Eleventh edition

Contract Law

Catherine Elliott & Frances Quinn

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Preface

The eleventh edition of this book aims to build on the strengths that have led to the success and popularity of the previous editions, which have been extremely well received by both teachers and students alike. It incorporates all the important legal developments that have taken place since the publication of the last edition. As with our previous editions, our aim has been to provide a clear explanation of the law of contract. As well as setting out the law itself, we look at the principles behind it, and discuss some of the issues and debates arising from contract law. We hope that the material will allow you to enter into some of that debate and develop your own views as to how the law should develop.

One of our priorities in writing this book has been to explain the material clearly, so that it is easy to understand, without lowering the quality of the content. Too often, law is avoided as a difficult subject, when the real difficulty is the vocabulary and style of legal textbooks. For that reason, we have aimed to use 'plain English' as far as possible, and explain the more complex legal terminology where it arises. There is also a glossary explaining common terms at the back of the book. In addition, chapters are structured so that material is in a systematic order for the purposes of both learning and revision, and clear subheadings make specific points easy to locate.

Although we hope that many readers will use this book to satisfy a general interest in the law, we recognise that the majority will be those who have to sit an examination in the subject. Therefore, each chapter features typical examination questions, with detailed guidance on answering them, using the material in the book. This is obviously useful at revision time, but we recommend that, when first reading the book, you take the opportunity offered by the questions sections to think through the material that you have just read and look at it from different angles. This will help you both to understand and to remember it. You will also find that the Appendix at the end of the book gives useful general advice on answering examination questions on contract law.

This book is part of a series that has been produced by the authors. The other books in the series are *English Legal System, Criminal Law* and *Tort Law.*

We have endeavoured to state the law as at 1 January 2017.

Catherine Elliott and Frances Quinn
London 2017

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Introduction

This chapter discusses:

- why we need contract law;
- the history of contracts;
- the importance of procedural fairness in the development of contract rules;
- the courts' emphasis on looking at the contracting process objectively;
- the impact of the Human Rights Act 1998; and
- the influence of Europe.

Ask most people to describe a contract, and they will talk about a piece of paper – the documents you sign when you start a job, buy a house or hire a television, for example. While it is certainly true that these documents are often contracts, in law the term has a wider meaning, covering any legally binding agreement, written or unwritten. In order to be legally binding, an agreement must satisfy certain requirements (which will be discussed in Part 1) but with a few exceptions, being in writing is not one of those requirements. We make contracts when we buy goods at the supermarket, when we get on a bus or train, and when we put money into a machine to buy chocolate or drinks – all without a word being written down, or sometimes even spoken.

Why do we need contract law?

The obvious answer is because promises should be binding, but in fact the law only enforces certain types of promise, essentially those which involve some form of exchange. A promise for which nothing is given in return is called a gratuitous promise, and is not usually enforceable in law (the exception is where such a promise is put into a formal document called a deed).

Why then do we need laws specifically designed to enforce promises involving an exchange? The major reason appears to be the kind of society we live in, which is called a market capitalist society. In such a society, people buy and sell fairly freely, making their own bargains, both on the small scale of ordinary shoppers in supermarkets, and on the much bigger one of a project such as the construction of the Channel Tunnel, which involved many different parties, each buying and selling goods and services. Although, as we shall see, there are areas in which government intervenes, in general we choose what we want to buy, who from and, to some extent at least, at what price.

It would be impossible to run a society on this basis if promises were not binding. Long-term projects show this very clearly – contractors working on the Channel Tunnel, for example, would have been very reluctant to invest time and money on the project if they knew that the British and French Governments could suddenly decide that they did not want a tunnel after all, and not be expected to compensate the contractors. On a smaller scale, who would book a package holiday if the tour operator was free to decide not to fly you home at the end of it? How would manufacturers run their businesses if customers could simply withdraw orders, even though the goods had been made specially for them? A market economy will only work efficiently if its members can plan their business activities, and they can only do this if they know that they can rely on promises made to them.

