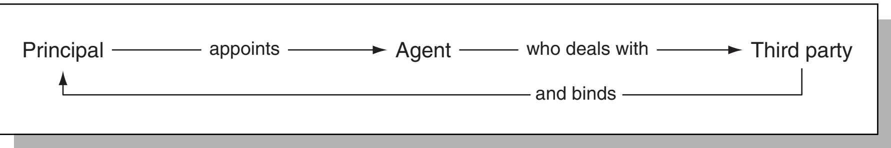


Figure 6.1
The agency relationship.

Peugeot, not its agent. A distributor is not an agent in the legal sense, because it does not act on behalf of the supplier. If this were the case, the supplier would enter into a direct contractual relationship with the end purchaser, which it does not. The distributor contracts to buy goods from the supplier which are then resold by the distributor on its own account and for its own profit.

As an agent can incur liabilities on behalf of the principal, the relationship has to be based on trust and confidence. Therefore, a company contemplating appointing an agent to represent it in the export market should first establish the reputation and financial standing of the person concerned by making detailed and extensive enquiries. The results of these should determine whether the proposed agent is a person in whom the exporter can place the necessary trust and confidence.

While the concept of agency is recognised in both common law and civil law jurisdictions, the legal features of the relationships involved, particularly those existing between the principal and the third party, are not always identical.

The ability of the agent to affect the legal position of the principal stems from the authority bestowed on him by the principal. Although the precise nature of this will depend on the terms of appointment, it is likely that the agent will have been engaged either to introduce potential customers to the principal, who will personally conclude any contract resulting; or, in addition to finding customers, make any necessary contracts with them on the principal's behalf.

A principal will be bound by the agent's actions provided the agent was acting within the scope of his authority at the time. However, an agent's authority can arise in different ways and can exist even though the principal has not expressly authorised the action in question. The agreement appointing the agent will spell out, probably in detail, the express or, to use technical terminology employed in common law jurisdictions, the *actual* authority granted by the principal. In addition to his actual authority, the agent will be cloaked with *implied* authority. This will include authority to carry out acts incidental to the execution of his actual authority and also those acts which, because of the custom of the particular market or

trade, an agent would normally have authority to undertake. However, in the latter case, the custom must be reasonable and not conflict with the terms of the agent's actual authority.

An agent who acts without actual or implied authority will, nevertheless, bind the principal if the act in question comes within his *apparent* authority. This is the authority which, from the third party's perspective, the agent appears to have. The appearance must have been created by the principal. This could occur because of the previous conduct of the principal. For example, if an agent appointed only to make introductions has on occasions concluded contracts with the third party which the principal has nevertheless honoured, the third party would be entitled to assume that future contracts made by the agent would be with the principal's authority. Apparent authority may also arise by virtue of the type of agent involved or the particular transaction for which he was appointed. For example, in an English case,[1] an agent was appointed to sell fertiliser. He warranted to a potential buyer that it contained 30 per cent phosphate of lime. The fertiliser supplied did not correspond with this assurance and so the buyer sued the principal for breach. It was proved that in the fertiliser trade it was normal to give a warranty of this nature. Accordingly, the principal was liable for its breach although he had not authorised the agent to enter into such an undertaking.

If an agent acts without authority of any kind, the principal will not be bound. However, in common law countries and some civil law jurisdictions, such as Germany, a principal can ratify an unauthorised act. The ratification relates back to the time of the act in question with the same consequences as if the agent had authority in the first place.

Clearly, if an agent discloses to the third party that he is acting in a representative capacity, although not necessarily naming the principal, any contract concluded is between the principal and third party provided that the agent was acting within the scope of his actual, implied or apparent authority. The agent will not be a party to the contract and, consequently, will acquire neither rights nor obligations under it. He may, however, be liable to the principal if he has disobeyed the instructions of the latter who, despite this fact, is nevertheless bound to the third party.

An agent is not obliged to disclose his representative capacity. It may be that for some reason the principal not only wishes to remain anonymous but also to keep his very existence secret. In such a case, the principal is said to be *undisclosed* and as far as the third party is concerned, he is contracting with the agent alone. In civil law countries, the contract will exist only between the agent and the third party, the position of the undisclosed principal not being recognised. However, in common law jurisdictions an undisclosed principal is a party to the contract and can, if necessary, sue the third party on it. Similarly, if the third party subsequently discovers the principal's existence, he can enforce the contract against either the agent or the principal.

In civil law jurisdictions, there exists a particular type of agent known as a 'commissionaire'. The commissionaire, although acting as an agent for his principal, contracts with the third party in his own name. Although the agent must account to his principal for any profit resulting from the transaction, no contractual relationship exists between the principal and the third party. Accordingly, the principal cannot sue the third party and, conversely, neither can the third party sue him. On the surface, the commissionaire might resemble an agent acting for an undisclosed principal under common law. However, there is an important difference. Whereas an undisclosed principal is a party to the contract with the third party, this is not the case as regards a contract made by a commissionaire. In the case of the latter, it is only the agent who is entitled to enforce the contract and, similarly, it is the agent and not the principal who will incur liability under it.

An agency relationship gives rise to duties on the part of both the principal and the agent. The following are the main duties and ones which will be recognised in most jurisdictions.

Duties owed by the agent to the principal

1 *To obey instructions.* The agent must act in accordance with the authority he has been given. If he binds the principal to unauthorised contracts or otherwise incurs liability on behalf of the principal, he will be responsible to the principal accordingly.

2 *To act with appropriate skill and care.* An agent undertakes to carry out his tasks with reasonable diligence, demonstrating the customary standard of skill and care which would be expected of any person carrying out a similar role. If he falls below this standard and causes loss to his principal as a result, he will be personally liable to make good the loss.
3 *To avoid conflict of interest.* As an agency relationship is based on trust and confidence, the agent must not allow his own personal interests to conflict with those of the principal. Accordingly, if he is appointed to sell on behalf on the principal, he must obtain the best price. Therefore, he would be in breach of his duty if he personally bought from the principal and sold on for his own profit without disclosing this fact. Similarly, he must not, without the principal's permission, also act as agent of the buyer and receive double commission on the transaction.
4 *To disclose all material facts.* The agent must notify the principal of all information which might influence the latter in deciding whether to proceed with a transaction with the third party. For example, if an agent, having been instructed not to deal with X, receives an order from Y, X's partner, the agent would have to disclose the relationship between Y and X when forwarding the order to his principal.
5 *Confidentiality.* The principal may well have disclosed confidential information such as trade secrets, know-how, etc. to the agent in order to enable the latter to carry out his duties. The agent, therefore, must use this information for the purposes for which it was given and not disclose it to third parties either during or after termination of the agency.
6 *To account.* The agent must account to the principal in the manner and at the times specified in the agreement. He must keep proper books of account detailing all agency transactions and must account to the principal for all monies received by him in the course of the agency. An agent must not allow his own money to become mixed with that of the principal.

Duties owed by the principal to the agent

1. *To remunerate the agent.* The entitlement of the agent to remuneration for his services will normally be set out in the agreement. However, in some jurisdictions, there are legislative provisions governing the question of an agent's remuneration. For example, in the European Union, the Commercial Agents (Council Directive) Regulations 1993 govern not only the issue of remuneration, but many other aspects of the relationship between a principal and a self-employed agent. Under these regulations, if there is no agreement as to the agent's remuneration, the principal must pay the agent such remuneration as is customary. Where there is no evidence of custom or implied agreement, the principal must pay the agent what is reasonable for the services provided. If the agent works on a commission basis, the regulations provide detailed rules governing, *inter alia*, the occurrence of events which give rise to an entitlement to commission, the time and manner in which commission must be paid, and the agent's right to information held by the principal for the purposes of calculating the commission owed.
2. *To indemnify the agent.* A principal must indemnify his agent against all liabilities reasonably incurred or discharged by him in carrying out his duties. This would not extend to the agent's normal trading expenses unless this was stipulated in the agreement. However, it would cover, say, the costs of recovering monies owed by a defaulting customer provided that such action was taken with the approval of the principal.

If the agency is governed by the Regulations governing commercial agents mentioned above, the agent may be entitled to an indemnity or compensation on termination of the agency and this applies even though the agency has been properly terminated in accordance with the notice provisions contained in the Regulations. The object seems to be to provide the agent with a 'severance package' reflecting the commission he might have earned if the agency had not been terminated, the expenses he has incurred and the benefit in terms of new customers which he has brought to the principal's business.

The appointment of a 'sole' or 'exclusive' distributor

As explained in the previous section, an exporter who employs the services of an agent in order to sell his products in the foreign market will, in the classic scenario, be in a direct contractual relationship with the end purchaser. This means that, should there be any defects in performance of the contract, the exporter will be personally liable to the customer. Contracting through an agent also carries other risks. In order to maximise his commission, the more unscrupulous agent may well be more interested in the quantity of business obtained for his principal than its quality. The risks associated with dealing with customers of dubious financial standing will primarily fall on the exporter and not the agent. For these and other reasons, an exporter may choose to appoint a distributor for the country or region concerned rather than operate through the intermediary of an agent.

A distributor trades on his own account. He buys the exporter's products under a contract of sale and then sells them on to his own customers for his own profit. Should any goods prove to be defective, it will be the distributor who is primarily answerable to the customer and not the exporter, although the distributor may well have recourse against the exporter under the contract of sale which exists between them. Equally, if the end customer proves to be a reluctant payer or, worse, becomes insolvent, the financial fallout will have to be borne by the distributor and not the exporter.

If, say, a manufacturer appoints a distributor for a particular country or region, he may well grant the distributor a degree of exclusivity. In this connection, the terms 'exclusive' or 'sole' distributor are often used. Neither expression has a precise legal meaning, although in commercial usage they are commonly interpreted as indicating the following:

1. In the case of both an *exclusive* and *sole* distributorship, the manufacturer agrees not to appoint another distributor in the territory covered by the agreement.
2. Where *sole* rights are granted to the distributor, this does not prevent the manufacturer making sales on his own account in the allotted territory. However,

> if the distributorship is *exclusive*, the manufacturer agrees not to compete with the distributor in the territory covered by the agreement.

Although a court may well attribute the above meanings to the terms *sole* and *exclusive*, the parties would be better advised to stipulate in the agreement itself precisely the degree of exclusivity being granted to the distributor.

Although the manufacturer and distributor will from time to time conclude individual contracts of sale, the distributorship agreement itself is not a contract of sale. It provides the legal framework governing the overall relationship between the two parties, which might be intended to be long term. They are free to design the agreement in any way they wish. Typically, in exchange for the exclusivity granted by the manufacturer, the distributor will agree to purchase the goods covered by the agreement only from the manufacturer and not to deal in those of a competitor. The distributor will also often agree to concentrate on his own 'patch' and not to seek orders from outside the allotted territory. However, a word of caution should be sounded here. In many countries, there exist strict laws outlawing certain forms of anti-competitive behaviour. Such is the case, for example, in the USA and in Member States of the European Community. As a distribution agreement granting exclusive rights will, by its very nature, contain restrictions on the part of both the manufacturer and the distributor, it may well be subject to competition rules. Contravening such rules can have serious consequences, as will be explained later in this chapter, but suffice it to say at this stage that great care should be taken when drafting such agreements.

To avoid potential uncertainty, it is advisable to include in the agreement precise definitions concerning the territory granted to the distributor, the goods covered by the agreement and the mechanism for determining the price, minimum quantities (if any) to be purchased by the distributor in any given period, any requirement for the distributor to advertise and promote the manufacturer's products, the duration of the agreement or if it is indefinite, which is more likely, the notice period required for bringing it to an end.

Opening a branch office or forming a subsidiary in the export territory

An exporter might consider a more permanent form of representation in the foreign market as the best way of exploiting the opportunities it offers. Establishing a branch office or subsidiary in the country concerned are two ways of achieving this. Whereas a branch office is merely an extension of the exporter himself, a subsidiary company is a separate legal entity formed under the law of the country where it is situated. The consequence of the distinction is that, in the case of the branch office, the exporter will be regarded as being 'present' in the country where the office is located. This raises the possibility of the exporter being subject to the jurisdiction of the local courts should a legal dispute arise. On the other hand, if the exporter operates through a subsidiary then, despite the control exercised over it through its shareholding, the exporter will be shielded by the veil of incorporation, leaving the subsidiary to face the music alone. It is true that, in some jurisdictions, a parent and subsidiary can be regarded as the same person but, as was explained in the last chapter, this tends to be the exception rather than the rule. Apart from questions of potential liability, the decision to establish a branch office or subsidiary will depend on the particular circumstances of each case. It may be that the regulatory framework applying in the country concerned is more favourable to one form than the other, making a choice easier to make.

Although in many jurisdictions there is no requirement for a foreign-based company to obtain permission before establishing a subsidiary, in some countries a government licence has to be obtained. Whether this is straightforward or fraught with difficulties will depend on the country involved. Apart from any licensing requirements, the local law might place restrictions on the degree of control a foreign-based concern can exercise over locally incorporated companies. This might take the form of limiting the number of shares the foreign company can hold and/or requiring that all or a majority of the managers or directors shall be nationals.

The export country's tax laws might have a significant bearing on the decision whether or not to set up a subsidiary. If the

official policy is to encourage foreign investment, the tax regime may provide the 'sweetener' of a privileged tax status. However, the tax climate existing in other countries might not be so sympathetic. In the USA, for example, some state laws regard a parent and subsidiary as a single unit for tax purposes. This can result in the 'enterprise' being taxed on its total income whether or not it was generated in the state concerned.

Even if employees are drafted in from the home country to staff the branch or subsidiary, it is likely that the exporter will recruit additional personnel from the local workforce. While the contracts of the expatriates will, in many cases, be governed by the law of the home country, local employment law will apply to the indigenous staff. This might provide employees with extensive and potentially expensive employment rights, covering such matters as discrimination, equal pay, maternity and paternity rights, unfair dismissal and redundancy. An exporter would be well advised to give careful thought to the implications of this when considering establishing himself in a foreign market by a branch or subsidiary.

Establishing a joint venture with a local partner

The exporter might wish to enter into a joint venture with a local enterprise. Entering the market in this way can have advantages for both parties to the arrangement. The synergy resulting from a pooling of their respective expertise, financial resources, skills, knowledge and experience may lead to a more profitable exploitation of the market potential than would arise from individual endeavour. Developing countries often see the establishment of joint ventures as a way of securing much needed financial and technological investment from the more advanced economies. The foreign investor, in return, can often expect to reap the benefits of tax and other financial incentives, a more relaxed regulatory regime governing matters such as planning and a plentiful supply of skilled and cheap labour.

Joint ventures can be formed for a single activity or project maybe having a limited life span, or they can be created as a vehicle for an ongoing co-operative relationship of indefinite

duration. Whatever the strategic aim of the joint venture, its key provisions should include:

- clearly defined business objectives;
- the extent of each party's participation in the venture and the management of it;
- contribution of capital and non-cash assets, such as know-how, intellectual property, etc.;
- division of profits and losses;
- confidentiality undertakings;
- termination of the joint venture, rights to property and buy-out provisions;
- dispute mechanisms, such as mediation or arbitration, to avoid management deadlock and the possibility of litigation;
- the law governing the joint venture.

A joint venture will normally take one of three forms, namely:

1. a contractual joint venture;
2. a partnership joint venture;
3. a corporate joint venture.

A contractual joint venture is a relationship based on a contract between the two parties and is governed by the general principles of contract law. Unlike the corporate joint venture and, to a lesser extent, the partnership, there is no specific body of legal rules governing this type of joint venture and as a result the joint venture agreement will have to provide for every aspect of the joint venture's operation. For this reason, the contractual joint venture is probably more suitable for a single or one-off project rather than for an ongoing business relationship, or one where differing ownership interests have to be accommodated or the identity of the participants is likely to change. This said, however, there are advantages to the contractual joint venture. There are few formalities governing its creation and termination. Property contributed by each party remains the property of the party concerned. As no separate entity is involved, profits will be taxed in the hands of the parties. Unlike a partnership, each party is responsible for its own actions and does not bind the other party. However, in many jurisdictions, such as the UK, the USA,

Germany and France, a partnership can be found to exist even though the parties did not intend their relationship to be such. It is difficult to state precisely when this will occur, but there is a risk of such a finding when achieving the project's objectives reveals a mutuality of purpose going beyond the pursuit by each party of its individual commercial interests. If a partnership is found to exist, each of the parties will be fully liable for the debts and other obligations of the joint venture.

