Ashurst London
April 2013

Commercial contracts newsletter

Contracts: recent developments in brief

Contents

Good faith

Comment: The two cases below on the issue of good faith in contract appear inconsistent, and indeed the *Yam Seng* case was initially seen as an indication that the English courts are increasingly willing to recognise that a general duty of good faith exists. However, the higher authority (Court of Appeal) decision in *Compass* confirms that good faith will not be implied. The area may, of course, evolve further but for now the message is clear: if a party wants the other side to exercise good faith in performing its obligations, it must draft expressly.

Good faith in context

Summary: It is well established that parties contract with one another "*in the expectation of honest dealing*" (Lord Hoffmann in *HIH Casualty -v- Chase Manhattan Bank* [2003] 2 Lloyd's Rep 61) and in fact honesty is essential to give business efficacy to commercial transactions. Although the general view is that no implied term of good faith exists in contract, in *Yam Seng PTE Limited -v- International Trade Corporation Limited* [2013] EWHC 111 (QB), the court took the view that implying such a duty is not actually new or unusual but is consistent with the general theme of protecting the parties' reasonable expectations. However, the scope of the duty is heavily dependent on context. Here, the court felt that long-term contracts requiring mutual co-operation and ongoing dialogue may well require good faith if they are to operate effectively, an approach which is not inconsistent with the usual judicial approach to construction. In this case, a distributorship agreement contained a clear implication that the manufacturer, ITC, would not knowingly provide false information to the distributor and would not undercut the duty-free prices specified in the agreement.

Background: On 12 May 2009, the parties entered into a short agreement under which ITC granted Yam Seng the exclusive right to distribute Manchester United branded fragrances in specified territories. In July 2010 the relationship ended acrimoniously and Yam Seng alleged breach by ITC; namely, late shipment of orders, failure to supply, undercutting prices and providing false information. It also claimed that it was induced to enter into the agreement by misrepresentation. Key points were:

- **Obligation to ship promptly:** The issue was whether ITC's various delays were repudiatory and therefore sufficiently serious to justify Yam Seng in treating the contract as discharged. ITC was obliged to ensure that shipments were made "*promptly*". In all, four shipments were made. The first was two months late although Yam Seng did not complain at the time. The third shipment suffered an insignificant delay and the fourth was made promptly. Products for the second shipment were ordered on 6 August 2009 but were not shipped until 18 November of that year. This was a serious delay which caused significant embarrassment to Yam Seng. However, in the context of a distribution agreement of two and a half years' duration and covering many territories, it was not serious enough to deprive Yam Seng of substantially the whole benefit of the contract. In any event, the contract was affirmed when Yam Seng decided to proceed with it despite knowledge of the breach.

- **Obligation to make products available:** Only one product was available for the first six months of the agreement, and three of the six toiletries products were never supplied. Usually, a grant of rights to a distributor to distribute, market and sell products would include an implied term that the products would be available throughout the contract term. However, the background to this contract included a clear understanding that a number of products would be launched on dates specified in side letters from ITC which were sufficiently certain to have binding contractual effect. ITC had therefore breached its obligation to make these products available, although again in the court's view the breach did not amount to repudiation.
- **Implied duty of good faith:** Yam Seng argued that a term should be implied that the parties would deal with each other in good faith. Whether such a duty exists in English law has been the subject of much discussion. The orthodox view is that generally it does not, although the courts have provided "*piecemeal solutions in response to demonstrated problems of unfairness*". English law differs in this respect from most civil law systems. In fact, other common law systems (in particular the US, Scotland and Australia) seem more willing to recognise the doctrine. Traditionally, terms will be implied only if they are so obvious that they go without saying and are necessary to give business efficacy to the contract (*Attorney General for Belize -v- Belize Telecom Limited* [2009] 1 WLR 1988). However, implication is just one element of the task of construing the contract as a whole, to which background is important. Every contract includes as part of its background "*unstated shared understandings*" between the parties which include shared values and norms of behaviour. As well as the expectation of honesty (which is seldom, if ever, mentioned expressly), other implied standards of commercial dealing exist and observing them may well be a key aspect of good faith. Exactly what is required by "good faith" is sensitive to context. In some contracts it may extend to an expectation that the parties will share relevant information – so deliberately withholding such information may amount to bad faith. The court thought that this was particularly true in longer-term "relational" contracts which require a lot of communication and co-operation based on mutual trust and confidence (e.g. some joint venture agreements, franchise agreements and long-term distributorship agreements). Whether and how the test of good faith applies to such contracts is objective, i.e. it does not depend on each party's perception of what is improper but on what would be regarded as so by reasonable and honest people.