In fact, contract law rarely forces a party to fulfil contractual promises, but what it does do is try to compensate innocent parties financially, usually by attempting to put them in the position they would have been in if the contract had been performed as agreed. This has the double function of helping parties to know what they can expect if the contract is not performed, and encouraging performance by ensuring that those who fail to perform cannot simply get away with their breach.

The origins of contract law

In order to understand the rationale underlying contract law, it helps to know a little about its history. Although some principles of contract law go back three centuries, the majority of contract rules were established in the early nineteenth century. Before that, contract hardly existed as a

separate branch of law, and took up very few pages in textbooks. Yet today, it is one of the core subjects which lawyers must study, and affects many areas of daily life. What caused the change?

The answer lies in the transformation of our society which occurred during the late eighteenth and early nineteenth centuries, a transformation which has been described as a move from status to contract. Today, we are very used to the important role that 'the market' plays in our society. We take it for granted that, for example, the price of food should generally be set by the manufacturer or retailer, with the customer choosing to take it or leave it. We may not actually negotiate a bargain in many areas of ordinary life, but we see the operation of the market in the fact that manufacturers have to set prices at which people will buy. We would be rather surprised if Parliament suddenly made it illegal to charge more than 50p for a loaf of bread.

Before the nineteenth century, however, there were many areas of life where free negotiation and bargaining were simply not an issue. An example is the market for what were regarded as essential foodstuffs, which included wheat, bread and beer. Although bakers and millers were entitled to make a profit, that did not mean they could sell at whatever price people would pay. Prices and quality standards for bread were fixed, according to the price the baker had had to pay for the wheat, so limiting their profits, and ensuring that they could not take advantage of shortages.

Activities such as buying goods and then selling them in the same market at a higher price, buying up supplies before they reached the market, and cornering the market by buying huge stocks of a particular commodity are all seen as good business practice now, but in the eighteenth-century market for essential foodstuffs, they were criminal offences, called regrating, forestalling and engrossing, respectively. The basis for this approach was explained by Kenyon J in **R** *v* **Rusby:** 'Though in a status society some may have greater luxuries and comfort than others, all should have the necessaries of life.' In other words, there was a basic right to a reasonable standard of living, and nobody was expected to negotiate that standard for themselves.

A similar, though less humane, approach was taken to relationships between employer and employee – or master and servant, as they were called then. These days, we expect to have an employment contract detailing our hours of work, duties and pay, even though the amount of control we actually have in negotiating those areas may be negligible. In a status society, employment obligations were simply derived from whether you were a master or a servant; masters were entitled to ask servants to do more or less anything, and criminal sanctions could be used against an employee who disobeyed. Employers had obligations too (though rather less onerous than those of employees), which sometimes included supplying food or medical care. Both sets of obligations were seen as fixed for everyone who was either an employee or an employer, and not a matter for individual negotiation. Even wages were often set by local magistrates.

All this began to change in the eighteenth and nineteenth centuries. Society itself was undergoing huge changes, moving from an agricultural to an industrial economy, and with that came political changes, and changes in the way people saw society. With the rise of an economic doctrine called *laissez-faire* came a view that society was no more than a collection of self-interested individuals, each of whom was the best judge of their own interests, and should, as far as possible, be left alone to pursue those interests. If we apply this view to the market for bread, for example, it would suggest that bakers would sell bread for the highest price they could get, while consumers shopped around for the lowest, and the result should be a bargain suitable to both. The market would consist of hundreds and hundreds of similar transactions, with the result that everyone would be able to secure their own best interests, and the state would not need to intervene to do this for them – in fact it should not do so, because the parties should be left alone to decide what was best for them.

This *laissez-faire* approach carved out a very important place for contracts. As we have seen, where people make their own transactions, unregulated by the state, it is important that they keep their promises, and as a result, contract law became an increasingly important way of enforcing obligations.

Freedom of contract

Its origins in the *laissez-faire* doctrine of the nineteenth century have had enormous influence on the development of contract law. Perhaps the most striking reflection of this is the importance traditionally placed on freedom of contract. This doctrine promotes the idea that since parties are the best judges of their own interests, they should be free to make contracts on any terms they choose – on the assumption that nobody would choose unfavourable terms. Once this choice is made, the job of the courts is simply to act as an umpire, holding the parties to their promises; it is not the courts' role to ask whether the bargain made was a fair one.

