HERBERT SMITH FREEHILLS
DISPUTE RESOLUTION

This is the first in our series of **contract disputes** practical guides, designed to provide clients with practical guidance on some key issues that feature in disputes relating to commercial contracts under English law.

CONTRACT DISPUTES PRACTICAL GUIDES
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WHEN DO YOU HAVE A BINDING CONTRACT?

IT MAY BE MORE (OR LESS) OFTEN THAN YOU THINK

Sometimes what appears to be an agreement is not in fact binding, for example because it is incomplete or its terms are uncertain, or perhaps because the necessary contractual intention is lacking.

Conversely, a binding agreement might be reached despite appearances to the contrary, for example where parties commence work before a formal agreement is signed.



Tim Parkes, **Chris Bushell** and **Robert Moore** consider the problems that can arise and some practical steps that can be taken to minimise the risks.

TOP TIPS TO MAKE SURE YOU ENTER INTO CONTRACTS ONLY WHEN YOU WANT TO:

- DO remember a contract can be made by e-mail or discussions or by conduct
- DO mark all correspondence and drafts "subject to contract"
- If agreeing heads of terms DO make clear what (if anything) is binding
- DON'T start work until everyone has signed on the dotted line
- If you need to start work sooner DO try to agree key matters first
- DO make sure all obligations are clearly defined
- DON'T settle for an "agreement to agree"

"An oral contract, or one implied by conduct, is just as binding as a formal written agreement – but a lot less clear"

1. NO PARTICULAR FORMALITIES NEEDED

A contract will be formed when the parties have agreed on its essential terms, though of course that basic analysis may involve many potential complications (see our decision tree on page 9 for the key requirements for a binding agreement).

In deciding whether a contract has been concluded, the court will look at the parties' words and conduct overall and apply an objective test. Under English law, there is no general requirement for particular formalities to be satisfied before a contract is formed; it is possible to make or accept an offer orally or by conduct, as well as in writing (though this general principle is subject to exceptions for certain types of contract, where formal requirements are imposed by statute, eg contracts for the sale of land.)

Even where a contract specifies that it will only become binding if accepted in a particular way, for example if it is signed by both parties, the court may conclude that any such requirement was waived either expressly or by implication (see section 4 below).

The Court of Appeal decision in *Maple Leaf Macro Volatility Master Fund v Rouvroy* [2009] EWCA Civ 1334 illustrates the point. In that case the court found that there was a binding agreement despite the lack of signature by an essential party. The fact that the agreement contained a space for the relevant party's signature, and that the other parties had signed the agreement, did not mean that signature was a precondition for a binding agreement. It was enough that the party had in fact accepted the terms of the agreement.

2. FORMAL AGREEMENT STILL TO BE EXECUTED

Parties may agree terms in discussions or correspondence with the intention that a formal document setting out the terms will be executed later. In these circumstances, it is often assumed that there is no binding agreement until that happens. That assumption may be misplaced. In fact the court will look at the parties' words and conduct to determine whether, judged objectively, they intended to be bound immediately or only when the formal document was executed.

"The 'subject to contract' label isn't a complete magic bullet, but not using it may be asking for trouble"

The best way to avoid entering into binding commitments before you are ready is to ensure that all correspondence and draft documentation is clearly labelled "subject to contract". That gives a strong indication that the parties do not intend to create a binding contract (though it is not foolproof – see section 4 below).

Other wording may have the same effect, for example a counterparts clause which provides that no contract will come into existence until each party has executed and exchanged the counterparts. However, references to recording the terms in a formal agreement, or to an agreement "in principle", may not always be effective.