In a partnership joint venture, a true partnership relationship exists between the parties, with all the legal implications this has. In the previous chapter, the principal characteristics of the general partnership as found in the UK, the USA, France and Germany were explained. In all cases, the most significant consequence of operating through this type of structure is that the partners are both jointly and individually liable to the full extent of the partnership's liabilities. In the context of a joint venture, this means that each party acts as a representative of the venture and as such will bind the other participant(s) to transactions concluded with outside parties. As will be recalled, in most jurisdictions it is possible to form a limited partnership where some, but not all, the partners can enjoy limited liability. There must be a general partner with unlimited liability, which can in many cases be a limited liability company (see, for example, the German GmbH & Co. KG). However, the limited partners cannot participate in management; if they do, they risk losing their limited liability. In the USA and UK, it is also possible to form a limited liability partnership (LLP) in which all the partners have limited liability. Operating a joint venture through a partnership of whatever kind has certain advantages, such as tax transparency, flexibility of management structures and control mechanisms and, except for the LLP, privacy relating to the financial aspects of the venture.

A corporate joint venture involves the creation by the participants of a separate legal entity through which to pursue the venture, such as a limited company (UK), corporation (USA), SARL (France) or GmbH (Germany). The parties to the joint venture will be the parent shareholders in the entity and as such will have limited liability.

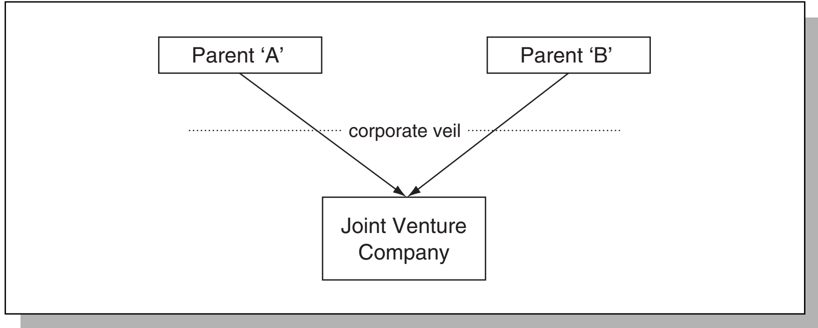


Figure 6.2
A corporate joint venture.

The control and management of the venture will be reflected in the number of shares each parent holds in the entity and the composition of the board of directors. Apart from the limited liability of the participants, the corporate joint venture has a number of advantages. In most jurisdictions, there is a detailed legal framework regulating companies which provides a degree of certainty regarding the rights and obligations of the participants. The options for raising finance are wider than for other forms of joint venture. The company can seek further investment by issuing shares. In many jurisdictions, different types of share are permitted, such as preference shares, which carry a preferential right to a dividend but will normally have restricted voting rights. As potential investors may be motivated by different factors, being able to issue shares with different rights attached to them may better accommodate the particular interests of the investor concerned. As the company has a separate and perpetual existence, the identity of the members can change without the need for a fundamental restructuring exercise being undertaken. Apart from raising equity finance, the company can borrow in its own name, using its own assets as security. In some circumstances, however, a lender might require additional security in the form of guarantees from the joint venture participants themselves which, to some extent, undermines the benefits of limited liability.

A corporate joint venture has certain disadvantages. Information about the company, particularly relating to its finances,

will have to be given at intervals to the appropriate government body. As this is likely to be made publicly available, the degree of privacy the parties to a corporate joint venture can enjoy is limited. There can also be tax disadvantages. The profits of the company are likely to be taxed separately and, depending on the jurisdiction, there is no guarantee that any credit will be given for this when the profits are distributed to the parent shareholders in the form of dividends. Further, if the joint venture incurs losses, it may not be possible to offset these against profits made by the parents in connection with their other separate business interests.

Licensing and franchising agreements

The owner of a patent, copyright, trade mark or other form of intellectual property might wish to exploit the rights attaching to such property in a particular country or region by licensing a third party to utilise the property in the territory allotted to him. Such an arrangement allows the owner to derive the benefits from an exploitation of his intellectual property but, at the same time, relieves him of the necessity of providing capital to fund the exercise. In a similar vein, the commercial risks that may be associated with the property's exploitation will be the licensee's and not the owner's.

The viability of entering into a licensing agreement will be determined, in part, by legal issues such as taxation of royalties, the extent to which intellectual property rights are protected under the law of the country where the licence is to operate and, if the agreement between licensor and licensee may have an effect on competition in the territory concerned, the impact of any applicable competition rules.

One particular form of licensing arrangement is the franchise agreement. Here, a company (the 'franchisor') which, through its name, logo, style, get-up, etc., has built up an established corporate or 'brand' image may allow another person (the 'franchisee') to carry on his or her own business, but utilising the business system and brand identity of the franchisor. From the public's point of view, there will be no discernible difference between a business operated by the franchisor itself and one operated by a franchisee. Although

franchise businesses are usually associated with high street names such as McDonald's, KFC, Burger King, etc., franchise arrangements go far beyond fast food and other consumer-oriented businesses, and cover the provision of a vast array of goods and services for the business sector itself.

A franchise agreement can have benefits for both parties. The advantages for the franchisor include the following:

- The franchisee will provide most, if not all, of the capital.
- The franchisee will invest his or her own skills and entrepreneurial flair in developing the business and promoting the brand.
- Most of the commercial risk will lie with the franchisee.

On the other hand, a franchisee:

- can start a business despite limited capital and experience;
- can take advantage of the goodwill generated by a nationally or internationally known brand name or product;
- will obtain the benefits of the franchisor's advertising and promotional activities without incurring the associated costs;
- can rely on the franchisor's business expertise in such areas as marketing and research.

The franchise agreement, which will invariably be drawn up by the franchisor, will give the franchisor extensive control over how the franchisee runs his or her business. As in most situations the franchisee will have little bargaining strength, there exists the possibility that the franchisor will exploit this position to impose unfair terms on the franchisee. For this reason, the law of some countries seeks to protect franchisees from the worst forms of exploitation; for example, in the USA, the courts are prepared to use notions of good faith and commercial reasonableness to strike down grossly unfair terms in a franchise agreement. The International Franchise Association has produced a Code of Ethics. While not legally binding,

it provides franchisors who subscribe to its provisions with minimum standards of conduct to observe. In addition, the International Chamber of Commerce has produced a Model Franchising Contract, together with a detailed commentary. The parties to a franchise agreement can therefore base their relationship in whole or in part on the provisions of this contract.

Promotional and marketing strategies

Although a company is broadly free to adopt promotional and marketing strategies best suited to its own business and the market in which it operates, the law does intervene to control and regulate certain types of activity deemed to be harmful to the general public interest. The form of such intervention and the circumstances when it will occur will depend on which country's law is involved. However, there are certain matters which are likely to be the subject of control, whatever the jurisdiction. For instance, the law of many countries seeks to protect consumers from injury or damage caused by defective products. In most countries, the maintenance of free competition in the marketplace is regarded as a priority, representing a means of achieving an acceptable balance between the interests of producers and those of consumers. Companies which, either alone or in conjunction with others, seek to distort the competitive forces that otherwise would exist are likely to fall foul of the law.

Although much of the law's protection is aimed at the private consumer, businesses can also claim protection from activity regarded as unacceptable, even in the heat of a competitive marketplace. So, for example, a company whose goodwill and reputation is being unfairly exploited by a competitor may be able to assert its intellectual property rights and obtain redress through, say, an action for trade mark infringement. Similarly, a business harmed as a result of an unlawful collusion between its competitors may seek compensation under competition rules prohibiting such conduct. A number of the issues just raised will be further explored below.

Product liability

Even though an exporter may channel his products into a particular market through a distributor, franchisee or other independent operator, he may still be held liable to a person suffering injury to health as a result of a product defect. The term 'product liability' has come to strike fear into the hearts not only of manufacturers, but also anyone associated with a product's design, production and distribution. The 'compensation culture' which has developed in many countries has resulted in an explosion of claims being brought by disaffected consumers against manufacturers, some of which have produced startling results. Notorious among these is the claim brought by a seventy-nine-year-old American woman who was burned when spilling a cup of hot coffee over herself which she had purchased at McDonald's. She was awarded compensatory damages of $200 000 and punitive damages of $2.7 million! The only crumb of comfort for McDonald's was that these sums were reduced on appeal to $160 000 and $480 000 respectively.

As will be explained below, liability for a defective product is not necessarily confined to the manufacturer. By way of example, consider the following scenario. X is driving to work in her car which she has recently purchased from a local retailer. As she approaches a road junction, she puts her foot on the brake but nothing happens. Unable to stop, X collides with another car which is crossing the junction at the same time. Both X and Y, the driver of the other car, are seriously injured. It transpires that X's car failed to stop because of a defect in the braking system. In singling out who should be held responsible for X and Y's injuries, it would not be unreasonable to point the finger at the manufacturer of the car and this, of course, is where primary responsibility may very well lie. However, depending on the circumstances, other parties could also be brought within the frame. Suppose, for example, that an independent firm of engineers had been engaged to design the braking system and it was because of a fundamental fault in the design that the system failed; or that the braking system, although incorporated into the finished product, had been

manufactured by a subcontractor. Should either of these prove to be the case, it is likely that the party concerned would also be involved in any action brought by X or Y. In addition, the retailer might also be implicated as far as X's claim is concerned, as the person from whom she purchased the car.

The USA has led the way in developing product liability laws. The way that producers of defective products have been held to account and the size of compensation awards made by the courts have caused alarm, not only among American manufacturers, but also among foreign producers exporting to the American market. Other countries have been influenced by the trends in the USA and have developed product liability regimes which in some instances either equal or come close to the strictness of the American system. A good example of where this has occurred is the European Union. This said, however, the multimillion dollar awards which characterise many American product liability suits are not as common in other jurisdictions and this is basically for two reasons. Firstly, a jury decides on how much a claimant is going to receive. In most other countries, the judge decides on the size of the award. While an average jury member might be influenced by an exhortation from the claimant's lawyer to 'hammer' the defendant, a judge is less likely to be swayed by such rhetoric. The second reason is the contingent fee system which operates in the USA and on the basis of which many product liability cases are brought. Under this system, a lawyer may be willing to take a case on the understanding that if it is lost, no fee will be payable for the services provided. However, if the claim is successful, the lawyer's reward will be to take part of the compensation awarded to the claimant, which could be as high as 40 per cent. If the jury suspects that a significant proportion of anything they award will find its way into the pocket of the claimant's lawyer, they may be tempted to factor this into their decision of how much to award. Critics of the contingent fee system say that it encourages 'ambulance chasing' and the more unscrupulous lawyers to bring dubious 'try-on' cases in the hope that the defendant will settle rather than become entangled in protracted litigation.

As the number of countries introducing stringent product liability regimes grows, so does the risk to producers of having

to face costly compensation claims. Where different export markets are involved, different risks may be involved. By way of example, the principles relating to product liability as found in the USA and Member States of the European Union will now be considered. As will be seen, despite some differences, there are similarities in approach which may also be reflected in the way other countries deal with issues relating to product liability.

A person who is injured as a result of a product defect may, depending on the circumstances, be able to pursue an action for damages based on contract and/or tort.

Contract

As was explained in Chapter 3, the seller of goods owes certain obligations to the buyer as regards the quality of the goods. These obligations can arise from *express* undertakings by the buyer – for example, that the goods will do a specified thing or serve a specified purpose – or they can be implied. Implied obligations arise by operation of law. Under both US law and that of EU Member States generally, goods supplied under the contract must be free of defects rendering them unfit for the ordinary purpose or purposes for which such goods are commonly used. If this standard is not satisfied, the seller will be in breach of contract and potentially liable for the harm caused by the breach. In the USA and most EU countries, contractual liability is *strict*. This means that the seller is liable without there having to be any fault on his or her part. So, for example, a supermarket will be liable to a customer who purchases and consumes a tinned food product sold under a leading brand name only then to be struck down with food poisoning due to the product being contaminated. The fact that the supermarket, in all probability, could not have detected the defect however careful they had been would be no defence.

As a contract normally creates rights and obligations only between the parties to the contract, this would appear to rule out the possibility of a buyer taking direct action against the manufacturer or a non-buyer suing the seller of the goods. In many but not all jurisdictions, this is in fact the case. For example, under French law, a purchaser can bring a contractual

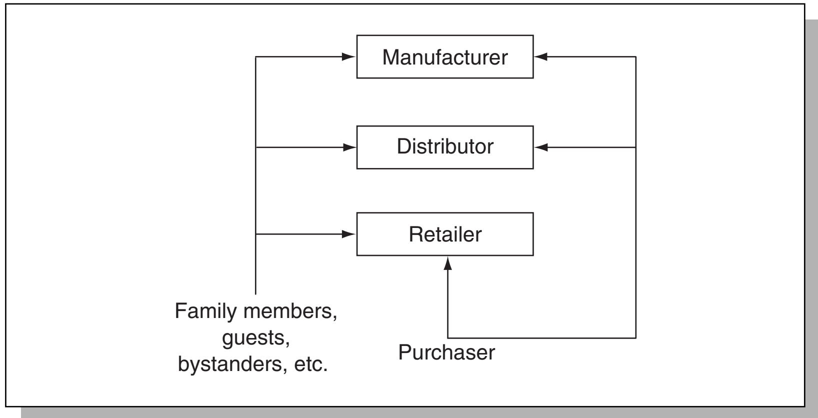


Figure 6.3
Contractual claims under US law.

claim against the manufacturer even though the product in question was bought from a retailer. Under US law, contractual liability is more extensive than this. A seller's responsibility extends not only to the buyer, but also to all persons on the same level of consumption as the buyer so long as the seller could reasonably anticipate that such persons would be exposed to, and might be injured by, the defective product. So, for example, the seller's obligations will extend to members of the buyer's family, guests in his house, a customer in his place of business, etc. In a similar vein, the buyer can proceed against any party in the production and distribution chain, including the manufacturer, the wholesaler, the distributor, etc. These parties will also be potentially liable to other persons on the same level as the buyer provided that it was foreseeable that such persons would be exposed to risk of injury from the defective product.

Tort

In addition to liability arising out of contract, product liability can arise from tort. The two possibilities are an action in *negligence* and an action founded on *strict liability*.

Negligence is failure to follow some generally accepted standard of care. So, if an aerosol canister explodes, shampoo causes the user's hair to fall out or a car's braking system fails,

the claimant must first establish the standard of care it would be reasonable to expect from a manufacturer of goods of that kind and, secondly, that the defendant has fallen below that standard. A famous case[2] decided by the House of Lords in 1932 provides the basis in UK law for a manufacturer's liability in negligence. A Mrs Donoghue was out for a walk with a friend. As it was a hot day, it was not long before they felt the need for some liquid refreshment. They stopped at a café and the friend, having purchased two bottles of ginger beer, gave one to Mrs Donoghue. As the bottle was made of dark glass, it was not possible to see the contents. Had this been the case, Mrs Donohue would probably not have consumed the ginger beer with such enthusiasm, because it contained the remnants of a decomposed snail which apparently slithered into the daylight when she replenished her glass. As a result of drinking the contaminated ginger beer, Mrs Donoghue claimed she became ill and sued the manufacturer, Stevenson. Stevenson denied liability all the way up to the House of Lords, arguing that a manufacturer owed no duty of care to the ultimate consumers of its products. However, the court thought differently, holding that where a product is sold in such a form that it is likely to reach the consumer in the same form in which it left the manufacturer and with no likelihood of intermediate examination, the manufacturer owes the consumer a duty to take reasonable care in order to prevent the consumer suffering harm.

In most cases, it is for the claimant to prove the defendant's negligence, something which is often either difficult or even impossible to achieve. In some countries, harshness of this rule is sometimes mitigated. For example, under German law, when a manufacturer of a defective product is sued for the harm it causes, the burden of proof is reversed. Rather than the claimant having to establish negligence on the part of the manufacturer, it is up to the latter to prove that they were not negligent. If they cannot do this, they will be liable. In US and English law, the principle of *res ipsa loquitor* ('the thing speaks for itself') may assist the claimant. Under this principle, negligence need not be proved by the claimant if (a) the product was under the exclusive control of the defendant at the time of its manufacture and (b) injuries such as those suffered by

the claimant do not ordinarily happen in the absence of negligence. In the case mentioned above, the extra ingredient in Mrs Donoghue's ginger beer was not included to give it an exotic flavour; the snail simply should not have been there and the only reason it was must have been due to negligence on the part of the manufacturer.