Some academics, notably Professor Atiyah (*The Rise and Fall of Freedom of Contract,* 1985), have suggested that this extreme position lasted only a short time, and that the courts were always concerned to establish some concept of fairness. His view has been challenged, but in any case, it is clear that over the last century, the courts have moved away from their reluctance to intervene, sometimes of their own accord, sometimes under the guidance of Parliament through legislation such as the Unfair Contract Terms Act 1977. However, as the basic principle still holds, decisions which actually have their basis in notions of fairness may be disguised behind more technical issues.

Contract and fairness

Traditional contract law lays down rules which are designed to apply in any contractual situation, regardless of who the parties are, their relationship to each other, and the subject matter of a contract. This means that the law uses basically the same rules to analyse the contract that arises when you go into a supermarket to buy a tin of beans as it does to analyse the contract to build the Channel Tunnel.

The basis for this approach is derived from the *laissez-faire* belief that parties should be left alone to make their own bargains. This, it was thought, required the law simply to provide a framework, allowing parties to know what they had to do to make their agreements binding. This framework was intended to treat everybody equally, since to make different rules for one type of contracting party than for another would be to intervene in the fairness of the bargain. As a result, the same rules were applied to contracts in which both parties had equal bargaining power (between two businesses, for example) as to those where one party had significantly less economic power, or legal or technical knowledge, such as a consumer contract.

This approach, often called procedural fairness, or formal justice, was judged to be fair because it treats everybody equally, favouring no one. The problem with it is that if people are unequal to begin with, treating them equally simply maintains the inequality. This has obvious repercussions in contract law. Take, for example, an employment contract stating that if either party is dissatisfied with the other's performance, the dissatisfied party can terminate the contract at any time. This

clearly amounts to treating both parties in exactly the same way, making them play by the same rules. But in doing so, it gives the more powerful employer the useful opportunity to sack the employee at any time, while the corresponding 'benefit' to the less powerful employee will in many cases amount to no more than the chance to become unemployed.

Over the last century the law has to some extent moved away from simple procedural fairness, and an element of what is called substantive fairness, or distributive justice, has developed. Substantive fairness aims to redress the balance of power between unequal parties, giving protection to the weaker one. So, for example, terms are now implied by law into employment contracts so that employers cannot simply dismiss employees without reasonable grounds for doing so. Similar protections have been given to tenants and to consumers, and in these three areas (and some others) traditional contract rules are overlaid with special rules applying only to particular types of contract. (You can see the way in which this approach operates in Chapter 16.)

The balance between substantive and procedural fairness in contract law is always an uneasy one, but major academics such as Treitel *(The Law of Contract,* 2015) and Atiyah (1985) believe that there has been, as Atiyah puts it, 'a move from principle to pragmatism'. He suggests that in modern cases, the courts have been less concerned with laying down general rules, and more with producing justice in individual cases. In fact, an examination of the cases, especially those between businesses, where bargaining power is assumed to be equal, shows that although the courts are often attempting to secure substantive justice, they still tend to hide that attempt behind what appears to be an application of the traditional rules. The cases on innominate terms (p. 145), and on reasonable notice, particularly **Interfoto** (see p. 161), have been seen as examples of this.

The objective approach

Contract law claims to be about enforcing obligations which the parties have voluntarily assumed. Bearing in mind that contracts do not have to be in writing, and that even where they are, important points may be left out, it is clear that contract law faces a problem: how to find out what – or even whether – the parties agreed. For example, if I promise to clean your car, meaning that I will wash the outside, and you promise to give me £10 in return, assuming that I will vacuum the inside as well, what have we agreed?

