

# Chapter 1

## Commercial and legal objectives of contracts

### What is a commercial contract?

Contracts are used in widely varying situations. A contract may be required to confirm a transaction such as the sale or supply of products, materials or assets, or for the provision of services, or to create a legal relationship. A contract may be verbal or written. It may be expressed in very simple words or it may be extremely complex, in which case it is likely to be in the form of a long written document with appendices and schedules. Whatever the contract is about, it is an arrangement made between two or more parties as an agreement with respective rights and obligations, which legally bind them.

The contracts being discussed in this book are those made for commercial purposes between businesses, including not-for-profit organisations. These principles also apply to contracts made in the public sector, although in practice other special rules, such as regulations on public procurement tendering also apply, which are beyond the scope of this book. Consumer contracts are also excluded.

### Why have contracts?

In the cut and thrust of commercial life, contracts are often taken for granted. But it is worth taking a step back to analyse the reasons for having contracts. This will better enable a good contract to be drawn up that meets the particular purpose for which it is required.

#### Investment

One commonly held view is that a contract is simply a document to be kept as a regrettable insurance in case something goes wrong – a ‘disaster purchase’. If matters do not work out, as a last resort the contract can be invoked, to provide a legal remedy for the fault that has occurred. But this is a negative and reac-

tive view of contracts. It also means that attention is not paid to creating a good contract, because at the outset both parties assume that it will succeed, and no one believes that it could possibly go wrong.

However, it is more practical to use the law positively as a resource, to create a contract that will achieve the parties' respective strategic and commercial aims, as an investment, to regulate the commercial relationship.

### **Framework of rights and responsibilities**

Each party to a contract comes to the negotiating table with different objectives – perhaps to sell or buy products, make a profit, or obtain a good service, acquire something useful for a business, or add value to research. Taking the perspective that a contract is an investment, a contract may be negotiated that will properly reflect each party's requirements and their different interests in the outcome, as a nexus of rights and responsibilities – one party's rights mirrored as the other's obligations for both parties' mutual benefit.

### **Identification of important issues**

A good contract establishes and reflects the specific terms that are important to the parties. It can become a focus for discussing and clarifying their respective intentions. In this way it is effectively a plan to ensure that all the relevant issues are covered in precise language, and that there is agreement and mutual understanding; for example, what is being included for the price being paid, and what would incur separate charges.

### **Certainty**

One major function of a contract is to provide continuing certainty, which is important for commercial activities and relationships. A contractual relationship should survive any changing business circumstances or changes of personnel in either party.

### **Anticipation of contingencies**

A contract can anticipate and allow for possible contingencies. If there are future possible events that the parties envisage might occur, a contract can state what would happen in those circumstances. For example, if the contract is with a consultancy service organisation for the provision of services by an individual consultant from that organisation, and the appointed consultant is subsequently

promoted or otherwise moves on, the contract can clarify whether the client is permitted to have a say in the choice of the consultant's successor.

### **Source of reference**

The contract framework can act as a guide or checklist to ensure that all the issues are considered and recorded. Then it can become a useful source of reference for the parties working together while the contract is in force – for instance if a reminder is needed about how the management meetings are convened and who should attend.

### **Risk management**

A contract allocates risks and liabilities between the parties according to how much risk they are each prepared to accept or pass on. Some risks may be eliminated or avoided, but others may have to be controlled and managed. For example, one risk is that payment may be made late. It can be managed by a contractual provision for interest to be due and payable in that event.

### **Enforceability**

If contract terms are important enough to negotiate, they are important enough to remember and carry out. Once a contract has been negotiated and signed, it is a mistake to regard it as something “put away in a drawer” and never subsequently referred to. If the expectations set out in the contract are not met, the contract should be formally enforceable.

With these reasons in mind during the contract's drafting and negotiation, a contract can be agreed which is fit for purpose. Perfectionism is not always achievable or even necessary. The objectives in constructing a contract are based on the assumption that the parties want to do business together, and can reach mutual agreement about the way that the business should be carried out. Point scoring or posturing is of no value.

It is also worth weighing up whether the expense, effort and time of major negotiation is warranted. If the subject matter is high value, complex, involves a long time scale to implement or is going to have a critical impact on the business of either of the parties, then there will be no question that time should be spent in agreeing a contract. But if the arrangement is for a sale of simple goods, which have been sold thousands of times before, or the contract is low value, then although it is still important to agree the terms of the sale, it may not be realistic to spend days, weeks or months in finalising the small print.

## Contract title

The title of a contract should make it clear what it is about from a legal and commercial perspective. The commercial representatives of both parties may give the agreement an inaccurate working title, such as 'Marketing Agreement' or 'Agency Contract', when the main purpose of the agreement is to set out the arrangements for product distribution by a contractor who is independent of the supplier, not an agent, where agreed marketing arrangements are only a small part of the overall terms and conditions. The title should reflect the content.

## Contract introduction or recitals

Normally an agreement starts by naming the parties to it, and this is discussed further in Chapter 2.