In the design of new products, a manufacturer must take sufficient care in the research and development phase to ensure, so far as possible, that there are no safety problems which could pose a risk to those using or coming into contact with the product. If the manufacturer fails to identify problems which would have been detectable through the exercise of due diligence, they will be potentially liable. However, if no amount of care on the part of the manufacturer would have revealed the problem, there will be no negligence. This could occur where 'state-of-the-art' products are involved. If the then existing state of scientific or technological knowledge was not so advanced to enable the risk to be identified at the time, the manufacturer would be able to plead what is known as the 'development risks' or 'state-of-the-art' defence in any action brought against them. The human tragedy surrounding the drug thalidomide in the 1950s and 1960s shows this defence at work. Thalidomide was a mild sedative taken by women in early pregnancy to combat morning sickness. It gradually became apparent that the drug had a potentially devastating effect on the developing foetus. Eventually, thalidomide was withdrawn, but not before thousands of children throughout the world had been born suffering from severe limb and other physical deformities. In several European countries, legal action was started against manufacturers of the drug on behalf of children who had been affected by it. Unfortunately for them, the defendant companies had a defence. Expert evidence was produced to show that the drug-testing procedures used at the time would not have indicated any risk to the unborn child. In other words, the defendants were relying on the development risks defence.

The furore surrounding the thalidomide tragedy in Europe started a debate. It was clear that a product liability system which depended on the establishment of negligence failed victims such as those in the thalidomide case. A new direction

was needed. In the USA, the courts had developed a regime of strict product liability. Under this system, a manufacturer and, depending on the circumstances, other parties in the production and distribution chain are liable for injuries resulting from a defect in a product even though there has been no negligence. The term 'defect' is applied fairly broadly and can apply even where, despite having been properly manufactured, a product nevertheless fails to provide the degree of safety an ordinary consumer may reasonably expect. So a chainsaw without an adequate guard, a nightdress made out of material easily combustible when exposed to a flame, a child's toy which could cause cuts or bruises may all be potentially defective.

The growing pressure in Europe for the introduction of a system based on strict product liability caused alarm in some manufacturing circles. The movement for reform was not helped by so-called examples from the American experience being quoted as illustrations of strict product liability in action. For example, an amply proportioned housewife is said to have successfully sued the manufacturer of a fridge which had caused her injury. Apparently, she had been using it as a stepladder in order to clean her kitchen ceiling when the top succumbed to her weight and she plunged through it, lacerating her legs. More bizarrely is the case involving the demise of a pet poodle. After the dog's weekly bath, the owner was accustomed to drying it in the gas oven at a low heat. When the gas oven was exchanged for a microwave, the same procedure was followed only with disastrous results. Following the dog's incineration, its distraught owner brought an action against the manufacturer of the microwave which, reputedly, she won. Whether these cases ever happened in the first place is beside the point, but the mythology surrounding them and similar 'horror' stories emanating from the USA were sufficient to galvanise significant resistance in some European countries to the introduction of strict product liability. However, after protracted wrangling and a number of compromises, the European Council of Ministers eventually adopted the Product Liability Directive 85/374. The Directive introduces strict liability for product defects throughout the European Union. Each Member State is obliged to enact the terms of the

Directive by introducing legislation to that effect in the state concerned. For example, this has been achieved in the UK by Part 1 of the Consumer Protection Act 1987 and in Germany by the Product Liability Act 1989.

Under the Directive, a *producer* is *strictly liable* for injuries caused by a *defect* in a product.

'Producer' includes not only the manufacturer of the finished product but also the producer of any raw material or component included in that product. So if ice-cream causes food poisoning due to the milk used in its production being contaminated, both the ice-cream manufacturer and the supplier of the milk will be producers and, accordingly, potentially liable. The term also extends to an own-brander, the classic example being where a supermarket sells its own 'in-house' brands alongside products produced by other manufacturers. 'Producer' also includes the first importer into the EU. So if, for example, an Italian company imports a product from Korea into Italy and then re-exports it to France via a French company, it will be the Italian company who is the producer and not the French company. Neither a retailer nor wholesaler is classed as a producer. However, if either is asked to identify the party from whom the defective product was obtained, this information must be given within a reasonable time, otherwise the retailer or wholesaler, as the case may be, will become a producer.

A product is 'defective' if it does not provide the safety which a person is entitled to expect taking account of all the circumstances, including its presentation, the use to which it could reasonably be put and the time it was put into circulation. As under US product liability laws, a product can be defective because of inadequate safety features, warnings or instructions as to use. Producers will also be expected to anticipate a degree of misuse and provide appropriate warnings. The kind of misuse and the extent to which the producer should have anticipated this are likely to be contentious issues in any case involving the issue. However, the producer is entitled to assume that a consumer will possess a modicum of common sense and so if the claimant is injured while using the product in a blatantly improper way or combines it with another product in a way that make it dangerous or fails to

maintain it properly, the producer will probably escape liability. Whether using a fridge as a stepladder or a microwave oven to convert a poodle into a hot dog would come within the range of misuse a producer should anticipate is not certain, but it would doubtlessly test the limits of the idea.

Certain defences are available to the defendant. For example, a manufacturer might establish that the product was not defective when it left the factory and that the defect must have been introduced at some stage further down the distribution chain. Controversially, the development risks defence is available in some, but not all, Member States. This has prompted criticism that tragedies similar to the one involving thalidomide have not necessarily been consigned to history.

Compensation can be claimed for death or personal injuries resulting from the defect and for damage caused to private, but not business, property. In some Member States there is an overall limit to the financial liability of a producer arising from a single defect. However, any such limit must not be less than €70 000 000.

As a final point, it should be noted that the system of product liability introduced by the European Directive does not supplant liability based on contract and/or negligence; it is a third option for someone wishing to pursue a compensation claim for harm suffered as a result of a product defect. In most cases, the Directive will be the route of first choice; however, there may be circumstances where the option is not available – for instance, where the defect was introduced not by the manufacturer, but by some other person further down the distribution chain. In such a case, the injured party will have to pursue an action in negligence against the person concerned or, if he or she was the purchaser of the product in question, an action for breach of contract against the seller.

Protection of intellectual property

In the pursuit of profit, a company will seek to utilise its assets in the most efficient way possible. Tangible property such as buildings, machinery and equipment will play a vital role, but not necessarily the only one. A business may depend equally

on other types of property, such as patents, trade marks, registered designs, design right, and copyright for success. The examples just given are collectively known as 'intellectual property'. Intellectual property is a form of intangible property resulting from human creativity. It can be highly valuable and as such is vulnerable to unauthorised exploitation by persons other than its creator. The law therefore defines the rights attaching to the various forms of intellectual property and provides protection for those rights. Depending on the jurisdiction, the extent of the protection given and the effectiveness of the remedies available can vary. In some countries, the enforcement of intellectual property law is lax, providing opportunities for the unscrupulous to pirate or counterfeit everything from drugs to the latest Hollywood 'blockbuster'. This said, however, there has been a significant degree of international co-operation over the years designed to harmonise certain aspects of intellectual property law and to establish between different countries mechanisms for the reciprocal protection of the rights granted by it. In the case of many forms of intellectual property, registration is required and the timing of this can be vital. Where two or more persons are vying for the same rights, the first to register will often secure the prize. An applicant wishing to apply for registration in several different countries will have to run a parallel race and runs the risk of being beaten to the line in one or more of the countries concerned. The problems associated with competing applications have been lessened where countries have agreed between themselves to establish registration procedures recognising the filing date in one country as the same for an application made in another within a particular period of time.

The vast majority of the world's developed nations are members of one or more of the international conventions relating to intellectual property. A number of these are administered by the United Nations World Intellectual Property Organisation (WIPO). One of the most important and earliest conventions is the Paris Convention for the Protection of Industrial Property 1883, to which there are currently 169 signatories. It establishes basic principles for laws in individual countries, and reciprocal protection. It also establishes

a priority system for the filing of intellectual property applications. Under this system, the first filing date for, say, a patent application in one convention country will be recognised as the filing date for an application made in any other convention country within a certain period. WIPO also administers the Berne Copyright Convention and the Madrid Agreement concerning the international registration of trade marks.

Among the most important international initiative on intellectual property is the TRIPs agreement (Trade-Related Aspects of Intellectual Property), concluded on 15 December 1993 during the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). TRIPs is now administered by the World Trade Organisation (WTO), which succeeded the GATT on 1 January 1995. TRIPs came into being as a result of increasing alarm, particularly in the USA and European Union, over counterfeiting, piracy and other forms of intellectual property misuse. The agreement aims to create minimum standards for the protection and enforcement in all signatory states of the rights attaching to, amongst other things, trade marks, copyright and patents. Each country must protect the nationals of other contracting states by granting them the rights set out in the agreement and the degree of the protection given must be no less favourable than that given to their own nationals.

The law relating to intellectual property can be extremely complex and it is beyond the scope of this book to provide anything other than a general description of some of the various rights the law seeks to protect. Patents, copyright and trade marks are taken as examples.

Patents

A person who has developed a drug which reverses the ageing process or has discovered a way to turn lead into gold may well wish to prevent others capitalising on his discovery by seeking a patent. A patent is a monopoly right granted by a state to an individual who has invented a product or a process. It gives the owner the exclusive right to exploit the invention for a certain period of time which, in the case of both the EU and the USA, is twenty years. Not every new idea is capable of

being patented. Before a patent is granted the following basic requirements must be satisfied.

Novelty

The invention must be innovative. This means that it must not form part of the state of the art at the time when the initial application is made. The state of the art consists of all matter which has at any time before that date been made available to the public anywhere in the world. So, for example, the inventor of the 'biro' pen was refused a patent because he had previously had some pens made up and had distributed them among friends.

Inventive step

The discovery must involve an inventive step which takes the science forward. If anyone could have come up with the idea, it will not be patentable; in other words, it must not be obvious. Of course, the context must be taken into account. Lowering a car's fuel consumption by incorporating a 'new' method of introducing fuel into the carburettor may not be obvious to the average motorist, but may be blindingly so to an automotive engineer. The test is whether the product or process would have been obvious to someone having some knowledge of the technology or science relevant to the invention involved. The degree of skill or knowledge attributed to the 'skilled technician', as this person is sometimes referred to, will vary according to the circumstances. If the technology involved in the invention would only be comprehensible to someone with a doctorate in science, it will still fail the test if it would be obvious to other persons in the industry having those qualifications, even though not to someone having merely a GCSE.

Industrial application

The invention must be capable of industrial application. If it can't be manufactured industrially or does not relate to an industrial process it will not be patentable. Therefore, ways of treating human beings or animals by, say, surgery or

therapeutic techniques will not be patented, although a drug for use in conjunction with such procedures, if it satisfied the other requirements, would be.

Exclusions

There are certain things which cannot be patented. Among these are natural phenomena, such as the effect of the moon on tidal movements, mathematical methods or scientific theories. Therefore, however ground-breaking Einstein's theory of relativity may have been, $E = mc^2$ would not have received a patent.

Procedure for obtaining a patent

In the EU the law relating to patents is, to a large extent, harmonised. A person wishing to apply for a patent in the EU must submit an application either to the national patent office of a Member State or to the European Patent Office in Munich designating the Member State(s) for which registration is sought. The date on which the application is submitted is known as the *priority date* and the duration of the patent is calculated from that date. The application should be in the prescribed form and filed in the prescribed manner, accompanied by the appropriate fee. The application must include a 'specification', a 'claim' or 'claims' and any drawings that are referred to. The application should also include an abstract.

The *specification* is basically a description of the invention. It should be as full as possible, giving sufficient detail of how it is intended to work so that a 'person skilled in the art' could perform or make the invention. The *claims* should explain precisely what is novel about the invention and the subject matter which requires protection. The precision and clarity with which the claims are presented will be an important factor in any proceedings brought by the patentee for infringement. As they effectively ring-fence the patentee's proprietary rights in the invention, a person accused of encroaching on these could exploit any laxity in their drafting in order to escape liability. The *abstract* should contain a full explanation of the technical aspects of the invention, the idea being to

allow someone skilled in the particular field to see where it goes beyond what is already known.

The documentation submitted will be subject to official examination to ensure that the legal requirements for patentability have been satisfied. This being the case, a patent will be granted and a notice to this effect published.

A patent will, in general, be infringed by making, using or selling something in the state where the patent is registered without the owner's consent. Where an infringement is established the owner may bring a civil action against the infringer. The remedies available include an injunction against further infringing activity, an account of profits earned from the unauthorised use and damages.

Copyright

Copyright is the protection given to the tangible output of a person's creative effort. It covers things such as literary, dramatic and artistic works, musical compositions, films, television broadcasts, and computer programs. The copyright owner has the exclusive right to print, reproduce, sell and exhibit the protected material. Generally, copyright does not require registration. Copyright protection automatically arises when the original work is first placed in a tangible form of expression. Although the use of a copyright notice (©, Name, Date, All rights reserved) is not legally required, it can serve a useful purpose of alerting third parties to the fact that copyright protection exists and it will make it more difficult for someone to claim innocent infringement. Copyright lasts for the life of the creator and for a certain period thereafter which, in the case of both the EU and the USA, is generally seventy years.

Infringement of copyright occurs where, without the consent of the owner, a person does one or more of the following:

- copies the protected work or a substantial part of it;
- issues copies of the work to the public;
- rents or lends the work to the public;
- performs, shows or plays the work in public;
- broadcasts the work; or
- makes an adaptation of the work.

The growth of the Internet has expanded the terrain in which copyright infringement might occur. While the average 'surfer' might consider the downloading of material from the web a harmless exercise, the owner of the work involved might not share the same opinion. The music industry is becoming more aggressive in protecting its rights; for example, in the USA, the Record Industry Association of America has filed 1977 lawsuits against individuals illegally swapping music files over the Internet. In Europe, the International Federation of the Phonographic Industry has begun legal action against nearly 250 'pirates' in Germany, Denmark and Italy who had been making music files available on the Internet for downloading. The commercial wisdom of pursuing members of one's target market through the courts is debatable, but nevertheless the precedent for doing so has been firmly established.

A person who deals commercially with infringing copies of a protected work can also be liable, even though he or she did not make the original copy. However, it has to be shown that the person concerned had some knowledge or reasonable belief that an infringement was likely to be committed. Likewise, infringement will occur if a person in the course of his or her business uses anything which facilitates the copying of a protected work. A case[3] illustrating the last point came before the American courts involving a company called Napster. Napster enabled Internet users to share MP3 music files with each other. The company was held to have *vicariously infringed* (permitted and profited from others infringing) and to have committed *contributory infringement* (knowingly causing third parties to infringe).

Unlike patents, the exclusivity of copyright is subject to a number of exceptions. For example, limited copying by libraries and archives is usually permitted and in many jurisdictions the concept of *fair dealing* is recognised, whereby a person is allowed to make limited copies for private research and/or study or for the purposes of review or criticism.

In some countries, such as the Member States of the EU, the author of a work can assert *moral rights* in connection with a protected work, even though he or she may no longer be the owner of the copyright in the work. For example, the authors of literary, dramatic, musical and artistic works have a right to

be identified as such and to object to any derogatory treatment of the work.

A person whose copyright has been infringed may bring a civil action against the infringer, claiming a variety of remedies including an injunction, the delivery up to the owner of any infringing articles, and damages. In addition, infringement occurring in the course of business and for commercial gain is, in many jurisdictions, a criminal offence for which the perpetrator could be prosecuted.

Trade marks

A trade mark is basically any sign capable of being represented graphically which is capable of distinguishing goods or services of one trader from those of another. It can consist of words, designs, letters, numerals or the shape of goods or their packaging and, in some circumstances, sounds, colours and smells. To a company, a trade mark is a valuable asset. In the public's mind's eye, the use of a trade mark not only represents a guarantee of origin, but can create an impression of superior quality in comparison with the products of competitors. Rolex are able to charge more for their watches even though they may not necessarily be better than those produced by other manufacturers of quality watches.