The court discussed good faith in some depth. In its view, "*any traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent that it still persists*" is misplaced. Recognising an implied duty is entirely consistent with the case-by-case approach which English law has taken to protecting the parties' reasonable expectations.

ITC's repudiatory breaches. The court found that ITC was in repudiatory breach by indicating that it planned to use another distributor in two territories in breach of the exclusivity granted to Yam Seng and in giving Yam Seng information about retail prices on which Yam Seng was likely to rely and which ITC knew to be false. As well as claiming damages for breach of contract, Yam Seng was able to recover under section 2(1) of the Misrepresentation Act 1967, having been induced to enter into the agreement by false representations that ITC had a licence to manufacture and sell the products.

Good faith: no general obligation

Summary: The Court of Appeal has held that the High Court was wrong in implying a general obligation on the parties to a long-term catering contract to co-operate in good faith. There is no such duty which applies generally in English law and if the parties want to include one, the onus is on them to draft something expressly. The good faith obligation in this agreement applied only to the two specific purposes identified in the clause in question. As a result, the respondent was not entitled to terminate the contract as a result of the appellant's conduct: *Mid Essex Hospital Services NHS Trust -v- Compass Group UK and Ireland Ltd (trading as Medirest)* [2013] EWCA Civ 200.

Background: Compass – trading as Medirest – entered into a seven-year contract with the Trust to provide catering services for two hospitals, commencing on 1 April 2008. The contract was a complex one but in Jackson LG's words was a "*cobbled together*" combination, in four documents, of a standard NHS contract coupled with a PFI-based mechanism by which Medirest was obliged to record any service failures and allocate "points" for each one, for which deductions would be made from the Trust's monthly payments. At the early stages, the Trust was faced with poor performance by Medirest (in particular, staff shortages, a decline in the cleanliness of the ward kitchens, and the presence of out-of-date food). In addition, Medirest failed to report service failures or monitor performance for the first few months. The Trust began its own monitoring and allocated service failure points, and calculated deductions, in a manner which Cranston J in the High Court described as "*patently absurd*". A few examples included:

- a box of out-of-date ketchup sachets attracted 30,860 service failure points and a deduction of £46,320;
- a supervisor's failure to sign off a cleaning schedule attracted 4,737 points and a deduction of £11,842.50;
- other cleaning issues led to 4,737 points and a £71,055 deduction;
- an £84,540 deduction was made for a one day out-of-date chocolate mousse; and
- £96,060 was deducted for some out-of-date bagels belonging to staff or patients.

Both parties were obliged by the contract to "*... co-operate with each other in good faith and take all reasonable action necessary for the efficient transmission of information and instructions and to enable the Trust ... to derive the full benefit of the Contract.*" The court at first instance held that this should be construed widely as a general obligation to co-operate in good faith, not merely in relation to the provision of information, because of the long-term, complex nature of the contract and the fact that it was put in place for the wider benefit of patients and not just the Trust. The Trust's conduct in calculating the deductions, demanding payment for them, refusing to amend them, and failing to respond to Medirest's approaches were material and substantial breaches.

Court of Appeal: Trust's discretion. The first question which the Court of Appeal addressed was the extent of the Trust's discretion in allocating service failure points and calculating deductions. The wording of the contract was, at first sight, inconsistent. One clause stated in general terms that the Trust was entitled to act this way, but another document set out a detailed and precise mechanism for making the calculations which left no room for discretion. The only sensible way to construe these provisions was to follow the precise rules and not the general wording. Context was relevant: "*the Trust is a public authority delivering a vital service to vulnerable members of the public*". It could not be criticised for allocating the full number of points, or making the maximum deduction, that it was contractually entitled to. Its only "discretion" was whether or not to exercise this absolute contractual right.