Next, although it is not obligatory, it is usually helpful to state the purpose of the agreement, and the facts of which the reader should be aware in order to understand the document. The background to the arrangements may set the scene. The relationship of this agreement to other contracts may be relevant. This section may simply be called 'Introduction' or 'Background', or it may be in more technical language, headed 'Recitals' followed by 'Whereas'.

Such information serves as an introduction, and does not actually comprise terms or conditions of the agreement. Consequently promises, undertakings, warranties or assurances by either party should not be included at this point, and it is useful to make it subject to the terms of the agreement, so that if there is any conflict between what it states and the content of the terms themselves, the construction of the latter will not be affected by it.

This illustration is for a simple consultancy agreement, the Client and the Consultant having previously been identified as parties to the contract:

### **Introduction**

**The Client has agreed to engage the services of the Consultant to provide computer consultancy, programming and related services from time to time as an independent contractor, and the Consultant has agreed to accept such engagement on the following terms and conditions.**

Another simple, but more technically expressed, example is for a contract for specific development of software that has already been licensed by the Licensor to the Licensee, as these parties would already have been identified:

### **WHEREAS:**

- a) **By a Software Licence Agreement dated...the Licensor has licensed software to the Licensee subject to its terms and conditions;**
- b) **The Licensee wishes the Licensor to carry out modifications, enhancements, or further development from time to time in relation to such licensed software;**
- c) **The Licensor will carry out such work on the terms and conditions of this Contract and its associated appendices, as these may be added to the Contract from time to time by mutual agreement in writing and thereby incorporated into the Contract ('Appendices');**

### **IT IS THEREFORE AGREED:**

## Contract formation life cycle

Ways of doing business evolve, and consequently contracts change in style, content and scope. Formal or less formal language may be preferred, and either is acceptable, so long as the wording is clearly expressed.

### The essence of the contract

A common, but inadvisable, starting point for drafting a contract is by using a precedent with apparently the same objectives or one that has previously met a similar purpose. Ideally the starting point should be to set out the principal requirements of the commercial arrangements for which a contract is needed, and the relevant legal terms considered. The focus will be on outlining the main principles of the contract relationship or transaction; and the essence of the contract: a description of the products or services concerned, identification of any special conditions and exclusions, and the principal contributions each party will make. Only once this has been done should a precedent or template be consulted, as a check that everything necessary has been covered.

### Producing the first fully worded draft

The draftsman can begin by drawing up a structure or skeleton of headings. This first draft may well be incomplete. There may be clause headings without the detail, or gaps left, or schedule headings without the content, or alternative proposals put forward as options.

At this point a decision will be taken on the sequence of clauses, discussed later in this chapter.

### Schedules

A schedule is often used for definitions to be expanded, for descriptions or for setting out details. For example 'Territory' may be defined as "'Territory' means the countries listed in the Territories Schedule". It may need to be completed in the first place by the people who are technically involved, such as for the definition of 'Software' or the description of 'Technical Specification' and reviewed for precision and clarity. Sometimes a schedule will consist of information that may need to be conveniently referred to during the lifetime of the contract, such as the procedure for meetings, or of information that may be varied from time to time (as allowed for within the contract) such as a price list. The body of the

document must contain a statement referencing and incorporating the schedule. Traditionally a schedule consists of paragraphs and sub-paragraphs rather than clauses and sub-clauses.

### **Iterative discussion and agreement**

The other party will review the draft initially sent, amend or add to it, or remove any provisions that it finds unacceptable, and return it. These modifications will then be considered by the proposing party. The review and negotiations will be an iterative process, and may take place by sending the document backwards and forwards, without meetings or between meetings, as well as at face-to-face meetings.

It is neither constructive, courteous nor professional to amend a draft simply on account of style.

It is preferable to deal with a group of related matters together, such as the payment terms and sanctions for non-payment or late payment. Opportunities for trade-offs can then be taken logically together.

It may not be necessary to draft an amendment at the meeting itself where the revision has been discussed. Under pressure it may be hard to compose appropriate wording. Outside the meeting it is often easier to devote time to consider wording that accurately states what has been agreed.

### **Execution and implementation**

Under English law, once all the terms of the contract have been agreed, it is not normally necessary for it to be signed formally for it to take effect. However, a contract in writing where the terms and conditions have been negotiated, will typically be concluded by each party signing. The contract may be implemented immediately on execution, or with an agreed timetable, or at a later agreed date, depending on what it states.

## **Sequence of contract terms**

The sequence of clauses will affect the presentation and understanding of the contract, but is a matter of art, not an exact science. There is no one single correct method to achieve this structure, and different people will hold different but equally valid views as to which is the best sequence for negotiators and for future

readers of the contract. Considerations will include: how to keep the order logical; stating the most important rights and obligations early, and the exceptions and contingencies later; whether to incorporate contractual events chronologically; which clauses are required for good legal practice rather than for their significance to the particular terms being negotiated, and where they can most reasonably be located. For a lengthy contract, a Contents page is helpful.

The following is one possible sequence for clause headings for a contract for supply or purchase of products or services, although the final decision will depend on the particular content and purpose of the contract.