A company can protect a trade mark by registering it with the appropriate public authority in the country concerned. In the EU, it is possible to apply for the single registration of a Community Trade Mark which, if granted, will provide protection in all Member States. Obviously, there are rules governing what can and cannot be registered as a trade mark and these rules will differ according to the jurisdiction concerned. However, in the EU the law relating to trade marks has been harmonised and so the basic principles governing registrability will apply whichever Member State is involved.

In the EU, in order to obtain registration, a trade mark must be capable of being represented graphically. This poses few problem when words, designs, letters or numerals are concerned. When a shape or packaging is involved, such as the Coca-Cola bottle, a three-dimensional drawing will provide the graphic representation. Difficulties may occur when the trade

mark consists of a sound, although a musical notation might suffice in appropriate circumstances. Colours and smells can prove more difficult, although a precise and unambiguous description of the trade mark might satisfy the requirement. For example, in an application for a Community Trade Mark,[4] a company applied to register 'the smell of freshly cut grass' to tennis balls. In the opinion of the Second Board of Appeal of the Community Trade Marks office, the description encapsulated precisely what the mark was. As the Board observed, 'The smell of freshly cut grass is a distinct smell, which everyone recognises from experience. For many, the scent or fragrance of freshly cut grass reminds them of spring or summer, manicured lawns or playing fields, or other such pleasant experiences'.

The trade mark must also be capable of distinguishing one trader's products from those of another. A completely invented word, such as 'Microsoft', will have a distinctive character, but problems can occur where a word is regarded as descriptive of the product itself rather than indicative of its origin. In an English case,[5] a manufacturer of pet food applied to register 'Pussikin' as a trade mark for cat food. The court considered it to be directly descriptive of cat food and as such was incapable of distinguishing the applicant's product from that produced by other manufacturers of pet food. The test seems to involve asking whether other traders in good faith might legitimately wish to use the word and if the answer is 'yes', it will be refused registration. In another case,[6] Unilever attempted to register the red stripe in its toothpaste as a trademark. The stripe contained the fluoride which was added as a mouthwash. Apparently, red was one of the few colours in which fluoride could be incorporated into toothpaste. Allowing it to be registered as a trade mark would prevent other toothpaste manufacturers using the colour, something the court regarded as unfair.

A trade mark will not be registered if it consists exclusively of signs or indications of quality, quantity, intended purpose, value or geographical origin. Words such as 'deluxe', 'giant', 'mega' and so forth would appear to come within this category. In one case,[7] the word 'perfection' was rejected as a trade mark because it was descriptive and laudatory. As regards place

names, an English company called York Trailer Holdings[8] applied to register a trade mark which consisted of the word 'YORK' in white capital letters on a black background with a maple leaf drawn inside the letter 'O'. In the court's view, the mark lacked distinctiveness and therefore was refused registration. Neither will a mark be registered if it consists of a word or words which have become customary in a particular trade. A case[9] illustrating this involved the word 'Treat', which the applicants wished to apply to a syrup produced by them for pouring over ice-cream and desserts. One of the reasons for the court rejecting the word was that it had become customary in the current language of the trade, or as the judge put it: 'Lots of people use "Treat" in advertisements and on goods.' Despite what has just been said, a mark will be registered if it can be shown that it has, in fact, developed distinctiveness in the public's mind's eye through use. This possibility was introduced by the European harmonising legislation.[10] The York Trailer case mentioned above was decided under the English trade mark law existing at the time. Had it arisen today, in all probability it would have been registered because there was evidence that the mark, through use, had become distinctive of the applicant's products.

Registration of a trade mark gives the owner the exclusive right to use the mark in the country concerned in connection with the goods or services for which it is registered. Only the owner of a registered mark can apply the symbol®. The use of this in connection with unregistered marks is a criminal offence. An infringement will occur if any other person without the owner's consent uses the same mark in relation to identical goods or services. 'Use' means affixing it to goods or their packaging, offering goods or services for sale under the mark, importing or exporting goods under the mark, and using the mark on business documentation or advertising. If there is a likelihood of public confusion, using the *same* mark in relation to *similar* goods or services or a *similar* mark in relation to *identical* or *similar* goods or services will also amount to an infringement. From what has just been said, it might be thought that using the same or a similar mark but in relation to different goods or services would be permissible. However, this is not necessarily so. An infringement will still

occur in these circumstances if the registered mark has developed a reputation and the use of the competing mark would be taking unfair advantage of this or would otherwise be detrimental to the distinctive character of the mark. Therefore, a fast-food outlet selling 'Rolls Royce' beefburgers might well incur the wrath of the car manufacturer.

Remedies for infringement include an injunction, damages, an account of profits and delivery up of infringing articles. As in the case of copyright, there are a number of criminal offences which apply to trade mark infringement. They are principally aimed at those persons who make a profit from deliberately selling counterfeit goods.

The principles dealt with above relate to registered trade marks. However, in many jurisdictions, protection can exist for unregistered marks. This could occur where a trader has operated under a mark for a period of time and as a result has built up a reputation in the mark. Although it might lack the distinctiveness required for registered marks or for some other reason be unregistrable, the law will intervene to prevent some other trader unfairly exploiting the goodwill and reputation engendered in the mark in a way that is misleading to the public. In common law jurisdictions, protection exists in the tort of passing off.

To succeed in an action for passing off, the claimant must establish the following:

1. that there is a goodwill or reputation attached to his goods or services;
2. that there has been a misrepresentation by the defendant, whether or not intentional, leading or likely to lead the public to believe that the goods or services offered by him are those of the claimant;
3. that, as a result of the misrepresentation, loss has been suffered.

A misrepresentation can take various forms – for instance, using the claimant's mark or the get-up of the claimant's product, or using the design or shape of the claimant's product. In 1990, a dispute over a plastic lemon gave the House of Lords food for thought in a famous English case.[11] The claimant produced lemon juice and sold it in yellow, lemon-shaped

containers under the name of 'Jif'. The defendant sold lemon juice in a container which was similar but not identical in that it was bigger, and had a green top and flat side. Nevertheless, the 'get-up' of the defendant's container was deceptively similar to that of the claimant's and as a result the defendant was restrained from continuing to use it.

The misrepresentation can relate to matters such as the quality of the goods. For instance, a manufacturer of 'Orb' footballs successfully prevented another company selling footballs under that name, but which were of an inferior quality.[12] Alternatively, there might be a misrepresentation of the product's origin, as in the case of a company producing 'Spanish champagne'.[13] The claimant, a leading producer of the genuine article, argued that the public associated the word 'champagne' with the wine produced in a particular region of France, and as such its use in relation to products not originating from there was damaging to its established reputation. The court agreed and the claimant succeeded in its action for passing off. Even copying another company's advertising theme may provoke a successful challenge if it can be proved that the public are misled. In a case[14] originating from Australia, a company marketed an orange drink under the name of 'Solo'. It was sold in cans bearing a medallion. The launch of 'Solo' was accompanied by an extensive advertising campaign which conjured up nostalgic images of times gone by and, in particular, 'rugged masculine endeavour'. The product, to the surprise of many, sold well. The defendant, realising that the Australian male was not averse to drinking orange squash despite his normal reputation, started producing 'Pub Squash'. This was sold in cans similar to those used for Solo and the accompanying advertising campaign adopted a similar theme. Although the defendant admitted that it had taken advantage of the claimant's advertising campaign, there was no evidence that the public had been misled into believing that Pub Squash was the claimant's product and so the action for passing off failed.

As the case just mentioned shows, an essential requirement for a passing off action is that evidence must be produced that the public have been or are likely to be misled. The British Communist Party failed to establish this fact when attempting

to protect the title of its weekly newspaper, the *Morning Star*.[15] The defendants published a tabloid newspaper called the *Daily Star* which was sold to the general public through newsagents. In the case which followed, the court examined the two papers side by side and, in the memorable words of the judge, came to the conclusion that 'only a moron in a hurry' would confuse the two!

If the claimant can show that, as a result of the defendant's misrepresentation, he has suffered loss, he will be entitled to a remedy. This might take the form of an injunction to prevent further loss and an award of damages to compensate for loss which has, in fact, occurred.

Competition law

A company trying to sell its products in a competitive market might be tempted to pursue strategies aimed at shielding it from the forces of competition with which it would otherwise have to contend. The desired effect could be achieved by, for example, reaching some form of accommodation with its competitors or, if the circumstances allow, exploiting its own dominance in the market to reduce or eliminate competition. In many countries the law seeks to ensure, so far as possible, that free competition is maintained in the market place. Any collaboration between competing businesses which seeks to prevent, restrict or distort competition between them is likely to be illegal. So, for example, agreements to fix prices, share markets or restrict production would clearly come within this category.

Most countries have strict rules governing anti-competitive behaviour, their enforcement being the responsibility of the national competition authority. Very often, criminal sanctions are imposed which can be severe. In addition to risking heavy fines and the possible imprisonment of its managers, a company acting in breach of the law could face a civil claim for compensation from another business suffering damage as a result of the illegal activity.

In the majority of cases, national competition law will extend only to conduct affecting competition in the country

concerned, and not to activities whose effects are felt beyond its borders. However, in some contexts competition laws exist which extend beyond national frontiers, bringing international business activity within their scope. Notable examples of such laws are those found in the European Union. A company conducting business within the European Union should be aware of the circumstances giving rise to an infringement of the law, and no exemption is given merely because a company has its base outside the Union. Nintendo, the Japanese electronics giant, has discovered this the painful way. In 2002, the company, together with seven of its European distributors, was found guilty of illegal price fixing. The fines which were imposed totalled €168 million.

European competition rules extend far and wide and are not restricted to obvious anti-competitive practices such as price fixing, market sharing and other forms of cartel. No matter what form it takes, any arrangement designed to affect competition and which impacts upon cross-border trade within Europe is likely to be illegal, with all the implications that has. A broad understanding of how the rules operate and the kind of activity caught by them should enable those responsible for planning or executing international business strategies to avoid the most obvious pitfalls and the punitive sanctions that could otherwise be imposed.

What follows is an overview of the main principles of competition law as found in the EU. However, it should be borne in mind that in targeting the types of activity described, competition regimes applying in other jurisdictions may well adopt a similar approach.

Articles 81 and 82 of the Treaty of Rome

Articles 81 and 82 contain the fundamental rules of EU competition law. The rules apply to any enterprise trading directly or indirectly in the EU, no matter where it is established. Article 81 deals with collusive agreements between two or more enterprises, whereas Article 82 deals with the abuse of a dominant position by a single enterprise.

Article 81

Article 81(1) declares illegal and void all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market. There then follows a non-exhaustive list of prohibited practices, including those which:

- directly or indirectly fix purchase or selling prices;
- limit or control production, markets, technical development or investment;
- share markets or sources of supply;
- apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
- make the conclusion of contracts subject to the acceptance by other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

Article 81(1) refers to 'undertakings' which, according to a ruling of the European Court of Justice (ECJ), includes 'every entity engaged in an economic activity regardless of the legal status of the entity and the way it is financed'. Therefore, companies and partnerships would clearly come within the definition of an undertaking. It has also been held to include an individual carrying on a business. Public bodies, when acting in a commercial capacity, also can be classed as undertakings.

Article 81(1) does not apply to agreements between undertakings which constitute a single economic unit. An obvious example of this would be an agreement between a parent company and its subsidiary where, because of the relationship between them, it would be reasonable to regard them as a single entity. In such a case, even if restrictions are imposed, the arrangements between the two companies will be viewed as matters of internal management rather than an agreement between independent enterprises.

The term 'agreements' includes not only legally binding contracts, but also non-binding 'understandings' or 'gentlemen's agreements'. Even though two companies may not be in direct contact with each other, activities between them can be co-ordinated if, say, they belong to the same trade association. Recommendations by such an association to its members as regards, for instance, prices to be charged could amount to a 'decision', even though not legally binding, and as such could be caught by the prohibition in Article 81(1).

Article 81(1) also extends to understandings between two or more companies which, although not amounting to an agreement as such, nevertheless indicate the existence of a 'concerted practice'. This has been defined by the ECJ as 'a form of co-ordination between undertakings which, without having reached the stage where an agreement properly so called has been concluded, knowingly substitutes practical co-operation between them for the risks of competition'. While companies are entitled to conduct their business in the light of current market conditions and to respond to actions taken by their competitors, any measures implemented must be the result of independent decision-making and not stem from a collusive understanding between market rivals. The authorities responsible for enforcing European competition law have wide powers of investigation, and meetings between competitors might come under suspicion, particularly if there are subsequent parallel movements in, for instance, prices. While periodic meetings between managers of rival businesses may be perfectly innocent, they are not always advisable. The competition authorities may see them as an indication of collusion. Any unexplained price movements or other market activity following such meetings could be seized upon by the authorities as evidence of a concerted practice.

For an agreement to infringe Article 81(1) it must have the potential for affecting cross-border trade within the EU and have as its object or effect the prevention, restriction or distortion of competition within the common market. An illustration of the interplay of these two requirements can be seen in a case[16] involving Grundig, the German producer of electrical goods, and its French distributor, Consten. Grundig

appointed Consten to be its sole distributor in France for Grundig products. In the agreement, Consten undertook not to export goods to which the contract related to other countries, either directly or indirectly. Grundig had imposed similar restrictions on its distributors for other European countries. Consten was also allowed to register the Grundig trademark 'GINT' in the French trade mark registry, thereby allowing it to prevent any GINT-branded products entering the French market without its consent. However, another French company, UNEF, bought Grundig products from one of Grundig's other European distributors and started selling them in France more cheaply than those marketed by Consten. Consten started proceedings against UNEF in the French courts, and the matter was eventually referred to the ECJ. The court found that the restriction on exports imposed on Consten infringed Article 81(1). The same decision was given in respect of the use by Consten of the GINT trade mark. The export ban was designed to prevent companies like UNEF obtaining Grundig products from other parts of the common market in order to sell them in France. Thus, the restriction prevented imports into France, and accordingly affected trade between Member States. Consten's use of the GINT trade mark similarly affected trade because it allowed Consten to prevent any imported goods bearing the mark being sold on the French market. The effective isolation of the French market meant that Consten was not subject to the sort of price competition that could arise if parallel importers such as UNEF were allowed to enter the market. As result, competition was affected and thus Article 81(1) was infringed.

The finding by the ECJ in the above case does not mean that agreements granting sole distribution rights are always illegal. The competition authorities are concerned to ensure that parallel imports are not hindered and, provided this is so, an infringement of Article 81 is less likely. It may also be that careful drafting of a distribution agreement giving exclusive rights will earn an exemption from the prohibition in Article 81(1), as will be explained below.

For agreements to be caught they must have an appreciable effect on competition. In 1969 the ECJ formulated what became known as the *de minimis* doctrine, whereby agreements

not having such an effect would escape the prohibition. The case[17] coming before the court involved a German producer of washing machines and its Belgium distributor. Under the agreement the Belgium company was given exclusive rights to the Belgium and Luxembourg markets and guaranteed absolute territorial protection against parallel imports. As the German manufacturer's market share for the product in question was negligible, the ECJ considered that the exclusivity given to the Belgium distributor would not appreciably affect competition.

Since the above case, the Commission have issued a series of Notices giving guidance as to the type of agreement which will come within the *de minimis* principle and thus fall outside the Article 81(1) prohibition. The latest Notice was issued in 2001, under which agreements between undertakings falling below certain thresholds will be assumed not appreciably to effect competition. The thresholds are:

1 agreements between competitors where goods or services covered by agreement do not exceed 10 per cent of the total market for such goods or services in the area of the common market covered by the agreement;
2 agreements between non-competitors – for example, a manufacturer and its distributor – where the goods or services do not exceed 15 per cent of the relevant market.

It should be noted, however, that the Notice does *not* apply to what may be called 'hardcore' cartels. Therefore, the following agreements will continue to be prohibited whether or not they fall below the above thresholds:

1 agreements between competitors which fix prices, share markets or fix production or sales quotas;
2 agreements between non-competitors which fix resale prices or contain territorial protection clauses in the form of, say, export bans.