Extent of good faith was limited to the purposes set out in the clause. The clause containing the good faith obligation was described as "*a jumble of different statements, set out in an incoherent order*". Its meaning could be varied substantially by adding punctuation in different places. In establishing the correct construction, Jackson LJ was guided by the fact that there is no general duty of good faith in English contract law and if the parties wish to impose one, they must do so expressly. If this had been the parties' intention, they should have stated it in a stand-alone clause. In addition, this was a very detailed contract in which the obligations of the parties and the consequences of breach had been spelt out in precise detail and, as a result, commercial common sense did not support the existence of a general overarching duty of co-operation in good faith. As a general rule, the extent of the duty is heavily dependent on context. Here, there was no general duty; it was limited to the purposes set out in the clause, namely passing on information and enabling the Trust to obtain the benefit of the contract.

Given the above, what did it mean in practice? According to the authorities, honesty is a key element of good faith, and in this contract the obligation meant that the parties must "*work together honestly endeavouring to achieve the two stated purposes*". Analysing the Trust's conduct, it had made deductions which were not agreed with Medirest and which exceeded the amounts it was entitled to deduct. It had therefore breached some provisions of the contract – but not the good faith clause. It had not acted dishonestly; the deductions were irrelevant to the two purposes stated in that clause; and when it repaid the wrongful deductions, it effectively "cured" its breaches before Medirest purported to terminate.

The Trust had benefited from the contract. It was also relevant that, although relationships between the management of the parties grew very strained, on a day-to-day basis the contract operated as it should: information was passed on correctly, patients received their meals on time, the wards were kept clean, and patients received a good service.

Additional points: The following issues of general interest were also discussed:

- In any contract where one party has a discretion, there is an implied term that it will not exercise that discretion in an "*arbitrary, capricious or irrational*" manner; such a term is extremely difficult, but not altogether impossible, to exclude.
- Context is key when working out the extent of any duty of good faith – the authorities which were quoted were not directly comparable with the Trust's situation; it was relevant that it was a public authority providing vital services to patients (which Cranston J identified too).

- When considering a discretion, the addition of a qualifier such as "*reasonable*" imports an objective element and may operate as an adequate control mechanism.
- It is vitally important to make sure contractual documents are consistent and as precisely drafted as possible; here, the drafting came in for considerable criticism, especially since the contract was complex and substantial in nature. The Court of Appeal's use of words such as "*cobbled together*", "*jumble*" and "*incoherent*" speaks volumes and the comment was also made that the drafting itself gave rise to conflict between the parties.

Authority: be on your guard in unusual situations

Summary: It can be difficult, when dealing with an individual representing an organisation, to work out exactly the extent of that person's authority in situations where it is not clear cut. Problems are compounded where he or she acts in an unusual way, and as a result any third party faced with an uncertain situation should not be afraid to ask questions. This was highlighted in a recent High Court case in which the defendant's action failed because he had relied on his personal relationship with the individual in question and not on any representation by the organisation regarding that person's authority: *Acute Property Developments Ltd -v- Apostolou and others* [2013] EWHC 200 (Ch).

Dr S engaged the claimant, Acute, to carry out some building work. Although Acute's profits were shared equally between three individuals, one of them (Mr A) was neither a director nor a shareholder, even though he was responsible for the company's financial matters and the general management of the business. Dr S and Mr A had a very close, almost fraternal, relationship. Dr S paid £155,000 which he thought would be a payment on account of the building work. Of this, £125,000 was paid to Mrs A and £30,000 to Mr A's other business, rather than Acute itself, as requested by Mr A. The other individuals within Acute assumed that Dr S had failed to pay and Acute stopped work. Dr S claimed that he was entitled to treat the £155,000 as having been paid on account as he had followed Mr A's instructions. The question for the court was whether he could rely on Mr A's apparent authority to direct him how to pay.

Apparent authority: a question of estoppel. It was common ground that Mr A had no express authority to seek payment from Dr S, but he did have implied actual authority (and, therefore, apparent or ostensible authority) to do so because he was employed to manage financial matters and seeking payments from clients is within the usual authority of the manager of a building business. It was also common ground that he had no actual authority, express or implied, to seek payments from Dr S outside the usual course of business. The classic modern authority on apparent authority is *Freeman & Lockyer -v- Buckhurst Park Properties (Mangal) Ltd* [1964] 2QB 480 at 504-6 in which Diplock LJ made it clear that apparent authority is based on estoppel, i.e. the principal is estopped from denying the agent's authority by reason of the representation which that principal has made as to the extent of that authority. In order to establish this type of estoppel, the representation must have been made by someone with actual authority to manage the relevant organisation, either generally or in respect of the matters within the scope of that particular contract, and the representation must have induced the representee to act. However, Dr S's decision to comply with the unusual payment requests was not induced by any representation by Acute as to Mr A's authority. "*The reason he did not ask for the explanation is that he regarded [Mr A], in effect, as his brother, and therefore placed unquestioning trust in him*".