The point can be illustrated by two recent cases, both in the context of settlement agreements:

i) In *Newbury v Sun Microsystems* [2013] EWHC 2180 (QB) (see this post on our Litigation Notes blog) the High Court found there was a binding agreement where the defendant had made an offer to settle the proceedings by paying a stated sum, "such settlement to be recorded in a suitably worded agreement." It was significant that the offer specified a period for which it was available for acceptance, and a period in which payment would be made if accepted. It was also relevant that the letter was not expressed to be "subject to contract"; the presence of those words would have been a clear indication that the terms were not intended to be binding, and their absence was a relevant factor indicating the contrary.

ii) In *Bieber v Teathers Limited* [2014] EWHC 4205 (Ch) (see post) the High Court held that a binding settlement was agreed in an exchange of e-mails between the parties' solicitors despite their subsequent failure to agree formal terms. Again, it was significant that the e-mails were not labelled "subject to contract", and also that the offer was described as "a take it or leave it offer" and "a final gesture to reach settlement". Even a reference in the correspondence to the offer being "in principle" did not, in the context, mean that the offer was conditional. The context of the correspondence was also significant, in particular that the parties were under time pressure as a further tranche of counsel's fees would become payable unless settlement was reached quickly.

3. HEADS OF TERMS

Once parties have agreed the main terms for a transaction, they may decide to record those terms pending negotiation of the full agreement in a document known variously as a heads of terms, heads of agreement, term sheet, letter of intent, or memorandum of understanding.

In general, heads of terms are not intended to be binding, though they may include terms that are meant to be binding and as a result apply from the outset, such as confidentiality, exclusivity and governing law.

As noted above, the courts will determine the question of whether parties intended to be bound before execution of a full formal agreement based on an objective assessment of their words and conduct. It is therefore essential to make plain in any heads of terms or similar document whether it is intended to form a binding agreement at all, and if so to what extent, through use of the "subject to contract" label or a clear statement that the heads of terms are not intended to be legally binding except as specifically set out in the document – though no such formula can be guaranteed to prevent a binding agreement in all circumstances (see section 4 below).

It is also important to distinguish between a binding but conditional agreement and a non-binding agreement. So, for example, saying that terms are subject to shareholder or regulatory approval could potentially give rise to a conditional agreement (with a possible obligation on the relevant party to use reasonable endeavours to satisfy the condition) rather than no binding agreement at all.

The case of *Diamond Build Limited v Clapham Park Homes Ltd* [2008] EWHC 1439 (TCC) illustrates the difficulties that can arise with letters of intent or similar documents. The parties had signed a letter of intent pending execution of a formal contract for construction works (which was to be executed as a deed, according to the requirements in the tender specification).

The letter of intent stated that if it was not possible to execute a formal contract in place of the letter, the employer would reimburse the contractor's reasonable costs capped at £250,000. The employer purported to terminate the letter of intent and rely on the cap. The contractor argued that the letter of intent had been superseded by a formal contract, although no such contract had been executed.

The court noted that a letter of intent can fall into one of several categories: it may not give rise to a contract at all; it may give rise to a simple contract which is applicable pending execution of a formal contract; or it may be a contract so far as it goes, but not subject to entering into a formal contract.

On the facts, the court concluded that the letter of intent did give rise to a contract which applied until the formal contract was executed. Therefore, the contractor's rights were limited to the letter of intent.

4. BEGINNING WORK WITHOUT FORMAL AGREEMENT

Problems commonly occur where the parties agree terms "subject to contract" (whether in the form of heads of terms, a draft contract or merely an exchange of correspondence) and then begin to perform the obligations envisaged without ever concluding the anticipated formal agreement.

It may then be unclear whether they have, in fact, concluded a contract on the terms set out in the pre-contractual documentation, or whether they have concluded a contract on some more limited terms, or whether there is no binding contract at all.

Although use of the "subject to contract" label (or equivalent wording) will normally prevent the creation of a binding agreement, as it indicates a lack of intention to create legal relations, it can be overridden by other circumstances. In particular, a court may find that the parties agreed to waive the "subject to contract" requirement, so that they would be bound despite the absence of a formal signed agreement. Such a waiver might be express or it might be inferred from the parties' communications and conduct. The question of whether the parties intended to be bound, and by what terms, will all depend on the facts.

"If work has to start before full terms can be agreed, make sure you've got a clear interim agreement – and extend it as needed"

The difficulties in applying these principles in practice are well illustrated by a Supreme Court decision from 2010. In *RTS Flexible Systems v Müller* [2010] UKSC 14 (see post) the High Court, Court of Appeal and Supreme Court all reached different conclusions on the contractual position where a contractor continued work following expiry of a short form contract (described as a Letter of Intent Contract) while the parties negotiated the final contract.