Some agreements can be exempted from Article 81(1) and if this is the case they will not be void. Article 81(3) provides an individual exemption from the prohibition for agreements which contribute to improving the production or distribution

of goods or to promoting technical or economic progress while allowing consumers a fair share of the benefit. Achieving an exemption is not necessarily easy. However, in attempting to do so, a manufacturer might argue, for example, that his distributor should have an exclusive territory in which to promote a new product as an incentive to sales and a means of increasing competition between different brands, which would ultimately produce dividends for consumers. Again, two manufacturers might press the case that, rather than having to compete over an entire range, an agreement allowing each to specialise in a particular product would optimise efficiency and, as a result, prove beneficial both to themselves and the consumers of their products.

The Commission from time to time issues what are known as *block exemptions*. A block exemption will cover a particular category of agreement and, provided an agreement is drafted in accordance with the terms of the exemption, it will not come within the prohibition of Article 81(1). Typically a block exemption will contain a 'black' list of prohibited clauses. An agreement containing any clauses on this list will lose the benefit of the block exemption and will have to qualify for an individual exemption under Article 81(3) if it is to remain valid. There are a number of block exemptions covering a wide variety of commercial agreements. By way of example, the block exemption contained in Regulation 2790/99 covers vertical agreements, which include distribution agreements. In order to qualify for the exemption the supplier must have less than 30 per cent of the market for the particular product. Among the restrictions which are *not* permitted under the exemption are those which seek to impose minimum resale prices and those which tend to isolate markets through various forms of territorial restriction.

Article 82

Article 82 of the Treaty of Rome differs from Article 81 in that it is concerned not with collusive activity, but with the dominance of undertakings whose position is powerful enough to allow them to abuse their market strength to the detriment of their competitors and consumers.

The text of Article 82 is as follows:

> Any abuse by one or more undertakings of a dominant position within the common market or a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States.

There then follows a non-exhaustive list, closely modelled on that contained in Article 81(1), of the kind of practice which will amount to an abuse.

In order to ascertain whether an undertaking has dominance, the relevant market has first to be identified. One factor in determining the market is to look at the extent to which other products are available and the ease with which consumers will switch between them. For example, are bananas a separate market or merely part of the market for soft fruit? In one case,[18] it was decided that there is a demand for bananas which is distinct from other fresh fruit, especially as the banana is a very important part of the diet of certain sections of the community.

Once the relevant market has been ascertained, it then has to be determined whether the undertaking in question has dominance in that market. The ECJ has defined dominance as 'a position of economic strength enjoyed by an undertaking which enables it to hinder the maintenance of effective competition on the relevant market by allowing it to behave to an appreciable extent independently of its competitors and customers and, ultimately, of its consumers'.[19] Although market share is not the only determinant of dominance, the Commission has taken the view that a dominant position could well have been reached where an undertaking has acquired a market share of between 45 and 50 per cent.

Article 82 does not prohibit dominance *per se*, merely the abuse of such a position. There are numerous practices commonly adopted by businesses which, depending on the circumstances, could amount to an abuse. For example, as a condition of supplying a product, the seller may require the buyer to agree to purchase all or part of its requirements for a second and, possibly unrelated, product only from the seller; or a producer may take advantage of the lack of effective competition by charging excessive prices for its products. On

the other hand, a supplier might charge unreasonably low prices in order to undercut and eventually eliminate a competitor. The categories of potential abuse are virtually limitless. In a case[20] decided by the ECJ in 2003, the distribution system operated by the principal ice-cream manufacturer in Ireland was held to be abusive. The manufacturer supplied retailers with freezer cabinets at no cost provided that the cabinets were used exclusively for the manufacturer's products. The practical effect of this arrangement was to restrict the ability of retailers to offer competing products for sale.

Enforcement

Both the European Commission and the national competition authorities of the Member States have jurisdiction to enforce Articles 81 and 82. The penalties for companies transgressing the law can be severe. Fines can be imposed of up to 10 per cent of an undertaking's turnover in the previous year and this is not limited to the turnover in the market affected by the infringement nor, indeed, the EU.

An agreement which infringes Article 81(1) also attracts the sanction of 'voidness'. Such a consequence may be as much a 'punishment' for the participants as a fine. Of course, the participants in a hardcore cartel will not intend enforcing their agreement through litigation, so the fact that it is void will be of scant concern to them. Their principal worry will be keeping their arrangement secret and ensuring that it does not come to the attention of the competition authorities. However, as explained above, an otherwise perfectly legitimate commercial agreement can fall foul of Article 81(1) if it imposes restrictions beyond what is permissible. Voidness in these circumstances can have serious consequences for the parties to the contract, for not only will it undermine the very foundation of their relationship; it will mean that the obligations the agreement was intended to create will be unenforceable.

As a final point it should be noted that third parties adversely affected by an undertaking's infringement of either Articles 81 or 82 will have a right to bring a civil action for damages against that undertaking in the national courts of a Member State.

Summary

The following issues were dealt with in this chapter:

1. The various ways in which a self-employed agent can acquire authority to bind his principal.
2. The duties owed by an agent to his principal and vice versa.
3. How the establishment of a subsidiary company rather than a branch office can benefit an exporter.
4. Legal distinction between a self-employed agent and a distributor, and the implications this has for the exporter.
5. The nature of 'sole' and 'exclusive' distribution rights.
6. The joint venture and the various forms it can take.
7. How a franchise agreement can provide benefits for both franchisor and franchisee.
8. Product liability and the risks it presents for companies involved in the design, production and distribution of goods.
9. How intellectual property rights can be acquired and protected.
10. The impact of competition law on business activity.

Notes

1. *Dingle* v *Hare* [1859] 7 CBNS 145.
2. *Donoghue* v *Stevenson* [1932] AC 562.
3. *A&M Records, Inc* v *Napster, Inc* [2001] 239 F.3d 1004 (9th Circuit).
4. Venootsschap onder Firma Senta Aromatica Marketing's Application [1999] ETMR 429.
5. H. Quennel Ltd's Application [1954] 72 RPC 36.
6. Unilever's Trade Mark [1984] RPC 155.
7. Crosfield and Other Application [1910] Ch 130.
8. *York Trailer Holdings* v *Registrar of Marks* [1982] 1 All ER 257.
9. *British Sugar plc* v *James Robertson & Sons* [1996] RPC 281.
10. EC Directive 89/104/EEC.
11. *Reckitt & Coleman Products Ltd* v *Borden, Inc* [1990] 1 All ER 873.
12. *A. G. Spalding & Bros* v *A. W. Gammage Ltd* [1915] 84 LJ Ch 449.
13. *Bollinger* v *Costa Brava Wine Company* [1960] Ch 262.
14. *Cadbury Schweppes Ltd* v *Pub Squash Company Ltd* [1981] 1 All ER 213.

15 *Morning Star* v *Express Newspapers Ltd* [1979] FSR 113.
16 *Consten and Grundig* v *Commission,* cases 56/64 and 58/64 [1966] ECR 299.
17 *Volke* v *Vervaecke,* case 5'69 [1969] CMLR 273.
18 *United Brands Co* v *Commission* 27/76 [1978] ECR 207.
19 *United Brand Co* v *Commission,* supra.
20 *Van den Bergh Foods Ltd* v *Commission* [2003] *Times,* 7 November.

CHAPTER 7

Export contracts and associated financing arrangements

Introduction

In Chapter 3, mention was made of contracts for the sale of goods and the particular characteristics associated with that type of contract. This chapter returns to the theme but in the context of international trade.

The export contract is a contract for the sale of goods and one which potentially involves the same legal and commercial problems inherent in any such contract. If a dispute arises between the parties over, say, the performance of the contract,

it will have to be resolved by referring to the express terms of the contract or, if these do not offer a solution, by applying the default rules provided by the law. In the case of English law, these will be found in the Sale of Goods Act 1979. Should the contract be governed by civil law, reference would have to be made to the provisions of the civil and/or commercial codes of the particular country concerned. At this point, however, it should be noted that, as an international contract for the sale of goods is involved, the relationship between the parties might be governed by an international convention, a prominent example being the UN Convention on Contracts for the International Sale of Goods (Vienna, 1980) sponsored by UNCITRAL. Various aspects of this convention will be considered in the next chapter.

In addition to the problems which can arise in connection with any sale of goods transaction, the fact that the parties are based in different countries raises issues not present in a purely domestic contract. For example, the exporter may be reluctant to relinquish control over the goods until he has been paid or at least received a guarantee of payment. Likewise, the buyer may not wish to part with his money until the goods arrive. For this reason, it is highly likely that one or more banks will be involved in order to provide a payment mechanism which will reconcile the concerns of both the exporter and the buyer. Other questions will arise, such as how are the goods to be transported to the buyer and whose responsibility is it to arrange this? During transportation the goods could be lost or damaged. Bearing in mind this risk, who should be responsible for arranging appropriate insurance cover? The result of all this is that, in addition to the sale contract, an export transaction will involve the making of other contracts with carriers, insurance companies and banks. As will be explained, a number of important documents will be issued in connection with an export transaction and the fact that the rights created by these can often be transferred to another party by mere delivery makes the documentary aspect of the export contract a defining characteristic.

Figure 7.1 illustrates the various contractual relationships existing in a typical export transaction.

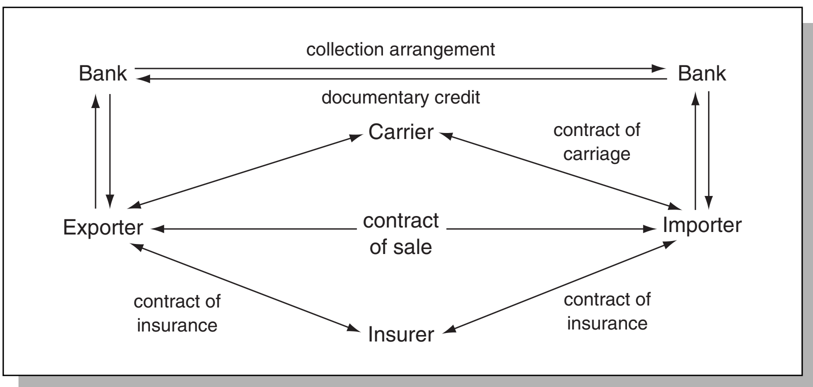


Figure 7.1
Contractual relationships in a typical export transaction.

Although this representation might, at first sight, appear dauntingly complex, the explanation which follows will hopefully clarify the issues involved.

Forms of export contract

The contract of sale, which is at the heart of the export transaction, is concerned not only with the identification of the goods, quality, price and so on, but will also have to specify whose responsibility it is to arrange the ancillary contracts relating to the carriage and insurance of the goods. Although the allocation of such responsibilities could be subject to endless permutations, in practice the seller and buyer will probably adopt a recognised and established form of contract, the legal features of which are well known. In doing this, they will automatically be apportioning between themselves responsibility for arranging the ancillary contracts together with their associated costs. The forms of export contract available are distinguishable by the trade term applied to the particular contract. Among the most commonly used terms where sea transit is involved are:

- f.a.s. ('free alongside ship');
- f.o.b. ('free on board');
- c.i.f. ('cost, insurance and freight').

Although these and other less common terms have worldwide recognition, they are not necessarily interpreted in exactly the same way. Differences can exist depending on the jurisdiction involved, or it could be that the custom of a particular trade or port attributes particular characteristics to a trade term which are not shared elsewhere. In addition, it should not be forgotten that the parties themselves are free to modify the obligations which would normally attach to a particular term. All this provides great scope for uncertainty. To avoid this prospect, the parties may choose to base their contract on one of the sets of standard trade terms available. One of the most widely used is 'Incoterms', to which reference was made in Chapter 3. Incoterms are published by the International Chamber of Commerce in Paris and provide standard definitions for terms commonly used in international trade. Parties wishing to transact on the basis of Incoterms should make reference to them in the contract itself. By concluding a contract, say 'c.i.f. Rotterdam (Incoterms 2000)', the parties would be incorporating into the contract the obligations attaching to a c.i.f. contract as defined by the 2000 edition of Incoterms.

By adopting one or other of the terms contained in Incoterms, the parties will be allocating between themselves certain responsibilities and costs and, in addition, depending on the term involved, will be providing for other eventualities. Suppose, for example, that X has sold a valuable sculpture to Y on f.o.b. terms. Shortly after it has been loaded onto the ship, the sculpture is irreparably damaged when a forklift truck, negligently driven by a member of the ship's crew, collides with it. A question which might immediately spring to Y's mind is whether he still has to pay for the sculpture. The issue involved here concerns the passing of risk from seller to buyer. It will be recalled from Chapter 3 that this question is determined in accordance with the agreement made by the parties. If they have made no express provision, the issue will be settled by reference to the default rules provided by the law. However, by transacting on trade terms such as f.o.b. or c.i.f., they will be taken to have accepted the obligations normally attaching to these contracts, including those relating to matters such as the transfer of risk. In an f.o.b. contract, the risk of loss or damage to the goods passes

on shipment – that is, when they have been loaded. In the scenario just described, therefore, as the accident happened after this point, the risk would have passed to Y, who would still remain liable to pay.

The vast majority of export contracts involve sea transit and among the most common forms used are the following:

F.o.b. (free on board)

Although the parties sometimes depart from the obligations normally associated with an f.o.b. contract, typically the 'classic' or 'strict' f.o.b. requires the seller to arrange for goods of the contract description and within the agreed date to be transported to the port of shipment specified in the contract and loaded on board the ship nominated by the buyer. All the costs associated with these operations are borne by the seller. The buyer must arrange with a sea carrier for the transportation of the goods. Further, he must give the seller sufficient notice of the name of the ship and the time of its arrival to allow the seller to get the goods to the port and have them loaded within the contract period. The buyer must insure the goods and pay for them once they have crossed the ship's rail. It is also at this time that the risk passes to the buyer and, unless otherwise agreed, the ownership of the goods will similarly pass.

It is possible for the parties to contract on f.o.b. terms but to provide for additional services to be performed by the seller. In this case the seller will, himself, arrange the contract of carriage and take out appropriate insurance cover. However, unlike under a c.i.f. contract, he will undertake these acts as agent of the buyer and for the buyer's account. The price for the goods will not include these additional costs, which will be included as separate items on the invoice.

F.a.s. (free alongside ship)

F.a.s. contracts are similar to f.o.b. contracts, although they are not so frequently used. Unlike in the case of an f.o.b. contract, the buyer in an f.a.s. contract is responsible for the loading of the goods on board ship and the costs involved. The seller

discharges his obligation by delivering the goods at the port of shipment alongside the ship nominated by the buyer within the contract period. 'Alongside' is normally taken to mean within range of the ship's loading gear. However, the seller might have to bear the costs of having the goods transported alongside by barge if, in the particular port, the ship is not moored at the quayside. The risk passes to the buyer when the goods are alongside, as does the ownership unless otherwise agreed.

C.i.f. (cost, insurance and freight)

The c.i.f. contract is the most commonly used form of export contract. The seller discharges his obligations by delivering to the buyer or his agent the documents specified in the contract. These will include a bill of lading, an insurance policy and an invoice. In addition to these, the contract may require the delivery of other documents, such as a certificate of quality. In a c.i.f. contract, the documents are regarded as the commercial equivalent of the goods themselves. Accordingly, if the seller tenders to the buyer the correct documents, he has completed his part of the transaction and is entitled to be paid. This is still the case if, before the documents are tendered, the goods have been lost. If the risk giving rise to the loss is covered by the insurance policy, the buyer will be able to proceed against the insurers. Otherwise, his only remedy will be against the carrier or other person who caused the loss, but if liability for this has been excluded, the buyer may have to bear the loss himself.

Under a c.i.f. contract the seller must ship goods of the contract description within the agreed time. Further, he must arrange a contract of carriage and take out appropriate insurance for a reasonable value with reputable insurers. It will be recalled that if, in an f.o.b. contract, the seller undertakes these duties, they are performed as agent of the buyer, who will be responsible for the costs. However, in a c.i.f. contract, the seller acts as principal in arranging carriage and insurance, the costs of which will be included in the contract price. The seller must make out an invoice in accordance with the terms of the contract of sale. This might require the invoice to

be in a particular form, which may be especially so if, under the law of the buyer's country, it has to comply with, say, the requirements of the tax authorities.

The seller discharges his obligations by tendering to the buyer or his agent the documents specified in the contract. If the documents are in accordance with the contract, the buyer is bound to accept them and pay the price. If incorrect documents are tendered, he is entitled to reject them.