Where the clause is discussed further in this book, the chapter reference is given:

- Parties' identities and addresses (Chapter 2);
- Purpose of the contract; introduction or recitals (this chapter);
- Definitions (Chapter 5);
- Duration of the contract and any renewal (Chapter 6);
- Prices, charges and payment terms for the products or services;
- Obligations of supplier – e.g. product development, preparation and delivery;
- Obligations of customer – e.g. to pay for the products;
- What is excluded from the contract – e.g. if services are being provided, there may be certain services specified to be outside the scope of what has been agreed for the charges being made;
- Supplier's intellectual property rights – e.g. if the contract is a software licence;
- Supplier's warranties – e.g. that the services will be provided with professional skill and care;
- Supplier's indemnities and limits of liability (Chapters 4 and 7);
- Confidentiality provisions (Chapter 7);
- Termination provisions (Chapter 6);
- Standard 'housekeeping' or 'boilerplate' contract provisions, such as:
  - Entire Agreement (Chapter 3);
  - Assignment and Novation (Chapter 2);
  - Force Majeure, Notices, Waiver, Severability (Chapter 6);
- Law and Jurisdiction (Chapter 3).

## Which party should initiate the contract?

The party whose regular business is the subject matter of the agreement, such as the sale of goods, will be likely to have at least a basic format for its contracts, if not standard terms and conditions, covering all relevant points. It may be more economical for the other party to review that document (but not necessarily). However, a party who believes it is the most powerful, may insist on its own draft contract as a starting point. For example, a major blue chip company or public sector customer may wish to propose its own terms, where the contract is of very high value, or where it perceives that the contract will be prestigious for a small or new supplier; whether or not this is actually the most efficient way to proceed.

## Standard terms and conditions

A party, usually the supplier, may habitually make its contracts on its standard terms and conditions.

This does not mean that the contract cannot be negotiated. It should still be read and carefully reviewed, and any objectionable issues negotiated, or terms added if required by the other party.

Standard terms and conditions have the following advantages for the party who has drawn them up.

### Covering all relevant areas

The terms and conditions should contain a coherent set of interdependent provisions for the sale or supply of the goods or services, according to the supplier's way of doing business and so that nothing is overlooked. They must also allow for what the supplier knows will be required as a matter of course by its customers.

### Taking account of business interests

The supplier must be committed to its terms and conditions, to the extent that its sales people can defend each one with clear commercial and legal reasons.

### **Consistency**

Terms and conditions will essentially offer identical terms to all customers with similar requirements. Customers often expect that the terms of their contracts are the same as, or certainly no worse than, anyone else's.

### **Identifying and protecting proprietary interests**

Proprietary rights should be identified, defined, asserted and acknowledged in a contract, the owner not merely relying on the general law. Third party rights may need to be expressly reserved.

### **Limitations and exclusions of liability**

In standard terms and conditions, limitations and exclusions of liability must always be justifiable to be enforceable. The justification may be expressly stated in the terms. It may be in terms of the risk to the supplier, or the limits may be associated with insurance cover, or by reference to the overall price charged, which will be directly related to the terms on which the goods or services are supplied.

### **Supplying the same goods or services to many customers**

Where the supply or purchase is of relatively low value, standard terms can ensure that the supplier's pricing policies and proprietary rights are still safeguarded.

## **Framework agreements**

A framework agreement sets out the main principles of agreement between the parties for a number of discrete transactions, individually agreed from time to time, which may take place over many years.

For example, the supply of goods may be governed by a framework agreement which sets out the criteria of the payment terms, rights and obligations of each party, supplier's warranties and general contract clauses, binding the supplier to supply goods on those conditions over an agreed period. These terms and conditions will be negotiated only once, at the outset.

The customer may be required to place orders for a minimum quantity or value of products over the agreed period, or there may be no commitment to do so. Each time the customer requires goods, it will place an order for the products

to which the agreement applies, or make a selection from the supplier's catalogue that may be updated from time to time. Each order will be an individual contract that is made subject to the framework agreement terms and conditions.

The prices for the goods may be set as part of the framework agreement, but will more usually be agreed as part of an individual order, perhaps from the up-to-date catalogue. Any special requirements, such as for delivery or customisation, will be specified as part of the order.

Framework agreements are also often used as the basis of the supply of services of various kinds, or for project developments.

## Presentation aspects

A contract that is well presented and visually agreeable is more likely to be read and understood.

This may be achieved as follows:

- A readable typeface and font size;
- Headings, sub-headings and indentations;
- Short sentences;
- Numbered clauses and paragraphs;
- Avoiding ambiguities; for instance, by repeating a name rather than using a pronoun if there is likely to be any doubt;
- Clear formal language; note that there is normally no need to include the obvious to lengthen a contract unnecessarily: for example at law<sup>1</sup> the masculine will automatically include the feminine and the singular will include the plural. If this exceptionally does not apply, it would be worth stating;
- Use of commas and semi-colons in a contract where these are grammatically correct, and assist understanding.

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<sup>1</sup> S61, Law of Property Act 1925