Contract law's approach to this problem is to look for the appearance of consent. If my words and/or actions would suggest to a reasonable person that I was agreeing to clean the inside of your car as well as the outside, then that is what I will have to do before I get my £10. This approach was explained by Blackburn J in **Smith** *v* **Hughes** (1871): 'If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe he was assenting to the terms proposed by the other party, and that other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms.' This point was repeated by the Supreme Court in **RTS Flexible Systems** *v* **Molkerei Alois Mülier** (2010) where it stated:

> Whether there is a binding contract between the parties and, if so, upon what terms depends upon what they have agreed. It depends not upon their subjective state of mind, but upon a consideration of what was communicated between them by words or conduct, and whether that leads objectively to a conclusion that they intended to create legal relations and had agreed upon all the terms which they regarded or the law requires as essential for the formation of legally binding relations.

In some cases, the basis for this approach is obvious. If you get into a taxi and simply state your destination, it is perfectly reasonable for the driver to assume you are agreeing to pay for the ride; it would not be right to allow you to claim at the end that although your behaviour might have suggested that, you had no such intention in your mind, and so are not obliged to pay. In practice, the principle has led to some potentially harsh results, such as the rule, established in a case called **L'Estrange** *v* **F Graucob Ltd** (1934), that a person who signs a contractual document is bound by it, even though they may not have understood or even read it.

The Human Rights Act 1998

The Human Rights Act 1998 came into force on 2 October 2000. This Act incorporates the European Convention on Human Rights into English law so that rights contained in the Convention can be enforced by English courts. The Act has not yet had a major impact on contract law, and the extent of any future impact depends on how it is interpreted. Under s. 3 of the Act, legislation on the subject of contract law will have to conform with the Convention. This section states:

> So far as it is possible to do so, primary legislation and subordinate legislation must be read and given effect in a way which is compatible with Convention rights.

If legislation is found to be incompatible with Convention rights, then the courts may make a 'declaration of incompatibility' (s. 4).

Contracts are frequently made by private individuals and businesses, though some contracts are made with public authorities, such as a local council. Section 6 of the Act states that it is 'unlawful for a public authority to act in a way which is incompatible with a Convention right'. There has been considerable debate as to whether the Act would affect a contract which was only made between private individuals so that a public authority is not a party to the contract.

Many of the Convention rights are unlikely to be relevant to contracts, but one provision which could be important in this context is Article 1 of the First Protocol. This provides that 'every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to law'. The implications of this provision on contract law were considered by the Court of Appeal in **Shanshal** *v* **Al-Kishtaini** (2001) (which is discussed on p. 256).

Topical issue

The influence of Europe

European law has had an increasing impact on contract law in England. A range of European directives have been passed, particularly in the field of consumer law. The aim of these directives has been to promote the development of an internal European market by harmonising the relevant law across Europe. But these directives have been quite narrow in scope and have been criticised for having an inconsistent drafting style. In addition, there have been significant differences in the way the directives have been implemented in the various European countries, so the aim of harmonisation has not been completely achieved. As a result, the European Commission published a *Communication on European Contract Law* (2001). This document considered whether the European Union needed to change its approach to contract law. It identified four options:

- do nothing, and leave the market to resolve any problems that arose;
- draw up common principles of contract law which would provide guidance to member states, but would not bind them;
- improve the existing European directives in the field to achieve greater consistency;
- adopt binding principles of contract law.

This document led to considerable debate and in 2003 the European Commission published an action plan. It concluded that Europe would continue to issue directives in the field. It would encourage the use of standard European contractual terms for certain types of contract. It would give further consideration as to whether in the future a code of European contract law should be drawn up which might or might not be binding in member states. For the time being it would focus on the development of a 'Common Frame of Reference for European Contract Law'. The final draft of the Common Frame of Reference containing recommendations on model rules, principles and definitions was published in December 2008.

In 2011, the European Commission published a proposed regulation for a Common European Sales Law (CESL). This draws heavily on the draft Common Frame of Reference. It is a proposed law for the sale of goods across Europe which could be applied to both business to consumer (B2C) transactions and business to business (B2B) transactions (where at least one business is a small or medium enterprise). It would not replace national law, but be an optional law that the trader could opt to use for its transactions. If it wanted a transaction to be governed by CESL, it would provide a leaflet to the consumer explaining this and the consumer would have to agree to this for the sale to proceed.