Payments could not be treated as made on account. Dr S was not entitled to treat the payments as payments on account for the building work because, in the absence of Mr A's actual authority, Dr S could not establish that he relied on his apparent authority. This was a decision which the judge regretted, as there was no doubt that Dr S had acted honestly. The comment was also made that asking for payment of such large amounts in cash, or for payment to be made to a third party without giving a good reason, was unlikely to be within a manager's usual authority. A customer faced with such a situation would be acting perfectly reasonably in asking for an explanation. The explanation may well bring the request within the scope of usual or apparent authority, which would probably protect the customer even if it were untrue.

Construction: context over semantics

Summary: The case of *Mueller Europe Limited -v- Central Roofing (South Wales) Limited* [2013] EWHC 237 (TCC) is a breach of contract claim in which Mueller was awarded over £21m in damages following a disastrous fire in its factory in Bilston, West Midlands. The court held that Central's breach of its contractual obligations to carry out the work safely and report incidents was the effective cause of the fire, although Mueller had also failed to do what it should. Also included in the judgment is an interesting comparison of the meanings of "request" and "require" in a contract – with the usual emphasis on context – and a reminder of the principles of waiver and causation.

The parties entered into a major contract to refurbish the roof of Mueller's factory. Central rigged a suspended "birdcage" scaffold just below the roof so that it could work while enabling Mueller to continue production below. Fire broke out because heaters suspended from the roof structure had not been isolated and set fire to the combustible materials in the scaffold – "*an obvious fire hazard*", according to the judge.

A "*sedulously detailed and analytical*" approach was wrong. Under the contract, Central was primarily responsible for the overall safety of the project, although it was Mueller's responsibility "*to protect and electrically/mechanically isolate all plant as required during the contract works*". Mueller argued that this sentence should be read as "as required/requested by Central", whereas Central argued that it should be read as "as being necessary" – which was Mueller's construction. Central analysed the contract for other uses of the word "*required*" and submitted that it meant "*requested*" wherever the request came from an identifiable party. Where no party could be identified, it argued that it should be read as "as necessary", in which case it imposed an absolute obligation.

The judge thought this was unrealistic for several reasons. In a commercial contract like this, the parties would not have focused on semantics. Central's analysis showed the word could be flexible and its exact meaning would depend on the context in which it appeared. The commercial objective was clear – Mueller wanted the work to be carried out by experts upon whom it could rely, but wanted to keep physical control over its own plant and equipment. This would not be achieved by making Mueller responsible for identifying when isolation of plant and machinery might be necessary. Mueller could not do that on its own. However, there were difficulties with Mueller's interpretation too. The judge preferred to construe the clause as obliging Mueller to act as required, on information of which it was, or should have been, aware.

No waiver by Mueller. Mueller had not insisted on Central complying with its method statement and had allowed it to carry on working without written confirmation that the electrics, heating and crane had been isolated. Central argued that Mueller had therefore waived any right to assert that Central had acted in breach of contract in relation to each obligation. Both parties agreed that waiver only arises where a party behaves in a way which conforms with only one or other of two alternative, inconsistent courses of action open to it. Central's view was that waiver may apply whenever a party has to decide whether or not to exercise a right it has become entitled to, and that the principle can apply to non-contractual performance falling short of repudiatory breach. Mueller emphasised the need for a clear and unequivocal communication of the relevant choice. Although Mueller did not insist on Central complying with the method statement, this was not itself a contractual obligation – and failure to comply was not therefore a breach of contract. Secondly, Mueller had not chosen one of two alternative inconsistent courses of action. Its conduct indicated that it was prepared to rely on its remedy in damages if Central's behaviour led to loss. Thirdly, there was no clear and unequivocal communication by Mueller. Both sides "took their eye off the ball" in respect of the non-compliance without discussing the matter. Finally, there was nothing to suggest that Mueller had, by its conduct, given Central an unequivocal representation that it would not be expected to comply with its other contractual obligations.