A draft contract was agreed (subject to some points of detail which, the Supreme Court held, were not regarded as essential) but was never executed. The draft contained a counterparts clause which provided that the contract would not become effective until the parties had executed and exchanged the counterparts. This was treated as equivalent to a "subject to contract" provision.

On these facts:

- The trial judge held that, after the expiry of the letter of intent, a new contract had been concluded between the parties on limited terms, not the terms of the draft contract.
- The Court of Appeal held that there was no binding contract at all following the expiry of the letter of intent.
- The Supreme Court held that the parties had agreed to waive the counterparts clause in the draft contract and there was a binding contract on those terms, not the more limited terms found to exist at first instance.

Another example can be found in the Commercial Court decision in *Reveille Independent LLC v Anotech International (UK) Ltd* [2015] EWHC 726 (Comm) in March this year (see post).

In that case it was held that a Deal Memorandum was binding in circumstances where it had not been signed by the claimant, despite an express provision that it was not to be binding until signed by both parties.

The judge referred to the well-established principle that the signature of the parties to a written contract is not a precondition to the existence of contractual relations, as a contract can be created equally well by conduct. Although the Deal Memorandum provided for a prescribed mode of acceptance, in that it had to be signed by both parties, that was stated to be for the claimant's benefit alone so it could waive the requirement.

Here the judge was satisfied that the contract had been created by conduct. In reaching his decision, he was clearly influenced by the fact that the work envisaged by the Deal Memorandum had been carried out.
The defendant argued that the examples of alleged performance by the claimant were consistent with the parties acting in anticipation of agreement being reached.
The judge dismissed this argument, saying that the relevant acts were significant and consistent only with the parties recognising that they were contractually bound.

The Court of Appeal is due to hear an appeal against this decision in April 2016.

As the Supreme Court commented in *RTS Flexible*, the moral of the story is to agree first and to start work later. In many situations, however, that may be a counsel of perfection. So what can parties do to protect themselves if commercial considerations demand that they start work first and agree the terms later?

The answer is probably to agree as much as possible, even if the full terms cannot be agreed, and set out the agreed terms in a short form interim contract or binding heads of terms. This should include matters such as: what work is to be done at this initial stage; what payment will be due; how long the interim contract will last and whether / how it can be terminated earlier; and what happens if it expires or is terminated before a formal agreement is put in place.

Where agreement on the full terms cannot be concluded before the interim contract expires, and work needs to continue, the interim contract should be extended expressly.

Otherwise parties may find themselves arguing, potentially at great cost, over whether there is a contract at all and if so on what terms.

5. TERMS INCOMPLETE OR UNCERTAIN

Sometimes parties may intend to enter into a binding agreement, and believe they have done so, but a court may find that the parties' agreement is incomplete, or is too uncertain to be enforced.

As a result of this principle English law will not enforce a mere "agreement to agree". Such an obligation is too uncertain to form a binding contract: there is simply no way to determine what the parties are obliged to do.

A 2014 case illustrates the point. In *Dany Lions Ltd v Bristol Cars Ltd* [2014] EWHC 817 (QB) the court held that an obligation in a settlement agreement to use reasonable endeavours to enter into a third party contract (for the restoration of a classic car) was too uncertain to be enforced.

Although the extent of the works was set out in the settlement agreement, there was no mention of the terms of the contract that was to be entered into with the third party restorer, such as the price, and there were no objective criteria by which the court could evaluate whether it was reasonable or unreasonable to refuse to agree to any particular terms on offer.

That is not to say, however, that parties must agree every term of a proposed contract before they can be bound by it. In some cases the court may find that, judged objectively, the parties intended to enter into a binding contract even though some terms are left to be agreed. Where that is the case, the contract will be enforceable so long as:

- they have agreed all the essential terms, so that the failure to agree the remaining terms is not fatal; or
- where an essential term remains to be agreed, the court can "fill in" the missing term by implication.

Where parties reach deadlock in negotiations, it may be tempting to include provisions which leave certain points to be agreed at a later date. And indeed that may be inevitable in some circumstances, for example in a long-term agreement where it is not possible to agree terms in advance to cover all eventualities and there may be a need for some flexibility.