The principal document to be tendered will be a bill of lading. It basically has three functions:

1. It is a document of title to the goods, in effect representing the goods themselves. By transferring the bill of lading to the buyer, the seller is also transferring the rights and obligations attaching to it. Importantly, possession of the bill will give the buyer the right to claim possession of the goods, say from the carrier.
2. It is a receipt for the goods. The contract will often provide for a 'shipped' bill to be tendered. In this case, the bill will acknowledge that the goods have actually been loaded on board ship as opposed to merely having been *received* for shipment. In addition, the bill will have to be 'clean'. This means that it must be free of any fraudulent alterations, say as to the date of shipment, and must indicate that the goods, when shipped, were in 'good order and condition'; in other words that, from an external point of view, there was no apparent damage to the goods or other defect affecting them.
3. It is evidence of the terms of the contract of carriage between the seller and the carrier, in which the carrier will undertake certain obligations in relation to the goods. The transfer of the bill of lading will also operate to transfer the carrier's obligations to the buyer, giving the latter the right to sue the carrier under the contract should he default in performance, say as regards the safe custody of the goods.

In addition to the bill of lading, the seller will have to tender a policy of insurance 'usual' or 'current' in the trade. The policy must cover only the contract goods and not include other goods

which the seller might have included in the same policy, but which are destined for other buyers. In addition, the tender must be of the policy itself, although the parties can agree to substitute other documents, such as a certificate of insurance issued by the insurance company.

The seller must also tender an invoice made out in accordance with the contract of sale.

If the documents are not in conformity with the contract of sale, the buyer is entitled to reject them and walk away from the contract. However, he loses this right where the documents have been taken up and dealt with – for example, by being accepted for payment by a bank appointed by the buyer for this purpose. However, the buyer may still have the right to reject the goods themselves on arrival if they do not conform with the contract in terms of description, quality, fitness for purpose, etc. It should be noted, therefore, that the right to reject the documents and the right to reject the goods are distinct.

Even if the goods are contractually correct, the buyer may still have a remedy in damages if he later discovers that he could have rejected the documents – for example, because they are forged. This is certainly the case in English law, where the buyer can sue for *loss of right of rejection*. Here the damages will be the difference between the contract price and the market price at the time the breach was discovered (assuming the market price has dropped). In one case[1] coming before the English courts, a seller in London sold goods to a buyer in Hong Kong, shipment to take place not later than 31 October 1951. Unknown to the sellers, the goods were shipped after that date but the bill of lading was backdated, showing 31 October as the date of shipment. The buyers, who were unaware of this, accepted the documents and subsequently disposed of the goods. Later they discovered the forgery and sued the sellers for damages. The court held that, in a c.i.f. contract, the two rights to reject the goods and reject the documents are distinct and the disposal of the goods by the buyers did not result in the loss of their right to reject the documents as not being in conformity with the contract. As they were prevented from rejecting the documents, they were entitled to damages.

It should be remembered, however, that the buyer only has an action for loss of right to reject where the defect was not apparent on the face of the documents. In other words, if an examination of the documents would have revealed the irregularity, the buyer will not later be able to sue for loss of the right to reject. An illustration of this can be seen in a case[2] involving a quantity of maize. The contract provided that the goods should be shipped in June/July 1965. The goods were actually shipped between 10 and 12 August, but the bill of lading was backdated to 31 July. Cargo superintendents had taken samples from the cargo before loading and stated in their certificates of quality that they had done so between 10 and 12 August. The documents were accepted and paid for without question. The court held that the buyers were precluded from later complaining of either the false bill of lading or the late shipment.

A c.i.f. contract is sometimes referred to as a 'cash against documents' transaction. This emphasises the documentary aspect of the transaction which, from a commercial point of view, is often paramount. As an English judge remarked in a case[3] in 1915, a c.i.f. contract 'is not a contract that goods shall arrive, but a contract to ship goods complying with the contract of sale, to obtain, unless the contract otherwise provides, the ordinary contract of carriage to the place of destination, and the ordinary contract of insurance of the goods on that voyage, and to tender these documents against payment of the contract price'. Thus, if goods are shipped and lost during the sea transit, the seller is still entitled to tender the proper shipping documents to the buyer and claim the purchase price, and this rule applies even if, at the time of tendering the documents, the buyer proves that the goods have been lost. As the risk will have passed to the buyer at the time the goods crossed the ship's rail, his remedy will be restricted to claiming under the insurance policy or suing the carrier if the policy does not cover the particular eventuality. If the contract of carriage excludes the carrier's liability, the buyer will have to bear the loss personally.

The above principles apply only to c.i.f. contracts properly so called. They do not, for example, apply to 'arrival' or 'ex ship' contracts. Here the seller's obligation extends to delivering the

goods to the buyer from the ship at the agreed port of destination. If the goods don't arrive, the buyer is not entitled to payment. In other situations, the seller and buyer might ostensibly contract on c.i.f. terms but depart from the strict requirements normally associated with such contracts. Where this happens, there is likelihood that the contract will be viewed as an arrival contract and not one based on c.i.f. terms. In one case[4] heard by the English courts, a seller who sold on c.i.f. terms reserved the right to substitute for the bill of lading a document having different legal characteristics. The buyer accepted this document and paid the price. However, the ship carrying the goods was diverted and delivery was never made. The House of Lords decided that the buyer was entitled to the return of the purchase price because, by permitting the seller to tender a document other than a bill of lading, the contract was not a true c.i.f. contract or, in the words of one of the judges, 'payment was not made for the documents but as an advance payment for a contract afterwards to be performed'. The contract was therefore an arrival contract. As the seller had failed to deliver the goods at the port of destination, he had not performed his part of the transaction and, accordingly, was liable to refund the purchase price to the buyer.

Payment in international sales

When it comes to payment for the goods in an international sale, the seller and buyer will have conflicting interests. By its very nature, the export contract creates risks for both parties. Imagine the seller, who has sold goods on credit, anxiously standing on the dockside as the ship bearing his goods sails out into the wide blue yonder. Equally, consider the plight of the buyer who has already paid for the goods as he nervously scans the horizon for a sign that they are, in fact, going to arrive. Where the seller and buyer have an established relationship and share a mutual trust in each other, the seller might be prepared to dispatch the goods and await payment, say by a cheque or credit transfer; conversely, the buyer might be willing to make payment before he has actually received the goods. However, where such a relationship does not exist,

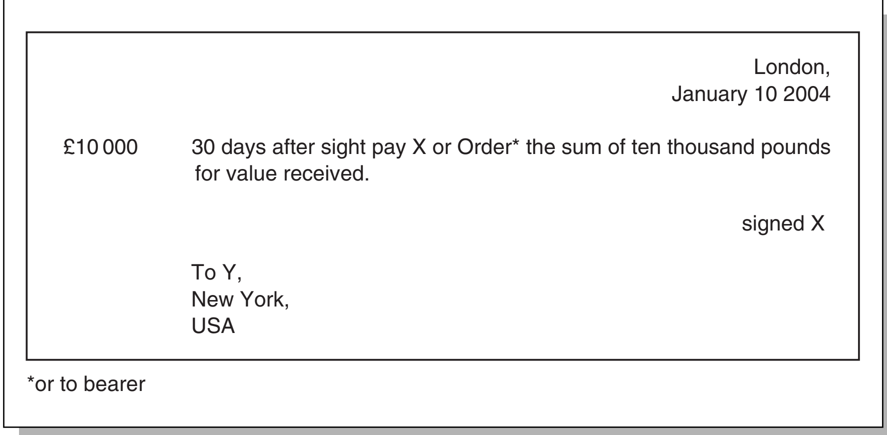
the seller will be reluctant to lose control of the goods unless he has received payment for them or, at least, a guarantee of payment. Similarly, the buyer will not want to part with his money until he has either acquired physical possession of the goods themselves or a document of title to them. In order to reconcile these divergent interests, the involvement of one or more banks will be required.

The most frequent payment methods involving banks are a *collection arrangement* or payment under a *documentary credit* or *letter of credit*, as it is often called. In the case of the collection arrangement, the bank receives its instructions from the seller. The exchange of the documents of title representing the goods and payment of the price is normally effected at the place where the buyer has his business. On the other hand, in the case of a letter of credit, the instructions to the bank normally come from the buyer, with the exchange of documents and payment of the price normally being effected in the seller's country. Whether payment is being effected by a collection arrangement or under a letter of credit, a bill of exchange is likely to be involved.

The bill of exchange has a long history and as a method of transferring money has achieved international recognition. Although the law governing this type of instrument is complex and can vary from country to country, a significant degree of harmonisation has been achieved through a number of international conventions. In the case of English law, bills of exchange are governed by the Bills of Exchange Act 1832. S.3(1) defines such an instrument as 'an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a certain sum of money to or to the order of a specified person, or to bearer'. For example, suppose that X and Y have concluded a contract and have agreed that payment shall be effected by means of a bill of exchange. Further, X has allowed Y a period of credit and does not require payment until thirty days after Y has had sight of the bill. X (the 'drawer') will prepare a document requiring Y (the 'drawee') to pay the amount owing on a specified date to a named person (the 'payee'), who is likely to be X but does not have to be, or,

simply, to the bearer of the bill. X will sign the bill and send it to Y. If Y 'accepts' it, he will do so by signing the bill and as a result will become liable as the 'acceptor' to pay the amount specified in accordance with the terms of the bill. Figure 7.2 shows how the bill of exchange may look.

The advantage of the bill of exchange is that it is negotiable. This means that it can be transferred by indorsement or, if it is a bearer bill, simply by delivery. So, in the example given, X can either wait for the credit period to expire and then present the bill to Y for payment or, if he wants to receive the money earlier, he can indorse the bill by signing it on the back and transfer it to another person, say Z, who will pay X the amount owed on the bill but less a discount. When the thirty days have expired, Z will present the bill to Y for payment. A bill of exchange may change hands several times before finally being presented to the acceptor for payment. In such circumstances, the current 'holder' assumes all the rights attached to the bill but, by indorsing it, also becomes a party to the bill and potentially liable as a consequence. A most important feature of a bill of exchange is that a person who, in good faith, takes a bill complete and regular, on the face of it, is not then affected by any defect in the title of the transferor or any person holding the bill before him. Should the bill be presented for payment to the acceptor at the proper time and


London,
January 10 2004

£10 000 30 days after sight pay X or Order* the sum of ten thousand pounds for value received.

signed X

To Y,
New York,
USA

*or to bearer

Figure 7.2
A bill of exchange.

be dishonoured, the holder will have rights of action against the acceptor, the drawer and all other prior parties to the bill. The simplicity of the transfer of the bill of exchange and the security obtained by a holder taking it in good faith make it invaluable in international trade transactions.

As stated above, the two most common methods of financing international trade are payment under a *collection arrangement* and payment under a *letter of credit*. Both are governed by international regulations sponsored by the International Chamber of Commerce and applied by most banks in the world. Collection arrangements are governed by the Uniform Rules for Collections (1995 Revision) and letters of credit by the Uniform Customs and Practice for Documentary Credits (1993 Revision).

Collection arrangements

Under this arrangement, the seller will draw a bill of exchange on the buyer and deliver this together with the documents relating to the goods to his bank (the 'remitting bank'). The seller will instruct the bank to make arrangements with a bank in the buyer's country (the 'collecting bank') to receive payment by presenting the bill of exchange to the buyer for acceptance. The remitting bank will send the documents to the collecting bank, which will then present the bill of exchange to the buyer for acceptance. If the buyer accepts the bill, the collecting bank will release the documents to the buyer so that he can obtain possession of the goods. The collecting bank will then send the bill of exchange to the remitting bank, which will hand it to the seller. However, the remitting bank will often discount the bill for the seller, crediting his account with the amount due on the bill less commission and charges. In this case, the bank will become a holder of the bill, with all the rights which that implies.

Under a collection arrangement, the remitting bank acts as the seller's agent. As such it must carry out the seller's instructions precisely. If it defaults, it will be liable to the seller for the consequences of any failure to do so. As agent of the remitting bank, the collecting bank is in a similar position with regard to its principal.

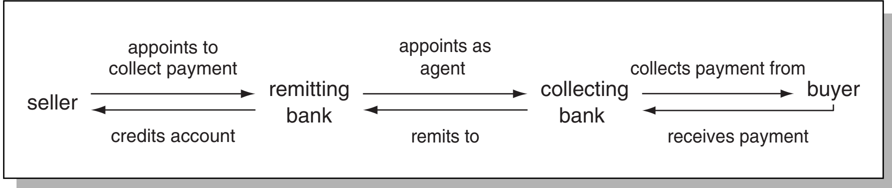


Figure 7.3
The relationships in a collection arrangement.

In summary, Figure 7.3 illustrates the various relationships in a collection arrangement.

Letters of credit

As far as security of payment is concerned, the documentary credit offers the most advantages. If the contract of sale provides for this method of payment, the buyer will instruct his bank (the 'issuing bank') to open a credit in the seller's favour. This bank will normally appoint a bank in the seller's country (the 'correspondent bank'), which will then advise the seller of the opening of the credit. If the seller presents to the correspondent bank the correct shipping documents, he will be allowed to draw on the credit and hence receive payment.

The main attraction of the documentary credit is that it provides security for all the parties involved. First of all, the buyer will give specific instructions to the issuing bank as regards the documents to be presented by the seller before payment can be made. The seller will receive payment from a bank in his own country, the correspondent bank, provided he tenders the correct documents. The correspondent bank, in turn, will have the documents as security pending reimbursement by the issuing bank of the amount paid under the credit and, likewise, the issuing bank will retain the documents until paid by its customer, the buyer.

Letters of credit take various forms and the one to be adopted in any transaction will be specified in the contract of sale. Letters of credit can be *revocable* or *irrevocable, confirmed* or *unconfirmed*. Whether the credit is revocable or irrevocable depends on the commitment of the issuing bank, whether it is

confirmed or unconfirmed on that of the correspondent bank.

The revocable and unconfirmed credit

Here, neither the issuing nor the correspondent bank enters into a commitment to the seller. The credit may be revoked at any time and thus affords little security to the seller that he will receive the purchase price through a bank. In practice, this form of credit is not widely used.

The irrevocable and unconfirmed credit

As the name suggests, under this type of credit, the authority given to the issuing bank by the buyer cannot be revoked. In addition, the issuing bank is under an obligation to the seller to pay on tender of the correct shipping documents. The seller is assured, therefore, that if he presents the correct documents during the time the credit is open, the bank must pay. If it refuses to do so, it will be liable to the seller. The disadvantage, as far as the seller is concerned, is that any legal action against the issuing bank will normally have to be taken in the country where it is based. If, by chance, it has a branch office in the seller's country, it may be possible to commence proceedings there. From the seller's point of view, the best outcome would be if he had recourse against the correspondent bank in his own country, something which will be possible if a confirmed credit is involved.

The irrevocable and confirmed credit

If the correspondent bank adds its own confirmation of the credit, it enters into a direct undertaking to the seller to pay against tender of the correct documents within the stipulated time. The seller therefore has a guarantee of payment in his own country. A confirmed credit which has been notified to the seller cannot be cancelled by the bank on the buyer's instructions, and if the bank refuses to pay it will be liable to the seller in damages.

From what has been said above, it can be seen that various relationships are involved when an export contract is financed

by means of a letter of credit. This aspect requires further explanation.

Before the credit is opened, the buyer will send instructions to the issuing bank stipulating which documents must be presented to it (or the correspondent bank) before payment can be made. The issuing bank is the buyer's agent and, likewise, the correspondent bank is the agent of the issuing bank. If either bank fails to act in accordance with the instructions it has received, the principal, who is the issuing bank or the buyer as the case may be, can refuse to accept the documents and, further, would not be bound to reimburse the amount paid out on the credit. The bank in question would have to suffer the loss and would have to mitigate this as best it could by selling the goods to which the documents relate. For this reason, a doctrine of *strict compliance* has developed, under which banks will pay only against documents which conform exactly with the buyer's instructions. Even a minor departure from these will entitle the buyer to refuse reimbursement. In a case[5] brought before the English courts, the documents tendered to the bank were to include a certificate signed by '*experts*'. In fact, the bank paid against a certificate signed by '*expert*'. The House of Lords held that the issuing bank was not entitled to claim reimbursement from the buyer. Another reason for the bank's insistence on strict compliance lies in the fact that it is a dealer in finance not goods. As such, it cannot be expected to appreciate the reasons why, in a particular contract of sale, the buyer may have stipulated for the inclusion of certain documents. All it does know is that if it departs one iota from the buyer's instructions, it risks being left saddled with the goods which it must then deal with as best it can in order to rescue its position. Figure 7.4 summarises the various relationships created by the use of a letter of credit.