Causation. The general rule is that a breach will lead to liability if it is an "effective" or "dominant" cause of the claimant's loss rather than merely an occasion for it. The words "effective" and "dominant" cannot be precisely defined but probably do not differ significantly in their meaning. Where concurrent causes exist, the question of which is effective is one of fact and the key question is often whether the effect of one is to "obliterate" the effect of the other. Unreasonable conduct on a claimant's part will not necessarily break the chain of causation. In this case, Mueller's failure to isolate the heaters was clearly a concurrent cause of the fire, but Central's breaches were the effective cause.

Construction: radical changes in circumstances: purposive interpretation applies

Summary: It is often very difficult to give practical advice on how to construe a term of an existing contract to deal with radical and unforeseeable changes in circumstances. The Supreme Court has confirmed that when such issues arise, the documents must be seen in the context of the circumstances which prevailed at the time they were entered into. In *Lloyds TSB Foundation for Scotland -v- Lloyds Banking Group PLC* [2013] UKSC 3 this meant that a gain on acquisition, made when Lloyds Banking Group (LBG) rescued HBOS in 2008, had to be ignored when calculating the sum payable by LBG to the Foundation in the relevant accounting year. As a result, the Foundation would receive only the minimum sum of £38,920 rather than the £3,543,333 for which it argued. The case is a clear example of the purposive approach to construction and interpretation issues taking precedence over the literal meaning of the words.

Fundamental change in accounting practice. In 1985, the Trustee Savings Bank Group established the Foundation to make grants to charities helping disadvantaged people. The Foundation and LBG entered into a deed in 1997 in which LBG covenanted to pay the Foundation a certain sum each year. This sum was the greater of a specified minimum (£38,920) or an amount calculated by reference to the group profit (or loss) before taxation as shown in the Audited Accounts (as defined). At the time, this was the most tax-efficient way of structuring the arrangement. At the time the deed was made, two fundamental legal and accounting principles prevailed – i.e. first, that a profit and loss account included ordinary activities, not one-off acquisitions or disposals, and secondly, that only profits – or losses – realised at the date of the balance sheet should be included.

However, in July 2002 the European Union adopted Regulation 1606/2002 which led to a fundamental, and completely unforeseen, change in the accounting requirements for listed companies and after 1 July 2005 any negative goodwill arising from a "bargain purchase" had to appear in the profit and loss account so that it was visible immediately notwithstanding the fact that it represented an unrealised gain. The HBOS business fell within the "bargain purchase" category because it was acquired at half book value in anticipation of its likely losses. As a result, LBG argued that the £11bn "gain on acquisition" from the discounted HBOS deal should be left out of the reckoning for the purposes of the deed when ascertaining the group profit and loss before tax.

"The proper approach is contextual and purposive". Although Hope LJ and Clarke LJ remarked that it was a difficult case, the Supreme Court upheld LBG's argument. The words of the deed had to be read in the light of what a reasonable person would have taken them to mean in 1997, when the concept of introducing negative goodwill into the profit and loss account was "*unthinkable*". The "*landscape, matrix and aim of the 1997 Deed ... could not be clearer*". It was focused on realised profits and losses which would then be used to calculate group tax. The issue was now "*how its language best operates in the fundamentally changed and entirely unforeseen circumstances in the light of the parties' original intentions and purposes*" (Lord Mance) and not the literal meaning of the words. The natural, and best, approach was to use the realised profits or losses for the calculation and ignore the unrealised gain on acquisition in the 2009 accounts. Once this was taken out of the equation, the balance was a loss, and the minimum sum was payable.

Beware wide rights under audit clauses

Summary: An audit clause is frequently included in long-term contracts to oblige a supplier or service provider to maintain records relating to its performance of the contract and provide the customer with copies of, or access to, them. The circumstances in *Transport for Greater Manchester -v- Thales Transport Security Limited* [2012] EWHC 3717 (TCC) were unusual in terms of the severity of the issues and the size of the overspend. However, the case confirms that although the exact scope of what is covered by an audit clause depends on the wording, such clauses may potentially result in suppliers being obliged to make available a huge range of documents. As a result, it may be worth reviewing any such clauses to restrict the nature of the information which may be covered (and the purposes for which it can be requested) and to include an express right to redact sensitive or irrelevant material.

