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# qLegal Online Publication

# How contracts work

This online publication explains some of the basics regarding how English law contracts work in business-to-business situations and some of the key things to think about if you're entering into a business agreement.

**What Is a Contract?**

A contract is a written or spoken agreement between two or more parties that creates mutual legal obligations. If one party breaks the terms of the agreement, the other can enforce those terms in Court. Although a legally binding contract does not need to be written down, it is advisable to make sure you properly record what has been agreed so that both parties know exactly what their obligations are and no one can claim any misunderstanding down the road. If you made a verbal agreement, it can be difficult to prove what exactly has been agreed and the Court may not be able to help you.

**The Building Blocks of a Binding Contract (When will a contract be legally binding on my business?)**

If you're putting a contract in place, there are 5 crucial building blocks to looks out for:

1. One party must make an **offer** - If it's unclear *exactly* what is being offered, it cannot be accepted by the other party.
2. The other party must **accept** that *exact* offer - If someone makes a counter-offer, the initial offer is automatically considered rejected and cannot be accepted later on.
3. Both parties must give something of some value and receive something of some value (this is known as **consideration**) - e.g. one party may give money and receive a service whilst the other party provides the service and receives money. Consideration doesn't have to be fair, it just has to have some value in the eyes of the law.
4. Both parties must **intend to be legally bound** - The presumption that a person intends to be legally bound is greater in commercial agreements than promises between family and friends.
5. Both parties must have **contractual capacity -** This includes companies, limited liability partnerships, and people above the age of 18.

Once these 5 requirements have been met, a valid contract comes into existence. This means that if either party breaks the terms of the contract, legal consequences may arise.

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**How are the terms of the contract expressed?**

The terms of a contract can be either express or implied. The terms of a contract that parties have explicitly agreed upon, either in writing or orally, are referred to as "**express terms.**" These are more easily identifiable in a written contract. Terms of a contract can also be implied. **Implied terms** are terms the parties did not explicitly agree to include in the contract but are implied into the contract by the court. Factors that play a role in determining the existence of implied terms include:

- Usage or industry customs;
- Historic conduct of the parties between themselves;
- Intentions of the parties;
- Statute and Case law over the years.

To ensure that you do not leave your business exposed or become subject to obligations you didn't anticipate, you should consider excluding any implied terms where possible when drafting your contracts. However, it may be that some implied terms will work in your favour depending on your circumstances. You should be aware that some implied terms that arise out of statute cannot be excluded at all - for example, if you're selling goods, you cannot exclude the implied term that you actually have the right to sell those goods.

**How can I limit the liability my business will be exposed to?**

In commercial dealings, you will likely want to limit the liability your business could be exposed to. Limitation of liability clauses are common in business agreements and usually set out:

- The types of liability that neither party is allowed by law to exclude (for example, losses caused by fraud, dishonesty or deceit, and for death or personal injury caused by negligence);
- Certain categories of losses which one or both parties won't be liable for (for example, loss of goodwill, loss of profit, and indirect or consequential losses); and
- A limit on what one or both parties could be liable for (for example, this could be a fixed number such as £1,000 or could be a percent of the value of the contract).

Generally speaking, a party to a contract can exclude or limit its liability in a contract. However the Unfair Contract Terms Act 1977 ("**UCTA**"):

- does not allow for some types of liability to ever be limited or excluded (for example, liability for death or personal injury caused by negligence); and
- only allows some types of liability to be excluded or limited if they are reasonable.

Some contracts fall outside of the UCTA for example, the international supply of goods, shipping, employment, securities, and intellectual property contracts.

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If the limitation of liability clause falls within the remit of UCTA it must pass the "**reasonableness test**" in order to be effective. What is reasonable is determined by the court on a case-by-case basis. Factors that are taken into account by the court include:

- The relative bargaining strengths of the parties;
- Whether the customer was induced to accept the term agreed to;
- Whether the customer knew or ought to have known about the term;
- whether the purchaser could have entered into a contract with someone else that did not include a similar term;
- If it is a conditional exclusion, the likelihood of compliance with the condition at the time the contract was concluded;
- Whether the goods/services are bespoke.

Limitations and exclusions of liability are very important in contracts and you should be careful to check what these clauses say to make sure you understand what liability your business could be subject to and also what you may or may not be able to recover from the other party if things go wrong.

**Can the terms of a contract be amended?**

Circumstances may arise that mean you want to change certain things in your contract. For example, you may want to change pricing, payment dates, introduce or exclude products, etc. Parties to a contract are at liberty to vary or amend their original contract, as long as they satisfy the following requirements:

- There is a mutual **agreement** to amend the contract;
- There must be **consideration** for purposes of the amendment;
- They comply with the **formal requirements** of the contract.

The original contract can only be amended if the parties agree to do so. The consideration element must relate to the new change in the original contract. It is important to note that past consideration is not sufficient. Therefore, the performance of an already existing obligation in the original contract does not constitute consideration for purposes of the amendment. Once the parties have agreed to amend the contract, establish the consideration, they must then ensure that the changes comply with the formal requirements of the existing contract. For example, the original contract may have a requirement that changes must be put in writing and signed by both parties. It is generally advisable to make sure any contractual changes are properly documented so that both parties know exactly what their obligations are and no one can claim any misunderstanding down the road.

**What to Include in a Contract**

To ensure that a contract covers these building blocks and includes all of the necessary details, you should check that the following sections (or 'clauses') are included:

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- All of the information for both parties - for example, business names, registered addresses, etc.
- The start and end date of the contract - this is known as the "term" of the agreement and you should also look at the "termination" provisions to see how the parties could bring the agreement to end before the end of the "term".
- Any key terms used and their definitions - these are usually capitalised in the agreement and should be easy to spot.
- The products or services being provided and the fee (or other forms of 'consideration') that is being given in return - it is important to check this covers everything you have actually agreed because you likely won't be able to rely on statements or guarantees that have been made outside of the contract.
- The terms of payment - such as the due date, late payment fees, and how invoicing will work etc.
- Any insurances or liability requirements.
- Any confidentiality obligations - this is important where commercially sensitive information is involved.
- A dispute resolution process or breach-of-contract process.
- A space on the last page for signatures and dates.

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