"It may not be possible to anticipate every eventuality and cover it off in the agreement. But that doesn't mean you shouldn't try"

However, leaving matters to be agreed may be saving up trouble for the future and, in the worst case scenario, may involve expensive litigation to find out whether or not the terms are enforceable at all. Where possible, it is best to agree all important terms in advance. If matters are left to be agreed, the agreement should ideally set down clear criteria against which agreement is to be reached, or else some other machinery for resolving disputes in the event of a deadlock.

Each case will turn on its facts, but these decisions give some examples of the court's approach:

i) In *MRI Trading AG v Erdenet Mining Corporation LLC* [2013] EWCA Civ 156 (see post), the Court of Appeal held that a contract for the sale of goods which left matters, including certain charges and a shipping schedule, to be agreed was enforceable. The court was prepared to imply a term requiring the charges / schedule to be reasonable. Since the parties had agreed every other aspect of the contract including quality, specification and price, and had stipulated for the arbitration of disputes by a market tribunal, the court said it would be "almost perverse" to find that they did not intend to conclude a binding agreement, in particular where this formed an integral part of a wider overall transaction compromising an earlier dispute.

ii) Similarly, in *Proton Energy Group SA v Orlen Lietuva* [2013] EWHC 2872 (Comm) (see post) the Commercial Court found that a contract was formed for the supply of crude oil blend even though some of the core terms were stated to be subject to further negotiation. This was a classic spot deal; the speed of the market necessitated that the parties agree the main terms and leave others to be negotiated later. Both parties used language of commitment and subsequently conducted themselves as if a contract had been agreed.

6. PROMISES ON BOTH SIDES

Unless it is by deed, an agreement will not be enforceable unless each party has provided "consideration" which means some sort of payment or value. Commercial agreements normally involve obligations being taken on by each party, and so questions of a lack of consideration rarely come up. However, problems may arise, for example, where a contract is being varied for the benefit of one or other party, who may not be taking on any additional obligations in return.

If there is any doubt, parties should ensure that a token consideration is paid (eg, £1) or that the agreement is in the form of a deed so that no consideration is necessary.

"If your contract leaves matters to be agreed, don't assume you can get round it by refusing to agree - that may not be the case"

DECISION TREE: DO YOU HAVE A BINDING CONTRACT?

Have the parties agreed the essential terms? Generally this is analysed in terms of offer and acceptance: has one party made an offer that the other party has accepted (whether in writing, orally or by conduct)? An attempt to introduce new terms into the acceptance will result in a counter-offer, so that no agreement is reached unless and until the original offeror accepts the additional terms.

N → NO BINDING CONTRACT

Y ↓

Are the terms sufficiently certain to be enforced? Even if the parties believe they have agreed all essential terms, it may be that they are too vague or uncertain to enable the court to give them a practical meaning. A classic example is where parties agreed to acquire goods "on hire-purchase"; this was simply too vague to be enforceable.

N → NO BINDING CONTRACT

Y ↓

Is there an intention to create legal relations? There will be no contract if, judged objectively, the parties did not intend to create legal relations. So if the parties make it clear that they do not intend to be bound, for example by marking correspondence or a heads of terms "subject to contract", there will be no binding contract even if all terms are agreed.

N → NO BINDING CONTRACT

Y ↓

Have both parties provided "consideration"? Unless the contract is contained in a deed, some sort of payment or value must be provided by each party in order for a contract to be enforceable, though a court will not look at whether the value provided by each party is adequate in comparison to the value obtained.

N → NO BINDING CONTRACT

Y ↓

Is there some other reason the contract may be void or unenforceable? A contract may be void or unenforceable for other reasons, for example because it is illegal or contrary to public policy, or it was entered into as a result of duress or undue influence.

Y → NO BINDING CONTRACT

N ↓

BINDING CONTRACT

NO BINDING CONTRACT

But remember the parties may have rights against each other arising in other ways, for example in tort (eg, a claim for negligence) or in restitution (eg, a claim for a "quantum meruit" for work completed).

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