The claimant (TGM) entered into a £22m contract with the defendant (Thales) for the supply of monitoring and communications equipment and trackside equipment as part of the expansion of the Manchester Metrolink tram system. The project was badly delayed, and Thales claimed an extension of time and an additional £42m. When Thales resisted TGM's request for documents to verify this claim, TGM applied for an order for specific performance. The parties' arguments focused on whether the relevant clauses in the contract should be given a broader or narrower interpretation. Briefly, the clauses obliged Thales, as supplier, to maintain in a form suitable for inspection "Records" (as defined) relating to performance of its obligations under the agreement for at least 12 years. TGM, as customer, had a wide right to request copies of, and access to inspect, the documents. The clauses applied to the Records plus other "*information, records or documents*" relating to them.

Wide right to audit "*not intrinsically or inherently unfair or non-commercial*". The court identified a number of key points concerning the context and commercial background of the contract. The contract was a key part of a much larger infrastructure project costing around £1bn; TGM was a public body – in other words, accountable for the use of public funding; and the nature of Thales' requests suggested that "*something has gone seriously wrong*". Hence TGM was justified in seeking detailed knowledge of exactly what was happening with the contract.

The vast majority of the documents which TGM requested were ordered by the court to be provided. One interesting point is that the word "auditing" in the context of "*auditing any information supplied*" was given a meaning wider than its accounting meaning (the official verification of financial accounts) and was interpreted instead as "vetting" or "checking". Similarly, the concept of "*performance of its obligations*" included any failure to perform – use of the words "*relating to*" performance suggested a broader construction was correct. Hence, the clause covered records of costs incurred and records made after the event. It could also extend to confidential documents, subject to the caveat that TGM, as recipient, would be obliged not to disclose them further.

- The board minutes of Thales UK Limited (a separate company within the group) were included in the order as it would be "*surprising*" if a project so much delayed and over budget was not brought to the attention of the Thales UK board. Matters in those minutes unrelated to this particular contract could always be redacted.
- The order did not include documents explaining the departures of senior management at Thales. The court had concerns that this part of the request could be a "fishing expedition" and might touch upon some extremely confidential issues. It is worth noting that the Data Protection Act would not necessarily prevent disclosure "*… given that disclosure of otherwise protected documents pursuant to compliance with a court order must provide some defence to any charge of breach of that Act*".
- It was common ground that privileged documents, such as legal advice, would not be disclosable under the contract but further evidence was needed as to whether specific documents fell under this heading.
- Some items were described in terms which were too vague to allow the disclosing party to know accurately what it was required to provide (one example was "*documentation relating to integration and performance of suppliers' equipment within the overall system*"). In each of these cases it would have been possible to narrow down the description.

Post-termination restrictions and the "*reasonable protection of a valid interest*"

Summary: The High Court has held that a one-year non-compete covenant which was limited to a specific territory (defined according to the customers' locations) in a franchising agreement was reasonable and enforceable. This franchise had been carried over beyond its contractual expiry date by agreement between the parties and it was held that the one year should run from the date the relationship actually ended and not the date set out in the original contract. *PSG Franchising Ltd -v- Lydia Darby Ltd* [2012] EWHC 3707 QB.

This was an action by PSG Franchising Ltd (PSG) to enforce post-termination restrictive covenants in an agreement with the defendant. PSG grants franchises of local property search services to franchisees who then typically provide the services to solicitors, conveyancers and mortgage lenders. The franchise agreement here was for a fixed five-year term and ended on 31 March 2011, although the parties carried on their relationship as though the agreement was still in place until it was formally terminated by deed of surrender effective from 31 August 2012. PSG alleged that the defendant had been carrying on a competing business since September 2011 and continued to do so after termination and sought to enforce various restrictive covenants:

- a one-year restriction on involvement with "*any business which provides any services which compete with any of the Services provided by the Company (i.e. the franchisor) or any of its franchisees within the Territory*" (defined according to various post codes); and
- a one-year non-solicitation covenant.

Defining the scope - the natural meaning of the words. The first covenant was in issue in the case. The defendant argued that, rather than being geographically limited, it covered the entire UK, which was too wide to be reasonable. It also claimed that the definition of "Services", which included new or substitute services as may be developed from time to time, was too wide as well which supported the unenforceability of the clause. In examining the territorial aspect, the court looked at the agreement as a whole. The document included specific obligations on the franchisee to promote the business and operate it efficiently "*within the Territory*" and had specific clauses addressing what should be done with approaches from customers outside the Territory. (The critical element in deciding whether a service could be provided within the Territory was the location of a customer's office.) The court quickly held that the natural meaning of the clause was that it was limited geographically. The words "*within the Territory*" qualified the place in which the services were provided and not the location of the other franchisees. In addition, the agreement as a whole made it clear that the address of the customer, and not the address of the franchisee(s), was key. This was a "*straightforward and workable*" approach – the franchisee would easily be aware of the location of its customers but had no way of knowing where the other franchisees were based.