The credit is autonomous in that it is separate from and independent of the underlying contract of sale. The bank that operates the credit is concerned only with whether the documents tendered by the seller correspond with those specified in the instructions. The bank is not affected by any dispute between the buyer and seller over the contract of sale; that is a matter for them. Letters of credit have been

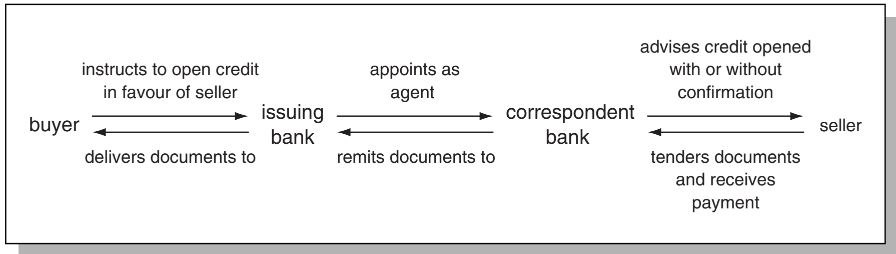


Figure 7.4
Relationships ensuing when using a letter of credit.

described as the 'lifeblood of commerce', and to enable a bank to refuse payment on the instructions of the buyer would undermine the confidence universally placed in this form of finance arrangement. The only situation where a bank should refuse payment against apparently conforming documents is where fraud can be established. Such a fraud may occur if the shipment of the goods is fraudulent or if the bill of lading tendered under the credit is falsified or forged. If there is merely a suspicion, perhaps even a grave suspicion, that forgery has occurred, the bank must still pay. Even where fraud can be established, if it cannot be proved that the seller was either a party to it or at least knew of the fraud, the bank should still pay. This can be illustrated by a case[6] which came before the English courts in 1983. A British company sold a glass fibre-forming plant to a Peruvian company. Payment was arranged under an irrevocable letter of credit issued by a Peruvian bank, and confirmed by the Royal Bank of Canada at its London branch. Shipment was to be made from London on or before 15 December 1976, while the credit was open until 31 December 1976. Shipment of the installation was made on 16 December. The bill of lading, however, was backdated to indicate that shipment had taken place during the agreed time. The correspondent bank was advised of the fraud and refused to pay when the documents were presented to it. The court found that the bill of lading had been fraudulently backdated by an employee of the company responsible for loading the plant and without the knowledge of the sellers. Accordingly, the bank should have paid and were liable to the seller.

Summary

This chapter dealt with the following issues:

1. The nature of the export transaction and how it involves the conclusion of additional contracts ancillary to the contract of sale.
2. How Incoterms can provide certainty in the meaning of various trade terms used in the export trade.
3. The obligations of the parties to an export contract, in particular those arising under f.o.b. and c.i.f. contracts.
4. How collection arrangements and letters of credit provide effective payment methods for export contracts.
5. The various forms of letter of credit and the liability of the issuing bank and correspondent bank in each.

Notes

1. *Kwei Tek Chao* v *British Traders and Shippers Ltd* [1954] 2 QB 459.
2. *Panchard Freres SA* v *Etablissements General Grain Co* [1970] 1 Lloyds Rep 53, CA.
3. Per Scrutton, J., in *Arnold Karberg & Co* v *Blythe, Green, Jourdain & Co* [1915] 2 KB 379 at 388.
4. *Comptoir d'Achat* v *Luis de Ridder* [1949] AC 293.
5. *Equitable Trust Company of New York* v *Dawson Partners Ltd* [1927] 27 LILR 49.
6. *United City Merchants (Investments) Ltd* v *Royal Bank of Canada* [1983] 1 AC 168.

CHAPTER 8

International business disputes and their resolution

Introduction

To listen to lawyers, one could be forgiven for thinking that all business transactions are doomed to end in a legal dispute. Nothing could be further from the truth. The fact is that the vast majority of business transactions are carried through without any dispute arising. If problems do occur, these are often resolved amicably, to the mutual satisfaction of the parties involved. Such an outcome is particularly important if the overriding objective is to develop an ongoing business relationship or maintain one that is already established. Occasionally, however, a situation may occur which is not amenable to

informal resolution. In this case, if the issue is not of major significance, the aggrieved party may decide to overlook it as not worth pursuing in terms of time, money and effort. On the other hand, the conduct complained of may be so provocative or involve such severe financial consequences that it cannot be ignored. In this case, there may be no alternative other than to resort to a more formal method of dispute resolution.

A number of processes are available for settling commercial disputes, whether purely domestic or involving an international dimension. In the latter case, however, there are additional aspects which have the potential for complicating the issue. As an illustration of this, contrast the two following situations.

X and Y are two companies incorporated in France and transacting business only in that country. X and Y conclude a contract under which X is to supply Y with certain goods for a stipulated price. Suppose that when X delivers the goods, Y rejects them as not being of the correct quality. X denies this and demands that Y pays for the goods. Y refuses. If no settlement to the dispute can be achieved, and X decides to take legal action against Y:

- such action will take place in France, as both parties are located there;
- the dispute between X and Y will be resolved according to French law;
- If X wins and Y is directed to pay the price, X will, if necessary, be able to enforce this order against Y and its assets located in France.

Now consider an alternative scenario. A contract for the sale of goods is concluded in Japan between an English company and an Australian company. Delivery of the goods is to be in Chile. Again, suppose that, on delivery of the goods, the Australian buyer rejects them and refuses to pay the price. If the English company decides to proceed against the buyer it will face problems which were not present in the dispute between the two French companies. The dispute between the French companies was purely a domestic matter, having no international dimension. However, in the second scenario, the dispute is anything but domestic! The contracting parties are based in different countries, the contract was concluded in a third country and delivery was to take place in a fourth.

In deciding to take action against the Australian buyer, the English company would have to address the following issues:

- Should proceedings be commenced in England, where the seller has its business; Australia, where the buyer is located; Japan, where the contract was made; or, perhaps, Chile, where the goods were rejected?
- Should the dispute be resolved according to English, Australian, Japanese or Chilean law?
- If the English company succeeded in its action, could any compensation award be enforced against the Australian company?

Problems such as the above and the uncertainty they produce are not uncommon in disputes over international contracts. A number of the issues raised will be considered below, but first a brief explanation will be provided of the various methods available for resolving business disputes.

Methods of dispute resolution

Dispute resolution procedures can vary from informal, relatively unstructured processes through to formal and highly regulated lawsuits. Anyone who has experienced the stresses of litigation – and the time, effort and expense involved – might come to the conclusion never again and that, in future, recourse to such action should be avoided at all costs. As was mentioned above, the parties to a dispute may have an overriding desire to preserve their business relationship and exchanging blows in a courtroom is not guaranteed to secure that objective!

Apart from litigation, other procedures are available which provide a less confrontational environment, such as alternative dispute resolution (ADR). ADR procedures include mediation, conciliation and arbitration.

Mediation and conciliation

Mediation and conciliation basically involve the same process, in which a third party attempts to find common ground between the disputing parties with a view to coaxing them

towards a settlement. The process is essentially non-legal, possessing none of the formalities of procedure and substance that characterise arbitration and litigation. Indeed, the mediator very often is not a lawyer, but a senior businessman or -woman experienced in the same sector or industry in which the present dispute has arisen. The advantages of mediation are that it is fast, relatively inexpensive, confidential and consensual.

As mediation is consensual, neither party can be compelled to submit to it, nor can any settlement be enforced unless the parties agree that this should be the case. If it is to be successful, however, both parties should undertake the process in a spirit of good faith and with the object of reaching a settlement.

The parties are, of course, free to determine for themselves how the mediation process should proceed. However, they may choose to specify in their contract that mediation should be conducted according to a predetermined set of rules, say those designed by the International Chamber of Commerce (ICC). The ICC has produced a variety of model clauses which the parties are free to include in their contract. For example:

> The parties may at any time, without prejudice to any other proceedings, seek to settle any dispute arising out of or in connection with the present contract in accordance with the ICC ADR Rules.

Arbitration

A large number of commercial disputes are submitted to arbitration. Arbitration is a form of dispute resolution in which the parties agree to submit their differences to a third party or a tribunal for a *binding* decision, a factor which distinguishes it from mediation or conciliation. The process also differs from litigation in that it is consensual in origin. However, it should be noted that once the parties have agreed on arbitration, whether in the original contract or subsequently, they are bound by their agreement and the decision handed down by the arbitrator.

The panel, whether consisting of one or more arbitrators, is appointed either by the parties themselves or as a result of the process specified in their agreement. Although the arbitrator(s) must decide the issue according to the relevant principles of

substantive law, the procedural framework, including the rules of evidence, is more flexible than would be the case in litigation.

Arbitration has a number of advantages when compared with litigation. For example:

- The parties can choose an arbitrator whom they respect and in whose skill and expertise they have confidence. In the case of litigation, they have no influence over the selection of the judge who will be appointed by the court before which the case is brought.
- It is often less expensive.
- The procedure is (theoretically) speedier in reaching a final judgment and the possibility of appealing the arbitrator's judgment through the courts is often limited. As a result, the parties avoid the risk of being involved in protracted litigation.
- The proceedings are in private.

Arbitration can be either self-directed or institutional. In the former case, the parties themselves prescribe the mode of appointment of the arbitrator, who, on being appointed, controls the proceedings himself, but within the limits laid down by the parties and the law governing the arbitration. In the case of an institutional arbitration, the arbitration is conducted within the established framework of a national or international arbitral organisation. In such a case, the arbitrator will be appointed and the proceedings conducted according to the rules of the particular organisation involved. The London Court of Arbitration is one such organisation. Such is its international reputation that it often arbitrates in disputes where the parties have no connection with the UK, but who nevertheless are prepared to submit to its jurisdiction. Another major player in the arbitration of international trade disputes is the ICC International Court of Arbitration in Paris. It is widely used and enjoys the confidence and respect of business practitioners all over the world.

As mentioned above, in international disputes, it may be that one or even both of the parties are located in a country different from the one in which the arbitration is conducted. A concern, therefore, will be whether the judgment, or 'award'

as it is known, will be enforceable against a party based outside the country of arbitration. A large number of countries throughout the world are signatories to *The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958*. The Convention provides for the reciprocal recognition and enforcement of arbitration awards between signatory countries.

Arbitration results from an agreement between the parties that a dispute between them shall be resolved in this way. If they have not reached such an agreement and mediation and conciliation is similarly not an option, litigation might be the only avenue available to the party wishing to obtain a final resolution to the dispute which has arisen. The process of litigation can present a number of problems, some of which will now be considered.

Problems associated with international litigation

Litigation involves the submission of a dispute to a court of law. The judge will be appointed by the state, and the procedure controlling the process of litigation, including the timescale, admission of evidence, production of relevant documents and the enforcement of any judgement, is prescribed by the law of the country where the court is located. A person who intends commencing litigation will have to address several issues, of which the following figure prominently:

- jurisdiction;
- which law governs the contract;
- enforcement against the defendant of any judgement handed down by the court.

Jurisdiction

The jurisdictional aspect of litigation concerns the question of where – that is, in the courts of which country – proceedings should be brought. The claimant might have a preference for commencing proceedings in the courts of his own country, not least because he will be able to appoint local lawyers having

in-depth experience of the system governing the litigation process. However, this choice might not be the most appropriate option. Other factors should be considered, including:

- the whereabouts of the defendant;
- the location of the defendant's assets;
- the location of the evidence in the form of witnesses and documents, etc.;
- overall costs;
- difficulties associated with enforcing any judgement awarded.

If, having considered all of the above factors, the claimant decides to bring the case before the courts of a particular country, the jurisdictional requirements of the particular court will have to be satisfied. Every court, whether it be high or low and whether situated in Lima, Paris, Tokyo or New York, will have rules to determine which cases it will hear. In order to determine whether the particular court has jurisdiction, the judge will refer to that branch of the local law known as 'private international law'. If the defendant is physically located in the country concerned, jurisdictional problems are less likely to arise. However, when it comes to extending jurisdiction to include a foreign-based defendant, the courts of most countries will be wary of trespassing on someone else's 'patch' and are likely to adopt a more restrictive approach. This said, however, the courts of some countries maintain a more flexible regime when it comes to accepting 'foreign' cases, and will sometimes assume jurisdiction where the link between the court and the parties to the action is somewhat tenuous. In such a case, the court is said to be exercising 'exorbitant' jurisdiction. In some cases, this can be advantageous. For instance, having surveyed the options, the claimant might decide that he or she could benefit more by bringing the case in one country rather than another; for example, more flexible procedural rules might offer advantages over those applying in other courts, there might be a better chance of winning the claim, and any award of damages could be larger. The tactical selection of a court for the reasons just mentioned is known as 'forum shopping'. An illustration of this involved the collapse of a British company called Laker Airways in the 1980s. Freddie

Laker, the founder of the company, had set up an airline offering cheap transatlantic travel. His success incurred the wrath of other airlines operating transatlantic routes, including British Airways and British Caledonian. A vicious price war broke out, which ended in the collapse of Laker Airways. The liquidator, who was appointed to salvage as much as possible for the creditors of the company, alleged that Laker had been brought down as a result of an unlawful conspiracy between, amongst others, British Airways and British Caledonian. The liquidator commenced proceedings against these companies, determined to make them pay for their illegal activities. However, he did not sue them in the British courts but brought the action in the USA. The reasons were various, including the more favourable procedural regime operated by American courts and, most importantly, the punitive damages that can be awarded under American anti-trust laws. Efforts by British Airways and British Caledonian to get the American proceedings blocked failed. Ultimately, the case was settled with the two Britich companies having to pay substantial damages to Laker's liquidator.

In order to avoid any uncertainty over the court having jurisdiction, the parties should make a clear provision in the contract to this effect. Even though the defendant and, possibly, the claimant might not be physically present in the country concerned, the parties' agreement to submit to the jurisdiction of the local courts should enable the case to be heard there.

If litigation is contemplated against a defendant based in the European Union, the matter of jurisdiction is governed by the *Regulation on Jurisdiction and the Recognition and Enforcement of Judgements in Civil and Commercial Matters 2000* (the Brussels Regulation). This regulation attempts to reduce the multiplicity of jurisdictions in the EU in which a claimant might choose to bring proceedings. The Regulation recognises the parties' right to confer jurisdiction on the courts of a particular Member State by including a provision to that effect in the contract; where this occurs, the courts of that state have exclusive jurisdiction. In the absence of selection by the parties, the basic rule is that there shall only be one court within the EU having jurisdiction and that is the court of the defendant's domicile, in other words the country where the defendant is permanently based.

The regulation does admit some exceptions to the basic jurisdictional rule just described. If a contractual dispute is involved, the courts of the place of performance will also have jurisdiction. In cases involving the commission of a tort, the courts of the country where the harmful event occurred will similarly have jurisdiction. Thus, the possibility of forum shopping is preserved, to a degree.

The law governing the contract (the 'proper' law)

Whichever court eventually hears the claim, the issue between the parties will have to be determined according to rules of law, but the question is – which law? If the contract is a purely domestic one, the judge will apply the local law. However, if the contract is international, a different problem might arise. Consider, for example, a contract concluded between an English seller and a Peruvian buyer involving goods presently on board an Italian ship which must be delivered to a German port and paid for in Switzerland. In such a case it is not immediately obvious which law should govern the contract. Identifying what is known as the 'proper' law can be a complex and uncertain exercise.

Unless the question of the governing law is raised, the judge will apply the local law or *lex fori*. This term literally means the 'law of the forum' or, in other words, the law of the land. However, one of the parties may argue that the *lex fori* is not the system with which the contract has the closest connection and that the law of another country should apply. This is particularly likely to happen if submitting the dispute to the alternative system would produce a result different from that of the *lex fori*, but to the advantage of the party raising the issue.