The aim of the CESL is to energise the EU economy by improving cross-border trade within the EU by removing legal barriers which increase the cost of doing business with other member states. The European Commission estimates that 500 million consumers in Europe are missing out on greater choice and cheaper prices on goods because businesses are not making cross-border offers. At the moment only 9 per cent of consumers in the EU buy goods from a trader located in another member state.

For consumers, internet shopping is the way in which they are most likely to buy goods across borders. The UK has one of the most developed internet economies in the world, but internet traders are often small enterprises run from home. Under a regulation known as Rome **I,** the current law provides that a trader which directs its activities to another EU member state must comply with the mandatory consumer protection Laws of that state. There is uncertainty over when a trader will be viewed as 'directing activities' to a member state. It is a fine line between an English business setting up a website which is accessed by consumers in France and an English company getting regular orders from France and making changes to its website to facilitate those orders (such as quoting reviews from French customers and accepting orders in euros). In the latter scenario, a company may be found to be 'directing activities' to France (**Peter Pammer** *v* **Reederei Karl Schlüter** (2011)). If the local consumer laws in France apply this would include the *Loi Toubon* which imposes a criminal sanction if websites are not translated into French.

Critics have argued that the CESL would add unnecessary confusion and legal complexity to consumer law. It is over 100 pages long and includes vague legal terms such as 'reasonableness', 'fair dealing' and 'good faith' which will leave a lot of discretion to the courts, which might interpret them differently in different member states. It gives consumers a right to reject faulty goods for up to two years from the date the consumer could be expected to be aware of the fault. Retailers fear that such a long period could be abused by consumers who simply no longer want the goods. While businesses could deduct money to reflect the consumer's use of the item, this calculation could be a source of dispute. Even if a common sales law existed across Europe, should litigation arise, language barriers and differences in national court procedures would remain a problem. The

CESL would not cover every aspect of contract law, so knowledge of the local law of contract might still prove necessary, for example, on the issue of illegality and ownership of the goods.

The Law Commission has suggested that practical problems rather than legal differences are the real barrier to cross-border trade. Fear of fraud, language barriers, VAT complexities and problems with delivery and payment are more likely to be discouraging cross-border transactions than a lack of harmonisation in consumer law. The Law Commission has suggested that instead of the CESL, there should be an optional European distance selling code which would primarily apply to internet sales.

Now that the United Kingdom has voted to leave the European Union, the impact of Europe on UK contract law is likely to reduce. Legislation that has already been passed is likely to remain unchanged, but there will be less impetus to make further changes.

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McKendrick, 'English contract law: a rich past, an uncertain future?' (1997) Current Legal Problems 25

Steyn, 'Contract law: fulfilling the reasonable expectations of honest men' (1997) 113 *Law Quarterly Review* 433

Treitel and Peel (2015) *Treitel on the Law of Contract,* London: Sweet and Maxwell

Reading on the internet

The Human Rights Act 1998 is available on the website of the Office of Public Sector Information:
http://www.opsi.gov.uk/acts/acts1998/19980042.htm

The *Communication on European Contract Law* (2001) issued by the European Commission is available on its website at:
http://ec.europa.eu/comm/consumers/cons_int/safe_shop/fair_bus_pract/cont_law/cont_law_02_en.pdf

Part 1

The formation of a contract

There are five basic requirements that need to be satisfied in order to make a contract:

- **An agreement** between the parties (which is usually shown by the fact that one has made an offer and the other has accepted it).
- **An intention** to be legally bound by that agreement (often called intent to create Legal relations).
- **Certainty** as to the terms of the agreement.
- **Capacity** to contract.
- **Consideration** provided by each of the parties – put simply, this means that there must be some kind of exchange between the parties. If I say I will give you my car, and you simply agree to have it, I have voluntarily made you a promise (often called a gratuitous promise), which you cannot enforce in Law if I change my mind. If, however, I promise to hand over my car and you promise to pay me a sum of money in return, we have each provided consideration.

In addition, in some cases, the parties must comply with certain formalities. Remember that, with a few exceptions, it is **not** necessary for a contract to be in writing – a contract is an agreement, not a piece of paper.

In this part of the book, we will consider these different requirements for the creation of a contract.