"Services" were defined not only as the provision of reports and other services existing at the time of the franchise agreement but also as other such things "*in addition to, or in substitution of, them as may be specified in the Operations Manual from time to time*" and the defendant took the view that this extended the restriction to an unreasonable extent. The court held that the term "Services" would be limited to the business of providing search reports and would not, for example, extend to prevent competition if either party started carrying out an entirely different type of business. However, it would prevent the defendant from introducing new types of search reports or new ways of providing existing reports within the Territory within one year after termination. No evidence was put forward about the way this clause worked in practice as no new services had been introduced.

The court also mentioned that, in addition to the usual rules of construction, there is a further principle to be kept in mind when construing a post-termination restriction. This is that, when choosing between two possible meanings, and without re-writing the clause, the meaning which limits the clause to the reasonable protection of a valid interest should be preferred over a rival meaning which would render the clause void: *Littlewoods Organisation Ltd -v- Harris* [1977] 1 WLR 1472).

Enforceability – reasonable to protect the claimant's "*legitimate business interest*". The territorial scope was reasonable (see above). Although the services element was in theory wider, in that it could apply to new services introduced after termination, this possibility had to be viewed in context:

- it was limited to one year only;
- it only applied to services which formed part of the business of providing property search reports; and
- it only extended to providing such services to customers within the Territory.

As such it was "*no more than was reasonable*" to protect PSG's legitimate interests. The point was also made that, when considering post-termination covenants, a franchise agreement was much more akin to a commercial contract (such as a business sale agreement) than an employment contract. It was also mentioned that a clause acknowledging that the defendants had been advised to seek independent legal advice about the agreement and that the restrictions were fair and reasonable probably could not be relied upon to support enforceability because whether or not a clause was void as an unreasonable restraint of trade is a matter of law and not agreement.

Defendants bound until 31 August 2013 not 31 March 2012. The defendants quoted a case called *Flat Roof Co Ltd -v- Bowden* [2009] EWHC 2894 (Ch) as authority for the proposition that post-termination restrictions in a franchise agreement do not usually extend beyond their original contractual expiry date, even where the franchise is carried over. However, the court found no evidence to support this and actually had doubts whether the case had been correctly decided. In any event, the fact that the parties had entered into a deed of surrender with a clearly-stated expiry date showed beyond doubt that the covenant would run for one year from then.

Sale of goods: excluding Sale of Goods Act implied terms

Summary: The courts have consistently held that clear words are needed in a sale contract to exclude the conditions about quality implied by the Sale of Goods Act 1979. This approach has been followed in *Dalmare SpA -v- (1) Union Maritime Ltd (2) Valor Shipping Ltd (The Union Power)* [2012] EWHC 3537 (Comm) and the point was made that the sale of a ship should be dealt with for these purposes in the same way as the sale of any other item of machinery or equipment. The court also held that the requirement for the ship to be "*as she was*" merely obliged the sellers to deliver her in the same condition as she was when inspected. Although this did not have to be decided, a sale of goods "as is" would probably exclude the right to reject, but would probably not be enough to exclude the right to claim damages for breach of the implied terms regarding description, satisfactory quality and fitness for purpose.

Clarity is paramount. This case involved the sale of a vessel, a 1994-built motor tanker, under an agreement which provided that it would be "*delivered and taken over as she was at the time of inspection, fair wear and tear excepted*" and "*delivered with her class maintained extended … without condition/recommendation, free of average damage affecting the Vessel's class*". When she was inspected before purchase, no-one noticed a reference in the class records to damage to the no. 1 crankpin on the main engine. Less than six weeks after delivery to the buyers, the main engine broke down because of an issue with the no. 1 crankpin; it was undersized and misshapen and the arbitrators found that it should have been obvious, at the time of delivery, that the crankpin was likely to fail very soon. The arbitrators held that the section 14(2) condition about satisfactory quality was implied into the sale contract and the sellers had breached it as a result of the problem with the crankpin.