When the issue of the governing law is raised, the judge cannot ignore it but must decide the question before going on to deal with the substantive dispute between the parties. To do so, he will again refer to the local rules of private international law. Remember that these rules are part of the *lex fori* and as such are not necessarily the same as those applying in other countries. In fact, there can be significant differences. In an ideal world the rules of private international law should ensure the same decision no matter before which court or in

which country a dispute is heard. Achieving such a result would promote the certainty of outcome which the successful advancement of international business relations demands. However, as will be shown, the real world falls a long way short of the ideal and, in practice, international litigation can prove somewhat of a lottery. For example, faced with the same dispute, a German court may decide to apply the law of country A, an Australian court the law of country B and a Brazilian court the law of country C. Attempts have been made and are still being made to overcome the problems created by differences in the rules of private international law, some of which will be described later.

Despite the fact that there can be differences in the way courts identify the proper law of an international contract, it is sometimes possible to discern a similarity in basic approach.

A first question to ask is whether the parties have chosen the governing law themselves. Most systems of private international law, to a greater or lesser extent, recognise the autonomy of the parties in selecting a law to govern the contract. Thus, the contract may contain a 'choice of law' clause stipulating that it should be governed by the law of a particular country or of a particular state, such as the laws of Switzerland or the state of New York. However, it is unlikely that any system of private international law will grant the parties total freedom in their choice of law. Where the selected system bears little or no relationship to either the parties or the subject matter of the contract, a court might be suspicious of the motives behind such a selection. Sometimes a court will override the parties' choice, particularly if it was made for fraudulent or illegal purposes, or to escape the effect of certain 'compulsory' or 'mandatory' rules of the *lex fori* which would otherwise apply, such as those which seek to protect consumers from unfair contract terms.

Where there is no choice of law expressed by the parties it may be possible, by examining the contract and all the surrounding circumstances, to identify an 'implied' choice. For example:

1 In previous dealings, the parties may have made an express selection which, by implication, they intend to apply to the present case.

2. The contract might provide that any dispute should be referred to arbitration in a particular country or to a particular court of arbitration. In this case, a presumption may arise that the parties intended the law of that country to govern the contract.
3. The parties may have used a standard form contract issued by an organisation based in a particular country. For instance, standard commodity contracts issued by the various members of the British Federation of Commodity Associations are in use all over the world. In the case of dispute, it may well be decided that such contracts should be interpreted against the background of English law.

Where the parties have neither expressly nor implicitly made a choice of law, the court will have to resort to a different approach. The private international law of many countries looks for the parties' 'hypothetical' intention. This involves looking at all the circumstances and attempting to discern the choice that the parties would have made had they thought about it. Although voiced in different ways, this idea is commonly shared. For example, the following views have been expressed by the courts of various countries:

> The intention which would have been formed by sensible persons in the position of X and Y if their attention had been directed to contingencies which had escaped their notice.
>
> (The English High Court)

> What the parties would have determined in a reasonable and fair consideration of all the circumstances.
>
> (The German Supreme Court)

> The law which the parties would have declared applicable if they had thought at all of stipulating on the question.
>
> (The Swiss Federal Tribunal)

> The law upon which the parties might be supposed instinctively to rely.
>
> (The High Court of Australia)

In determining the hypothetical intention, certain factors have acquired traditional weight – for instance, the domicile

and, in continental Europe, the nationality, of the parties; the location of the enterprise involved; the currency of the contract; the language in which the contract is expressed; reference to a law or term recognised by a particular legal system. None of these single factors is conclusive in itself, but any one might prove decisive. In addition, certain legal systems place particular emphasis on:

1 the law of the place where the contract was made (French, Belgian, Italian, Spanish and, to some extent, English law);
2 the law of the place of performance (German and English law, and also that of France and Italy when the presumption of the law of the place of contracting has been rebutted).

It should be stressed that the above represent presumptions only, which, in particular circumstances, can be rebutted. None is conclusive in itself. Neither is it inevitable that a single system will govern all aspects of the contract. In appropriate circumstances it could be decided that issues concerning, say, the formation of the contract should be submitted to the law of country X, while issues relating to the contract's performance should be submitted to the law of country Y.

In the EU, the matter of the proper law relating to international contracts is dealt with in the *Rome Convention on the Law Applicable to Contractual Obligations 1980* (the 'Rome Convention'). The Convention's objective is to provide in all Member States of the EU uniform rules for the ascertainment of the law governing an international contract. Broadly, it provides that the proper law shall be chosen by the parties. In the absence of a declared intention, the proper law is that with which the contract has the closest connection. There is a rebuttable presumption that this is the law of the country where the party *whose performance is characteristic of the contract* has his principal place of business. In a contract for the sale of goods, the party whose performance is characteristic of the contract is likely to be the seller.

Once the proper law has been identified, this will be applied in order to resolve the dispute between the parties. So, for example, if, in a case before him, a French judge has decided that the

proper law of the contract is Brazilian law, he will proceed to apply this law as though he was a Brazilian judge. The cry might go up, however, 'What does a French judge know about Brazilian law?' and the answer is probably little, if anything. The same could be said of neuroscience, but this would not prevent the judge deciding a case brought against a neurosurgeon for medical negligence. The truth is that expert evidence will have to be produced to 'educate' the judge in the technicalities of the subject involved. In the last example, no doubt the opinion of one or more eminent professors of neurology would be presented to the court. As regards Brazilian law, expert evidence would have to be given by, for example, a Brazilian lawyer, a Brazilian law professor or even a Brazilian judge!

If the law of every country were the same, it would not matter where a case was brought nor which law was applied, the result would be the same. However, as has often been mentioned in previous chapters, differences do exist between legal systems and this can produce uncertainty. Consider the following situation. A German company offers to sell goods to an English company for a stipulated price. The English company posts a letter accepting the offer but it arrives after the deadline set for acceptance. When sued for non-delivery by the English company, the German company denies that a contract was ever concluded.

It will be recalled from Chapter 2 that, under German law, an acceptance has to be received in order to be effective. On the other hand, English law applies the *postal rule*, under which a posted acceptance is generally effective on posting. Disparities such as these create what is known as the 'conflict problem', whereby a different result will be reached depending on which law is held to be the proper law. If English law applied in the above example, a contract would have been concluded, but not so if German law applied.

Various attempts have been made by governments and non-governmental organisations to harmonise international trade law, the idea being that, no matter in which court a case is brought, the applicable rules of law will be the same, as will, theoretically, be the result. As regards non-governmental activity, mention has been made in earlier chapters of the important initiatives provided by the ICC in the form of Incoterms, the Uniform Customs and Practice for Documentary Credits and

the Uniform Rules for Collection. Where contracts are concluded on the basis of such terms, there is less likelihood of wide variations in interpretation no matter where a case is heard.

At the governmental level, a number of international conventions have attempted to harmonise the substantive law governing international contracts for the sale of goods and their formation, a principal example being the UN Convention on Contracts for the International Sale of Goods 1980 (the 'Vienna' Convention). To date, sixty-five countries worldwide have adopted this convention, including Australia, Canada, China (PRC), Israel, the Republic of Korea, New Zealand and the USA. Although most Member States of the EU have ratified the convention, the UK has, so far, declined to do so.

As a very substantial number of international sales will be governed by the Vienna Convention, familiarity with its general provisions is advisable for any one engaged in the conclusion and execution of such contracts. Accordingly, an overview of its principal aspects now follows.

The Convention will only apply to an international sale if certain conditions are satisfied, namely:

- the contract must be for the sale of goods, therefore it would not apply to a contract for the provision of services;
- the parties to the contract must have their places in different states, so it will not apply to purely domestic contracts;
- the Convention will only apply when both states are contracting states *or* the rules of private international law lead to the application of the law of a contracting state.

Even where the Convention does not apply by virtue of the above conditions, the parties are free to stipulate in their contract that the Convention shall apply. Similarly, they can exclude the Convention where otherwise it would be applicable.

It is important to note that the Convention can apply even if neither party is located in a contracting state. Such a situation can arise either by the parties expressly providing that the contract shall be governed by the Convention, or where the rules of private international law lead to the application of the law of a

contracting state. This latter point needs further explanation. Brazil is not a contracting state but Chile is. Suppose that a contract for the sale of goods is concluded between a Brazilian company and a Chilean company, and a dispute arises over performance of the contract. Further, suppose that the dispute is eventually brought before a Brazilian court. As Brazil is not a contracting state, and assuming the parties have made no provision in the contract relating to the Convention, it will apply only if, under the rules of private international law, the proper law is found to be that of a contracting state. To determine the proper law of the contract, the judge will turn to the rules of Brazilian private international law. If, by applying those rules, Chilean law is found to be the proper law, the Convention will apply because Chile is a contracting state.

Certain contracts are excluded from the ambit of the Convention, such as consumer sales and those relating to ships, aircrafts and electricity.

The Convention governs only the formation of the contract and the personal rights and obligations of the seller and buyer arising from it. It is not concerned with the effect which, say, fraud or mistake may have on the contract nor with matters such as the passing of ownership in the goods. These issues will be left to the proper law of the contract.

Under the terms of the Convention, a contract need not be concluded in or evidenced by writing and is not subject to any requirements as to form. However, a contracting state can exclude this provision if the law of that state requires a contract of sale to be either concluded in or evidenced by writing.

As regards the formation of the contract, the concept of offer and acceptance is applied. The basic rules, which reflect the approach of civil law rather than common law, are as follows:

1. The offer must be addressed to one or more specific persons, otherwise it will be deemed a request for proposals.
2. An offer cannot be revoked if it indicates a specific time for acceptance or that it was to be irrevocable or if it was reasonable for the offeree to rely upon the offer as being irrevocable and the offeree has acted in reliance on the offer. This is different from the

general rule in common law which, it will be recalled, allows the offeror to revoke before expiry of the deadline provided this intention is communicated to the offeree before acceptance.

3 A contract is concluded on the acceptance of the offer. There must be a positive indication of an intention to accept; silence or inactivity does not in itself amount to acceptance. The Convention recognises that conduct could amount to an acceptance – for example, where the goods are dispatched in response to an offer.

4 A reply which purports to be an acceptance of the offer but which contains additions is a rejection of the offer and constitutes a counter offer. But where the different or additional terms do not materially alter the offer, the acceptance is effective on the terms of the offer as added to or varied unless the offeror objects to them without undue delay. However, this last provision has limited effect because the Convention specifies those matters which are deemed to alter the terms of the offer materially – for example, terms affecting the price, payment, quality and quantity of the goods, and time and place of delivery.

5 In order to be effective, an acceptance has to be received by the offeror. The Convention does not incorporate the common law postal rule which states that a letter of acceptance is effective on posting whether or not it arrives late, or even not at all. However, if there is a delay in receipt of the acceptance which is due to unusual circumstances and, in the absence of these, it would have arrived on time, the acceptance is deemed to have been communicated in time unless the offeror promptly informs the offeree that he considers the offer to have lapsed.

Under the terms of the Convention, the seller must deliver goods which are of the quality, quantity and description required by the contract. Goods do not conform with the contract unless they are fit for the purposes for which goods of the same description would ordinarily be used. In addition, where,

at the time of the contract, the buyer has either expressly or impliedly made known to the seller the particular purpose for which the goods are required, the seller must supply goods which are reasonably fit for that purpose unless the buyer did not rely on the skill and judgement of the seller or it was unreasonable for him to do so.

The principal obligation of the buyer is to accept and pay for the goods in accordance with the terms of the contract.

It will be recalled from Chapter 3 that an important issue in contracts for the sale of goods relates to the time at which the risk passes from seller to buyer. In many jurisdictions, unless the parties have agreed otherwise, risk passes with ownership. However, under the Convention risk is linked to control and not ownership. Thus, the risk will pass when the buyer takes delivery of the goods or, if carriage is involved, when they are handed over to the carrier for onward transmission to the buyer.

The Convention also provides for remedies available to the parties in the event of failure in performance. Whether or not a particular remedy can be claimed will depend on whether the breach involved is ‘fundamental’ or ‘non-fundamental’. A fundamental breach is defined as a breach by one of the parties which results ‘in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result’. The effect of the breach on the innocent party is the crucial factor. In some ways this resembles the approach of English law in circumstances where the term breached cannot be categorised as either a condition or a warranty. It will be remembered from Chapter 3 that, in this situation, the term will be regarded as innominate and the innocent party’s remedy will be dependent on the seriousness of the consequences flowing out of the breach.

Where the seller delivers non-conforming goods in circumstances amounting to a fundamental breach, the buyer has a number of options. If so minded, he can reject the goods, thereby avoiding the contract. Alternatively, he can reject the goods and demand that the seller makes good the

non-conformity by, for example, substituting different goods. The seller has a limited right to cure his defective performance provided that this does not cause the buyer any unreasonable inconvenience, but this right is lost if the buyer avoids the contract. Whatever the nature of the seller's breach, the buyer is entitled to damages. However, damages will not be available where the seller shows that his failure to perform was due to an impediment beyond his control and that he could not reasonably be expected to have taken that impediment into account at the time the contract was made, or to have avoided or overcome it or its consequences.

Enforcement of court judgements

Even if a claimant succeeds in his action against the foreign-based defendant, the question of enforcing the court's judgement remains. It could be that, on receiving the judgement, the defendant reaches for his cheque-book but, on the other hand, he might simply ignore it. Where a defendant is either located personally within the court's jurisdiction or has assets there, the claimant can invoke the court's assistance in order to have the judgement enforced. However, where the defendant and his assets are situated in another country and outside the court's jurisdiction, the claimant may face significant problems. One crumb of comfort would be for the claimant to discover that the defendant has assets within the jurisdiction, say money held in an account with a local bank, which could be seized in satisfaction of any judgement obtained. However, the risk to the claimant is that, as soon as the defendant suspects that he is about to be sued, a call to the bank and the press of a button will result in the claimant's 'security' being spirited away into the safety of an offshore numbered account. However, depending on the jurisdiction, it might be possible for the claimant to pre-empt such skulduggery by obtaining a court order freezing the defendant's assets within the jurisdiction pending the outcome of the case. In some circumstances, an English court is prepared to issue what is known as a 'Mareva' injunction. To obtain such an order, the claimant would have to show that he has an arguable case against the defendant and over which the court

would have jurisdiction, further that the defendant has assets within the jurisdiction and that there is a real risk that they will be removed if the injunction is not granted. If the claimant is successful in his application, he will be able to serve the injunction, say, on the defendant's bank, thus preserving the assets within the jurisdiction until the court gives its final judgment in the case.

If the above procedure is not an option, the claimant might have to face the uphill struggle of enforcing the judgment through the courts of the country where the defendant is located. The foreign court will have to recognise the judgment before giving effect to it. Whether this will occur will depend on the domestic law of the country concerned and, in particular, its private international law rules on the recognition of foreign judgments. These rules can differ from country to country and therefore there is no guarantee that a claimant will obtain final satisfaction from the defendant, even though judgment was obtained in the original case brought against him. One other possibility, however, remains. Many countries enter into either bilateral or multilateral agreements providing for the mutual recognition of court judgments. The UK, for example, has entered into such agreements with a number of countries. Any litigant wishing to take advantage of these will be subject to the provisions of the Foreign Judgements (Reciprocal Enforcement) Act 1933.

If the two countries involved in the claimant's case were found to be parties to a reciprocal agreement, the judgment obtained by the claimant could well be enforced against the defendant through the courts of his own country.

As a final point it should be noted that where the defendant and/or his assets are located within the EU, the claimant may take advantage of the Brussels Regulation. This Regulation was mentioned above in the context of jurisdiction within the EU, but it also relates to the recognition and enforcement of judgments. Under the Regulation, a judgment of the courts of any Member State must be recognised and given effect to by the courts of any other Member State. Thus, within the EU, court judgments are, as a matter of general principle, fully enforceable throughout the EU.

Summary

This chapter dealt with the following issues:

1. The nature of the international transaction and the potential legal problems associated with it.
2. The role of organisations such as UNCITRAL and the ICC in reducing such problems.
3. The advantages to be gained from settling business disputes through alternative dispute resolution rather than litigation.
4. Factors relevant in selecting the court in which to commence proceedings relating to an international transaction.
5. How divergences in the law of different countries can give rise to uncertainty, particularly in relation to identifying a contract's governing law.
6. The main principles established by the Vienna Convention on Contracts for the International Sale of Goods.
7. The problems associated with enforcing a court judgement when the defendant and/or his assets are situated outside the jurisdiction.

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