Express wording needed. Under section 55(2) of the Sale of Goods Act, the section 14 terms may be negated or varied by express agreement, by a course of dealing, or by usage binding on both parties, and an express term of the contract will not negative an implied term unless inconsistent with it. In practice this means that section 14 applies unless the parties expressly agree otherwise, or include a "*clear and unequivocal statement of an alternative regime as to quality*" which is "*wholly inconsistent*" with section 14(2). There is a great deal of authority for the principle that clear words must be used if terms which have the status of conditions are to be excluded; in such situations the court is not faced with the usual competing approaches to construction (i.e. one focusing on the actual words used, and the other favouring their natural meaning). Added to this, where express conditions or warranties are given, they usually operate in addition to the statutorily implied terms (Benjamin's Sale of Goods, 8th edn. [11-068]).

The words in the contract "*as she was*" were merely "*part of a temporal obligation*" – in other words, they were included to address the fact that there is usually a period of time between inspection and delivery and the buyer wants to ensure that the vessel is delivered in the same condition as at inspection. They say nothing else about the seller's obligations as to quality at either time. "As she was" differed from the phrase "as is", which is sometimes seen in sales contracts, and given the courts' strict approach, neither would be enough to exclude the statutorily implied terms. The tribunal's decision had been correct.

Sale of Goods Act: wide meaning of seller's "right to sell"

Summary: The Patents County Court case of *Azzurri Communications Limited -v- International Telecommunications Equipment Limited T/A SOS Communications* [2013] EWPCC 17 reminds us that the implied terms in section 12 of the Sale of Goods Act 1979 concerning the seller's rights to sell goods, and the buyer's right to enjoy quiet possession, can be breached in cases of trade mark infringement. Here, it was held that the buyer of counterfeit phones acted reasonably in delivering up the goods to the trade mark owner on discovery of the problem and could recover the full cost of buying replacement handsets from the seller, plus its costs in terms of staff time.

Section 12 SGA gives a wider, rather than narrower, interpretation. The claimant agreed to supply the Automobile Association with nearly 2,000 telephones for its UK call centres. It acquired one batch from a supplier called Westcon, and a second batch from the defendant. An investigation into problems with the phones purchased from the defendant revealed that the handsets were either refurbished or counterfeit. The trade mark owner brought infringement proceedings and the handsets were delivered up to it.

The contract was subject to the Sale of Goods Act 1979. As a result, a condition was implied, by section 12(1), that the seller had the right to sell the goods. In addition, there was an implied warranty in section 12(2)(b) that the buyer would enjoy quiet possession of the goods.

The "right to sell" is not just confined to the ability to pass property in the goods. Its meaning is wider – so that, if a third party with a superior title is able to obtain an injunction restraining the sale of the goods, the seller has no "right to sell" (*Great Elephant -v- Trafigura* [2012] EWHC 1745). In *Microbeads AG -v- Vinehurst Road Markings Limited* [1976] RPC19 (CA), Lord Denning had previously held that the "right to sell" includes the right to confer on the buyer the undisturbed possession of the goods. It was accepted by SOS that section 12(1) had been breached, as had the warranty in section 12(2).

Delivery up was reasonable. In the judge's view it was not necessary to rule on whether a court would or would not have ordered delivery up of the goods. The relevant issue here was one of mitigation. The claimant was threatened with proceedings for trade mark infringement and compromised that claim by (among other things) delivering up the goods to the trade mark owner. Was that reasonable mitigation? It was accepted that, although the onus was on SOS to show that Azzurri ought to have taken certain steps to mitigate its loss, the standard imposed on Azzurri would not be a high one because SOS was a "wrongdoer". "*The claimant is not under any obligation to do anything other than in the ordinary course of the business nor to take a step which might endanger his commercial reputation*". It was held that delivery up of the handsets to the trade mark owner was reasonable and was not a failure to mitigate on the claimant's part.

The principal loss incurred by the claimant as a result of the breach of the section 12 terms was the cost to it of buying replacement phones – i.e. the full cost, and not just the difference between the sum paid to Westcon and the sum paid to the defendant – plus staff costs.

Contacts

If you would like further information on any of the matters discussed in this newsletter, please contact:

Mark Lubbock
Partner, London
T: +44 (0)20 7859 1762
E: mark.lubbock@ashurst.com

Christopher Bates
Partner, London
T: +44 (0)20 7859 2388
E: christopher.bates@ashurst.com

Patricia Wade
Head of Professional Development, London
T: +44 (0)20 7859 1031
E: patricia.wade@ashurst.com